Baltic Rim Outlook

November 2010

Markets

Growth is back

After some tough years for the Baltics, Poland and Russia the crisis is now over, at least in terms of growth, which is back. Estonia's nearby membership of the euro club highlights that a new era has begun for the Baltic countries. Exports have been the key element in the early part of the recoveries in the region, while the development of the domestic economies varies significantly. Poland is clearly in the lead, with Russia gaining pace and the Baltics still struggling to get domestic demand to pick up.

In **Estonia** exports have been the main driver of the recovery. Although the labour markets have started to improve, consumption is still fragile. The euro adoption is expected to boost confidence in the economy both at home and abroad, strengthening the recovery. Whereas public finances are at sustainable levels, the economy has other challenges to overcome, such as accelerating inflation and high long-term unemployment.

In **Latvia** focus is on fiscal consolidation. The budget deficit should be cut below 6% of GDP in 2011 – a challenge from 10.2% in 2009. However, a gradual recovery is clearly seen in the economy, although the domestic economy is showing little sign of an upturn. The outcome of the recent elections was good news for the markets, but credibility needs to be upheld to ensure favourable conditions on the local financial markets.

Lithuanian GDP still has a long way up to pre-crisis levels, and for this also a recovery in domestic demand is needed. Although growth this year is seen lacklustre, acceleration is expected in 2011. However, a slowdown in export demand could keep the economy weak for a longer time. Budget cuts will also be needed, with preferably some structural reforms implemented. Stable government finances are necessary for sustainable growth.

Growth in **Russia** is seen slowing in the second half of the year, indicating that growth for 2010 as a whole will undershoot previous forecasts. Especially the agricultural sector has stagnated due to the summer drought. Although inflation has accelerated, we do not foresee double-digit figures over our forecasting horizon. The budget deficit will remain fairly large despite for example rising oil prices and privatisation plans.

The **Polish** economy continues to pick up speed and almost all engines are now up and running again after the global crisis. However, we expect the economy to start losing momentum late this year and in the first half of next year. Fiscal policy is our key domestic concern at the moment, especially since general elections are due next year. A lot of focus is currently on the central bank, as the first interest rate hike is near.

Helge J. Pedersen, Global Chief Economist
helge.pedersen@nordea.com +45 3333 3126

Contents:

Economic Research Nordea:

Denmark:

Helge J. Pedersen, Global Chief Economist
helge.pedersen@nordea.com, Tel +45 3333 3126

Johnny Bo Jakobsen, Chief Analyst
johnny.jakobsen@nordea.com, Tel +45 3333 6178

Anders Matzen, Chief Analyst
anders.matzen@nordea.com, Tel +45 3333 3318

Anders Svendsen, Chief Analyst
anders.svendsen@nordea.com, Tel +45 3333 3951

Troels T. Eriksen, Senior Analyst
troels.theill.eriksen@nordea.com, Tel +45 3333 2448

Jan Størup Nielsen, Senior Analyst
Jan.storup.nielsen@nordea.com, Tel +45 3333 3171

Bjarke Roed-Frederiksen, Analyst
bjarke.roed-frederiksen@nordea.com, Tel +45 3333 5607

Aurelija Augulytė, Analyst
aurelija.augulyte@nordea.com, Tel +45 3333 6437

Finland:

Martti Nyberg, Chief Economist Finland
martti.nyberg@nordea.com, Tel +358 9 1655 9941

Annika Lindblad, Analyst
annika.lindblad@nordea.com, Tel +358 9 1655 9940

Norway:

Steinar Juel, Chief Economist Norway
steinar.juel@nordea.com, Tel +47 2248 6130

Erik Bruce, Chief Analyst
erik.bruce@nordea.com, Tel +47 2248 4449

Thina M. Saltvedt, Senior Analyst
thina.margrethe.saltvedt@nordea.com, Tel +47 2248 7993

Katrine Godding Boye, Analyst
katrine.godding.boye@nordea.com, Tel +47 2248 7977

Sweden:

Annika Winsth, Chief Economist
annika.winsth@nordea.com, Tel +46 8614 8608

Torbjörn Isaksson, Chief Analyst
torbjorn.isaksson@nordea.com, Tel +46 8614 8859

Bengt Roström, Senior analyst
bengt.rostrom@nordea.com, Tel +46 8614 8378

Rickard Hellman, Junior analyst
rickard.hellman@nordea.com, Tel +46 8614 8726

Visit us at:
www.nordea.com/e-Markets

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28 October 2010

Currency forecasts (against DKK)

	28-Oct-10	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	10.50	10.54	10.65	10.65	10.65
LTL/DKK	2.16	2.16	2.16	2.16	2.16
PLN/DKK	1.88	1.91	1.96	1.96	2.01
RUB/DKK	0.18	0.19	0.20	0.21	0.23

Currency forecasts (against EUR)

	28-Oct-10	3M	6M	12M	24M
EUR/EEK	15.65	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	3.97	3.90	3.80	3.80	3.70
EUR/RUB	42.58	39.48	38.15	35.92	32.91

Currency forecasts (against NOK)

	28-Oct-10	3M	6M	12M	24M
EEK/NOK	0.52	0.51	0.50	0.49	0.49
LVL/NOK	11.47	11.32	11.29	11.00	11.00
LTL/NOK	2.36	2.32	2.29	2.23	2.23
PLN/NOK	2.05	2.05	2.08	2.03	2.08
RUB/NOK	0.19	0.20	0.21	0.21	0.23

Currency forecasts (against SEK)

	28-Oct-10	3M	6M	12M	24M
EEK/SEK	0.60	0.58	0.58	0.58	0.58
LVL/SEK	13.12	12.80	12.86	13.00	13.00
LTL/SEK	2.70	2.62	2.61	2.64	2.64
PLN/SEK	2.35	2.32	2.37	2.39	2.46
RUB/SEK	0.22	0.23	0.24	0.25	0.28

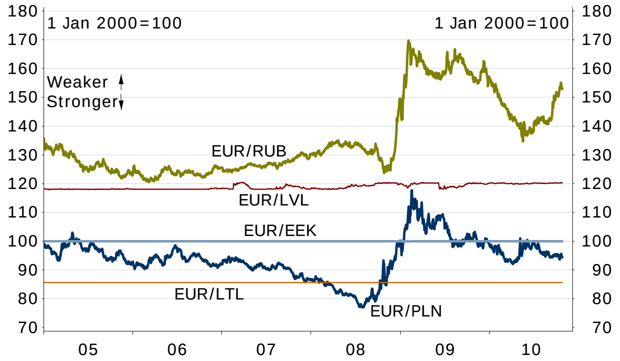
3M interbank rate forecasts

	28-Oct-10	3M	6M	12M	24M
Poland	3.82	4.00	4.30	4.60	5.15
Estonia	1.13	1.10	1.15	1.25	2.25
Latvia	1.22	1.20	1.35	1.80	2.00
Lithuania	1.61	1.80	2.20	2.50	2.80
Russia	3.74	3.80	4.00	4.50	6.00

