Swedbank

Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies April 22, 2010

Glimmers of light in the tunnel

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Global development

- Worldwide stimulus measures and financial sector support have boosted confidence, and global growth strengthens. However, the rebound is not convincing yet in many of the industrialized economies.
- We raise our global growth outlook to 3.9 % in 2010 and 3.6% in 2011. The unwinding of the stimulus packages will be felt primarily in 2011. In particular, Europe will lag behind, while the emerging markets will be the main engine of growth in the world.

Sweden

- Economic activity unexpectedly fell back in the last quarter of 2009, but strong labour market developments and public finances suggest that the economy has reached firmer ground.
- We lower our real growth forecasts to 1.8% in 2010 and 2.4% in 2011. Despite resilient household consumption, external demand and investments are expected to lag behind. The economic policy stance will remain expansive, however not sufficiently, with the repo rate reaching 1.75 % at end-2011.

Estonia

- Positive quarterly growth rates at the end of 2009 suggest that the bottom of the downturn has passed. Furthermore, data indicate that the Maastricht-criteria for euro adoption have been met, and that improves the prospects of Estonia becoming the 17th member of EMU.
- We expect positive growth rates of 1.5% and 4.5% in 2010 and 2011, respectively. Exports will initially drive the recovery, with domestic demand, boosted by increased foreign investments, taking over toward the end of the forecast period.

Latvia

- The economic slowdown abated at the end of 2009, while domestic cost adjustment continued at full speed. Spring of 2010 brought signs of stabilisation in the labour market.
- The recession is likely to be over in early 2010 driven by export growth, but the recovery will be bumpy and growth fragile. We expect the economy to contract by 2.5% in 2010 due to negative carry-over effects before increasing by 4% in 2011. Fiscal consolidation continues as planned, but “window of opportunities” to carry out structural reforms must be used more intensively.

Lithuania

- The deep recession in Lithuania was mitigated at the end of 2009 by stronger than expected export performance. Unemployment, however, continued to increase and wages fell, dampening domestic demand.
- GDP is expected to fall overall by 2% in 2010, with steady recovery starting in the second half of the year. In 2011, we expect real growth to reach 3%. Exports will recover, while private consumption will improve only modestly. The fiscal situation has stabilized but remains challenging.

From crisis to recovery – conditions for growth slowly improve

Worldwide stimulus measures and financial sector support have boosted confidence among households, companies, and financial markets. As global growth strengthens, a recovery in Sweden and the Baltic countries is taking hold. The conditions for growth have improved, but many challenges remain, both in the short- and long-term perspective.

The global economic environment has become brighter, and during this year global GDP is set to grow by 3.9% due to inventory adjustments, improved confidence, and large stimulus measures from central banks and governments. While many emerging markets are growing strongly, industrial countries – especially the European ones - are lagging behind. The need to deleverage in the private and financial sectors, as well as mounting debts in the public sector with an accompanying risk of increasing financial turbulence, is posing great challenges. Already by next year a number of countries will have raised taxes and lowered public expenditures, thus weakening domestic demand. Labour markets will improve, but unemployment will still remain at high levels. Global GDP is therefore foreseen as growing slower in 2011, by 3.6%.

The polarization between industrial countries and emerging markets regarding growth, is mirrored equally in the different prospects for inflation. Capacity utilisation will stay low in most industrial countries, and inflation pressures remain weak. As fiscal policy also becomes more restrictive, central banks are expected to move their policy rates upwards only slowly. In the emerging markets, meanwhile, capacity is becoming more constrained and price pressures are building up, including the effects from rising commodity prices and large capital inflows.

For Europe – Sweden's and the Baltic countries' most important export markets – there is a need to improve the fiscal situation while avoiding anaemic growth and strains in the eurozone cooperation. The European export market remain crucial to Swedish and Baltic companies in volume terms, and therefore it is important not to lose market share in this prevailing weak economic environment. The direction of trade is shifting towards faster-growing emerging markets, but it takes time to change the geographical structure of exports. Common goals for companies in our region to enhance competitiveness are increased productivity, lower costs, a product structure in demand, and higher value added in production through investments in R&D.

Sweden's economy is also characterized by polarization as exports falter and domestic demand picks up. Compared with last year's fall, the economy is now recovering. Contrary to what normally drives the economy in an upturn, households are the main growth engine, supported by a slow recovery in the labour market and stimulus measures. As the economy unexpectedly shrank in the last quarter of 2009, negative carry-over effects will cause GDP during 2010 to grow slower than previously foreseen, and reach 1.8% in calendar-adjusted terms. Net exports will contribute marginally to growth, and support will instead come from private consumption and from companies starting to restock. As industrial capacity is still low, investment growth will remain negative this year, but then slowly turn positive during 2011. Net exports will then contribute negatively to growth as imports increase faster than exports. Domestic demand will pick up even further and GDP is expected to grow by 2.4%. Inflation pressures are likely to be subdued, and the Riksbank can increase the policy rate slower than previously foreseen. At the end of 2011, it will have reached 1.75%. Also, even though fiscal policy will remain expansive, the general government budget deficit will not exceed 2% of GDP.

The Baltic countries have also reached a phase of recovery after shrinking by some 15-25% in 2008-2009. The overall sentiment towards the region

Macro economic indicators, 2008- 2011

	2008	2009	2010f	2011f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	-0.5	-4.7	1.8	2.4
Estonia	-3.6	-14.1	1.5	4.5
Latvia	-4.6	-18.0	-2.5	4.0
Lithuania	2.8	-15.0	-2.0	3.0
Unemployment rate, % of labour force				
Sweden	6.2	8.3	9.3	9.2
Estonia	5.5	13.8	14.0	11.5
Latvia	7.5	16.9	21.5	19.5
Lithuania	5.8	13.7	16.0	15.5
Consumer price index, annual change in %				
Sweden	3.4	-0.3	1.4	2.2
Estonia	10.4	-0.1	0.5	1.8
Latvia	15.4	3.5	-3.0	0.0
Lithuania	10.9	4.5	1.0	1.0
Current and capital account balance, % of GDP				
Sweden (current account)	9.6	7.2	6.2	6.5
Estonia	-8.4	7.4	8.5	8.0
Latvia	-11.5	11.8	12.4	9.7
Lithuania	-10.1	7.2	4.2	3.0

Sources: National statistics authorities and Swedbank from financial markets, international organisations, and rating institutes has improved. The political environment in each country has supported the process of budget consolidation and deleveraging. The prospects of maintaining the exchange rates fixed to the euro have strengthened, and Estonia is expected to join the euro zone in 2011. The objectives of Latvia and Lithuania are to follow suit in 2014. With a global recovery and these countries' adherence to fiscal consolidation and reforms, the prospects for achieving these objectives will improve.

Estonia's economy is expected to grow by 1.5% this year, and 4.5% the next. Initially, net exports will contribute to growth, but slowly domestic demand will take over as the growth engine, in particular due to inventory adjustment and EU-funded investments. The expected euro membership may also enhance foreign direct investments. Private consumption will remain sluggish but gradually pick up in 2011 in the light of improved confidence, lower unemployment, and slightly higher wages. This implies a short deflation period in the case of Estonia, and, with increasing labour costs, the challenge is to create sufficient competitiveness by enhancing productivity so that the export sector develops positively also in a longer-term perspective. Fiscal policy is expected to remain prudent, but increasingly the government will need to work on long-term issues, including efficiency of the public sector, the tax system, and the level of ambition for public services.

Latvia's recession seems to be over, but the recovery is expected to be slow and fragile. GDP will start to pick up, but in annual terms it will shrink by 2.5% this year due to carryover effects. Then, higher exports will gradually strengthen investments and inventory build-up, thus generating growth of 4% in 2011. Competitiveness has increased as unit labour costs have declined by more than 20% over the last year, and the adjustment is set to continue, although more slowly. The unemployment rate seems to have peaked in April, but the decline will be slow. The fiscal situation is developing according to plan, and the budget deficit will squeeze in below the target of 8.5% of GDP this year. A total consolidation of some 7% of GDP is still necessary to cut the deficit to the 2012 target of 3% of GDP, in order to achieve the goal of euro adoption in 2014.

