

# Baltic Rim Outlook

November 2008



## Risk of recession

Since our latest issue of Baltic Rim Outlook, the global economic outlook has sharply deteriorated. The Baltic Rim countries are of course also hit by the financial crisis, but the impact has varied quite significantly so far. The Baltic countries, in particular Estonia and Latvia that have experienced the strongest upswing, are now facing a severe downturn, but growth is also slowing considerably in Lithuania, Poland and Russia.

The pace of the slowdown in **Estonia** has been faster than expected and the economy is projected to contract markedly through 2008 and 2009 and to show only modest growth in 2010. Labour market flexibility in terms of rapid wage adjustment and swift reallocation of labour from declining industries to expanding and more productive ones is the key adjustment mechanism of the economy. The political commitment to the currency peg is strong, and we expect the currency board to hold.

The outlook for growth has also continued to deteriorate in **Latvia**. Along with a weakening housing market, credit growth has slowed rapidly. The sharp contraction of consumption and investment will ease inflationary pressures, but only gradually. The lat is currently under pressure, but in our baseline scenario we expect the currency peg to hold.

The **Lithuanian** economy still grew quite briskly in H1 2008, partly fuelled by sizeable personal income tax cuts implemented in Q1. However, the economy is heading towards a period of slower growth and during 2009 the Lithuanian economy is projected to contract, as the domestic economy is weak and external demand subdued due to the global downturn.

**Poland** has steered more or less clear of any direct impact of the financial crisis so far, but is certainly exposed to indirect effects such as tighter credit conditions, lower export market growth and a marked slowdown or even reversal of capital inflows. Consequently, we have revised down our GDP forecast for 2009, though we still expect a gradual upswing starting in the second half of next year. Poland now targets EMU membership on 1 January 2012

The global financial crisis hit the **Russian** economy in Q3 on top of the sharp fall in oil prices since July and the military conflict with Georgia in August. Sizeable capital inflows in 2007 and H1 2008 have turned into outflows during the autumn as investors have pulled money out of the Russian economy. The Russian authorities have reacted rapidly to the crisis with a rescue package worth more than 10% of GDP. In spite of these supportive measures we expect that growth will slow further in 2009.

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## Editorial deadline:

18 November 2008

**Currency forecasts (against DKK)**

	18-Nov-08	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	10.50	10.66	10.66	10.66	10.66
LTL/DKK	2.16	2.16	2.16	2.16	2.16
PLN/DKK	1.94	1.91	1.94	1.99	2.13
RUB/DKK	0.29	0.26	0.25	0.24	0.25

**Currency forecasts (against NOK)**

	18-Nov-08	3M	6M	12M	24M
EEK/NOK	0.57	0.54	0.52	0.51	0.51
LVL/NOK	12.59	12.00	11.71	11.43	11.36
LTL/NOK	2.59	2.43	2.37	2.32	2.30
PLN/NOK	2.33	2.15	2.13	2.13	2.27
RUB/NOK	0.22	0.20	0.19	0.19	0.20

**3M interbank rate forecasts**

	18-Nov-08	3M	6M	12M	24M
Poland	6.71	6.25	5.70	5.20	4.30
Estonia	7.02	6.20	5.70	5.50	5.50
Latvia	11.18	10.20	9.00	8.00	7.00
Lithuania	7.65	6.40	5.90	5.50	5.50
Russia	21.17	14.00	12.00	10.00	10.00

**Currency forecasts (against EUR)**

	18-Nov-08	3M	6M	12M	24M
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.71	0.70	0.70	0.70	0.70
EUR/LTL	3.45	3.45	3.45	3.45	3.45
EUR/PLN	3.84	3.90	3.85	3.75	3.50
EUR/RUB	34.63	37.60	38.70	38.90	36.40

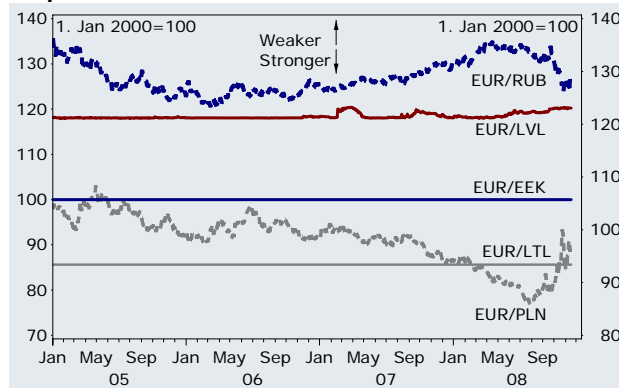
**Currency forecasts (against SEK)**

	18-Nov-08	3M	6M	12M	24M
EEK/SEK	0.650	0.623	0.614	0.601	0.588
LVL/SEK	14.329	13.929	13.714	13.429	13.143
LTL/SEK	2.943	2.824	2.780	2.722	2.664
PLN/SEK	2.650	2.500	2.494	2.507	2.629
RUB/SEK	0.258	0.223	0.212	0.206	0.218

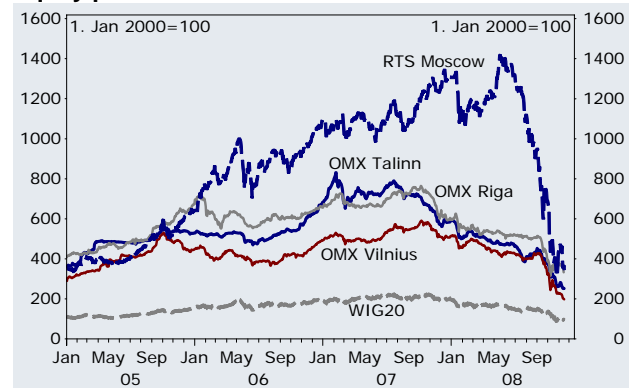
**3M interbank rate forecasts (spread to the Euro area)**

	19-Nov-08	3M	6M	12M	24M
Poland	2.56	2.95	2.80	2.40	1.50
Estonia	2.90	2.90	2.80	2.70	2.70
Latvia	7.03	6.90	6.10	5.20	4.20
Lithuania	3.50	3.10	3.00	2.70	2.70
Russia	17.02	10.70	9.10	7.20	7.20

**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	4.2	60.0	6.3	-15 / +15	
Estonia	2.7	10.9	3.5	-	0/0	2012
Latvia	0.1	15.8	9.5	5.8	-1.0 / +1.0	2013
Lithuania	-1.2	11.0	17.0	4.9	0/0	2012
Poland	-2.0	4.3	44.9	6.0	-11.9 / 8.2	2012

All data are from 2007, except the inflation rate

\* Weakest and strongest daily spot close of the last two years relative to the average the same period.