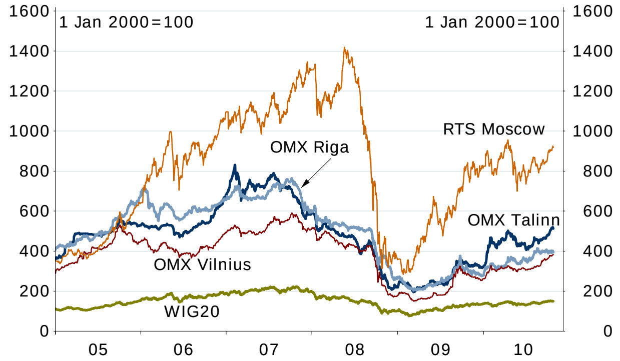
3M interbank rate forecasts (spread to the Euro area)

	28-Oct-10	3M	6M	12M	24M
Poland	2.78	2.90	3.15	3.35	2.90
Estonia	0.09	0.00	0.00	0.00	0.00
Latvia	0.18	0.10	0.20	0.55	-0.25
Lithuania	0.57	0.70	1.05	1.25	0.55
Russia	2.70	2.70	2.85	3.25	3.75

FX performance



Equity performance



Convergence criteria

	Budget balance, % of GDP	Inflation, %	Government debt, % of GDP	10Y yields, %	FX Stability, %
Criteria	*-3.0*	*0.29*	*60.0*	*7.5*	*-15 / +15*
Estonia	-1.7	0.98	7.2	-	0.07 / -0.13
Latvia	-10.2	-1.95	36.7	13.3	0.52 / -1.43
Lithuania	-9.2	0.75	29.5	6.5	0/0
Poland	-7.2	2.94	50.9	5.9	22 / -20.17

EMU entry forecasts, year
2011
2014
2014
2015

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	18,500 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	2011
GDP/capita	14,400 USD*	Prime minister	V. Dombrovskis
Currency	Lat	Next election	October 2014

* At PPP

Country facts Lithuania

Area	65,300 km^2	President	D. Grybauskaite
Population	3.6 mn	Next election	May 2014
GDP/capita	15,500 USD*	Prime minister	A. Kubilius
Currency	Litas	Next election	October 2012

* At PPP

Country facts Poland

Area	312,679 km^2	President	B. Komorowski
Population	38.5 mn	Next election	2015
GDP/capita	17,900 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	15,100 USD*	Prime minister	V. Putin
Currency	Ruble	Next election	December 2011

* At PPP

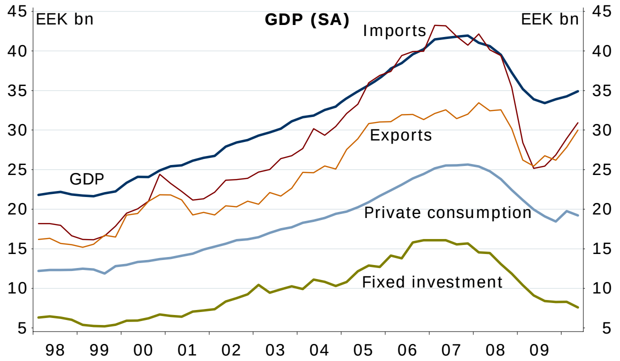
Exiting the recession slowly but surely

- Exports so far the main driver behind the revival
- Domestic demand needed to ensure stable recovery
- Inflation accelerating, but gains to remain modest
- No worries regarding government finances

The economy continued to grow quarter-on-quarter in Q2. As expected, foreign trade continued to recover as the global economy grew strongly. However private consumption and fixed investments still declined, reminding that the recovery still has a long and bumpy ride ahead.

Over the next couple of years we continue to expect a gradual recovery in the economy. Although so far exports have constituted the main driver for the recovery we expect to see domestic demand also picking up, as labour markets are improving and rising exports boost income. Based on this we see around 4% y/y growth over the next two years. Nevertheless that means that the Estonian economy will remain depressed for several years with still high unemployment for the forecasting period.

Exports still the main driver of growth



Estonia is adopting the euro in January 2011. The country is well prepared, as the EEK has been firmly pegged to the euro since the formation of the single currency and most loans are in euro. Joining the euro area is expected to increase confidence in the Estonian economy, further supporting foreign investments over the coming years. Estonia enters the euro area with one of the lowest GDP/capita shares and a comparatively low average wage, which should help attract foreign investors. With unemployment high labour availability is no longer an obstacle as it was during the boom years before 2008.

Domestic demand recovering slowly

Fixed investments have declined since 2008, having yet to find the bottom. Fixed investments are already at their lowest in 10 years in relation to GDP, so most of the collapse in investments is already behind us. The uncertainty regarding the recovery and the still weak credit markets restrain investments. Private consumption, on the other hand, is depressed by the weak labour markets and the uncertainty regarding future job and income prospects. Unemployment, which rose sharply from 3.9% in May 2008 to 19.8% in March this year, has been turning up in recent months.

The improvement in unemployment has been mixed but relatively fast, as especially the export industry has recovered swiftly. We expect the improvements in the labour market to continue, albeit slowly. Nevertheless, unemployment will remain one of the main challenges for the authorities over the next couple of years. The most dynamic part of the labour force, including young and recently unemployed, is likely to find a job relatively quickly, but long-term unemployment has, however, continued rising worryingly.

In addition to positive signs from the employment figures also wages are gradually turning up. Month-on-month wages have been growing since February 2010. Although restraining the advances in employment, a continued growth in wages would support consumption. However, the pass-through from improving labour markets to spending could remain limited in the near-term due to the uncertainty regarding the strength of the recovery next year, especially as worries regarding a slowdown in the US and Europe mount.

The quickly improving consumer confidence has so far been reflected only modestly in actual consumption. Retail sales have improved, but the revival has lagged that of consumer confidence. This probably reflects the anticipation of euro area membership, which has given a boost to confidence figures which is not matched by an actual improvement in personal finances. The still fragile

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

	2007 (EEKmn)	2008	2009	2010E	2011E	2012E
Private consumption	135,178	-4.7	-18.4	-0.7	4.8	5.0
Government consumption	41,228	4.1	-0.1	-1.0	0.8	1.5
Fixed investment	84,425	-12.1	-32.9	-9.0	7.5	7.0
Exports	177,910	-0.7	-18.6	12.2	7.3	6.8
Imports	205,572	-8.7	-32.5	12.8	7.3	7.0
GDP		-3.6	-13.8	1.8	4.2	4.6
Nominal GDP (EEKmn)	244,503	248,149	212,912	222,280	238,284	255,441
Unemployment rate, %		5.5	13.8	18.3	15.8	14.0
Consumer prices, % y/y		10.6	-0.1	2.9	3.5	2.8
Current account, % of GDP		-9.1	4.6	3.6	1.8	0.5
General govt budget balance, % of GDP		-2.7	-1.7	-2.2	-1.9	-1.5

situation of the economy limits near term gains in confidence from these already fairly high levels.

