

# Baltic Rim Outlook

June 2010



## EMU convergence back on the agenda

The Baltic Rim economies – Estonia, Latvia, Lithuania, Poland and Russia – have been fairly isolated from the sovereign debt crisis in the European Monetary Union. The reason is that public finances are in much better shape in the Baltic Rim than in Southern Europe. Moreover, Estonia's bid to join EMU, even if decided before this latest crisis, shows that the convergence process is still alive.

In **Estonia** recovery hopes have been further strengthened by the increasing likelihood of euro adoption in 2011 after the Commission's recommendation. We consider the risk of a political "no" to be very small, and thus see Estonia joining the euro area in 2011. The recovery is expected to be export-led, with one of the government's main challenges being reducing unemployment and thus supporting consumption.

The **Latvian** economy is stabilising, and we see a gradual recovery over the coming quarters. The main support is expected to come from the export sector. Increasing the uncertainty in the economy is the political instability, which is likely to intensify ahead of the parliamentary elections in October. The fiscal consolidation measures for the 2011 budget are likely to be postponed to after the elections.

The **Lithuanian** economy is recovering gradually, with Q1 2010 the weakest quarter since 2005 (in LTL). The main GDP components, except private consumption and inventories, continued to decline. Nevertheless, consumption is still at weak levels, and we see households struggling amidst declining wages and rising unemployment. Thus, we expect only lacklustre growth in the economy this year.

In **Russia** the first estimate for Q1 GDP was weaker than anticipated, indicating that the early recovery has been slower than expected. However, we expect growth to pick up later this year, with exports leading the recovery. In the long term the main risks to growth stem from the subdued activity in credit markets, capacity constraints in the energy sector and the old and inefficient structures of the economy.

The slowdown in the **Polish** economy in Q1 was temporary, and we believe the recovery is on track. We are seeing more signs of a stabilising labour market and expect the unemployment rate to peak this year. That could bring new growth drivers such as investment, credits and the housing market out of their global financial crisis hideout. However, it also means that we have fiscal and monetary tightening ahead.

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## Editorial deadline:

1 June 2010

**Currency forecasts (against DKK)**

	2/Jun/10	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	10.51	10.53	10.65	10.65	10.65
LTL/DKK	2.15	2.16	2.16	2.16	2.16
PLN/DKK	1.86	1.91	1.91	1.91	2.01
RUB/DKK	0.19	0.21	0.21	0.23	0.24

**Currency forecasts (against EUR)**

	2/Jun/10	3M	6M	12M	24M
EUR/EEK	15.64	15.65	15.65	15.65	15.65
EUR/LVL	0.71	0.71	0.70	0.70	0.70
EUR/LTL	3.45	3.45	3.45	3.45	3.45
EUR/PLN	3.99	3.90	3.90	3.90	3.70
EUR/RUB	38.51	35.75	35.38	32.69	31.05

**Currency forecasts (against NOK)**

	2/Jun/10	3M	6M	12M	24M
EEK/NOK	0.49	0.49	0.49	0.50	0.50
LVL/NOK	10.91	10.75	11.00	11.14	11.14
LTL/NOK	2.24	2.20	2.23	2.26	2.26
PLN/NOK	1.93	1.95	1.97	2.00	2.11
RUB/NOK	0.20	0.21	0.22	0.24	0.25

**Currency forecasts (against SEK)**

	2/Jun/10	3M	6M	12M	24M
EEK/SEK	0.62	0.60	0.59	0.58	0.58
LVL/SEK	13.67	13.37	13.21	13.00	13.00
LTL/SEK	2.80	2.74	2.68	2.64	2.64
PLN/SEK	2.42	2.42	2.37	2.33	2.46
RUB/SEK	0.25	0.26	0.26	0.28	0.29

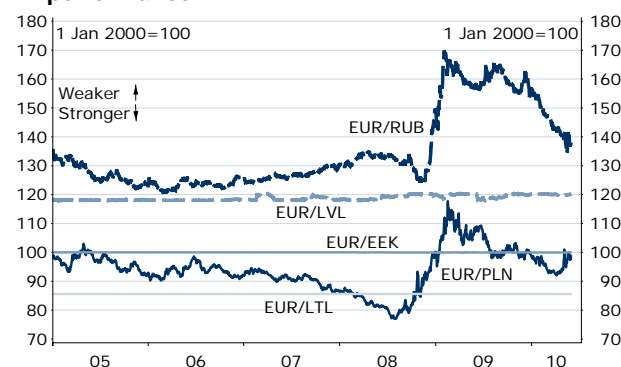
**3M interbank rate forecasts**

	2/Jun/10	3M	6M	12M	24M
Poland	3.86	3.90	4.40	4.75	5.25
Estonia	1.72	1.50	1.20	1.50	2.25
Latvia	2.34	2.00	1.70	2.00	2.30
Lithuania	1.59	1.30	1.50	1.80	2.30
Russia	4.40	4.00	4.00	4.50	6.00

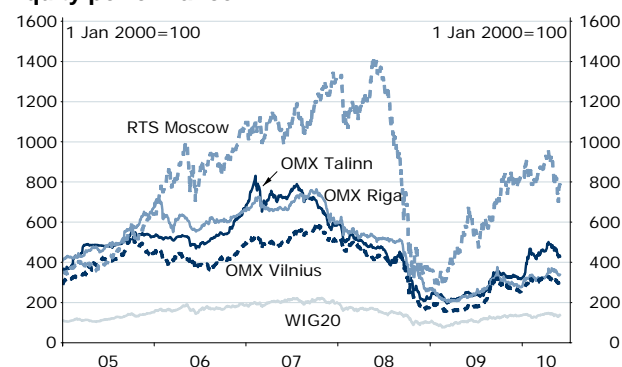
**3M interbank rate forecasts (spread to the Euro area)**

	2/Jun/10	3M	6M	12M	24M
Poland	3.18	3.25	3.65	3.25	3.00
Estonia	1.04	0.85	0.45	0.00	0.00
Latvia	1.66	1.35	0.95	0.50	0.05
Lithuania	0.91	0.65	0.75	0.30	0.05
Russia	3.72	3.35	3.25	3.00	3.75