**Country facts Estonia**

Area	45,226 km <sup>2</sup>	President	T. H. Ilves
Population	1.3 mn	Next election	Fall 2011
GDP/capita	21800 USD*	Prime minister	A. Ansip
Currency	Kroon	Next election	March 2011

**Country facts Latvia**

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

**Country facts Lithuania**

Area	65,300 km <sup>2</sup>	President	V. Adamkus
Population	3.6 mn	Next election	June 2009
GDP/capita	16800 USD*	Prime minister	G. Kirkilas
Currency	Litas	Next election	October 2012

**Country facts Poland**

Area	312,679 km <sup>2</sup>	President	L. Kaczynski
Population	38.5 mn	Next election	October 2010
GDP/capita	16200 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	140.7 mn	Next election	March 2012
GDP/capita	14800 USD*	Prime minister	V. Putin
Currency	Ruble	Next election	December 2011

## Low pressure to intensify

- The recession deeper than previously expected.
- Domestic demand in steep decline.
- The recovery delayed due to global downturn.
- Cooling economy eases inflationary pressures.

### Deeper-than-expected recession

The Estonian economy started to cool down during 2007. The pace of the slowdown has been faster than expected. GDP growth has plummeted from double-digit levels to below zero in little more than in a year. Annual growth is expected to settle close to -2% in 2008, and the economy is projected to contract markedly through 2009.

The GDP flash estimate for Q3 2008 growth published in November showed output falling 3.3% y/y. The weak GDP figure is well in line with other signs of falling activity in the latter part of 2008. Both the decline in retail trade and industrial production steepened in the third quarter. Consumer and business confidence indicators dropped sharply. The output of main export industries, such as wood products, deteriorated – except for metal and electronic products.

Real estate prices are falling and construction is slowing sharply. Credit growth has eased markedly and currently the credit stock is growing less than 1% month-on-month.

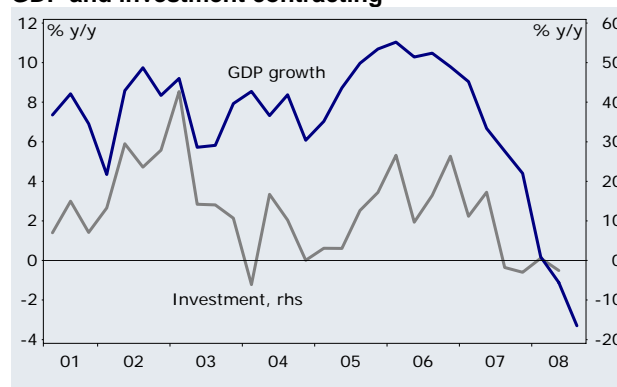
Private consumption will be badly hit as the weak housing market and rapid inflation will depress purchasing power. Falling house prices will lower consumption through wealth effects and plummeting confidence. Private consumption is expected to decline this year and to continue shrinking in 2009. Consumption spending will not speed up until inflation is in check and house prices have stabilised. We expect investment to fall clearly through 2008 and 2009 as construction contracts rapidly.

The external environment is also expected to be challenging due to the ongoing financial crisis. The US-led slowdown is forecast to stretch to 2010 and it will be deeper than previously expected. During next year growth will stall both in the Euro area and in the US. Estonia's biggest trading partners, Finland and Sweden, are also going

through a period of very weak growth. In Sweden the economy is projected to contract in 2009, and in Finland the economy is expected to grow by a mere 0.5%. This will be reflected in weaker growth in external demand for the Estonian economy.

The correction in the housing markets is likely to continue well into 2009. Private consumption and investment will gradually gather pace, but this will not materialise until 2010. Also external demand starts to gain strength, but only gradually. GDP is therefore expected to continue contracting through next year and to show only modest growth in 2010.

### GDP and investment contracting



### Inflation to ease

Inflation was the main worry in many economies last autumn, as food and energy prices soared. Estonia was no exception, as consumer price inflation hit 11% during the summer. Domestic overheating contributed markedly to surging inflation, with annual nominal wages hikes reaching 20%. The increases in excise taxes on alcohol and tobacco also contributed to price increases during 2008. The real economy is currently cooling down rapidly, which has started to bring wage growth down. It is still too early to assess whether the labour markets will turn out to be flexible enough to support employment developments during the recession. Wage trends in the coming quarters will show how swiftly upward drifting inflation expectations will return to sustainable levels. If wages keep rising as economic activity contracts, rising real wages will exacerbate the decline in the econ-

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

	2005 (EEKmn)	2006	2007	2008E	2009E	2010E
Private consumption	93,835	12.7	7.9	-1.9	-3.1	0.9
Government consumption	29,942	1.8	3.9	2.7	-2.0	0.6
Fixed investment	53,742	19.5	4.8	-5.3	-7.7	1.0
Exports	138,550	11.6	0.0	-4.0	-1.0	2.3
Imports	149,560	20.4	4.2	-6.0	-2.2	1.8
GDP		10.4	6.3	-2.1	-3.3	1.0
Nominal GDP (EEKmn)	173,530	205,038	238,929	258,999	263,402	275,255
Unemployment rate, %		5.9	4.7	5.2	7.2	8.4
Consumer prices, % y/y		4.4	6.7	10.5	5.0	3.5
Current account, % of GDP		-17.0	-18.5	-11.5	-8.5	-7.5
General govt budget balance, % of GDP		2.9	2.7	-1.5	-2.5	-2.0



omy by eroding competitiveness. In this worst-case scenario unemployment would rise faster than projected, which would strengthen the self-reinforcing downward spiral of the economy by curbing consumption and housing demand further.

Therefore, labour market flexibility in terms of rapid wage adjustment and swift reallocation of labour from declining industries to expanding and more productive industries is the key adjustment mechanism of the economy. This mechanism is yet to be tested, even though it seems that wage growth has started to respond to the slowdown in the real economy.

**We expect the currency board to hold**

The fiscal balance will deteriorate in 2009 despite the public expenditure cuts and the postponement of certain tax cuts. The rapid downturn will inevitably lead to falling revenues. We do not, however, expect the deficit to exceed the 3% threshold of the Maastricht Treaty.