The main worry regarding the decent recovery prospects is currently a significant slowdown in foreign trade, especially if this comes before private consumption gains more strength. All in all, it would be vital that private consumption would be able to compensate for the expected slowdown in exports if the global recovery slows, in order to ensure a stable and sustainable recovery. With the current account now showing a clear surplus there is some room for domestic demand to grow even without support from rising export revenues.

Inflation accelerating

At the moment one of the main uncertainties is the accelerating inflation rate. Estonia managed to join the euro area and fulfil the inflation criteria as the recession and wage correction pushed down inflation. However, inflation has picked up briskly and has again outpaced the inflation rate on the euro area.

Currently inflation is mainly supported by food and energy prices but going forward some price pressure will also materialise from the domestic economy, as domestic demand picks up and wage growth gathers pace. Thus we expect to see some acceleration in inflation during the next year. However, as the limited economic expansion and the high unemployment should contain wage increases over our forecast horizon, inflation rates are expected to stay within an acceptable deviation from the ECB's inflation target of a little below 2%. In the long run, as Estonia is catching up with the euro area in e.g. GDP per capita and living standards, inflation is likely to exceed the euro area average.

Towards a balanced budget

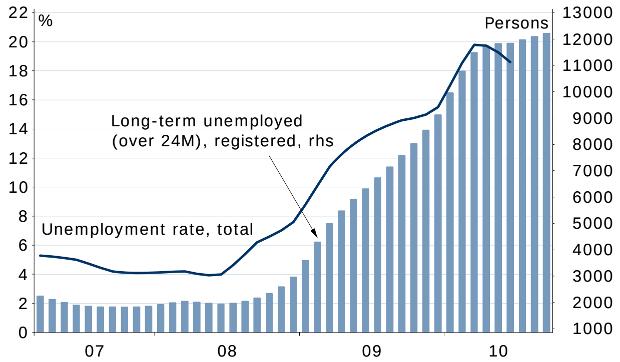
Estonia will enter the euro area in January 2011 with one of the lowest budget deficits and the lowest public debt among the member countries. Estonia is one of the few countries to still fulfil the Maastricht criteria on public finances. Despite this lack of outside pressure we believe the government to be committed to working towards a balanced budget. The two ruling parties, driving the consolidation effort, seem to still have wide-spread support. Parliamentary elections, scheduled for the spring of 2011, thus do not look likely to derail fiscal policy.

The government has considered taking a loan of approximately EUR 0.7bn in 2011, mainly to finance Eesti Energia's investments needs but also to finance the budget. Despite this, government debt will remain very modest compared to other euro area countries.

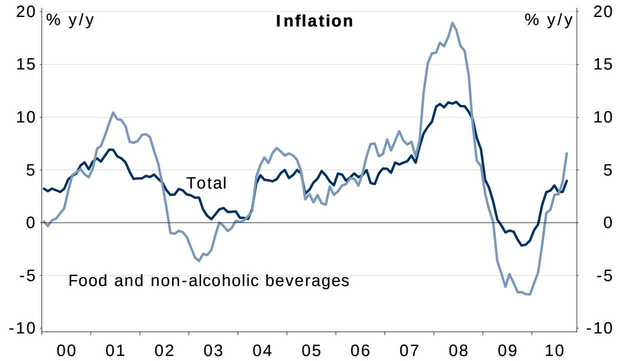
Annika Lindblad
annika.lindblad@nordea.com +358 9 165 59940

Sales increasing in line with higher confidence

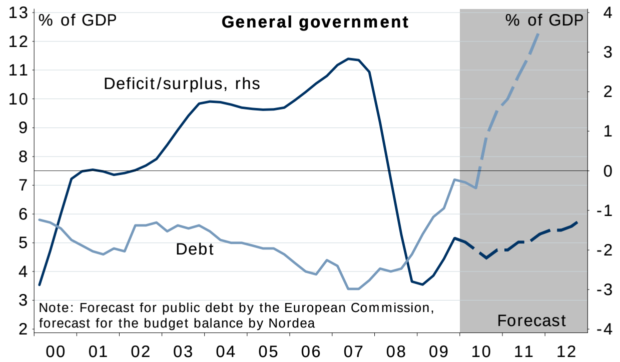
Long-term unemployment still rising



Food prices exaggerate fluctuations in inflation



Debt rising, but still very low

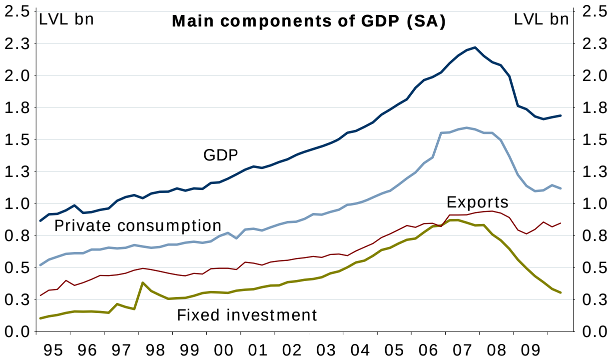


Fiscal consolidation key to sustainable growth

- Exiting the recession slowly
- Improving competitiveness in focus
- Government finances need further improvement
- Policy credibility important for sustainable growth

The domestic economy has barely started to recover yet in Latvia and GDP is only showing a modest turnaround. We do, however, expect to see a more positive development in Q3, based on improving industrial production and retail sales. Overall, the recovery is still very much export led, but rising export revenue is creating potential for an expansion also of domestic demand.

GDP turning around slowly



The currently rapid export growth has largely been driven by the strong initial recovery in Europe. There is a risk of slowing exports going forward, if the global industrial recovery loses steam. With the recovery in domestic demand still shaky, we see a fairly modest recovery next year, with the economy gathering pace in 2012.

Domestic economy improving slowly

The importance of remaining on track with the IMF programme puts focus on fiscal consolidation. Especially if the economic recovery turns out weaker than anticipated consolidation efforts could restrain spending further. We expect private consumption to gradually strengthen as the labour markets have started to gain traction.