**FX performance**



**Equity performance**



**Convergence criteria**

	Budget balance, % of GDP	Inflation, %	Government debt, % of GDP	10Y yields, %	FX Stability*, %	EMU entry forecasts, year
<i>Criteria</i>	-3.0	0.3	60.0	7.2	-15 / +15	
Estonia	-1.7	5.5	7.2	-	0.07 / -0.13	2011
Latvia	-9.0	8.2	36.1	12.0	0.52 / -1.43	2014
Lithuania	-8.9	4.9	29.3	6.2	0/0	2014
Poland	-7.1	2.0	51.0	5.8	22 / -20.17	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 <sup>2</sup>	President	T. H. Ilves
Population	1.3 mn	Next election	Fall 2011
GDP/capita	17,908 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	14,254 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	16,542 USD*	Prime minister	A. Kubilius
Currency	Litas	Next election	October 2012

\* At PPP

**Country facts Poland**

Area	312,679 km <sup>2</sup>	Acting president	B. Komorowski
Population	38.5 mn	Next election	June 2010
GDP/capita	18,072 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	14,919 USD*	Prime minister	V. Putin
Currency	Ruble	Next election	December 2011

\* At PPP

## Strengthening hopes of a recovery

- Domestic economy improving gradually
- The Commission recommended euro adoption...
- ...which is expected to accelerate the recovery

The economy declined in Q1 from Q4 2009, after growing 2.3% q/q in Q4. Thus the largely inventory-driven growth from late last year did not extend to Q1, although also exports have recovered slowly. Although the details for the GDP figure are not yet available, the significant support from inventory growth is likely to have abated. However, we see exports on a strengthening trend while consumer spending is weak, but gradually improving.

### Exports the main driver of growth



Although consumption and investment are expected to start turning to growth it will take years to reach the levels seen before the downturn. GDP fell by 14.1% y/y in 2009, as both export demand and domestic spending plummeted. Consumption was not only weighed down by rising unemployment and the downward adjustment in wages, but also by the fiscal consolidation measures, which totalled over 9% of GDP. Although public debt is low, the large stock of external debt is seen weighing on consumption in the long term.

All in all, the recovery of the economy is largely dependent on reviving export demand especially from the EU and Russia. Exports are seen recovering strongly this year, continuing on their upbeat trend from Q1. Industrial production has also strengthened clearly in recent months, mainly supported by the growth in export demand. We see GDP growing by 1.2% y/y this year, with

growth accelerating to 4% in 2011, as both exports and domestic demand support the economy. Improving productivity and competitiveness will be important in reaching sustainable growth over the medium term.

### Challenges still exist in domestic demand

The unemployment figures for Q1 were far from encouraging, and do not promise a particularly imminent recovery of consumer spending. Unemployment jumped to 19.8% from 15.5% in Q4, highlighting the difficult position of many households. Long term unemployment continued to rise as well, approaching 40% of total unemployment. This underlines the need for the government to focus on reducing unemployment when the most acute phase of the crisis has passed, in order to boost incomes and improve public finances. Various programmes for reducing unemployment have been planned, and we see a clear decline already in 2011, based on the improving export sector and the flexibility of the labour markets. Early green shoots have, in addition, already been seen in e.g. consumer confidence and industrial production.

The flexibility of the economy and in particular the labour markets has enabled a swift adjustment of the private and public economy, and is expected to support the upturn as well, by enabling a rapid reallocation of resources towards the more productive areas of the economy. Risks regarding a slower-than-expected recovery on the euro area, due to e.g. stricter fiscal consolidation measures after the Greek crisis, increase fears of the export-led recovery stagnating over the next quarters. This is the main risk to our main scenario, and it could have marked effects on the economy, as the recovery in domestic demand is related to a revival in exports.

### Euro adoption in 2011 increasingly likely

Estonia got a green light from the European Commission to adopt the euro in 2011. The Commission, who has the sole power to recommend new members, judged that the convergence criteria were fulfilled in 2009 and regarded the measures sustainable. For example the budget deficit was seen remaining below 3% of GDP, and inflation – which worries the ECB – was seen moderate. Thus we see Estonia joining the euro area in January 2011.

In June the European Parliament and the EU Heads of

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

	2006 (EEKmn)	2007	2008	2009	2010E	2011E
Private consumption	113,272	9.0	-4.7	-18.5	-2.5	4.0
Government consumption	33,839	3.7	4.1	-0.5	-1.0	0.5
Fixed investment	69,462	9.0	-12.1	-34.4	-4.0	6.0
Exports	165,888	0.0	-0.7	-11.2	6.0	6.3
Imports	189,517	4.7	-8.7	-26.8	4.2	4.8
GDP		7.2	-3.6	-14.1	1.2	4.0
Nominal GDP (EEKmn)	206,996	235,566	251,560	215,917	219,587	231,665
Unemployment rate, %		4.7	5.5	13.8	17.0	16.2
Consumer prices, % y/y		6.6	10.4	-0.1	0.5	1.5
Current account, % of GDP		-17.9	-9.4	4.6	4.0	2.0
General govt budget balance, % of GDP		2.6	-2.7	-1.7	-2.5	-2.2

State and Government will discuss Estonia's case, and although they have the legal power to decide upon membership, we find it unlikely that they would decide against the recommendation of the EC. The objections would be political, but motivating the "no" with the volatile nature of the small economy or the reluctance to take new, possibly problematic members while the Greek debt crisis remains unresolved, would be difficult, considering that Estonia is one of the few EU countries fulfilling all Maastricht criteria. However, the political risks can never be underestimated.

Euro-adoption is expected to increase confidence in the economy supporting consumption and foreign investment, and providing a stable base on which to rebuild sustainable growth. Both Moody's and Fitch have indicated that they could lift Estonia's credit rating once membership is affirmed in mid-July. The Commission noted that consumer prices were around 75% of the Eurozone average in 2008, indicating further convergence in the price level. The ECB noted that Estonia also needs to catch up on the GDP per capita level. The ECB worries that adjusting these imbalances could create inflationary pressure, which will be difficult to fight due to the limited options in influencing monetary policy.