We expect the currency board to stay in place in case of the projected outlook, even though some speculation will probably emerge as the economic slump deepens. If the current recession turns into a full-blown depression with sky-rocketing unemployment and plummeting output, the risk of devaluation will also increase. Another risk is contagion effects in case of devaluation in some other Baltic country.

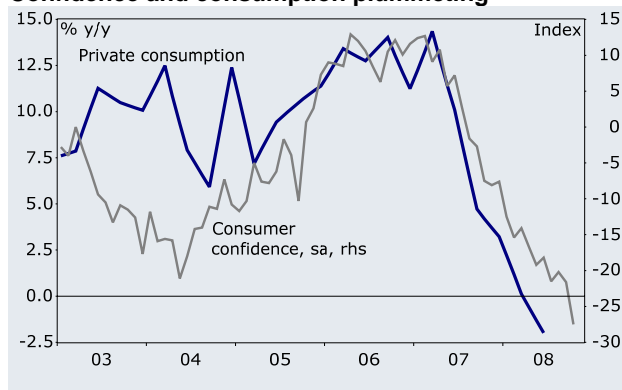
The political commitment to the currency peg is strong, and it will likely take a deep depression to shake that. And as about 75% of lending is in foreign exchange, mostly in euros, the devaluation could lead to more harm in terms of bankruptcies and insolvencies than good in terms of swiftly restored price competitiveness.

**Anssi Rantala**

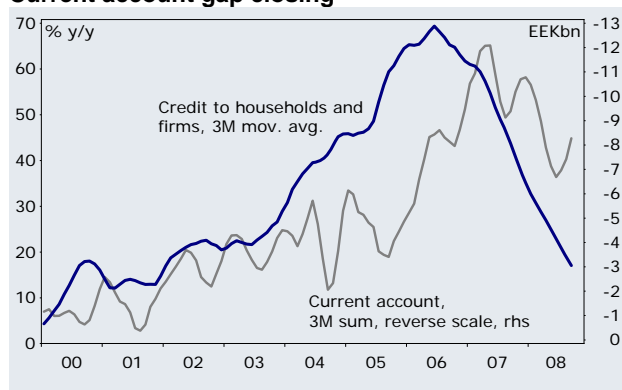
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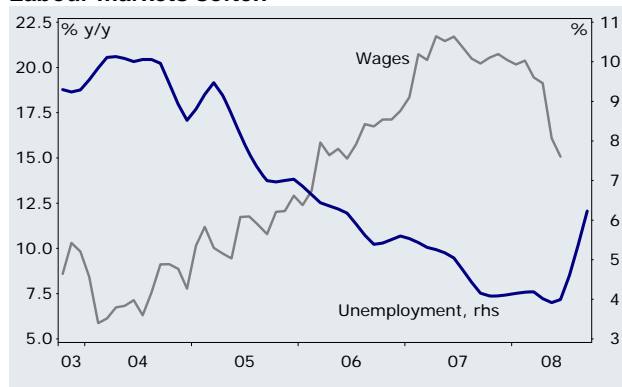
**Confidence and consumption plummeting**



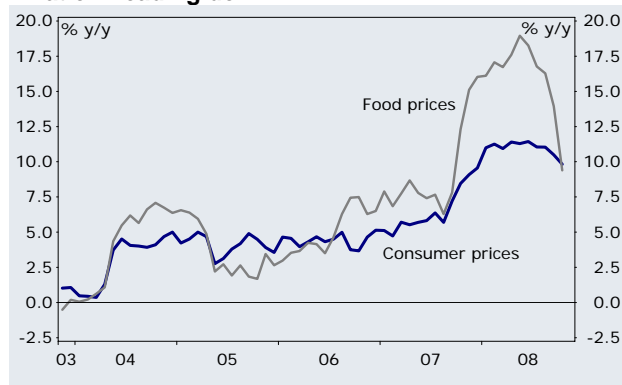
**Current account gap closing**



**Labour markets soften**



**Inflation heading down**



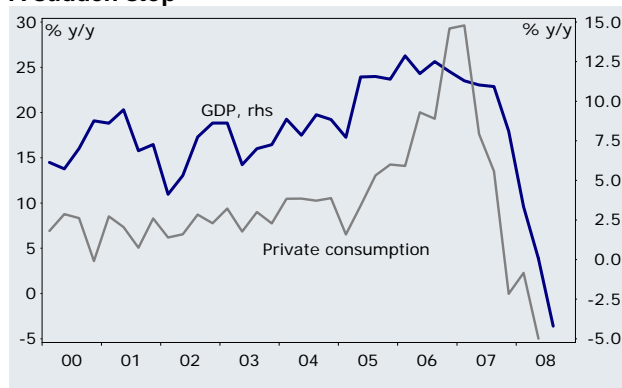
## A prolonged recession

- The Latvian economy contracting sharply.
- Housing markets still weakening.
- Inflationary pressures to ease.
- Currency peg under pressure.

### Domestic economy contracting

The outlook for growth has continued to deteriorate. Retail sales have fallen clearly from year-earlier levels and confidence indicators have fallen markedly. Industrial production has also declined. We forecast the Latvian economy to contract markedly through 2008 and 2009 as the indebted private sector adjusts to living within its means after the credit boom. GDP is projected to fall by more than 4% in 2009.

### A sudden stop



The Q3 GDP flash estimate showed a decline of 4.2% from the previous year. Both private consumption and investment have very likely decreased during Q3. The growth figures in the coming quarters will most likely be even more negative than the latest release.

Along with a weakening housing market, credit growth has slowed down rapidly. Trends in the housing market suppress the development in the Latvian economy in various ways. The direct impact comes via falling housing investments. Private consumption will also be depressed by the weak housing market through negative wealth effects and the fall in consumer confidence. Cooling housing markets will depress consumption also

through declining employment and weaker income growth.

The Latvian economy had been growing way too fast in recent years. The boom fuelled by strong credit growth cannot continue forever. The problem is not so much the level of credit stock, although it is relatively high currently, but the speed of change, which clearly was unsustainable. The adjustment to a sustainable and slower GDP growth track is now underway, and the correction is very rapid.

We expect to see a clear outright decline in both investment and private consumption in 2008-2009. Growth in consumption and housing investment is not likely to resume until housing prices have stabilised.

The external environment is also projected to be very challenging due to the financial crisis and its impact on the real economy around the world. Therefore, export demand is expected to remain subdued for the forest industry. The transport, storage and communication industries performed well in 2007, but growth turned out to be of a temporary nature. In addition, as Estonia and Lithuania are Latvia's biggest trading partners, the downturn in the two other Baltic countries will be directly transmitted to the Latvian economy through weaker export demand. In addition, the Russian outlook has deteriorated rapidly due to falling oil prices and the current financial crisis.