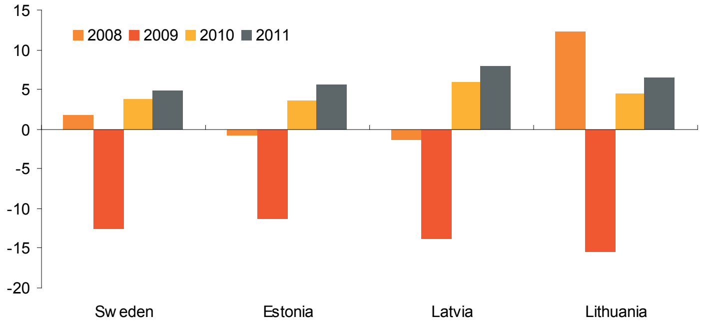
Lithuania's recession became less deep during last year due to stronger export growth than expected. Going forward, the carryover effects will result in a negative growth rate of 2% this year despite quarterly improvements, but a more robust annual growth of 3% will ensue in 2011. Net exports will contribute positively to growth both years, and gradually domestic demand will strengthen as prospects for investments improve, mainly due to EU structural funds. The internal devaluation is set to continue as wages will decrease further. Unemployment will stabilise on a high level, thus encouraging a new wave of emigration among the young. We do not foresee any strong rebound of consumer spending during the forecast period. Public finances have been stabilised, and the government has agreed to a plan with the European Commission to reach a deficit of 3 % of GDP in 2012. As the deficit is seen at 8% this year, the road to euro adoption in 2014 is still long, but not unachievable.

Forecast risks are balanced as the possibilities of reaching higher growth in Sweden and the Baltic countries are more or less equal to the risks of experiencing lower growth. The main areas of uncertainty include the global recovery. Even if the risk for a double dip has decreased, it has not totally disappeared. Commodity prices, exchange rates, interest rates, and equity prices are just a few of the factors that could influence growth and inflation prospects in our home markets. Domestically, risks are geared towards the labour market and the fiscal situation, as well as balance sheets of households and companies. The risks seen apart do not seem serious as such, but together they could change the forecast substantially.

Remaining challenges in our region are many, not least in the medium- and long- term perspective. Globalisation is continuing, increasing competition and at the same time providing new growth opportunities. Demography will lead to a decrease in labour supply, putting pressures on the welfare systems. Sweden's potential growth rate will be difficult to maintain, unless productivity is enhanced by structural reforms. The Baltic countries must work hard on the reform agenda to continue their convergence with the rest of the EU, as the financial crisis and recession have slowed growth. In particular, investments must again be able to strengthen without dependence on EU structural funds. Avoiding tax evasion in the region is another issue. Developing a tax system that is both efficient and effective is much needed to ensure that public finances become sustainable and are in line with welfare goals.

Cecilia Hermansson

Export volumes (change in %)



Sources: National statistics authorities and Sw edbank.

Global growth - but Europe is lagging behind

GDP forecast 2010 - 2012 (annual percentage change) [1/]

			April			January	
		2009	2010	2011	2012	2010	2011
US		-2.4	2.8	2.2	2.5	2.2	2.5
EMU countries		-4.0	0.9	1.3	1.9	1.1	1.6
Of which:	Germany	-5.0	1.3	1.5	2.0	1.5	1.8
	France	-2.2	1.5	1.8	2.2	1.6	2.0
	Italy	-4.9	0.6	1.0	1.5	0.7	1.2
	Spain	-3.6	-0.5	0.7	1.7	-0.1	1.3
UK		-4.8	1.1	1.6	2.2	1.0	1.9
Japan		-5.3	2.0	1.4	1.5	1.2	1.5
China		8.6	9.5	8.8	8.0	8.5	7.8
India		6.5	7.5	7.8	8.0	7.0	7.5
Brazil		-0.4	4.7	4.5	5.7	3.5	4.5
Russia		-7.9	4.3	4.5	5.0	4.3	4.5
Global GDP		-0.9	3.9	3.6	3.9	3.3	3.5

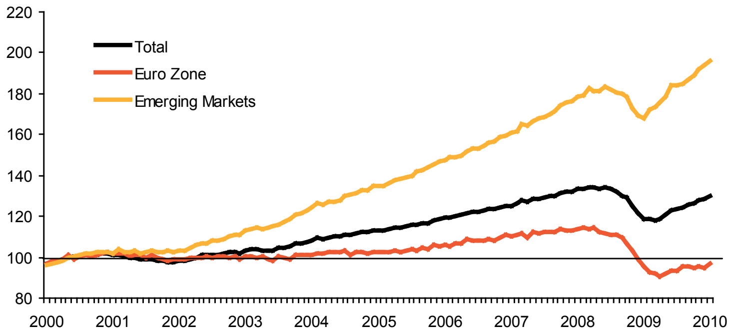
Sources: National Statistical authorities and Swedbank
1/ Countries representing around 70% of the global economy. The World Bank's weights from 2008 (purchasing power parity, PPP) have been used.

The global economy has moved from a stage of crisis to one of recovery, but, despite stimulus measures, the rebound isn’t convincing yet in many of the industrial countries. The major growth engines at the moment are the emerging markets, and, increasingly, North America and Japan. Europe, on the other hand, is lagging behind, as production has stagnated and the region is crippled with downside risks from mounting sovereign debt and weak domestic demand. Monetary policy is expected to remain expansionary, but fiscal policy is becoming restrictive later in the forecast period.

We have revised upwards our growth outlook for the global economy from our January forecast. Global GDP is now expected to grow by 3.9% this year and 3.6% in 2011, and again 3.9% in 2012. The phaseout of stimulus packages will have the biggest impact next year. Despite the current rebound in the US, the recovery from the second half of this year will be slower due to lingering problems with unemployment, deleveraging, and weak real estate markets. Also, Japan will grow faster in the short term, but somewhat slower next year, as most trading partners--except China and India, where the outlook continues to be bright--are contemplating contractionary measures. The growth outlook for the euro zone has been revised downwards from 1.1 % to 0.9% this year, and from 1.6% to 1.3% next year. The main reasons are budget consolidation, and still rather low confidence, as well as prevailing weaknesses in production, labour markets and the financial sector.

Downside risks in the short term are most important for industrial countries, as emerging markets are seen as holding up well in the next couple of years. Debt problems in the private, financial, and public sectors will result in deleveraging and budget consolidation, creating uncertainties regarding timing of fiscal measures, financial stability, and growth. Commodity prices are increasing, and an oil price above US$100 per barrel would cause negative effects on growth and inflation in many countries. The financial markets are faced with uncertainties regarding the sovereign debt crises and euro zone cooperation; the main risks include a Greek default and subsequent spreading of problems to other euro countries, such as Spain and Portugal.

Industrial production (index 2000=100)



Source: CPB

In addition, medium- and long-term sovereign debt concerns are building up with regard to larger economies such as the US, Japan, and the UK, with consequences for the political situation, growth, inflation, and interest rates. Protectionism threats remain, and the currency dispute between the US and China has not yet been resolved. Also, the effects on growth due to re-regulation of the financial sector constitute forecast risks in the years to come. Even if growth is becoming better balanced between the US and Asia, rebalancing global growth remains a long-term challenge.

Fiscal policy is already restrictive in Ireland, Greece, Spain, and Portugal. After the election in early May, the UK government is also expected to start budget consolidation. During 2011, many other industrial countries will follow, including the US, Japan, and Germany. A combination of higher taxes and lower public expenditures will dampen growth, especially private and public consumption.