However, Estonia still has some obstacles to clear, regarding for example the competitiveness of the tradable sector, which requires further wage and price adjustment. Although unit labour costs have adjusted downwards recently they remain elevated, pointing towards further adjustment. The Commission highlighted the need for budget consolidation measures to continue, in order to ensure that the public finances are on firm ground. The deficit is seen rising slightly from the low level in 2009, and work towards a balanced budget must continue. Thus the opportunities to support the economy through looser fiscal policy are very limited in the coming years as well.

**Interest rates normalising**

Interest rates have recently dipped below the levels seen before the downturn. The moderation has been largely driven by the stabilisation of the economic conditions and the hopes of adopting the euro in 2011. Thus we expect interest rates to remain low this year, converging to the rates on the euro area.

The banking sector is seen stable, but despite some recovery in lending banks remain cautious, which weighs on both companies and households. The economic adjustment has been reflected in deposit rates, which have declined in line with global monetary easing. Albeit initially higher than in the euro area, deposit rates are currently close to those in the euro area. The consolidation in rates will continue as Estonia is to adopt the euro soon.

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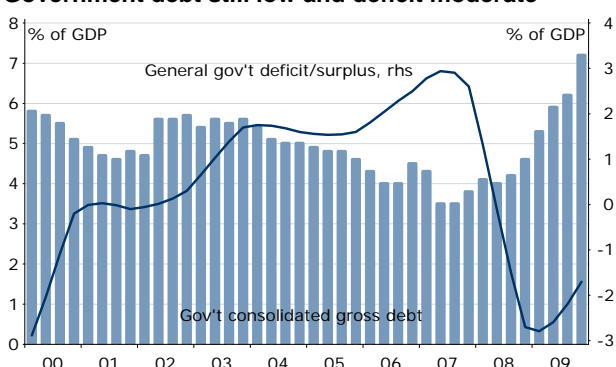
**Consumption recovering gradually**



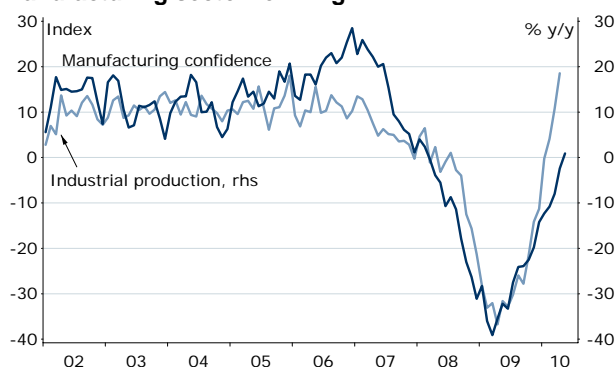
**Labour market adjustment continuing**



**Government debt still low and deficit moderate**



**Manufacturing sector reviving**



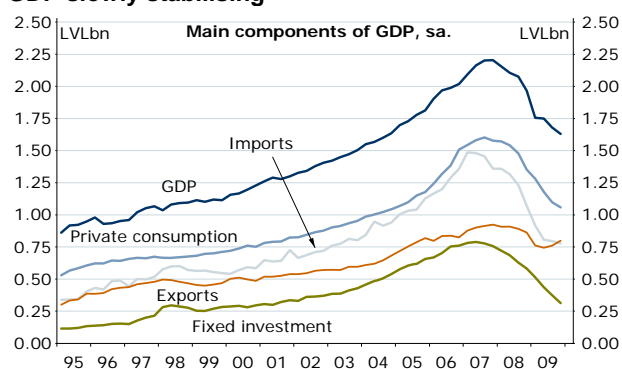
## Economy finding foothold

- Economy turning – but slowly
- Main hope of a recovery from the export sector
- Difficult budget cuts still necessary

### Steep decline only slowly abating

According to the flash estimate the economy finally turned to q/q growth in Q1 (in seasonally adjusted terms) after declining for eight consecutive quarters. Compared to the corresponding quarter the previous year, GDP fell by 6%. However, the sustainability of the rise is still uncertain, with the details of the GDP figure, released together with the first GDP estimate on 9 June, to shed additional light on the sources of growth.

### GDP slowly stabilising



The main support for GDP is anticipated from exports, where the quarterly rise is expected to continue, whereas domestic demand is still seen weak. Thus we expect an export-led recovery, with the main risk from a weaker than anticipated recovery in the EU. All in all, we expect the economy to still contract this year, with the decline averaging 2% y/y. However, along with a more broad-based recovery, growth around 3% is seen in 2011.

### Spending weak, but some signs of revival exist

Consumption and investment are expected to be the main drags on the economy still in Q1, and will remain below their 2007 highs for several years. With unemployment above 23% in March and real wages still falling, hopes of a brisk and forthcoming recovery in household spending are slim. We expect the wage declines to continue in 2010, although at a more moderate pace, as production

costs on especially the tradable sector are reduced, in an effort to improve competitiveness on the export markets.

Nevertheless, a significant decline in unemployment is not expected until 2011. All in all, reducing unemployment will be important in supporting sustainable economic growth in the long term. In addition, throughout the crisis, the government's fiscal consolidation measures, cutting e.g. public sector wages and raising taxes, have weighed on consumption, and the continued fiscal consolidation effort will restrain spending further.

However, some positive momentum already exists in e.g. consumer confidence, raising hopes of stronger domestic demand. Thus, despite the grim short term outlook spending is expected to revive on a longer horizon. Particularly in H1 main support for the economy will come from the export sector, as global demand recovers, but gradually also private consumption will gain strength. In addition, consumer confidence points towards declining unemployment expectations over the coming year.

Activity in the business sector is kept subdued by the weak credit markets. Credit growth in the private sector turned negative in November 2008, and has yet to recover. For 2010 we expect a steep decline in lending to households while lending to corporates should fall at a more moderate pace. In addition, uncertainty regarding tax policy, public finances and politics is likely to postpone major investment decisions until after the elections.