High unemployment still keeps consumption at depressed levels. Unemployment will remain one of the main problems, and focus should be on reallocating labour resources to more productive areas, in order to reduce structural unemployment. Due to the openness of the EU labour markets Latvia has also experienced labour outflows, thus losing some of the skilled workforce.

The good news is that the unemployment rate seems to have peaked. Households' unemployment expectations have also declined back to their historical average. However, the uncertainty regarding the future is still significant, keeping plans on major purchases depressed - despite the households' views on their financial situation having improved clearly from their bottom levels in 2009.

The recent crisis should also be taken as an opportunity to strengthen competitiveness on the external markets. As a small and open economy exports are important in increasing welfare in Latvia. Finding the areas in which Latvia has a competitive advantage will be important over the next couple of years. In order to promote entrepreneurship e.g. a stable tax policy is crucial, i.e. making tax cash flows predictable for the foreseeable future. This highlights the importance of the 2011 budget.

Government finances still in focus

Despite the tough austerity measures implemented the previous coalition got re-elected in the recent elections. This ensures that the IMF programme remains intact. Latvia will continue on the path of fiscal consolidation. However, the temptation to avoid painful reforms, although badly needed, increases with a firming economy.

There are indications that the international lenders will not accept any one-off measures of reducing the deficit. In addition, the re-elected government has a "window of opportunity" in the election cycle to push through a structural reform package rather than just pure tax increases or across the board expenditure cuts. This could improve the long term growth prospects of Latvia

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

	2007 (LVLmn)	2008	2009	2010E	2011E	2012E
Private consumption	9,196	-5.4	-23.9	-2.3	4.2	5.0
Government consumption	2,575	1.5	-8.7	-7.5	-2.0	1.0
Fixed investment	4,975	-15.6	-37.1	-20.0	8.8	7.0
Exports	6,259	-1.3	-15.4	8.6	8.5	7.0
Imports	9,220	-13.6	-35.4	9.5	9.3	7.5
GDP		-4.6	-18.0	-1.8	3.2	4.3
Nominal GDP (LVLmn)	14,780	16,243	13,244	12,900	13,570	14,493
Unemployment rate, %		7.5	17.1	19.4	17.4	15.8
Consumer prices, % y/y		15.3	3.6	-1.0	2.9	2.7
Current account, % of GDP		-13.0	9.4	5.8	2.0	0.2
General govt budget balance, % of GDP		-4.1	-10.2	-7.4	-5.8	-3.0

The Bank of Latvia estimates that roughly LVL 400mn in additional consolidation measures are needed to bring the budget deficit in 2011 below 6% of GDP. The revised figure for last year's budget deficit marginally exceeded the 10% of GDP threshold agreed with the lenders. The 2010 figure is expected to be around 8% of GDP, but the safety-margins are slim. The 6% of GDP deficit in 2011 should be viewed as a ceiling for the deficit, not a target.It is, however, still worryingly high, giving the government strong reason to seize every opportunity to reduce the deficit further, for example, by policies aimed at reducing the size of the grey sector.

Euro-adoption is currently planned in 2014. Whether this aim will be achieved or not depends not only on the government's ability to cut the budget deficit below the required 3% of GDP, but also on its capability to keep public debt below 60% of GDP as well as to keep inflation in check. Although public debt is rising fairly quickly, it is expected to remain below 60% of GDP. The State Treasury keeps more than EUR 2bn with the Bank of Latvia, which can be used to reducing the borrowing needs of the government, if confidence in the Latvian economy improves and Latvia is otherwise on the Euro track. Inflation, on the other hand, is likely to remain fairly modest as long as the economy is recovering and unemployment is high. However, if structural unemployment is not addressed effectively, it could be difficult to keep wage increases in some sectors in line with productivity improvements.

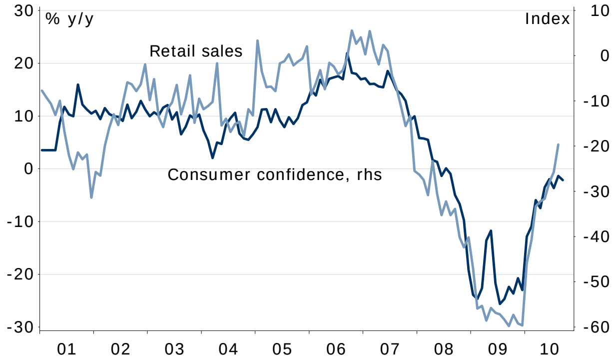
Policy credibility important for sustained growth

An important factor in the recovery is stable financial markets. Currently CDS levels are considerably lower than a year ago, and interest rates are at bottom levels. The inflow of currency driven by government borrowing has created a good liquidity situation helping to keep money market rates low. This currency inflow has also helped to keep the currency markets are calm. The outcome of the recent elections was good news for the markets, but circumstances on the global market can still change fast. Thus, credibility needs to be upheld to ensure that conditions on the local financial market remain favourable.

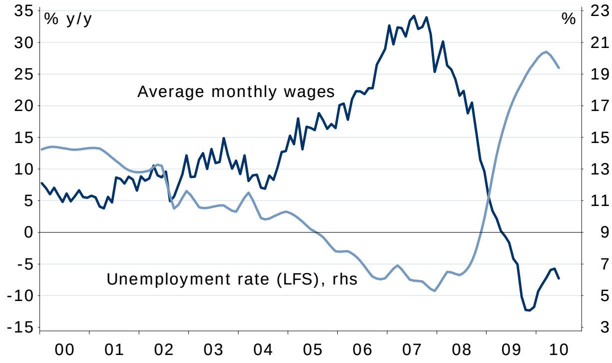
In the longer term credibility is also key to sustainable growth. The IMF/EC programme draws to a close in late 2011 and the state will have to start refinancing its loans on the international financial markets in early 2012. Latvia is still rated below investment grade by two of the main rating agencies. Thus, to improve the credit rating and be able to turn to the international markets at a reasonable cost, credibility needs to be sustained. This stresses the importance of the 2011 budget once more.