### Inflation pressures fading away?

Inflation in Latvia has skyrocketed recently, led by soaring food and housing-related prices. Inflation reached almost 18% before heading down. Accelerating inflation cannot be explained solely by external developments like food prices in international markets and the rising oil price. The domestic overheating is in the case of Latvia a clear contributor. Service sector prices for example in hotels, cafes and restaurants are still rising rapidly, and wages increased by over 30% last year.

The sharp contraction of the economy will ease inflationary pressures, but only gradually. This year's excise tax increases have boosted inflation, and the price increases in heating energy and gas prices in October further postpone the decline in inflation. The annual average infla-

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

	2005 (LVLmn)	2006	2007	2008E	2009E	2010E
Private consumption	5,666	21.2	14.2	-4.9	-8.0	-2.2
Government consumption	1,581	4.9	4.8	3.7	1.0	1.0
Fixed investment	2,774	16.4	8.4	-6.8	-9.5	-1.8
Exports	4,335	6.5	11.1	2.2	0.0	1.8
Imports	5,638	19.3	15.0	-6.1	-7.0	-1.0
GDP		12.2	10.3	-1.5	-4.2	-0.5
Nominal GDP (LVLmn)	9,059	11,172	13,957	15,953	16,559	17,304
Unemployment rate, %		7.0	5.7	5.3	8.5	9.5
Consumer prices, % y/y		6.6	10.1	15.8	8.0	5.0
Current account, % of GDP		-22.5	-22.9	-14.0	-10.0	-8.0
General govt budget balance, % of GDP		-0.2	0.1	-2.5	-4.5	-5.5

tion will settle above 15% this year.

**The lat under pressure**

The lat has recently been on the weaker side of the +/-1% trading band against the euro. The central bank has been forced to intervene in the FX market in order to support the currency.

The projected outlook consists of a relatively deep recession combined with record-high inflation this year. The fiscal balance is deteriorating markedly due to rapidly shrinking revenues. The current account deficit is still sizeable, even though the gap is contracting. In our baseline scenario we expect the currency peg to hold. In order to navigate through the rough times without a major currency crisis, the Latvian labour markets need to show flexibility. Wage growth needs to be in check, so that employment losses are minimised and inflationary pressures start to ease. Some easing of wage growth has occurred already. Wage growth exceeded productivity growth by a wide margin during the boom years. Cost competitiveness has deteriorated, and further appreciation of the real exchange rate would be detrimental to the recovery in this situation.

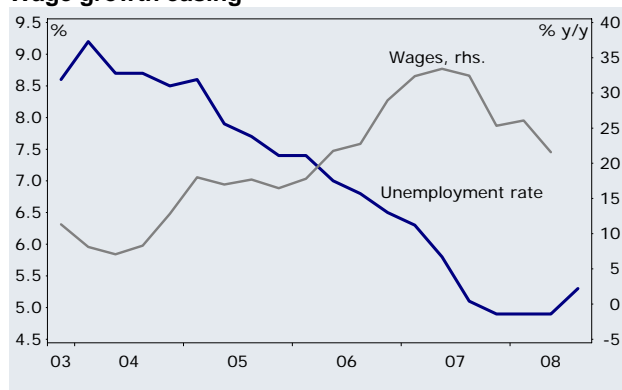
If inflation turns out to be more persistent than projected, which will erode price competitiveness further, and if the slowdown is considerably deeper, the risk increases of an even deeper crisis with sharply rising unemployment and a strong surge in the government deficit. Then the currency peg would be threatened, and devaluation could be used in a desperate attempt to save the economy from a total crash. As over 80% of private sector loans are in euros, a sizeable devaluation would mean a marked increase in debt servicing costs for an average debtor with income in local currency.

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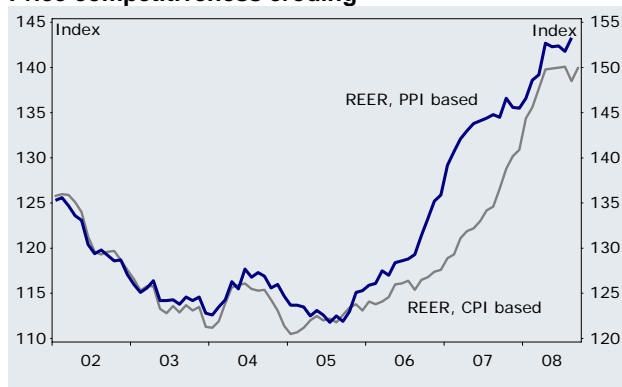
**Wage growth easing**



**Inflation heading down only gradually**



**Price competitiveness eroding**



**Continued volatility in the FX markets**



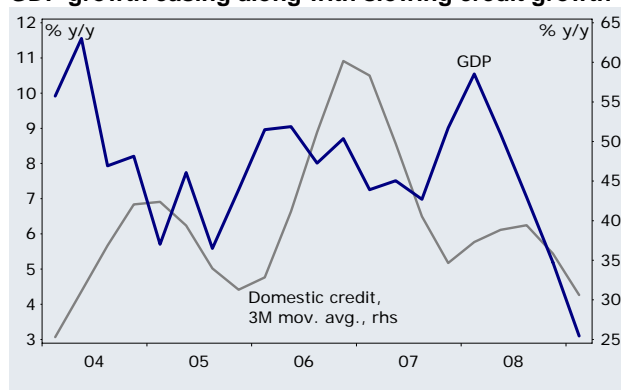
## Tougher times ahead

- Growth about to stall.
- Slowdown in both investment and consumption.
- Slowing inflation depends on moderate wage hikes
- The planned closing of Ignalina would be a further shock to the economy.

### The economy weakening

The Lithuanian economy peaked during 2007 at a growth rate of nearly 9%. In the first half of 2008 growth was still quite brisk, fuelled by sizeable personal income tax cuts implemented in Q1. Private consumption expanded on average by 9%, whereas investment contracted as early as H1 2008 due to the weakness in the real estate markets. Exports grew strongly, but this was explained by the recovery in oil refining. In terms of value added the impact of oil refining is, however, limited. The true export performance of the Lithuanian economy is notably weaker, as industrial production growth excluding refined petroleum products has actually stalled this year.