### Budget cuts still needed

The consolidated budget posted a 9% deficit in 2009. While the government is committed under the IMF programme to reduce its deficit to 3% of GDP in 2012, public debt is seen rising further, reaching 57.3% in 2011 according to the Commission's projections. However, this implicitly assumes that the international loan will be used in full. Already in 2009 public debt rose to 36.1%, however, about EUR 2 bn of the loan, or 10% of GDP, was placed in a deposit at the Central Bank. Thus, net public debt amounted to about 25% of GDP. Cutting the deficit below 3% requires significant effort by the government, unless the recovery exceeds expectations.

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

	2006 (LVLmn)	2007	2008	2009	2010E	2011E
Private consumption	7,281	14.8	-5.5	-22.4	-6.0	2.8
Government consumption	1,855	3.7	1.5	-9.2	-5.0	-1.0
Fixed investment	3,644	7.5	-15.6	-37.7	-5.0	4.5
Exports	5,014	10.0	-1.3	-13.9	5.5	5.8
Imports	7,412	14.7	-13.6	-34.2	3.5	4.5
GDP		10.0	-4.6	-18.0	-2.0	3.0
Nominal GDP (LVLmn)	11,172	14,780	16,243	13,244	12,688	13,005
Unemployment rate, %		6.0	7.5	17.1	22.5	20.5
Consumer prices, % y/y		10.1	15.3	3.6	-2.2	-0.5
Current account, % of GDP		-22.5	-13.0	8.7	7.0	5.0
General govt budget balance, % of GDP		-0.3	-4.1	-9.0	-8.0	-6.0

The parliamentary election in October poses one of the most interesting events this year. The largest coalition party, People's Party, resigned from the government in March, after already earlier disagreeing on some budget cuts. The government remains in minority, with pledged support from one of the opposition parties on nationally important issues. This will make the planning of the 2011 budget nearly impossible before the elections.

The LVL has remained firmly pegged, and the Treasury currently has enough funds until the end of the year. PM Dombrovskis has even indicated that Latvia might not need all the loan tranches agreed upon earlier. We do not see an imminent decision on a reduction in the loan package, although tranches could be further postponed. The main risk to the currency is exerted by political instability, in particular in combination to the elections and the negotiation on the 2011 budget.

Fiscal consolidation has already been extensive, with the cuts in the most recent 2010 budget amounting to more than 4.2% of GDP. Measures include an increase in the personal income tax, structural reforms in the public sector, and reductions in wages. After the widespread budget cuts, new cuts become politically increasingly difficult to find. Targeting specific sectors would ignite opposition from lobby groups, while targeting citizens and companies would be politically suicidal ahead of the elections. Thus we do not expect to see fiscal consolidation measures for the 2011 budget until after the elections.

**Interest rates low on good liquidity**

Interest rates have declined from their peaks, with the Rigibor 3M rate reaching its lowest since at least 1998. However, the steep decline in interest rates do not reflect only the improving fundamentals in the economy, as in addition to abating devaluation speculations, the low rates are induced by the increased liquidity on the money markets due to the IMF and EU loan tranches.

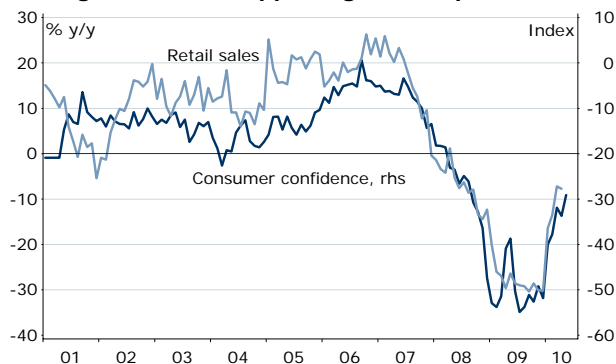
The increased liquidity, when the EUR received from the loan package are being sold by the State Treasury to the central bank, has lead to a sharp decline in interest rates. Hence the low rates are a result of the developments on the FX markets, and if the international funding would suddenly end, while the write-down of loans would continue, interest rates could rise swiftly. However, we see interest rates remaining relatively low this year, while upward pressure will start to emerge in 2011.

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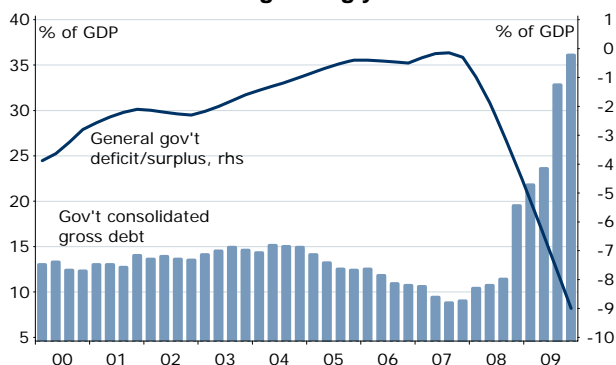
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**Firming confidence supporting consumption**



**Government debt rising strongly**



**Interest rates and CDSs at very low levels**



**LVL remaining within its fluctuation band**



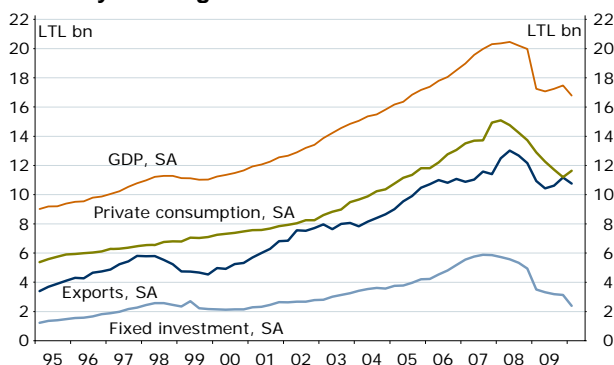
## Gradual recovery ahead

- GDP recovering slowly
- Domestic demand struggling
- Government finances still in focus

### GDP still fragile

The Lithuanian economy declined further in Q1, after growing for two consecutive quarters at the end of last year. Behind the -2.8% y/y decline were for example still a very steep fall in investments (-30.2% y/y) and private consumption (-10% y/y), while imports were reported to have turned to surprisingly strong growth (5.7% y/y). The economy was also supported by inventory growth. On the positive side, exports grew by 2.8% compared to the corresponding period the previous year, supporting the export-led recovery.