Annika Lindblad
annika.lindblad@nordea.com +358 9 165 59940

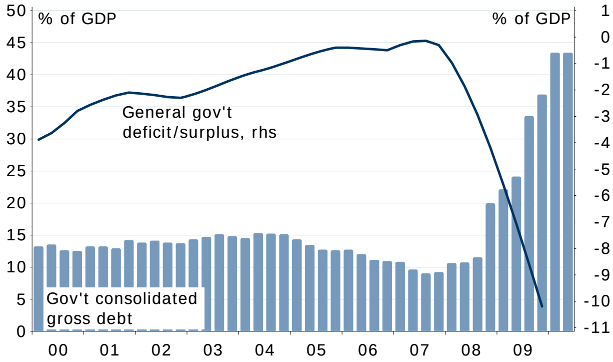
Firming confidence supporting consumption



Unemployment easing a little



Government debt rising strongly LVL remaining



Interest rates and CDSs at very low levels

Domestic recovery lagging

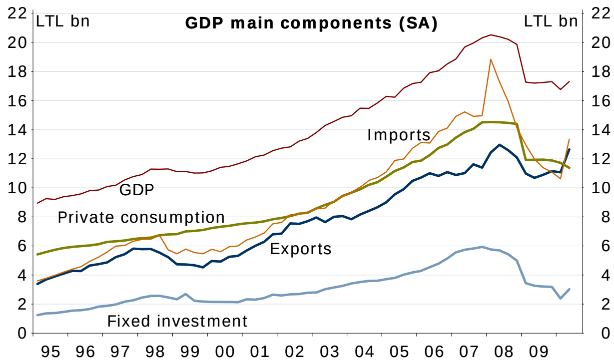
- Slow recovery mainly supported by exports
- Unemployment declining only gradually
- Gradual acceleration in inflation
- Long-term structural changes in focus

Patience required

The Lithuanian economy has started to recover modestly, with the stabilisation in the economy backed mainly by strong export growth. The main worry remains private consumption, which has continued to edge down. Although retail sales figures are showing a modest return to growth, domestic demand has yet to find proper foothold.

We expect to see the economy returning to modest growth this year, but a proper expansion will not be seen until 2011-2012. A gradually strengthening recovery requires a continued rebound in external demand, helping Lithuanian exports.

Recovery still fragile



The level of exports is already very close to the highs of 2008. Thus exports are currently the main engine of growth, boosting industrial production as well as employment. Future growth in exports remains dependent on the recovery in Lithuania's main trade partners: the EU, especially the neighbouring countries, and Russia. The global recovery prospects for next year remain very uncertain.

For a more sustained recovery an improvement in domestic demand would be very welcome. It is important that domestic demand gains strength, so that private consumption can substitute some of the possibly waning export growth.

We expect to see private consumption recovering further over the next year. There are some indications that unemployment is finally turning towards a slow decline, which should help consumption. Unemployment expectations in the consumer confidence index have also encouragingly declined quite clearly from their peak. In addition, the declines in wages are slowing, further removing one drag from the outlook for consumption.

The improving economic situation has also helped consumer confidence to rise fairly strongly this year. Households see both the general economic situation and the financial situation of households as less dire over the next 12 months than earlier. The consumer confidence index points towards increased spending, but this requires more decisive improvements in employment and incomes.

Inflation still at modest levels

After a very short deflationary dip Lithuanian consumer prices has turned back to growth. Inflation has been boosted by accelerating food, electricity, alcohol and tobacco prices. The decline in wages is also starting to reverse, giving a further boost to inflation. In addition, the tax hikes implemented to cover the budget deficit have supported consumer prices. As long as unemployment remains high and the domestic economy weak, inflation is unlikely to accelerate significantly. Thus inflation is seen remaining weak over our forecast horizon.

Considering euro adoption the earliest possible target date at the moment seems to be 2014-2015. A later date appears, however, more probable in the current circumstances. First of all, enough fiscal discipline to cut the deficit to below 3% of GDP in 2012 is needed. This requires some tough political decisions, but is likely to be rewarded through a stronger credit rating and thus lower borrowing costs.

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

	2007 (LTLmn)	2008	2009	2010E	2011E	2012E
Private consumption	63,736	3.6	-17.7	-3.5	4.0	5.0
Government consumption	17,638	7.9	-1.8	0.5	0.8	1.0
Fixed investment	27,919	-6.5	-39.9	-9.5	7.0	7.0
Exports	53,371	12.2	-12.5	11.9	7.0	6.8
Imports	66,537	10.5	-28.0	11.0	7.5	7.3
GDP		2.8	-14.7	0.4	3.2	4.0
Nominal GDP (LTLmn)	98,669	111,498	99,568	101,659	106,945	113,682
Unemployment rate, %		5.8	13.7	17.7	16.2	14.5
Consumer prices, % y/y		11.1	4.2	1.3	2.2	2.6
Current account, % of GDP		-11.9	3.8	2.5	1.8	0.3
General govt budget balance, % of GDP		-3.2	-9.2	-7.8	-6.0	-3.0

Budget cuts still needed

As the most severe stage of the crisis has been passed focus has shifted to the longer term structural changes needed to balance the budget and improve the effectiveness of the public sector. A crucial question is how to increase government revenues without hiking taxes significantly, which would result in limiting the households' purchasing power.

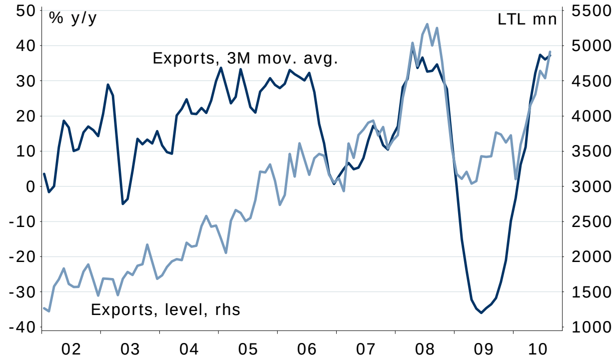
Spending has been cut vigorously, but in order to reach a balanced budget, higher government revenues would be welcome. The budget deficit for 2009 was recently corrected to show a larger than anticipated shortfall of 9.2% of GDP. The road to a balanced budget, or even a deficit below 3% of GDP, is thus still very long.

The risk is that with foreign finances readily available at a currently reasonable cost and the economy recovering the motivation to take politically harsh decisions could wane. This could be especially pronounced in late 2011 ahead of the parliamentary elections in 2012. However, the encouraging result in the Latvian elections in early October supports the current fiscal consolidation path in Lithuania as well. Making the situation potentially more difficult is that the government recently lost the support of a small opposition party. Without that support the government is now two seats short of a majority. Unless the government finds new support this could make it harder to push through new fiscal consolidation measures in the 2011 budget.

Lithuania needs to stabilise its government finances mainly because it needs to safeguard its credit rating, strive towards sustainable growth and fulfil its aim of joining the euro area within the foreseeable future. So far the government has managed without help from international lenders, and has been able to borrow money on the international financial markets. Currently the government is planning to raise approximately LTL 2.3bn from the international financial markets next year. However, for the international markets to remain accessible credibility in the economy needs to be maintained.