Although monetary policy is expected to remain expansive over the next two years, the degree of expansion will abate somewhat. Inflation pressures will be weak in most industrial countries and strong in many of the emerging markets where domestic growth is higher and stimulus measures expansive. The US Federal Reserve and the Bank of England will start raising their policy rates towards the end of the year, bringing them up to 2.25% by the end of 2011. The European Central Bank will wait till the first half of 2011 before raising the policy rate, and then slowly make further hikes, reaching 1.75% by the end of next year. We foresee that rising GDP growth and somewhat higher inflation will place upward pressure on the long-term bonds. In addition, concern about public debt and the phasing out of quantitative easing may raise bond rates even more. The wider spreads between Germany and euro countries with large imbalances will narrow somewhat as risks come down and subsidized loan packages are provided, but they will remain wider than before the financial crisis started.

We foresee that the US dollar will strengthen against the euro and the yen during the forecast period, as the US economy is expected to grow more strongly and interest rates are raised earlier. In addition, the turbulence within the euro zone will weaken the euro further, while the yen will be affected negatively by weaker finances and the revival of its status as a funding currency for carry trades. Already this year, or in the beginning of the next, the Chinese administration will return to a policy involving the slow appreciation of the renminbi.

Our assumption of an average oil price of US$ 75 for this year and US$ 80 for 2011 is based on an expectation of a stronger dollar, and then slower growth after the initial rebound in the first half of this year. However, the risks are skewed towards the upside, and higher oil and other commodity prices cannot be excluded. House prices are picking up from low levels in the US and the UK, but commercial real estate markets are lagging and may still pose downside growth risks. Especially, the combination of weak regional banks and falling commercial property prices in the US could weaken the outlook.

As many countries are starting to exit from their stimulus measures, there is a need to focus more on improving the functioning of the economies. Industrial countries will feel that competition is increasing from emerging markets where economic policy and the financial sector will be supporting growth in the years to come. In the European Union, the integration process should continue, financial sector regulation must be cleverly designed, and structural reforms should focus on enhancing growth. In particular, reforming the labour markets making them more flexible, and improving the climate for innovation and entrepreneurship are important. There is a potential for benefiting more from an increased division of labour and specialisation within the region, and thus improving the possibilities for competing with growing emerging markets around the world.

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Interest and exchange rate assumptions

	Outcome	**Forecast**			
	20 apr 2010	30 Jun 2010	31 dec 2010	30 Jun 2011	31 dec 2011
Policy rates					
Federal Reserve, USA	0.25	0.25	0.50	1.50	2.25
European Central Bank	1.00	1.00	1.00	1.25	1.75
Bank of England	0.50	0.50	0.75	1.25	2.25
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.34	1.32	1.24	1.20	1.20
RMB/USD	6.83	6.83	6.83	6.60	6.40
USD/JPY	93	98	105	112	115

Sources: Reuters Ecowin and Swedbank

Sweden: Export markets falter - yet household demand picks up

Key Economic Indicators, 2008 - 2011 1/

	2008	2009	2010f	2011f
Real GDP (calendar adjusted)	-0.5	-4.7	1.8	2.4
Industrial production	3.3	-15.5	3.8	5.2
CPI index, average	3.4	-0.3	1.4	2.2
CPI, end of period	0.9	0.9	1.7	2.3
CPIF, average 2/	2.7	1.9	2.1	1.4
CPIF, end of period	1.6	2.7	1.5	1.6
Labour force (15-74)	1.2	0.2	0.7	0.3
Unemployment rate (15-74), % of labor force	6.2	8.3	9.3	9.2
Employment (15-74)	1.1	-2.1	-0.3	0.3
Nominal hourly wage whole economy, average	4.3	3.4	1.8	2.2
Nominal hourly wage industry, average	4.4	2.9	1.6	2.0
Savings ratio (households), %	11.6	13.9	12.7	11.5
Real disposable income (households)	2.7	2.1	1.0	1.5
Current account balance, % of GDP	9.6	7.2	6.2	6.5
General government budget balance, % of GDP 3/	2.6	-0.8	-1.9	-1.7
General government debt, % of GDP 4/	38.3	42.3	42.8	42.8

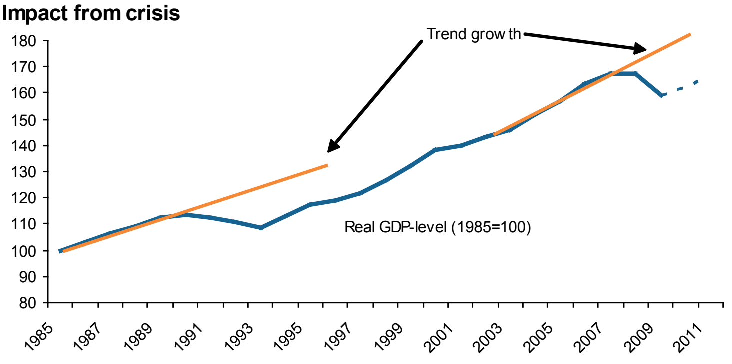
Sources: Statistics Sweden and Swedbank.
1/ Annual percentage growth, unless otherwise indicated.
2/ CPI with fixed interest rates.
3/ As measured by general government net lending.
4/ According to the Maastricht critera.

The decline in economic activity in Sweden unexpectedly deepened in the last quarter of 2009, and the economy contracted in real terms by almost 5% annually. Some of the momentum of the recovery was lost, and we are revising downwards our economic growth forecast to 1.8% for 2010. In particular, domestic demand was lower than expected. The sharp contraction of investments continued while household consumption did not provide as much support as expected. Labour market dynamics improved, however, and trend employment levels are edging up. Positive economic growth is expected continue in 2011, but due to a slowdown of quarterly growth rates, it will not exceed 2½%. We do not expect a recuperation of the losses to real GDP caused by the global financial crisis until 2012.

The overall global economic environment is set to improve over the next two years. However, Sweden's main export markets, in particular the euro zone and the U.K., are expected to lag amidst prevailing imbalances and eroding confidence. Furthermore, the composition of Swedish exports, with a predominance of investment and capital goods, will hamper export growth as investments are lagging in most developed countries. Thus, despite positive growth rates of export volumes, the recovery in 2010 is expected to be slower than we earlier anticipated. With expanding domestic demand fuelling imports, the contribution of net exports to growth has been revised downwards by more than ¾ percentage point of GDP.

We expect the policy stance to remain expansive for most of the forecast period. The fiscal outcome for 2009 was strong, with an estimated budget deficit of less than 1% of GDP. In particular, tax revenues surprised on the upside. With 2010 being an election year, we expect the deficit to continue to grow, but posing no threat to macroeconomic stability. We believe that the Riksbank will start raising the policy rate in July, but that the path to normalised rates will be somewhat slower than we previously anticipated. For end-2011, the rate is expected to have reached 1.75%. Consumers will continue to benefit from growing real disposable incomes and ample credit availability, which will underpin the recovery.

Impact from crisis



Sources: Statistics Sweden and Swedbank calculations.

Swedbank's GDP Forecast – Sweden

Changes in volume, %	2008	2009		2010f[1/]		2011f[1/]	
Households' consumption expenditure	-0.2	-0.8	(-0.6)	2.4	(2.2)	2.8	(2.5)
Government consumption expenditure	1.4	2.1	(2.0)	1.6	(1.5)	0.6	(0.4)
Gross fixed capital formation	2.6	-15.3	(-13.4)	-2.0	(-3.2)	4.0	(3.5)
private, excl. housing	4.6	-19.0	(-16.1)	-4.4	(-5.9)	3.4	(3.0)
public	2.8	6.9	(7.6)	3.2	(3.0)	2.2	(1.7)
housing	-5.2	-20.5	(-22.5)	1.2	(1.0)	8.7	(8.0)
Change in inventories [2/]	-0.6	-1.5	(-1.4)	0.8	(0.5)	0.4	(0.3)
Exports, goods and services	1.8	-12.5	(-12.5)	3.8	(4.6)	4.8	(6.0)
Imports, goods and services	3.0	-13.4	(-13.4)	4.4	(3.5)	5.9	(6.2)
GDP	-0.2	-4.9	(-4.3)	2.1	(2.3)	2.4	(2.6)
GDP, calendar adjusted	-0.5	-4.7	(-4.2)	1.8	(2.0)	2.4	(2.6)
Domestic demand [2/]	0.8	-3.0	(-2.6)	1.3	(1.0)	2.2	(2.0)
Net exports [2/]	-0.4	-0.5	(-0.5)	0.1	(0.8)	-0.1	(0.4)

Sources: Statistics Sweden and Swedbank.