### Recovery still fragile



Compared to the previous quarter, the details of the Q1 GDP release indicated that somewhat surprisingly, private consumption turned to modest growth (in seasonally adjusted terms) after declining for seven consecutive quarters. Thus consumption remains clearly below its peak. However, fixed investment plunged, falling below the levels seen in 2002, and also imports dipped clearly. Exports turned to a decline as well after two growth quarters, highlighting the unevenness of the recovery. All in all the release was, however, largely in line with expectations. The report also underlined the fragility of the recovery, as the seasonally adjusted GDP declined back to levels last seen in 2005. However, the weak Q1 could partly be explained by the closure of the Ignalina nuclear power plant at the end of last year.

This year we see the main boost coming from improved exports, while domestic demand continues to recover only gradually. In addition, it will take several years for the economy to reach pre-crisis levels. All in all, we see the economy turning to meagre growth this year, while a stronger recovery in domestic demand will support the economy to firmer growth in 2011.

### Households still struggling

The consumers were also hit hard by the downturn, and unemployment has risen steeply, reaching above 18% in March, which is its highest level since at least 1999. We expect unemployment to turn gradually this year, peaking in the second half of the year. However, a more significant decline is not expected until 2011, because the labour markets follow the business cycle with a lag, as companies remain cautious on adding on new workforce. In addition to high unemployment, the wage development is still weak. We expect wages to continue adjusting downwards, although at a slower pace than this year, improving the competitiveness of the tradable sector. Despite the still weak labour markets some positive signs are already visible in the economy, such as the upward trend in consumer confidence and firming exports. In May consumer confidence remained unchanged, as perceptions of the economic situation deteriorated, while employment expectations brightened.

Strengthening export demand is a necessity for a proper recovery in the domestic economy as well, and thus the main risks to our scenario are connected to an unsustainable recovery in Lithuania's main export partners, such as the Baltics, Russia and the EU. If global demand turns out lower than anticipated, also the recovery in Lithuania is likely to be postponed.

### Government finances still important

Although Lithuania does not face a similar necessity to cut its deficit as Latvia does, it does not mean it would not be beneficial for the economy to improve the efficiency of the public sector and lower the costs of production. Reducing the budget deficit and keeping public debt at a reasonable level will still require significant effort by the government. Recently, PM Kubilius has stated that the government plans to publish a two-year plan for achieving the necessary cuts soon, noting that economic

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

	2006 (LTLmn)	2007	2008	2009	2010E	2011E
Private consumption	53,449	12.1	3.6	-17.0	-4.0	3.0
Government consumption	15,966	3.2	7.9	-2.3	-3.5	0.5
Fixed investment	20,841	23.0	-6.5	-38.7	-4.5	5.0
Exports	48,917	3.0	12.2	-15.5	5.0	5.5
Imports	57,343	10.7	10.5	-29.3	3.8	4.0
GDP		9.8	2.8	-15.0	0.5	3.0
Nominal GDP (LTLmn)	82,792	98,138	111,498	99,456	98,959	102,422
Unemployment rate, %		4.3	5.8	13.7	17.0	16.5
Consumer prices, % y/y		5.8	11.1	4.2	-1.0	0.5
Current account, % of GDP		-15.0	-11.9	2.6	3.0	2.5
General govt budget balance, % of GDP		-1.0	-3.2	-8.9	-8.0	-6.8

growth will not be enough for consolidating the budget. The plan is expected to include measures on both the revenue and expenditure side.

Gross debt is expected to continue rising briskly. Although debt was still only at slightly less than 30% of GDP in 2009, the trend is upwards. The European Commission sees debt at 45.4% of GDP in 2011, and while still below the Maastricht criteria of 60%, also Lithuania needs to see a stabilisation in its public debt. This is also important in order to be able to continue borrowing from the international markets and avoid turning to the IMF.

The budget deficit came in at -8.9% of GDP last year, as tax revenues plummeted and social spending increased. Despite the measures already taken – cutting expenditure and raising revenues – Lithuania still faces consolidation measures of approximately 5.5 percentage points by the end of 2012 according to the IMF, in order to reach the target of a 3% deficit in 2012. This requires tough political decision though, and is likely to weigh further on household spending.

Lithuania targets euro adoption in 2014 – a plan which requires a budget deficit below 3% of GDP and public debt below 60% in 2012. If Estonia is, as expected, accepted as the next new euro member, this is likely to have both positive and negative effects on the neighbouring countries. The Estonian euro adoption would increase confidence in the chances of the other Baltic countries joining the euro area, but at the same time foreign investment to the region is expected to concentrate in Estonia.

**Currency peg still stable**

Recently fears of devaluation have virtually disappeared in Latvia, and thus also the Lithuanian peg is seen stable. However, Lithuania needs to do more to improve the competitiveness of the tradable sector. With a fixed exchange rate competitiveness has weakened recently, as prices have been slower to adjust than in countries with floating exchange rates. Thus, countries such as the Baltics have suffered in terms of weakening competitiveness in comparison to for example Poland, who has been able to adjust its exchange rate. Hence wages and other costs of production need to continue to adjust downwards in Lithuania.