### GDP growth easing along with slowing credit growth



The Q3 GDP flash estimate released in October was 3.1%. Retail sales growth slowed down almost to zero in Q3, which suggests that easing private consumption growth pulled growth down in Q3. Industrial production also showed much weaker growth than in previous quarters.

The Lithuanian economy is heading towards a period of slower growth. Investments are depressed by the plum-

meting construction activity, and consumption spending will ease as real income growth and credit growth slow down further and expectations about future incomes are scaled down. Export growth will be much lower in 2009 and 2010 than during the current year. Part of the slowdown is technical, as the extra boost from oil refining fades away. Export demand will be lower than previously projected, because the global downturn suppresses external demand. The outlook for the most important export markets, Russia and Latvia, is now darker.

Our forecast is that GDP growth will further slow down and settle below 4% in 2008 on average. In 2009 the Lithuanian economy is projected to contract, as the domestic economy is weak and external demand subdued due to the global downturn. Growth will drop way below its potential rate over the next couple of years.

A weaker economy will inevitably show up in rising unemployment, but as long as wage growth reacts downwards to the softening activity, the impact is expected to be limited. Wage growth needs to slow down along with the economy, and resources need to move flexibly from declining sectors to more productive ones. Wage restraint is needed not only in the private sector, but also in the public sector, where wage increases have been rapid. This is important also because the fiscal deficit is expected to grow due to falling tax revenues.

### High inflation risk to smooth adjustment

The real economy is clearly weakening, but inflation is still high. High inflation will weaken the purchasing power of consumers and contribute negatively to consumption growth. Strong price and wage hikes are also problematic because they pose a threat to the cost competitiveness of the economy.

Inflation in Lithuania had trended upwards for a few years due to the strong demand pressures, but prices really surged in the latter part of 2007, as commodity prices in the world market started to push food and energy prices upwards. During the summer of 2008, annual inflation peaked at 12.5%. The true danger in this development is how these changes in food and energy prices feed through to other prices and wages via increasing inflation expectations. When inflation becomes broad-based, it is difficult to drive out of the system. There are

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

	2005 (LTLmn)	2006	2007	2008E	2009E	2010E
Private consumption	46,453	11.9	11.6	5.3	-4.0	-0.5
Government consumption	12,231	3.7	3.3	5.5	3.0	2.5
Fixed investment	16,302	19.4	20.8	-2.5	-6.0	-1.5
Exports	41,440	12.0	4.3	11.4	3.0	2.5
Imports	46,667	13.7	11.6	11.2	-1.4	1.6
GDP		7.8	8.9	3.8	-1.0	0.1
Nominal GDP (LTLmn)	71,380	81,905	96,739	111,153	117,822	123,831
Unemployment rate, %		5.6	4.3	5.4	7.5	8.5
Consumer prices, % y/y		3.8	5.8	11.1	7.0	5.0
Current account, % of GDP		-10.4	-15.1	-13.0	-8.0	-7.0
General govt budget balance, % of GDP		-0.4	-1.2	-2.5	-3.5	-4.0



some signs of these spill-over effects in the Lithuanian economy. Annual wage growth stood above 20% in H1 2008, for example. However, we expect that annual inflation is heading downwards, and that inflation will decelerate notably in 2009-10 as demand pressures ease.

**The economic impact of Ignalina sizeable**

The planned closing of the Ignalina power plant at the end of 2009 poses a special challenge for the Lithuanian economy. In our baseline forecast, we are not taking into account the impact of the possible closing on the Lithuanian economy. If the power plant is closed as planned, the inflation impact will be substantial in 2010. The direct impact would be an addition of about 2% points to annual inflation, as local energy would be replaced by more expensive imported energy from Russia. It would also suppress GDP growth considerably in 2010, as local energy production would fall and imports would grow. In addition to the direct effect of the reduction of local energy production, higher energy prices would suppress growth in other industries. The negative impact on GDP growth in 2010 could be 2-3% points.

**Currency solid as long as political will is firm**

The currency board system faces no imminent risks from internal developments in our baseline scenario for the Lithuanian economy. The currency board is also well placed to withstand turmoil in global financial markets and has not come under any major pressure so far.

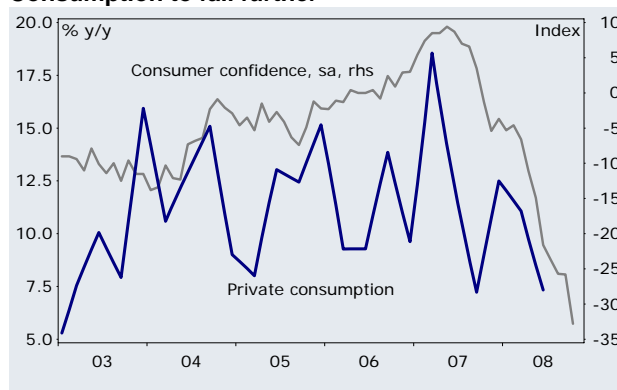
The key question is the strength of the political commitment to the currency peg. As the current economic cycle is even more pronounced in Latvia and Estonia, there might be contagion effects and pressure against the LTL in case of a currency crisis in one of the other Baltic counties.

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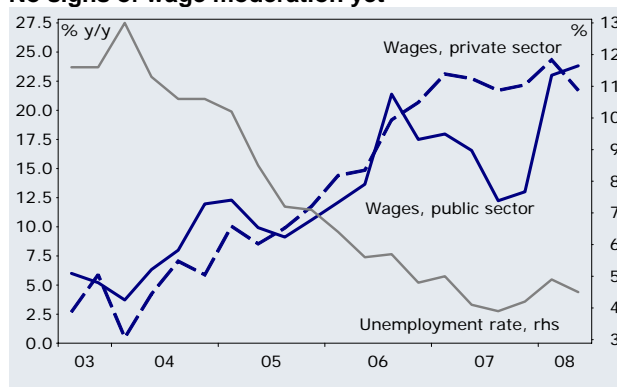
**Consumption to fall further**



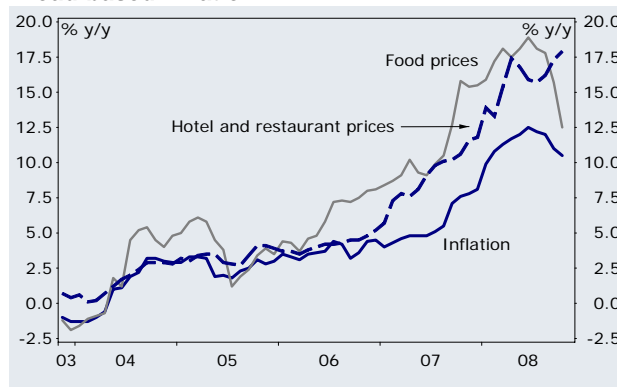
**Investment activity contracting**



**No signs of wage moderation yet**



**Broad-based inflation**



## Steeper slowdown

- No direct impact of the financial crisis...
- ... but tighter credit conditions and weaker exports.
- Lower inflation and interest rates next year.
- EMU in 2012 appears optimistic.