1/ The figures from our forecast in January 2010 are given in brackets.
2/ Contribution to GDP growth.

The main downside risks to our forecasts are external and relate to the rising uncertainties concerning sovereign solvency and financial market turbulence. If realized, this would have a further negative impact on Swedish growth, and on the labour market. The high credit growth and increasingly indebted households may pose a risk to private consumtion when interest rates increase, and could also affect house prices negatively.

Weaker export performance

Sweden's export performance unexpectedly continued to worsen in the final quarter last year. Despite a global recovery and growing import demand from the euro area, Sweden's export volume decreased further. This was the fifth consecutive quarter with falling exports. However, while exports of goods had a sharp drop, the decline in services was less pronounced.

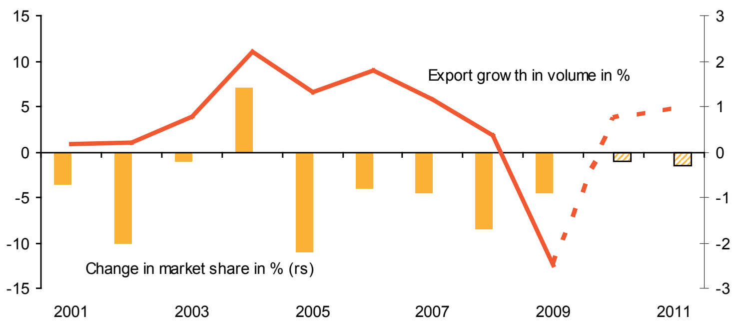
Swedish exports contracted more than the fall on the global level. An unfavourable demand composition, particularly for investment and inter-mediate goods, which are the bulk of Swedish exports, is the major reason why Sweden lost market share. However, as this was the fifth consecutive year with decreasing market share, competitiveness is also an issue. Since 2007, the increase in Sweden's unit labour cost has been strong and has exceeded, for example, Germany's, which is Sweden's major competitor on the export market. This is mainly the result of weak productivity developments.

In our global outlook, we foresee an export market growth for Swedish exporters of 4% in 2010, which is more or less unchanged from January despite a stronger global growth. A weaker growth in Europe, which accounts for more than 70% of Swedish exports, is compensated for by a stronger export market growth in emerging countries, Japan and the US. For next year, we expect a market growth of 5%, driven by further strong demand from the emerging markets and despite a weaker growth outlook in Europe than we earlier expected.

Due to an unfavourable demand composition and a stronger krona against the euro, we expect Sweden to continue to lose market share (in contrast to our January forecast). We have, thus, revised downwards the volume increase in total exports to close to 4% in 2010 and close to 5% in 2011. The negative outlook could be mitigated by lower production costs, which would enable Swedish companies to lower prices and regain market shares.

Weak domestic demand and industrial production significantly slowed down growth in Swedish imports in 2009. In 2010 and 2011, import volume is expected to grow by 4.4% and 5.9%, respectively, as industrial production starts to recover and domestic demand strengthens. The contribution from net exports to GDP is expected to be significantly smaller during 2010 than we expected in January. For next year we foresee a negative contribution to GDP due to stronger domestic demand and a limited export performance.

Export performance



Sources: Statistics Sw eden and Sw edbank's calculations.

Investments are slowly recovering

The downward trend in gross fixed investments continued in last year's final quarter. As investments decreased by 15.3% in 2009, the ratio of investment to GDP fell to 17%, the lowest level since 2005. Housing and the private business sector account for the largest reductions, while public investments increased due to stimulus directed to infrastructure.

We foresee a continued decline this year, although at a slower rate. We expect total investments to fall by 2%, mainly driven by the low capacity utilisation rate in the business sector and the fragile global outlook. A gradually better global outlook and a stronger domestic demand will lead to a modest recovery in the business sector in 2011, but for export goods the recovery will be smaller. Instead, there will be a shift to more domestic-oriented branches. A less negative labour market outlook and a stronger purchasing power among households will increase the demand for new houses. Publically funded infrastructure investments will continue to grow. Total investments will thus increase by 4% in 2011.

Stabilisation of the labour market within reach

The sharp deterioration of the labour market levelled out late last year, but overall employment levels still took a significant beating and decreased by more than 2% on average. The number of hours worked decreased even more as many firms reduced working hours in line with falling demand and production. The average unemployment level rose by more than 2 percentage points to 8.3% in 2009, and reached, in seasonally adjusted terms, 9.0% of the labour force at end-2009. Net of full-time students looking for jobs, the unemployment rate was 6.5% of the labour force, compared with 4.6% in 2008.

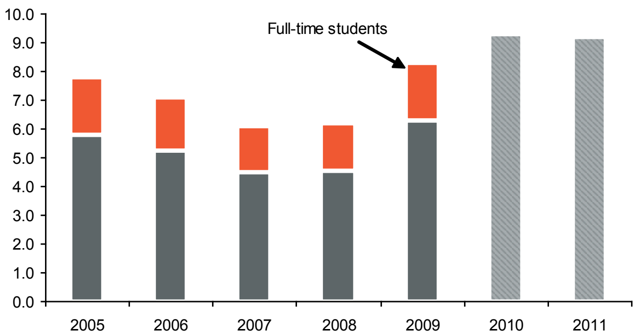
Recent months have seen some indications of a stabilisation of the labour market. The number of layoff notifications has dropped sharply while the number of advertised positions has risen. Furthermore, an increasing number of firms in the manufacturing sector have stopped shedding labour, and forward-looking surveys suggest a growing number of firms are planning to increase their hiring. The employment levels in the services sectors, meanwhile, have held up significantly better. Seasonally adjusted, overall employment levels edged up in early 2010.

Due to the stabilisation of the labour market dynamics, employment is expected to start recovering over the forecast period. However, as the responsiveness of the labour market to real economic activity seems to have decreased (employment rose in the last quarter of 2009 despite a contraction of real GDP), we expect employment to grow slowly. At the same time, labour supply is positively affected by the fewer discouraged workers, as well as by demographic factors. The reforms of the sickness benefit system will push an increasing number of people into the labour market. Put together, we expect the unemployment rate to reach 9.3% in 2010 before declining slightly in 2011. This implies that we expect total employment to decrease by a cumulative of 95,000 over 2009-11, compared to 170,000 in our January forecast.

The cost competitiveness of Swedish production is expected to improve following the latest rounds of wage negotiations. The collective bargaining process, involving more than 3 million employees, is coming to an end, and in general the agreements came in at relatively modest levels (in the paper industry and among electricians no agreements have been made and strikes are ongoing). The services sector agreements, in particular in retail, exceeded those of the manufacturing industries. In general, the agreements were considerably back-loaded, and we expect that wages for the overall economy will increase nominally by 1.8% in 2010, before reaching to 2.2 % in 2011.