Annika Lindblad

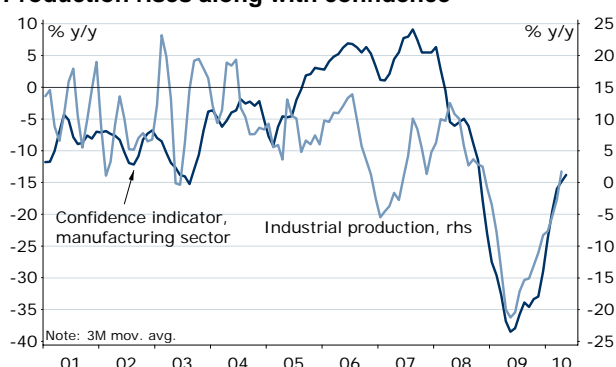
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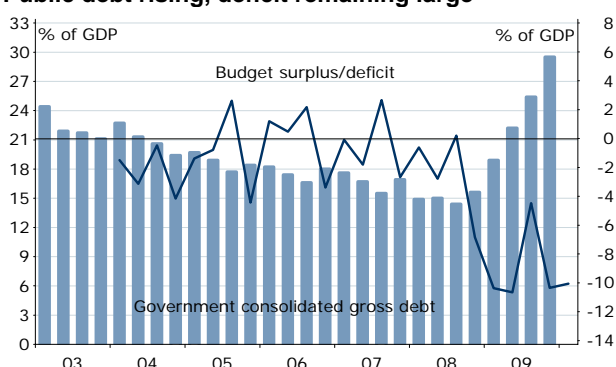
**Confidence continue strengthening**



**Production rises along with confidence**



**Public debt rising, deficit remaining large**



**Labour market conditions still deteriorating further**



## Temporary slowdown

- More signs of stabilising labour market
- Fiscal tightening ahead
- EMU membership still possible in 2014
- Rate hikes to come

The recovery is on track despite the temporary slowdown in the first quarter of this year. Exports continue to show strong momentum, though risks have increased with the government debt crisis in the Euro area. Risks have also increased when it comes to the domestic economy, as especially investment was very disappointing in the first quarter. The harsh winter weather was probably the main reason, but bank lending to non-financial companies is still not growing and the outlook for demand remains blurry. Therefore, it could be that the global financial crisis will take longer to overcome after all.

Still, we keep our forecast for moderate growth this year and in 2011 for now. Indeed, we expect that the labour market is close to its weakest point and that the domestic economy will gradually start to pick up speed during the second half of the year, which will help broaden the base of the recovery and make it more sustainable. Moreover, the stabilisation and subsequent downtrend in the unemployment rate, which we expect, will probably be the right medicine to secure a gradual pick-up in credits, housing market activity, investment etc.

### More signs of stabilising labour market

There are now more signs that the unemployment rate may be close to or even past its weakest point. Indeed, recent months have shown an increase in manufacturing employment and a pick-up in unfilled vacancies. And, according to our own seasonal adjustment, employment for the whole economy increased marginally in Q1 after three consecutive quarterly drops. Moreover, business surveys show a significant improvement in the balance between businesses expecting to hire and businesses expecting to lay off staff, though the gap remains slightly in negative territory.

Private consumption gained some momentum in the first

quarter as the labour market stabilised. Households' real disposable incomes are likely to accelerate gradually during the year, while the savings ratio probably increased significantly in the first quarter and could increase further until it has become clear that the unemployment rate has peaked and subsequently started to fall again. Even then, the unemployment rate will continue to be relatively high, wage growth relatively low and credit conditions relatively tight throughout our forecast horizon. Therefore, it will take time before private consumption growth will be strong again, but momentum will most probably improve.

Investment contracted significantly in the first quarter due mainly to the harsh winter weather and is still some way from recovering. Low capacity utilisation, tight credit conditions and uncertainties regarding the outlook for demand mean that businesses are holding back. For the same reasons we do not see a significant pick-up in investment until 2011.

### Fiscal tightening ahead

We maintain the view that the tragic death of President Kaczynski, Central Bank Governor Skrzypek and a number of high-ranking political and military persons will not prompt major shifts in economic policies in the near term. Polls suggest that acting president Komorowski of the governing Civic Platform is likely to win the elections and become the next president.

The government has had fiscal austerity on its agenda for some time, but the late president Kaczynski had threatened to veto large-scale austerity measures. The market reaction to the fiscal problems in the euro area is likely to have given further support to the government's eagerness to improve public finances. Therefore, we expect the first fiscal tightening measures to be taken shortly after the elections provided that the latter turns out as current polls suggest. More fiscal tightening measures are likely to come after the general elections, which could be held in the spring of 2011.

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

	2006 (PLNbn)	2007	2008	2009E	2010E	2011E
Private consumption	653	4.9	5.3	2.6	2.1	3.3
Government consumption	194	3.6	7.2	2.6	2.2	0.6
Gross fixed capital formation	208	17.2	9.5	-0.9	-5.6	5.0
Stockbuilding*	15	1.7	-1.1	-2.7	1.3	0.6
Exports	428	9.1	5.9	-7.1	8.8	5.2
Imports	447	13.8	6.1	-12.3	9.3	4.5
GDP		6.8	4.9	1.9	3.4	3.9
Nominal GDP (PLNbn)	1,115	1,177	1,275	1,344	1,413	1,503
Unemployment rate, %		12.7	9.8	11.0	12.4	11.4
Consumer prices, % y/y		2.6	4.4	3.4	1.9	2.5
Current account, % of GDP		-4.7	-5.1	-1.6	-2.1	-2.7
General government budget balance, % of GDP		-1.9	-3.9	-6.5	-6.0	-5.0

\* Contribution to GDP growth (% points)

**EMU in 2014-15**

Due to the prospects of fiscal tightening EUR adoption is possible as early as 2014. The general government budget deficit could be below 3% of GDP in due time and that is likely to be the most difficult hurdle to overcome. Poland no longer has an official target date for joining, but various government officials and the acting president have suggested that 2014 to 2016 would be the most likely period in which to join EMU.

**Rate hikes to come**

Former Prime Minister Belka has been nominated for next head of the National Bank of Poland (NBP). He did well as a prime minister and is respected as an economist with the IMF. Therefore, he sounds like a good candidate for the position. We do not think it is possible to say what he will mean for monetary policy, partly because he will be one in ten in the monetary policy committee, though holding a decisive vote in case of ties, and partly because we have seen many examples of central bank members in various countries who act very differently from what was expected once they are in the chair and are presented with all the staff inputs. So up front, we do not anticipate significant monetary policy changes.