The global financial crisis escalated during the autumn and its adverse effect on growth in the world's leading economies is now likely to become much more severe than previously thought. While Poland has steered more or less clear of any direct impact of the financial crisis so far, the country is certainly exposed to indirect effects such as tighter credit conditions, lower export market growth and a marked slowdown or even reversal of capital inflows. Consequently, we have revised down our GDP forecast for 2009 by two full percentage points to 2.5%. We still expect a gradual upswing from the second half of 2009, though, and see growth around 4% in 2010.

### No direct impact of the financial crisis ...

The direct impact of the financial crisis has been limited in the sense that no banks or major companies have been in need of bailout so far. The reason is probably that the banks have strong positions in local deposits and little direct exposure to the imploded international credit markets. Still, the interbank market froze and funding costs increased, as confidence between international financial institutions evaporated during September and October. After intensified worries about the Hungarian banking sector in the second half of October, the National Bank of Poland (NBP) stepped in with a confidence package, providing liquidity when needed and offering FX swaps daily. In late October, parliament passed a bill that provides a state guarantee for interbank loans and allows direct state lending to troubled banks.

### ... but tighter credit conditions...

At this point, the financial crisis is not over and banking sector risks remain, though the financial system in general is in good condition according to the October Financial Stability Report prepared by the NBP. Indeed, the development to date allows us to assume that we are not facing a period of costly restructuring of the financial system, which means that a deep and lengthy economic downturn may be avoided. Credit conditions are expected

to remain tight, though, and coupled with a much weaker outlook for demand and a marked slowdown or even reversal of capital inflows, investment growth has probably already slowed down significantly. We expect weak investment figures starting from Q3 this year and going into next year, taking the annual growth rate down to just 5% in 2009.

### ... and weaker export markets

The manufacturing sector has started to adjust to the significantly bleaker outlook for the main export markets. Thus, industrial production contracted 3% during Q3 compared with Q2 and the PMI indicator stood at 43.7 in October – the lowest in the history of the indicator – pointing to a marked contraction in manufacturing activity also in Q4 this year. Exports contracted in Q2 in volume terms and may stay weak well into next year. Our current view is that the Euro area is likely to contract in Q4 this year and Q1 next year before gradually picking up pace.

### Weaker private consumption growth

Also households are likely to feel the (indirect) effects of the financial crisis. Average interest paid on new housing loans have increased by 50% since 1 January and the FX denominated part of household lending (around 35%) is hurt by the 15% depreciation of the PLN versus the EUR since early August. Moreover, the labour market has started to weaken, with employment in the manufacturing sector falling a bit off its peak level in March although remaining somewhat higher than a year ago. So far, however, the unemployment rate has not started to increase, but is expected to do so early next year. We see unemployment peaking just below 11% at the end of 2009 up from the current level just above 9%, both in seasonally adjusted terms. As a consequence, real wage growth is expected to slow gradually over the course of next year. Still, the labour market is likely to weaken only gradually and from a relatively strong starting point, and should support decent – though slower – growth in private consumption going forward.

### Lower inflation, lower interest rates

Inflation probably peaked at 4.8% in August and has started to fall. On the one hand, falling food and energy prices together with the significant weakening of the

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

	2005 (PLNbn)	2006	2007	2008E	2009E	2010E
Private consumption	614	5.0	5.0	4.7	3.7	3.5
Government consumption	187	6.1	5.9	1.5	1.0	1.5
Gross fixed capital formation	179	14.9	17.3	8.5	5.0	4.5
Exports	365	14.6	8.4	3.2	2.8	6.0
Imports	372	18.6	12.2	4.9	4.4	5.5
GDP		6.2	6.7	4.8	2.5	4.0
Nominal GDP (PLNbn)	983	1,060	1,175	1,279	1,378	1,482
Unemployment rate, %		16.2	12.7	9.8	10.7	10.8
Consumer prices, % y/y		1.2	2.6	4.4	4.0	2.1
Current account, % of GDP		-2.7	-4.7	-5.0	-4.8	-4.5
General government budget balance, % of GDP		-3.8	-2.0	-2.3	-2.7	-2.5

economy point to rather fast disinflation, while lagged effects of the high energy prices and the weakening of the PLN will contribute to keeping inflation elevated. Moreover, even with slowing wage growth, unit labour costs are likely to continue rising and may add to a continued upward trend in core inflation (excluding food and energy prices). In sum, we see only a modest improvement in inflation.

The NBP has moved towards a neutral bias, but seems to be putting off the first rate cut to the beginning of next year, as the bank sees inflation risks also for 2009. In fact, a motion to *hike* rates in late October was only short one vote! Given that incoming data are likely to remain on the weak side, the first rate cut is more likely to come sooner rather than later, in our view. There are a number of wild cards that make the outlook for growth, inflation and interest rates more uncertain than normal, including oil and food prices and the PLN. We expect rate cuts of a total of 100 bp in 2009, with additional rate cuts of 100 bp in 2010.

The PLN has weakened due to global recession fears, global deleveraging and increased risk aversion. In the near term, the PLN is likely to follow the sentiment in international financial markets. However, once we see some stabilisation, a stronger PLN should be expected, as fundamentals remain relatively good and interest rates are fairly high. Renewed PLN strengthening could move forward the first rate cut.