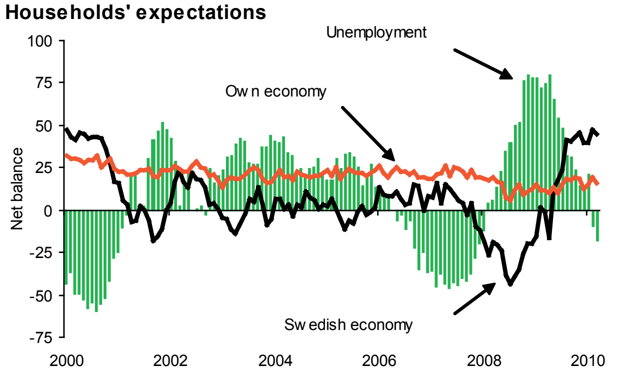
Productivity levels will rebound gradually. A period of economic downturns normally leads to weaker productivity growth as companies often delay laying off personnel when faced with falling demand. As economic growth rates turn positive, the opposite effect can often be observed. Thus, with a stable employment outlook and a relatively slow real economic recovery, we expect productivity to grow by about 2½ percent in 2010, before levelling off in 2011. Unit labour

Unemployment rate, 15-74 (% of labour force)



Sources: Statistics Sweden and Swedbank calculations.

Households' expectations



Source: NIER

costs will decrease, although more slowly than we expected in January, following some years of increased levels.

Wide-ranging reforms in recent years can be expected to improve the functioning of the labour market over the medium term and reduce the equilibrium rate of unemployment. In particular, reduced work-related taxes (including the lowering of the social contribution rates for people 25 years or younger), lower replacement rates in unemployment insurance, and a limit to sick benefits can improve incentives to seek employment, not only among those already in the labour force but also among those who are outside. It has been estimated that the equilibrium unemployment rate has increased by 3 percentage points since the early 1980s to approximately 6% of the labour force.[1] With the recent labour market reforms, this rate could decline.

Consumer prices have increased somewhat faster at the beginning of this year than we expected in January. The most important explanation is higher electricity prices, due both to stronger weather-related demand and weaker supply. We have thus raised our forecast for this year, both regarding the consumer price index (CPI) and CPI-F (with fixed interest rates) by 0.5 and 0.8 percentage points, respectively. Although prices will increase somewhat during this year, the developments during 2011 are revised downwards marginally, as it will take longer to close the output gap, the price pressures from the labour market are restrained and external prices pressures will be kept down. The inflation target of 2% will not be met in the medium term as the CPI-F will fall to 1.4% next year, although, including the effects of monetary policy, the CPI will reach 2.3% towards the end of 2011.

1 See, for example, Anders Forslund, ”Den svenska jämviktsarbetslösheten”, IFAU 2008.

Households to increase spending

After five quarters of falling private consumption, Swedish households increased spending in annual terms in the last quarter of 2009. Taking into account the stronger purchasing power, when real disposable income grew by 2.1%, households were cautious last year. As consumption fell by 0.8%, the savings ratio increased to 13.9% (and 8.3%, excluding pension fund reserves). It is the highest savings ratio[2] on record since 1994, i.e., since the last financial crisis.

Labour market developments have been negative, but not to the extent previously projected. Thus, real disposable income can continue to grow this year, but as savings and confidence are high, we expect consumption growth to be even stronger at 2.4% (2.2% in January). In 2011, households will use more of their savings, as the unemployment rate stabilises and household expectations remain optimistic. Private consumption will increase by 2.8% and will account for more than half of total growth, thus representing the main growth engine in the economy.

During the forecast horizon, risks will be balanced, as there are upside and downside risks facing labour and housing. Swedbank's housing affordability index signals rising house prices during this year, and possibly a stabilisation during next year. At the moment, house prices are increasing in line with the high credit growth of some 9%. Our interest rate projection, which has been lowered, supports the positive developments for retail trade, housing, and car registration.

2 The savings ratio is defined as household savings in relation to disposable income.

However, the risks are tilted towards the downside for 2012 and onwards. The debt ratio will then have risen to almost 200% and the interest ratio to close to 6%, and thus more of the disposable income will be used for interest rate payments. Consumption growth of goods and services, including vacation expenditures, will then dampen. We foresee increasing tensions regarding the households within a couple of years, and the risks include a much higher repo rate, higher mortgage rates due to financial regulation, and a worsening of the labour market, as well as falling house prices.

The Riksbank starts hiking – but at a slower pace

The Riksbank has kept the repo rate at 0.25% since July 2009 and has also provided banks with three fixed-interest rate loans that will mature in June, August, and October this year. As we foresee no new loans with fixed interest rates, the main policy tool going forward is the adjustment of the repo rate. In January, we reiterated our expectation of the first hike in September, but now July looks more likely for several reasons: 1) The Riksbank has signalled that an earlier hike may be needed as the signs of an economic recovery have become clearer; 2) the labour market is viewed as being less gloomy; and 3) the financial market is functioning better. The strong credit expansion towards

Interest rate and currency outlook

	Outcome	**Forecast**			
	2010	2010	2010	2011	2011
	20 Apr	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates					
Policy rate	0.25	0.25	1.25	1.25	1.75
10-yr. gvt bond	3.2	3.3	3.3	3.2	3.4
Exchange rates					
EUR/SEK	9.6	9.6	9.5	9.4	9.3
USD/SEK	7.1	7.2	7.7	7.8	7.8
TCW (SEK) 1/	129	129	129	128	128

Sources: Reuters Ecowin and Swedbank.
1/ Total Competitiveness Weights. Trade-weighted exchange rate index for SEK.

households may also signal a need to slowly adjust monetary policy to more normal conditions. By the end of 2010, the repo rate will have reached 1.25%.

During 2011, however, GDP growth in quarterly terms will start to dampen again, as Sweden's main export markets slow down. In addition, financial regulations to curb the credit expansion towards households may create expectations of wider interest rate spreads, thus contributing to a less expansionary monetary policy stance. Resource utilisation will be weak and labour costs lower than normal. The underlying inflation rate (CPI-F) is expected to decrease. These developments will provide arguments for adjusting monetary policy more slowly during next year. As many households have variable interest rates and are highly indebted, a slower hike of the repo rate may increase the likelihood of a more stable consumption and housing market in the years to come. At the end of 2011, the repo rate will be 1.75 %, thus 1.25 percentage points lower than in our previous forecast.

The Swedish krona is expected to strengthen against the euro during the forecast period. In the near term, the Riksbank will raise the repo rate faster than ECB, but towards the end of 2011, the policy spread will have disappeared. Stronger economic growth in Sweden and better fundamentals compared to the Eurozone should support the krona. However, in terms of a trade-weighted exchange rate (TCW), the krona appreciates marginally as the dollar strengthens against both the euro and the krona.

More room for fiscal policy

Strong tax revenues led to a significantly better than expected fiscal outcome in 2009. The general government balance is estimated at -0.8 % of GDP, compared with a widely expected deficit of more than 2 % of GDP. Surprisingly, indirect taxation, mainly value-added tax (VAT), increased, as did consumer spending, as a share of GDP. Growing household income supported direct taxation. On the expenditure side, spending related to unemployment shot up and, together with increased investment and consumption spending, led to a hike of 3½ percentage points of GDP.

In contrast to many other European economies, the fiscal stance in Sweden is only mildly expansionary. Various calculations indicate an impact from fiscal policy on the economy during 2009 of between ½ and 1 percentage point of GDP, including the effects of the automatic stabilisers and discretionary policies.The output gap is still substantial, and there is, thus, room for further fiscal expansion with no threat to macroeconomic stability. Indeed, the government has already signalled that the tax rate on pensions will be lowered again, and that spending on infrastructure will be brought forward.

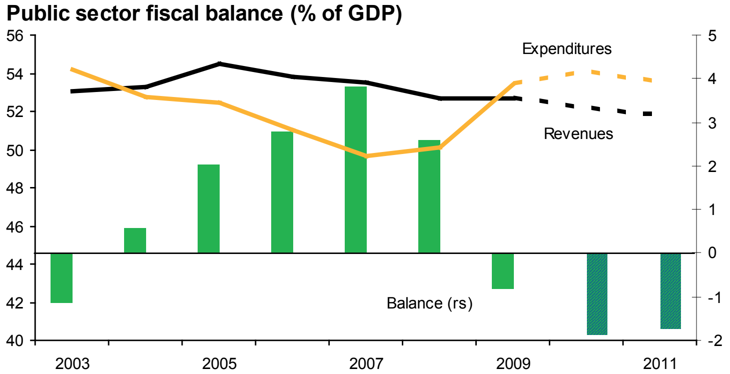
Against this background, and taking into account the general elections in 2010, we expect the budget deficit to continue to widen in 2010 before declining in 2011. The spring budget bill amounted to an expansion of about SEK 5 billion, including increased child allowances and spending on infrastructure. For 2011, we anticipate additional fiscal measures of SEK 35 billion (about 1% of GDP). Not only lower tax rates on pensions, but also increased spending on public service. However, following the strong performance in 2009, it is likely that the deficit remains below 2% of GDP in 2010 and improves slightly in 2011, due to improved real growth.