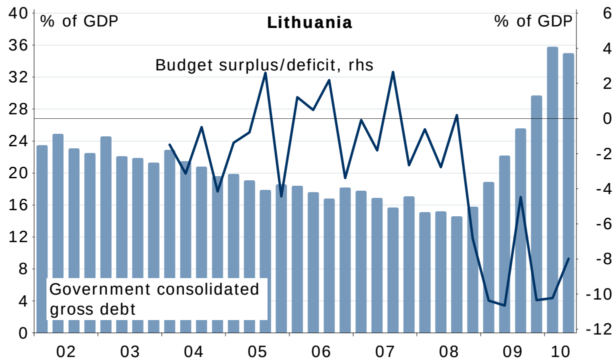
Annika Lindblad
annika.lindblad@nordea.com +358 9 1655 9940

Exports have bounced back strongly

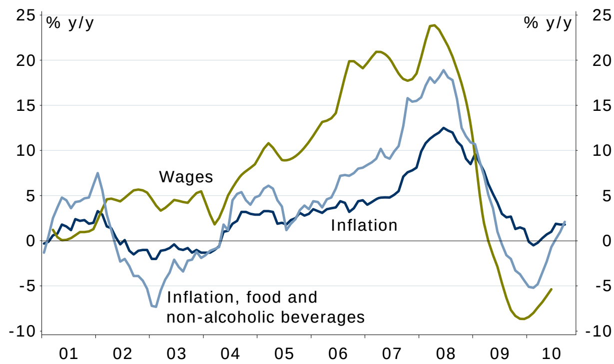


Unemployment turning gradually

Cutting the budget deficit a challenge



Inflation still at modest levels



Higher interest rates

- About to lose some momentum
- High government deficit key risk factor
- Higher interest rates
- PLN could strengthen further

The Polish economy continues to pick up speed and almost all engines are now up and running again after the global crisis. Exports are growing strongly and consumer spending has picked up speed lately. Only investment is still lagging momentum.

However, we expect the economy to start losing momentum late this year and in the first half of next year. Therefore, 2011 is likely to be a year with growth below normal and with annual growth slightly lower than this year. Still, with growth between 3% and 4% compared with a year earlier during most quarters in the next two years, the Polish economy will remain one of the most stable in the region.

Almost all engines are up and running again

The recent improvement of the labour market is supported a gradual shift of growth drivers from external demand and inventory rebuilding to more consumer spending. Indeed, new jobs are being created, especially in the bigger companies, but also in the economy as a whole. As a result, the unemployment rate has dropped more than 1% point since the peak early this year and real wages have started to increase just a bit faster. As a consequence, consumer spending has picked up speed. Retail sales accelerated during the third quarter and especially double-digit percentage increases in new car registrations are encouraging. Moreover, consumer confidence remains elevated and points to fairly brisk spending throughout the second half of the year. On the negative side, loans to households fell during Q3 and there are no indications that higher credit growth could be a supportive factor for consumer spending in the near term.

Investment is still lagging though and prospects remain uncertain. Capacity utilisation in the manufacturing industry continues to increase, but the outlook for demand is still uncertain and credit conditions remain fairly tight. Indeed, business confidence surveys point to a modest pick-up in investment activity in the second half of the year. EU co-financed infrastructure investment is expected to remain high ahead of the European Football Championship in 2012, which Poland hosts together with Ukraine.

About to lose some momentum

We expect the Polish economy to lose some momentum late this year and in the first half of next year. We see three main reasons: first of all, we expect most of the main export markets, including the important German market, to lose momentum at the beginning of next year. Secondly, the domestic economy will be somewhat negatively affected by the modest VAT hike and other fiscal tightening measures. Thirdly, the domestic economy will be negatively affected by the tighter monetary conditions.

We do expect the labour market to continue improving, although the pace of improvement could be slow, but it will not be enough to prevent the domestic economy from slowing in the early part of next year, in our view. Still, the improvement of the labour market puts the domestic economy in a good position to pick up speed again towards the end of next year and in 2012.

High government deficit key risk factor

Fiscal policy is our key domestic concern at the moment. The general government budget deficit is now expected at 7.9% of GDP, which is not only much higher than expected, but also higher than last year despite a much more favourable economic backdrop than initially envisaged in the budget. Moreover, the government expects next year's budget to be around 6.5% of GDP, which is also much higher than previously anticipated.

The government has announced some new measures including a 1% point VAT hike as of 1 January 2011 and a fiscal rule limiting the future growth of public spending. However, more needs to be done to get the budget deficit below 3% of GDP to adopt the EUR. Reducing the number of people eligible for various early retirement and pension schemes has been discussed, but is unlikely to be passed before the general election, which is due by Octo-

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

	2007 (PLNbn)	2008	2009	2010E	2011E	2012E
Private consumption	702	5.3	2.7	2.3	1.9	2.2
Government consumption	211	6.8	2.6	2.2	0.8	0.7
Gross fixed capital formation	254	9.7	-0.7	-1.6	9.2	6.7
Stockbuilding*	34	-1.1	-2.6	1.1	0.3	0.1
Exports	480	5.8	-6.0	12.2	5.4	7.3
Imports	513	6.2	-13.2	10.8	3.6	5.7
GDP		5.0	1.7	3.5	2.9	3.7
Nominal GDP (PLNbn)	1,177	1,275	1,344	1,417	1,505	1,598
Unemployment rate, %		9.8	11.0	11.9	11.4	10.9
Consumer prices, % y/y		4.3	3.7	2.9	3.2	2.5
Current account, % of GDP		-4.8	-2.1	-1.6	-0.9	-1.2
General government budget balance, % of GDP		-3.7	-7.2	-7.9	-6.5	-4.5

* Contribution to GDP growth (% points)

ber 2011. Polls currently put the incumbent government ahead of the opposition, but it is still too early for the government to fell safe and hence there is a significant risk of fiscal slippage ahead of the elections. In case the government gets re-elected with a stronger mandate, we would expect more reforms to reduce government spending and a new plan to join the EMU in 2015. Fiscal slippage poses a risk for the economy because government debt is closing in on the 55%-of-GDP mark, which will prompt further fiscal tightening, because the government will need to continue succeeding in its privatisations to finance the deficit.

Higher interest rates

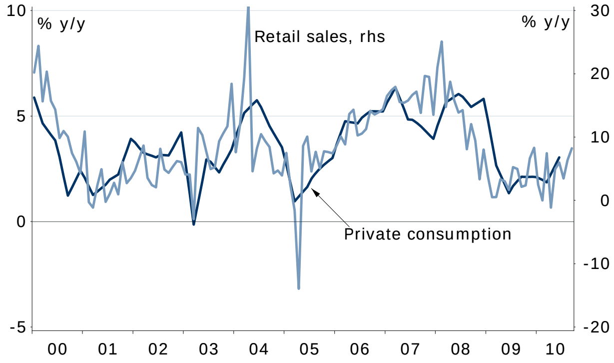
Inflation has started to creep upwards. In September, inflation hit the inflation target mid-point of 2.5% and is expected to continue upwards in the remainder of the year. Moreover, the VAT hike, if modest, will add around 0.5% points to inflation from January and hence we expect inflation around the 3.5% upper-end of the inflation target band during 2011Q1.