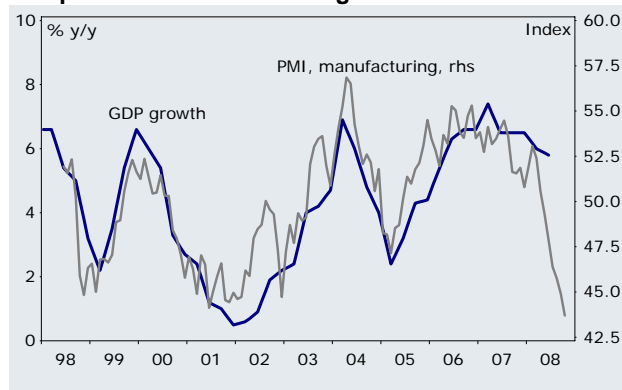
**EMU membership targeted for 2012**

The government has set a target for EMU membership on 1 January 2012. A positive move that signals political will and increases the likelihood of prudent fiscal and monetary policy. However, the new timetable is fairly optimistic for at least two reasons. The first reason is that EMU membership requires a constitutional change, which in turn requires a qualified majority in parliament and hence support from the main opposition party, the PiS. Statements from leading PiS people, including President Lech Kaczynski, confirm our view that tough political negotiations lie ahead. The second reason is that Poland must join the ERM-II no later than towards the end of Q2 2009, which would probably require the needed backing from the PiS and some stability of global financial markets. Should the incumbent government succeed in getting Poland into the ERM-II according to the timetable, it could have a huge positive effect on both the real economic outlook and financial markets.

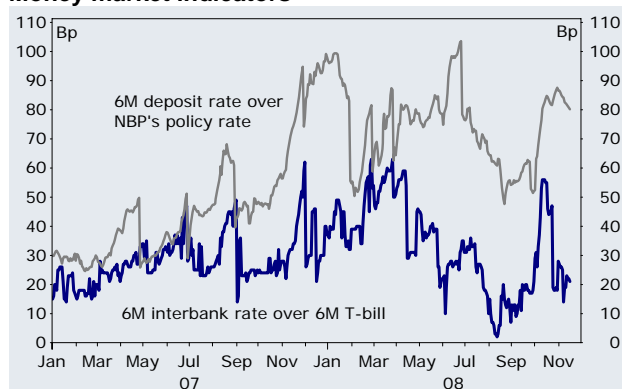
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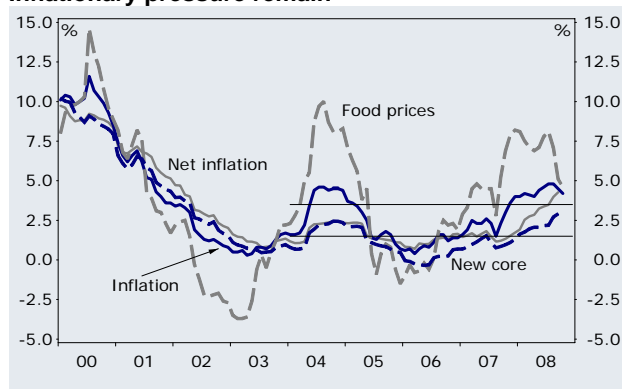
**Steeper slowdown than thought earlier**



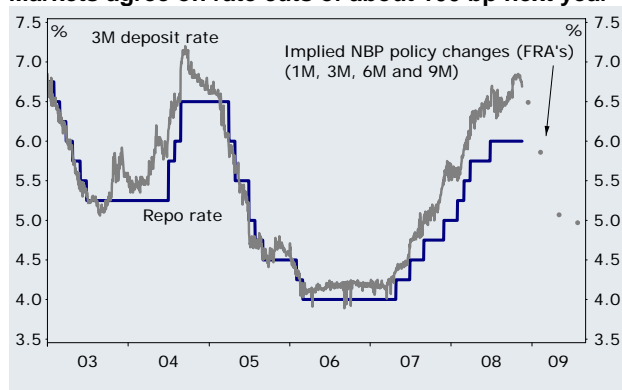
**Money market indicators**



**Inflationary pressure remain**



**Markets agree on rate cuts of about 100 bp next year**



## Hit by the financial crisis and falling oil prices

- Sharp slowdown in growth underway.
- The financial crisis, high inflation and falling oil prices suppress the economy.
- The rouble expected to depreciate gradually.

### Slowdown underway

In H1 2008 GDP growth was still relatively brisk at 8%, even though there were some signs of slight deceleration of growth in retail sales and investment. Surging inflation and strong wage growth suggest that the economy was clearly overheated. Inflation started to cut consumers' purchasing power and monetary policy was tightened during the summer of 2008 in order to curb inflation.

The global financial crisis hit the Russian economy in the third quarter. The interbank markets froze almost completely as foreign funding of Russian banks tightened sharply. Large Russian corporations and banks face serious problems in refinancing their foreign debts. This will considerably limit the companies' ability to invest in the near term. The sharp fall in oil prices since July and the military conflict with Georgia in August have had a sizeable impact on equity valuations in Russia. Sizeable capital inflows in 2007 and H1 2008 have turned into outflows during the autumn as investors have pulled money out of the Russian economy.

The economic policy focus has switched from monetary policy tightening to crisis management. The Russian authorities have reacted rapidly to the crisis. The rescue package contains several measures to improve the liquidity of the banking system and to ease the overall financing situation of banks and corporations. The total sum of the package is more than 10% of GDP. The Russian government has decided to allocate USD 50bn to firms and banks to refinance foreign debts due this year and the next. Also, USD 35bn is reserved to recapitalise the banking sector. The government has also promised to support certain key industries like residential housing construction, car manufacturing and agriculture in addition to tax cuts directed at oil companies.

In spite of these supportive measures we expect that growth will slow further to about 4%, as financing condi-

tions will stay tight, and the oil price is expected to stay below USD 60 per barrel on average next year.

Due to the financial crisis, growth in investment has already slowed down quite considerably. Tighter financing conditions will suppress private consumption as well. The availability of consumer credit is very poor, which will curb durable goods purchases. Car sales are severely hit, as according to some estimates up to 50% of the cars have been bought with credit.

Exports are expected to perform weaker than before. Oil production has stagnated during 2008. In the spring the government decided on the first new tax cuts to boost oil production. Mineral extraction taxation was lowered so that a larger fraction of oil revenues will accrue to the oil industry. Fairly long extraction tax holidays for offshore oil and gas fields were also introduced in order to support exploration. Due to the financial crisis and falling oil prices, the government has slashed oil taxation further. The calculation method of oil export duty has been changed to the benefit of oil companies and a further cut in mineral extraction tax is being debated.

The government measures will boost oil industry profits and are expected to increase the incentive to invest in new production capacity; the impact on oil production and exports will take a long time to materialise, though. Lower oil prices, tight credit markets and lack of confidence in government promises are likely to dampen the enthusiasm for investment.

### Inflationary pressures persist

Inflation has been accelerating since last autumn when food and energy prices in the world market started to rise. This surge in food and energy prices has now turned sharply. Also the impact of the domestic overheating should ease gradually.