Also, the projected path for general government debt has been revised downwards. The Maastricht debt increased to 42.3% of GDP in 2009, lower than expected due to large one-off transactions and a better fiscal outcome. The growing deficit in 2010 will add on to the debt before the recovering economy stabilises the debt ratio below 43% of GDP in 2011.

The main challenges over the medium term will be to reverse the underlying imbalances. We estimate that the surplus in the public sector's net savings need to be about 1% of GDP over 2011-14 in order to reach the surplus target (calculated over a 7-year business cycle). The reductions of tax rates are permanent measures that will be difficult to undo in full for whichever government takes office in late 2010. This means that the bulk of the adjustment will have to be found on the expenditure side. Part of the reductions will come from falling spending on labour market policies as the economy turns, and from the reforms of the sickness benefit system. However, it is likely that additional savings will have to be found elsewhere. Not an easy feat when the unemployment rates remain at elevated levels.

Cecilia Hermansson
Jörgen Kennemar
Magnus Alvesson

Public sector fiscal balance (% of GDP)



Sources: Statistics Sweden and Swedbank calculations.

Estonia – Economic prospects improve

Key Economic Indicators, 2009 - 2011 [1/]

	2008	2009	2010f	2011f
Real GDP	-3.6	-14.1	1.5	4.5
GDP, mln euro	16 073	13 730	13 700	14 700
Consumer prices (average)	10.4	-0.1	0.5	1.8
Unemployment level, % of labour force	5.5	13.8	14.0	11.5
Real gross monthly wage	3.2	-5.2	-5.3	1.5
Exports of goods and services (nominal)	6.9	-19.9	8.0	7.0
Imports of goods and services (nominal)	-2.8	-30.6	6.0	7.0
Trade and services balance, % of GDP	-4.3	5.9	8.0	8.0
Current and capital account, % of GDP	-8.4	7.4	8.5	8.0
FDI inflow, % of GDP	8.2	8.8	4.5	8.0
Gross foreign debt, % of GDP	118.5	126.8	121.0	115.0
General government budget, % of GDP	-2.7	-1.7	-1.4	-1.0
General government debt, % of GDP	4.6	7.2	10.0	12.5

Sources: Statistics Estonia and Swedbank.
1/ Annual percentage growth, unless otherwise indicated.

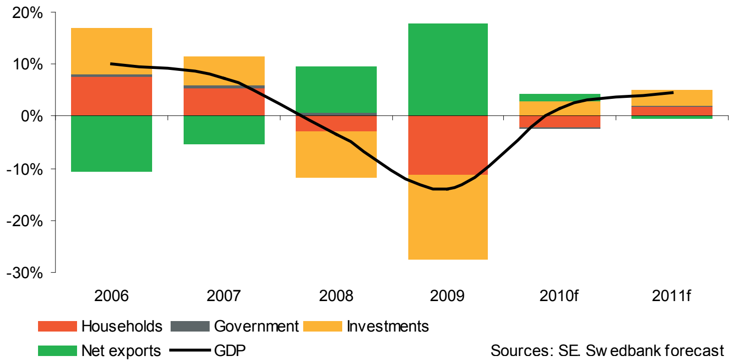
After a period of contraction, Estonia reported strong 2.5% quarterly economic growth in the fourth quarter of 2009, which indicates that the bottom of the cycle has passed. Annually, the decline was 9.5%, and the full year contraction was 14.1%, consistent with our previous forecast. Overall developments in the economy at the end of 2009 and in early 2010 have been according to our expectations, indicating a stabilisation of the economy and a start of the recovery. Net exports and inventory increase were the main contributors to growth, while other components continued their downward trend.

We keep our previous growth forecast, expecting 1.5% growth this year and 4.5% growth in 2011. Even though the outlook for Estonia's most important export markets have somewhat worsened, the outcome for the domestic market is expected to improve. With stronger than expected retail sales, together with increased confidence about employment and future developments in the economy, households will start to increase spending. In addition, we expect that at the end of 2010 there may be a onetime jump in consumption caused by the fear of a possible price increase accompanying the euro cash changeover. The expected EMU membership and better-than-expected outcome of the 2009 budget will have a positive effect on economic developments in 2010 and 2011; however, these are difficult to estimate.

The main assumption in our forecast is that Estonia has fulfilled the Maastricht criteria and will become the 17th member of EMU. The formal process, however, will take several months, and the final decision will be announced in the beginning of July. Estonia has so far maintained a prudent fiscal policy, and the Estonian government has committed itself to working towards a balanced budget in the medium term as well.

The growing public sector debt in many EU countries may cause turbulence that could increase the probability of negative risks for growth prospects in Estonia as well. However, in becoming a member of EMU, Estonia may benefit from a more stable environment and lower interest rates within the euro zone. Other possible risks for our scenario stem from household spending-saving preferences and foreign investors' strategies. The private sector savings reached an unprecedented level in 2009 and this is about to increase in 2010 before starting to decline in 2011. However, if the saving level were to remain high for a long time, it will dampen economic growth prospects. While EMU membership and the accompanying decline in currency risk may encourage investments, the uncertainties in the euro area may diminish this expected positive effect.

Contributions to GDP Growth



Sources: SE. Swedbank forecast

Swedbank's GDP Forecast – Estonia

Changes in volume, %	2008	2009		2010f [1/]		2011f [1/]	
Household consumption	-4.7	-18.5	(-18.5)	-4.0	(-6.0)	4.0	(2.0)
Government consumption	4.1	-0.5	(-0.8)	-1.5	(-1.8)	0.4	(1.0)
Investments	-16.6	-44.9	(-45.0)	13.0	(13.0)	12.5	(20.0)
Gross capital formation	-12.1	-34.3	(-32.0)	0.0	(4.0)	10.0	(10.0)
Changes of inventories/GDP (current prices)	0.4	-2.5	(-3.0)	1.0	(0.2)	2.0	(0.7)
Domestic demand	-7.4	-24.8	(-25.0)	0.5	(-0.5)	5.5	(6.5)
Exports	-0.7	-11.3	(-10.5)	3.5	(8.0)	5.5	(5.5)
Imports	-8.7	-26.8	(-27.0)	2.0	(4.0)	5.5	(6.0)
Net exports, contribution to GDP growth	9.0	17.7	(18.5)	1.5	(3.5)	-0.1	(-0.5)
GDP	-3.6	-14.1	(-14.0)	1.5	(1.5)	4.5	(4.5)

Sources: Statistics Estonia and Swedbank.

1/ These are averages of the forecast ranges, which are ca. 2 percentage points wide. Rounding and varying forecasts of the error term explains why some of the components do not always add up. The figures from our forecast in January are given in brackets.

Economic growth founded on external demand

The main contributor to growth in 2010 will be net exports as export growth will strengthen while import developments will lag. In 2011 the largest contributions will come from domestic demand. Investments (including inventories) will already start to grow in 2010, although a decline in some quarters is possible due to high fluctuations and one-off factors that are hard to predict. The EU structural funds will support public and private sector investments. Government spending is set to decline in 2010 as budget consolidation continues. Household consumption will also continue to decline, at least in the first half of 2010, and growth in the second half of 2010 will be sluggish. For 2011, the growth contributions have shifted compared with our January expectations, and we are forecasting stronger support from household consumption and slightly less from inventory build-up.