However, it will certainly be good for markets to get a new NBP head. Indeed, it appears to be more and more urgent given the internal conflicts in the NBP, the conflicts between the NBP and the government and the need to communicate *one* strategy to the markets instead of the personal views of nine different monetary policy committee members, at least in times of crisis.

We believe that the NBP will start to reduce the monetary stimulus gradually, by hiking interest rates, once the labour market is past its weakest point. The concerns about excessive PLN strength are gone and inflation will start to tick higher in the second half of the year.

**The PLN and interventions**

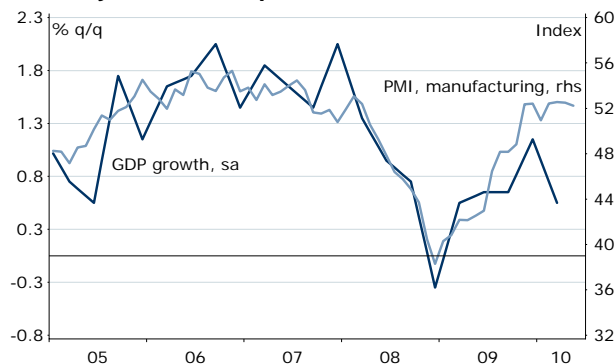
Discussions have been many in the markets about the exchange rate policy after the NBP's direct FX intervention in April, which was the first since the bank became independent in 1999. The NBP argues that the PLN is still a free float, that is, it does not intend to intervene regularly, but on the other hand the NBP does preserve the right to intervene again in case of excessive PLN moves. The PLN has weakened following the market turmoil due to the Euro-area government debt problems, but we expect renewed appreciation once markets normalise. Polish fundamentals are very strong, interest rates remain well above their Euro-area counterparts and EMU convergence may become a theme again once fiscal tightening begins.

Anders Svendsen

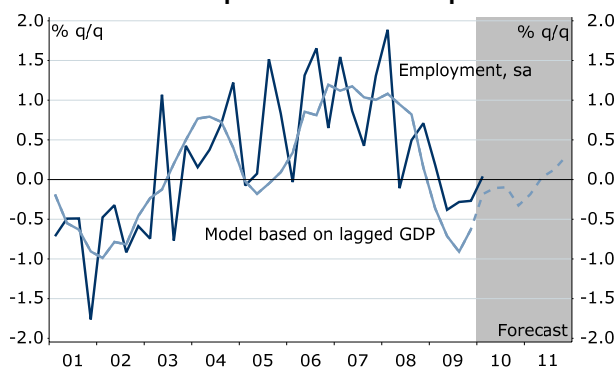
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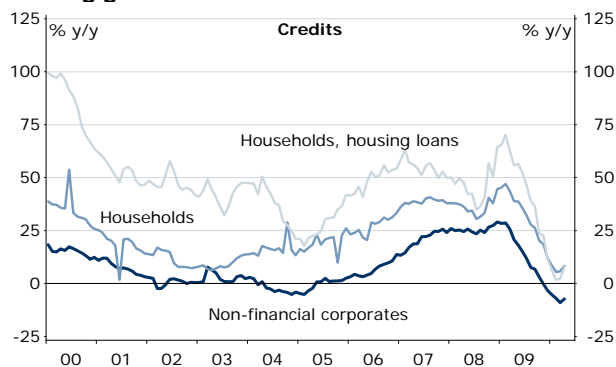
**Recovery on track despite slowdown**



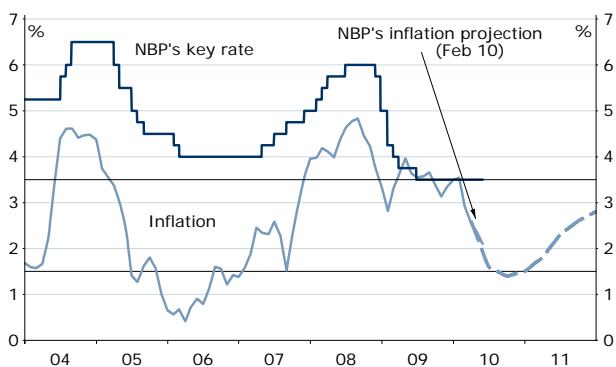
**Labour market has passed its weakest point**



**Lending growth still subdued**



**Rate hikes to come**



## A strong but unstable recovery

- Growth expected to accelerate in the coming quarters
- Interest rates close to bottom levels
- RUB to continue strengthening in the long term

### Economy recovering, but slower than expected

The flash estimate for Q1 GDP growth disappointed, showing an expansion of 2.9% y/y during Q1, against expectations of over 4% growth. This indicates that the anticipated strong recovery has been stickier than expected in the early days, but we still expect momentum to build during the coming quarters, as both exports and domestic demand firm. Thus, we remain confident with our expectations of 6% y/y growth in 2010, although the risks to our strong growth scenario seem currently to be on the downside.

The details of the Q1 GDP figure are released later, but we expect exports to have continued growing strongly from Q4, whereas investments and consumption could have developed weaker than anticipated. However, although unemployment has remained elevated, real wages have turned to growth, indicating a looming recovery in household spending during the first half of the year.

One of the most significant risks for exports is a decline in demand from the EU or a strong fall in the oil price. Despite the downturn, the EU continues to be Russia's most important export partner. In 2008 over 56% of total exports went to the EU but only 4.5% to e.g. China. This is generally not seen as the most "optimal" distribution of trade in Russia, largely reflecting the weak development of the trade relations between Russia and China due to the lack of proper transport infrastructure. Developing trade relations with China is expected to become an increasingly important objective in Russia.

### Future challenges

After the initial boost there is no certainty that growth will continue as briskly. The lack of investments on especially the oil sector poses limits on the growth potential, as new investments take time to become established. In addition, the lack of sufficient funding to explore new oil fields and the need for more modern technology to do this would necessitate the cooperation with foreign com-

panies. However, laws limiting foreign investment on various raw material sectors and the reluctance to allow foreign access to strategically important raw material deposits complicate the process.