Rising inflation has prompted expectations of interest rate hikes. During the NBP's previous three interest rate hiking cycles dating back to 1999, the first interest rate hike was executed at the first monetary policy meeting following the increase in inflation to the inflation target mid-point. Food prices account for more than a third of the increase in consumer prices from a year ago, though, and the same goes for energy prices. Core inflation, which excludes food and energy prices, is thus still low, which provides some comfort for the NBP. Even though we expect core inflation to start increasing significantly as well, we do not see a need for fast or aggressive monetary tightening. We expect interest rate hikes totalling 125 bp during the coming year.

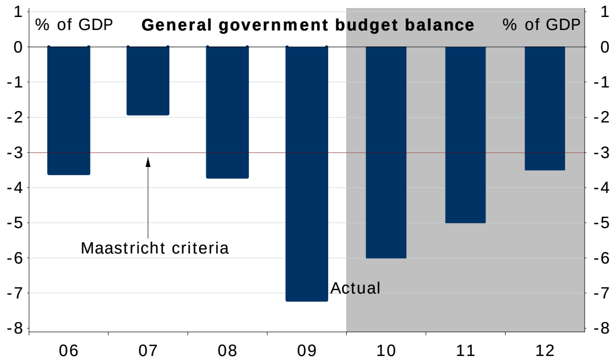
Stronger PLN

The PLN has remained in a fairly tight range during the year, but could strengthen somewhat in the near term. Excess liquidity abroad has spurred capital flows to countries with good growth prospects and higher interest rates, like Poland, especially from foreign investors buying bonds and equities, ie portfolio flows. This trend could continue for some quarters, but will eventually begin to work in the opposite direction, as both the Fed and the ECB will have to start draining liquidity in earnest at some point. In our view, the risks coming from abroad are significant. Expectations of interest rate hikes have also been a key support factor for the PLN recently, as have privatisation-related inflows. These factors in combination with a decent growth rate are the reasons we expect a moderate strengthening trend over the coming years.

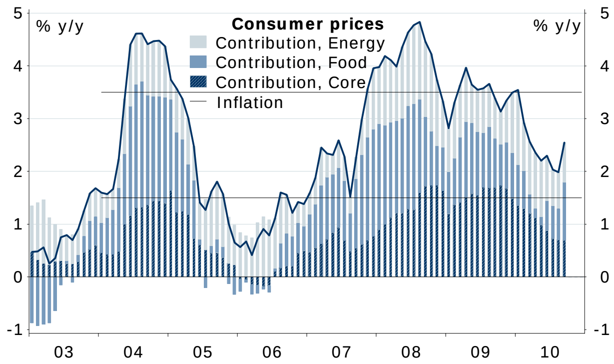
Domestic economy recovering



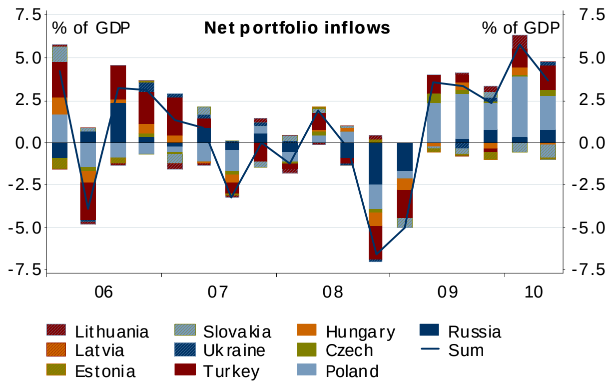
Government budget deficit key risk factor



Inflation creeping upwards



Capital flows support the PLN



Anders Svendsen
anders.svendsen@nordea.com +45 3333 3951

Hopes on domestic demand

- More modest growth in H2 2010
- Interest rates stable, first hikes in Q1 2011
- RUB seen stronger and more volatile

Economy picking up at a moderate pace

After a rather robust recovery in H1 2010, with Q2 growth of 5.2% y/y, Q3 was a bit of a disappointment. The summer drought hit the agricultural sector and consequently output in August was nearly 20% lower than last year. Fortunately, the negative development in the agricultural sector did not result in major damage to other sectors, as industrial production surprised positively, growing 7% and 6.2% y/y in August and September. Net exports have contributed negatively to GDP growth lately, with growth in imports reflecting a pick-up in domestic demand. Consumption will continue to be supported by robust real wage growth, personal credit rates back to pre-crisis lows, and close to potential unemployment levels. Lastly, we have also observed improvement in investment growth and expect it to further contribute positively to economic activity. While we see higher GDP growth in Q4, average y/y growth is unlikely to exceed 5% this year.

Inflation risks are not over yet

Due to the supply-side shock, inflation increased in August and September, led by price increases unusual for this period. While the latter trend moderated in October, it is still too early to call off accelerated price changes. Risks of further price rises persist in case higher prices of some food products lead to higher prices of other food products where they are used as inputs. An additional boost is expected from government spending, which is usually higher towards the year-end. As a result, we see inflation at high levels, ending the year above 8% y/y.

Going forward, another worrying development is money supply growth, which affects consumer prices with long lags, now pointing towards additional inflationary pressures in Q1 2011. This trend will be amplified if foreign capital inflows continue on higher oil prices, as the central bank recycles reserves to domestic rouble liquidity. That said, there is still slack in the economy and hence downward pressure on wage growth and inflation. The planned increase in domestic bond issuance from MinFin will also help mop up excess rouble liquidity, capping money supply growth in 2011.

Politics – business as usual

Political turmoil in the Moscow city government resulted in Mayor Yuri Luzhkov's dismissal in September. While there has been speculation that Luzhkov being fired might introduce tension between Russia's leaders – Putin and Medvedev – so far they have been showing cooperation. The newly appointed mayor, Putin's protégé Sergei Sobyanin, served as Putin's deputy prime minister and was head of Medvedev's election staff in 2008. So, his appointment is a step towards reuniting the Kremlin and Moscow, the city producing a quarter of Russia's output.
The outlook for parliamentary and presidential elections in December 2011 and March 2012 has thus not changed: the dominating United Russia looks set to win the parliamentary elections, while either Putin or Medvedev will likely take the presidential post. One way or another, no drastic changes in the policy course are expected.

Externally, Russia slowly but surely moves towards WTO membership, with the final issues expected to be solved within the next twelve months. While it sounds like something we have heard before, the finalisation process may now be closer than before. Joining the WTO will improve Russia's image in foreign investors' eyes – a prerequisite for attracting portfolio and FDI flows.