Exports strengthen but imports remain weak

Real export growth will be 4% in 2010 and 5.5% in 2011; real import growth 2% and 5.5%. We changed our foreign trade forecast due to the price and exchange rate movements, domestic and external demand patterns, and companies' abilities to reach export markets.

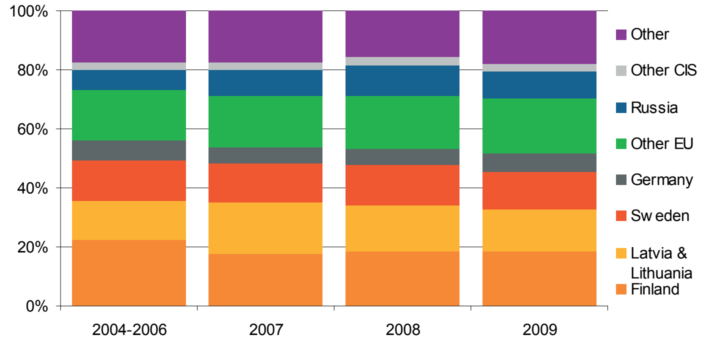
Although for EU countries the growth outlook has weakened for 2010, we project a comparatively good outcome for Estonia based on the change of geographical and product structure. Nevertheless, export growth will be slower than we expected. While the general structure of Estonian merchandise exports has been well diversified, the problem – well seen in late 2008 and early 2009 – is that Estonian companies are highly dependent on economic developments in a few countries. The sharp decline of industrial production in Sweden and Finland had the most devastating effect on Estonian producers. The importance of Finland and Sweden will remain high, but will diminish somewhat because Estonian producers are looking for other markets (e.g., non-EU countries). We are of the opinion that this tendency will deepen.

Services exports will continue to show good results as the opening of EU's services market and stronger price competitiveness will increase the possibilities for Estonian producers. The services will be provided not only in Estonia (e.g., tourism, IT, and business services) but also in the destination countries (e.g., construction). The transport and logistic services are about to recover, but this recovery might not be very rapid due to weak economic developments in neighbouring countries. The euro adoption may encourage tourism from the euro zone, particularly from Finland, as price comparisons will become more transparent and currency exchange costs will disappear after euro adoption in 2011.

Weak domestic demand for imported goods in 2010 will restrain the growth of imports. Households' consumption structure has been shifting not only more towards domestically produced goods and services (food, housing), but also towards cheaper products.

Price movements and euro depreciation have affected exports and imports more than we assumed

Export Structure by Destination Country



Sources: SE. Swedbank calculations

in previous *Swedbank Economic Outlooks*. Imports became substantially more expensive last winter due to price increase of oil products, which means that less import is consumed domestically, and, at the same time, the price of exported products will also rise in time.

The turnaround of the foreign trade balance during 2008-2009 was larger than we expected. The current and capital account surplus will, according to our forecast, continue to increase this year, after which gradual decline will follow. We also expect the financial account to show a big deficit in 2010 that will begin to decrease substantially already in 2011.

Foreign direct investments (FDI) inflow in 2010 will be smaller than in 2009 due to the privatisation of Estonian Telekom at the end of 2009. Excluding this, we expect FDI inflow to grow in 2010 and 2011 as the economic situation and growth outlook improves. Reduced risk estimates and the elimination of devaluation fears through the euro adoption will also be encouraging factors. We expect that the ongoing production transfer process (e.g., outsourcing) will intensify, thus creating exports and employment. FDI outflows will remain relatively high due to the need to recapitalize loss-making companies and due to Estonian companies investing in Latvia and Lithuania.

Investments growth supported by EU funds

We expect investments (including inventories) to grow by about 13% in 2010 and by 12% in 2011, thus keeping the outlook for this year and downgrading it for the next. According to our estimation, the economy is moving from inventory cuts to increases in inventories during 2010, and the growth rates will be very strong at first. Afterwards, as the economic turnaround ends, inventory growth will slow in 2011.

In 2010, we expect investment growth to be affected by the increased inflow of different EU funds. In 2011, we forecast fewer EU-funded investments, yet other investments are about to show modest growth. We have lowered our expectations because we see that in 2010 and 2011 FDI is composed mostly of M&A, and of loan payments, and less of production development. The excess capacities will be a strong obstacle for investments in new technology. Many FDI investments are targeting cheap production in Estonia, which also means that investment growth will be not very strong. The situation will hopefully change towards the production of goods at higher technological levels in the years beyond our forecast range.

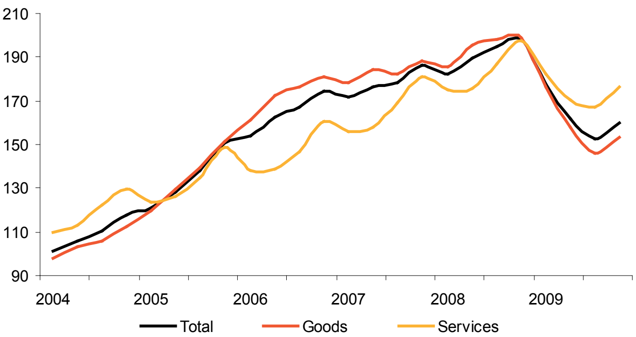
Household investments will remain low; however the harsh winter might have encouraged people to pay more attention to energy efficiency, which, together with state-supported programmes, may increase housing renovation investments. The first new residential real estate construction may start already in the second half of 2010; however, the non-residential real estate sector will remain in a stressful position throughout 2010, and maybe into 2011 as well.

Labour market stabilizing

We expect unemployment to reach its highest level in 2010, and the peak will be in the first half of the year. By the end of the year, seasonal factors and the economic recovery will gradually push employment up. Still, job creation will be slow as companies continue to increase the workload of existing workers (who so far are working part-time) — a trend that was already present in the second half of 2009. We also expect that the labour supply will decline but after one-two years start growing again. At the same time the amount of active jobseekers will decline due to aging that may be accounted as one of the major risks for Estonian economy in the long run. We are of the opinion, however, that the share of long-term unemployed and the structural problems on labour market will increase.

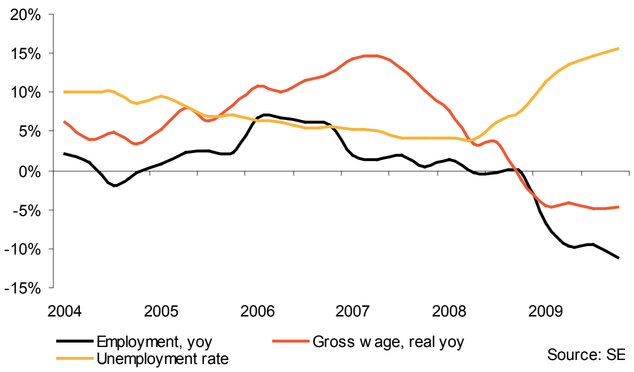
The private sector had already made downward adjustments in employment in 2008 and 2009, while the public sector started mostly at the end of 2009. It is possible that there will be additional layoffs in the second half of 2010 in the public sector as the budget situation deteriorates (see below). Hence, the negative effect of budget cutting will be felt on the labour market also in the first half of 2010, and to a

Export of Goods and Services, 1Q 2004=100



Sources: EP, Swedbank calculations

Labour Market Indicators



Source: SE

lesser extent afterwards.

The decline of average real monthly wage will be 5-5.5% in 2010, but we expect it to grow by 1.5% in 2011. Total wage payments will drop by 1-2% this year before growing by 5-6% in 2011. The difference between the average and total growth in wage payments is explained by the change in working hours: while in 2009 they dropped (hence cutting incomes more than the average wage, which is calculated for full-time employment), in 2010 they will increase.