Russia is continuing its privatisation efforts, which have so far evolved slowly. Amendments to privatisation laws to accelerate the process are still only being discussed. Russia plans on earning RUB 100 bn on privatisations this year, but none of the large and important state-owned companies are being privatised.

In the long term we see the risk of lower growth, as domestic demand remains fragile, the low investments on the oil sector create capacity constraints, and the rigid structures of the society and the lack of modernisation constrain growth potential. Some progress has, however, been made, with the approval of various modernisation projects. If government policy works towards diversifying the export sector, reducing corruption, promoting a favourable environment for foreign investment and modernising the economy, growth could turn out brisk also over a longer horizon.

### Interest rates close to bottom

The decline in interest rates has slowed down recently, as rates have even fallen below the levels seen before the financial crisis. We expect for example the Mosprime 3M rate to be very close to its bottom levels at a little above 4%. However, the central bank still worries about the high lending rates, and has thus continued to cut the refinancing rate. However, the refi rate has never been a very influential tool in the economy, with the O/N deposit rate seen more important by the central bank.

The central bank has cut the refinancing rate, currently at 7.75%, by 525bp as slowing inflation has enabled further cuts. However, the easing cycle is seen close to its end, as the CBR has become increasingly aware of the looming inflationary pressure in the second half of the year. If the easing cycle indeed has come to an end now, as we expect, we do not see rate hikes until 2011.

### Politics stable

Whether Putin or Medvedev will be elected President in 2012 economic policy is expected to remain stable. Presi-

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

	2006 (RUBbn)	2007	2008	2009	2010E	2011E
Private consumption	13,041	13.6	11.2	-8.5	4.5	5.0
Government consumption	4,589	3.4	2.5	1.9	3.0	2.0
Fixed investment	4,981	21.1	10.0	-21.0	4.5	5.5
Exports	9,079	6.3	0.5	-8.1	9.0	8.0
Imports	5,657	26.5	15.0	-17.9	8.0	7.0
GDP		8.1	5.6	-7.9	6.0	4.5
Nominal GDP (RUBbn)	26,904	33,111	41,668	43,251	48,874	54,592
Unemployment rate, %		5.7	7.0	7.5	7.2	6.8
Consumer prices, % y/y		9.0	14.1	11.7	7.0	7.2
Current account, % of GDP		5.9	6.2	3.5	4.0	3.0
Central govt budget balance, % of GDP		6.1	4.1	-5.1	-4.0	-1.5

dent Medvedev has been driving modernisation initiatives, contrary to Putin, but at least during his first term no significant changes have been pushed through. Thus, hopes of significant reforms during this term are slim, and even a second term might prove too short to push through any major changes. In general, Putin and Medvedev are seen representing two different sides of Russia. However, the term has been extended to six years with the option of one re-election, meaning that if Putin is elected he could serve until 2024.

The strong public sector budget surpluses turned into deficits in 2009, as the economy plunged and anti-crisis measures were implemented. The oil funds, where revenues from oil export duties were collected, have deteriorated sharply. Russia issued its first Eurobond in a decade this year, worth around USD 5.5 bn, to fill the budget gap. To a large extent, however, the issue was made in order to provide a benchmark for Russian public debt.

The anti-crisis measures included support for the banking sector, subsidies to certain domestic industries, such as the agricultural and car sector, as well as support for consumers, such as pension hikes. The support measures have been criticised for supporting old and inefficient structures and companies, as the crisis was not taken as an opportunity to modernise the economy and move resources to more productive industries. Some of the measures to protect domestic industries were reflected as increased protectionism. Reversing these measures will be necessary if Russia wishes to join the WTO, but will also mean that domestic companies will face fiercer competition from abroad. However, although Russia has indicated its wish to proceed with the 17-year long accession process to the WTO alone, the negotiations could well be prolonged further.

**Rouble strengthening in the long term**

The recent developments have clearly highlighted the risks in connection to short term volatility in the rouble. For example the high oil price and positive risk sentiment encouraged the RUB to reach its strongest levels against the basket since end-2008. However, the Greek debt problems together with the weakness in oil prices have lead to sharp fluctuations against the bi-currency basket.

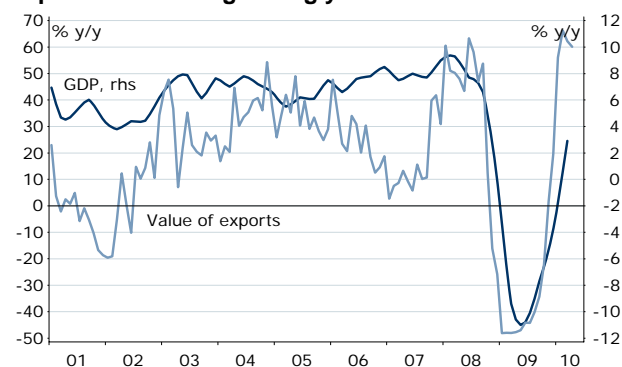
Thus, although we still see the rouble on a strengthening long term trend due to capital inflows and a strong oil price, the possibility of temporary, sudden weakness cannot be underestimated, as the rouble is very sensitive to changes in global risk appetite.

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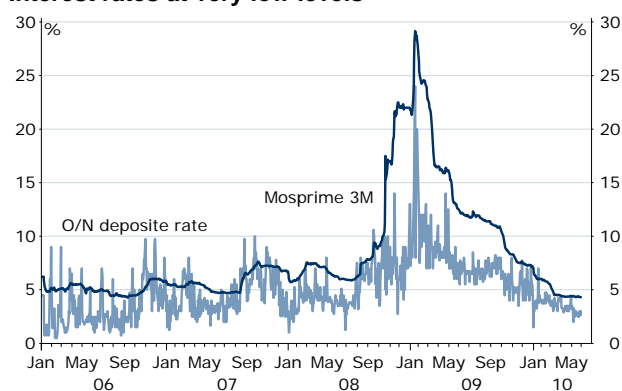
**Exports rebounding strongly**



**Positive signs on the industrial sector**



**Interest rates at very low levels**



**Rouble appreciation slowed down with interventions**



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