Privatisation as a boon to the economy

The mass privatisation plans have been moved a step forward in recent months, with the current version being mainly competitive asset sell-offs to the tune of nearly USD 60bn from 2011 to 2015. Among the planned sale of shares is nearly 900 companies in finance, transportation, agriculture and power production, including the largest banks VTB and Sberbank and the oil producer Rosneft.

Privatisation is clearly a win-win situation for the Russian economy. It will help the government supplement the financing from domestic borrowing and tax increases (the current budget draft assumes USD 10bn/year until 2013 from privatisation sources). Secondly, the reduction

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

	2007 (RUBbn)	2008	2009	2010E	2011E	2012E
Private consumption	16,193	11.2	-7.6	3.7	5.8	6.5
Government consumption	5,745	2.5	2.0	1.4	2.0	2.3
Fixed investment	6,984	10.0	-16.5	3.0	5.5	6.5
Exports	10,029	0.5	-4.6	8.0	5.0	6.3
Imports	7,138	15.0	-30.2	15.0	13.5	9.0
GDP		5.6	-7.9	4.8	5.4	5.5
Nominal GDP (RUBbn)	33,258	41,445	39,064	43,908	49,045	55,176
Unemployment rate, %		5.6	7.5	7.5	6.5	5.8
Consumer prices, % y/y		14.1	11.7	6.9	7.3	7.2
Current account, % of GDP		6.2	3.9	4.7	3.5	2.7
Central govt budget balance, % of GDP		4.1	-5.3	-4.9	-3.8	-3.0

of state assets will attract foreign private capital, just like in 2007 at the successful sale of Rosneft and Sberbank stakes, and improve foreign investors' perception of Russia as the state's role decreases. Finally, privatisation is a move toward modernisation, transparency and improved corporate governance in the target companies, which the government will likely take care of before selling to get a better price for the deals. The latter is supporting equity prices of the target companies and will continue to do so.

Interest rates reflect ample liquidity

The Central Bank of Russia (CBR) has kept refi rates stable at 7.75% since June. While the rate cycle is clearly at the bottom, the CBR is not ready yet to make the turn, saying the economy is still "fragile" and that global growth risks remain. That said, the official inflation forecasts have been changed from 6-7% to above 8% for this year, and the rhetoric has shifted from "food prices only" to "food prices and money supply growth". So, assuming that no external shocks (capital flight) will occur, base rates will likely be hiked in Q1 2011 to contain prices.

Interbank rate volatility has decreased over the summer, and due to ample liquidity in the banking sector, overnight rates are "stuck" at the lower end of the CBR's rate corridor. We expect to see rates at low levels for a few months to come, especially given the outlook for additional rouble liquidity from spending at the end of the year. As we move into 2011 and the CBR introduces measures to absorb liquidity, helped by domestic government bond issuance, rates will gradually move up.

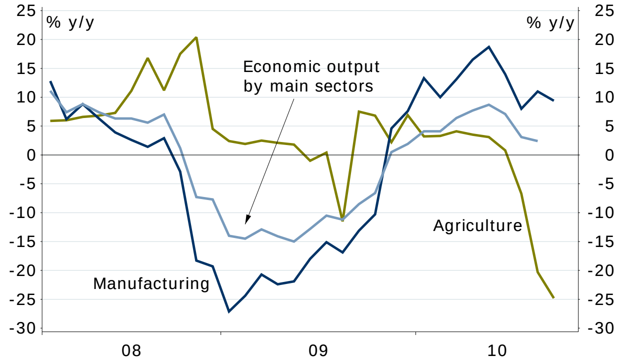
More flexible RUB ahead

After a period of stability in the bi-currency rouble basket during the summer, we observed sharp movements in September, as the basket depreciated somewhat. The latter can be explained mainly by corporate transactions (demand for foreign currency to execute deals) as well as a deteriorating trade balance. We expect to see slower import growth in the next few months, while exports will be supported by recently higher oil prices. As regards the financial account, private capital outflows in Q1-Q3 will be substituted by inflows in Q4, thus bringing the full-year balance towards zero.

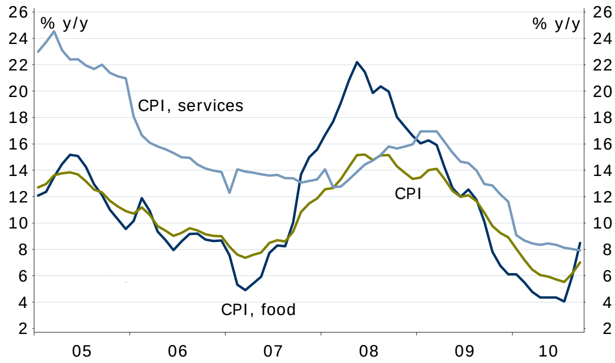
Going forward, unless there is another liquidity squeeze globally, private financial flows are expected to resume and become a supportive factor for the rouble. With oil prices comfortably above USD 70/bbl., the natural path for the rouble is gradual appreciation. That said, exchange rate volatility cannot be ruled out. As the CBR recently widened the floating band and will continue to reduce its presence in the FX market, the rouble is set to become more flexible and less predictable in the future.

Aurelija Augulytė
aurelija.augulyte@nordea.com +45 3333 6437

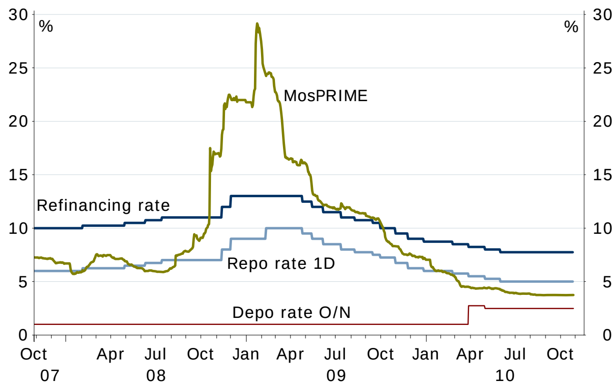
Economic growth slows down, agriculture hit



Consumer prices driven by food inflation so far



Interbank rates squeezed into the corridor



Rouble – no strict bands, wider floating range now

Nordea, Markets Division
Nordea Bank Norge ASA
17 Middelthuns gt.
PO Box 1166 Sentrum
N-0107 Oslo
+47 2248 5000

Nordea AB (publ)
10 Hamngatan
SE-105 71 Stockholm
+46 8 614 7000

Nordea Bank Finland Plc
Aleksis Kiven katu 9, Helsinki
FIN-00020 Nordea
+358 9 1651

Nordea Bank Danmark A/S
3 Strandgade
PO Box 850
DK-0900 Copenhagen C
+45 3333 3333