Still, we see inflation slowing only modestly. The labour markets are still very tight. The official unemployment rate has dropped close to 6% and nominal wage hikes show no signs of easing. The liquidity support measures to the financial markets can be inflationary. The 5% weakening of the rouble against the twin currency basket since early August will also contribute to price increases

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

	2005 (RUBbn)	2006	2007	2008E	2009E	2010E
Private consumption	10,728	11.2	12.8	11.6	7.0	8.0
Government consumption	3,591	2.5	5.0	2.7	3.0	3.0
Fixed investment	3,837	17.7	20.8	12.1	8.5	10.0
Exports	7,607	7.3	6.4	7.0	2.0	2.5
Imports	4,648	21.9	27.3	21.0	12.5	12.8
GDP		7.4	8.1	6.7	4.1	5.2
Nominal GDP (RUBbn)	21,625	26,880	32,987	39,881	46,302	52,877
Unemployment rate, %		7.2	6.1	5.8	5.8	6.0
Consumer prices, % y/y		9.7	9.0	14.2	12.0	9.0
Current account, % of GDP		9.5	5.8	6.0	-0.5	3.0
Central govt budget balance, % of GDP		7.5	5.5	6.5	-1.0	2.5



through higher import prices, especially as we suspect that this weakening will continue.

**Gradual depreciation of the rouble expected**

Since last autumn and until early June the central bank has not allowed the rouble to appreciate against the twin currency basket, even though inflation was on the rise and strong revaluation pressures existed. The monetary policy tightening cycle was underway during the summer before the financial crisis broke out. The central bank raised the key interest rates during the spring and summer and the mandatory reserve requirements of the banks were raised several times. The central bank announced a new, more flexible exchange rate policy, where the rouble would be allowed to fluctuate more against the basket. In practice this new policy meant that the rouble was allowed to strengthen gradually against the basket during the summer. These measures were intended to curb domestic demand and inflationary pressures by increasing borrowing costs and slowing down bank lending.

When the military conflict with Georgia broke out, the central bank allowed the rouble to depreciate against the basket up to the level of 30.41. During the financial crisis there have been strong devaluation pressures against the rouble. Until 11 November the central bank kept the rouble from depreciating above that level with currency interventions. The 1% devaluation against the basket to 30.71 suggests that the central bank may be willing to widen the fluctuation band gradually, which in the current market conditions implies a step-wise devaluation of the rouble. This would be consistent with the central bank's strategy to move towards an inflation targeting regime with a freely fluctuating rouble.

The central bank's foreign exchange reserves have declined by over USD 100bn since the early August due to interventions and net capital outflows. The FX reserves are still the third-largest in the world, so the authorities do have a lot of ammunition left if they want to support a certain exchange rate level. Thus, they have the ability to engineer a smooth depreciation of the rouble, if so desired.

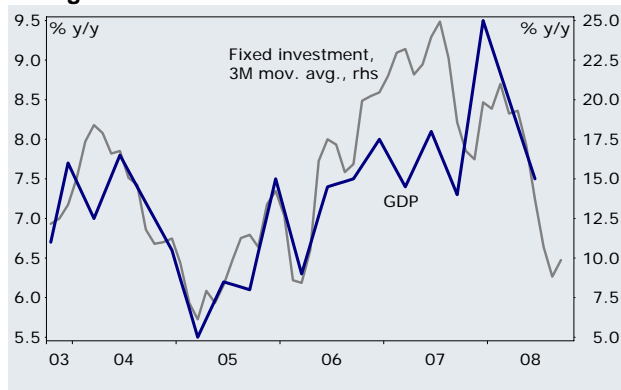
The twin surpluses, ie the current account and fiscal surpluses, of the Russian economy are very sensitive to oil price developments. The average oil price in 2009 is projected to be below USD 60 per barrel, which implies that the surpluses will melt away as early as 2009. We expect the rouble to depreciate by 15% against the basket on a 1-year outlook.

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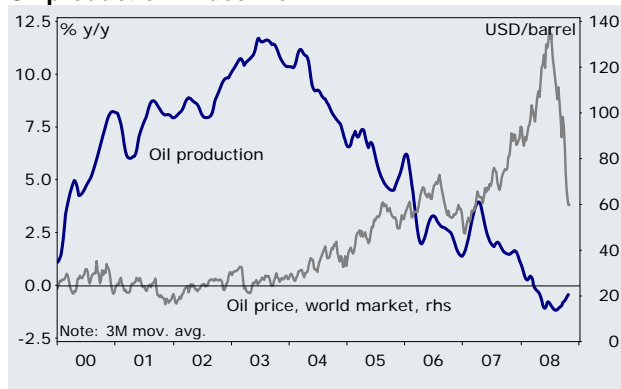
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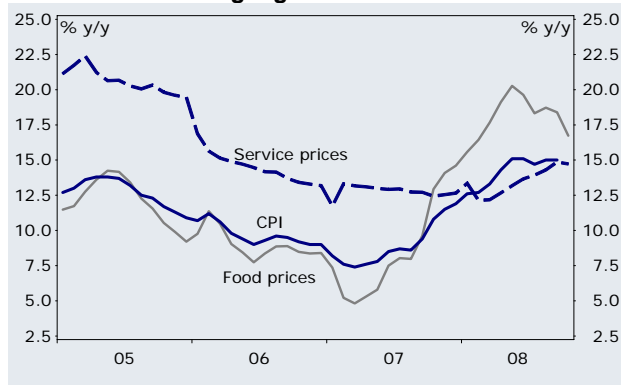
**GDP growth to slow**



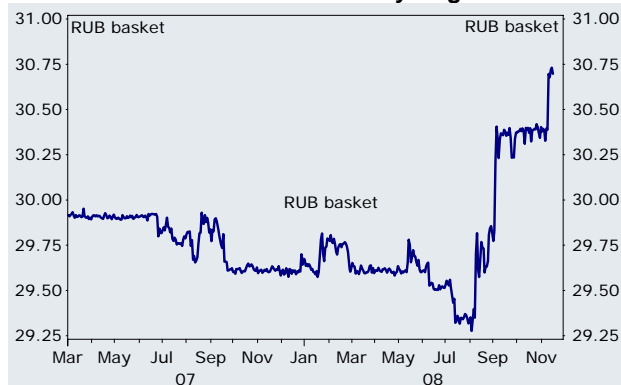
**Oil production in decline**



**Inflation still running high**



**The rouble 5% weaker than in early August**





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