Inflation to accelerate due to world market prices

The deflation period will be short in Estonia: after 0.1% CPI decline in 2009, we expect consumer prices to grow by about 0.5% in 2010 and 1.8% in 2011. The price growth is prompted by increases in tax rates (latest was in January), tariffs (electricity, heating, and natural gas) and global prices (most of all energy). However, weak household demand will limit price pressures, and most of the unregulated prices will continue to decline or remain stable. Households will also continue to shift towards cheaper products and services; hence, the consumption deflator will remain negative for this year. The growth of oil prices in the world will continue to have a strong effect on consumption of fuels in Estonia.[1] Similarly, the price growth of other products in the world market has affected consumption (and therefore the amount of imported goods).

Household consumption continuously weak

Household consumption will remain comparatively weak throughout 2010 - we forecast a 4% decline - but will recover in 2011, showing a 4% growth. The higher forecast is the result of the stronger developments in the retail sector observed at the end of 2009 and beginning of 2010. Besides, the optimism of households has been strengthened notably. Still, with strong seasonal spending growth on heating due to the unusually cold weather, a setback cannot be ruled out, which means that the risk of a lower outcome is relatively strong. The other reasons for upgrading the consumption forecast for this year and next is related to euro adoption and increased assuredness about employment, which seems to be encouraging confidence and, hence, may trigger additional spending. Still, as we mentioned above, the savings rate in the private sector is very high, partly because of deleveraging, and this might not change substantially in 2010-11, even though spending will slowly increase. Also, there is a possibility of a onetime increase in consumption at the end of this year due to households' fear of price increases after the euro cash changeover in 2011.

According to our observations, households have shifted their spending towards cheaper products. The share of the shadow economy may have increased, while people prefer to buy goods and services directly from producers or provide them by themselves. The growth of the informal economy may therefore underestimate current developments.

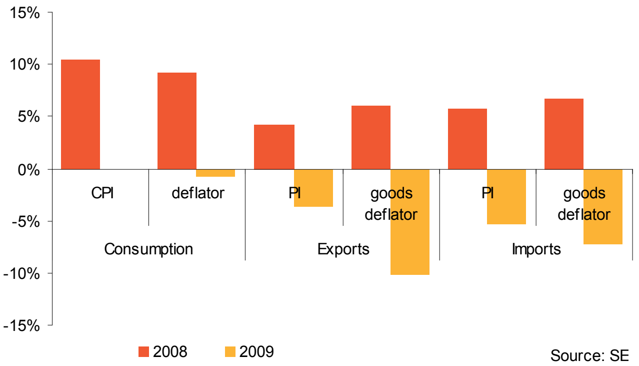
Tight fiscal policy continues

We expect that the public sector deficit will decline from 1.7% of GDP in 2009 to 1.4% in 2010 and to 1% in 2011. The public sector debt level will reach 12.5% of GDP at the end of the forecast period.

The Estonian government cut budget spending and increased revenues throughout 2009, thus ending the year with a public sector deficit of only 1.7% of GDP. The budget-tightening measures included some one-off items (e.g., the increased dividend payments from state-owned companies), and several decisions that affect the budget over several years (e.g., the stoppage of payments into the compulsory pension scheme and the smaller increase in pensions than the law stipulates lowered costs, but the promises to make compensations in 2011 and onwards will increase spending).Expenditures were lowered more by cutting costs and increasing efficiency, and less by cutting services provided. We urge that this efficiency-increasing approach continue and widen to areas that so far have been relatively untouched (e.g., to many municipalities), and a more case-by-case approach should be introduced instead of the one-measure-for-all approach, which was widespread in 2009.

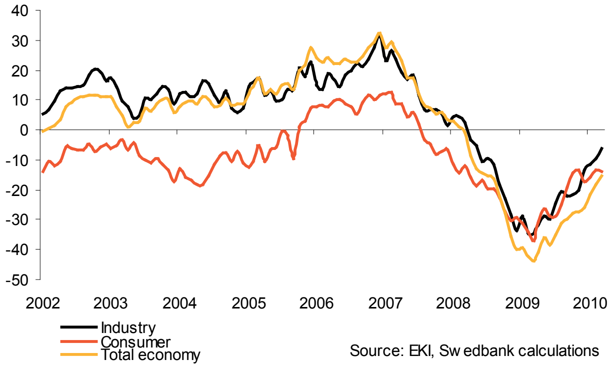
1 Of course, there are other factors as well, such as an increase in fuel excises, and growing unemployment (less demand for everyday travelling).

Price Indices and Deflators



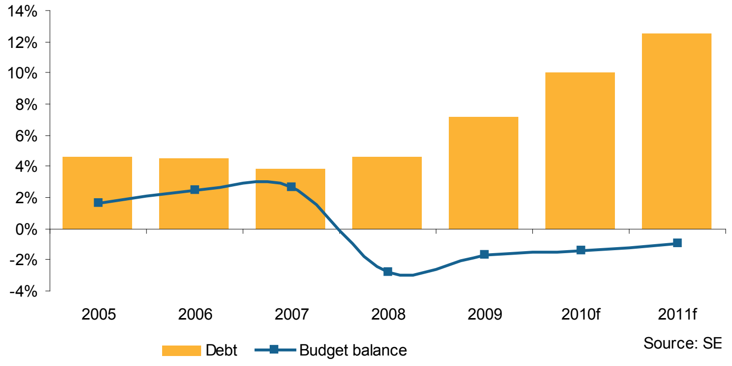
Source: SE

Confidence Indices, s.a.



Source: EKI, Swedbank calculations

General Government Finances, % of GDP



Despite strong budget cuts, their direct negative effect on economic growth remained relatively modest: government consumption fell by 0.5% in 2009, although in the second half of the year the annual decline reached 1%. This relatively modest outcome could be explained by increased use of EU funds (particularly starting in May-June), and not so much decrease of the services provided. Additionally, the outcome was affected by the increase in social services due to the sharp rise in unemployment.

Government budget spending will remain tight in 2010 and 2011, and we expect spending cuts to take place, but mostly in the municipalities that were not very eager to cut spending prior to the local elections in October 2009 and thus having large problems afterwards. Hence, the stronger tightening of spending started there in the fourth quarter, and this is about to continue throughout 2010. The municipalities' budgets remain one of the major risks in our budget forecast.

We are of the opinion that the central government will continue its existing budgetary policy and will reduce the central government budget deficit in 2010-2011. However, the municipalities' situation is about to worsen, we cannot expect a strong improvement in the public sector balance (although it may happen, depending on how the budgetary problems at the local levels will be solved). In 2011, several decisions taken in 2009 will lead to raised spending, e.g. on compulsory pension insurance - while declining unemployment will lead to a reduction. Although the government plans to reach a budget surplus after a few years, we are sceptical about this. We are of the opinion that the government will be forced to work on long-term development issues, particularly those affecting social services (e.g., the labour market and health system), or otherwise the Estonian economy will face another crisis in 10 years. The efficiency of the public sector should be improved, and access to public services as well. The tax system may need some stronger adjustments to ensure that social systems will continue to work properly when, after five-seven years, the working-age population drops sharply.

Maris Lauri
Annika Paabut

Latvia: Recession to be over earlier than expected

Key Economic Indicators, 2008 - 2011 1/

	2008	2009	2010f	2011f
Economic growth	-4.6	-18.0	-2.5	4.0
GDP, mln euro	21 952	18 067	16 444	16 859
Growth of GDP deflator, %	15.4	0.3	-6.7	-1.4
Consumer prices (average)	15.4	3.5	-3.0	0.0
Harmonised unemployment level, % of labour force	7.5	16.9	21.5	19.5
Real net monthly wage (average)	6.3	-5.9	-8.0	2.0
Exports of goods and services (nominal)	10.6	-17.8	10.0	14.0
Imports of goods and services (nominal)	-1.7	-37.6	0.0	15.0
Balance of goods and services, % of GDP	-13.6	-0.3	4.3	4.3
Current account balance, % of GDP	-13.0	9.4	9.0	6.5
Current and capital account balance, % of GDP	-11.5	11.8	12.4	9.7
Net FDI, % of GDP	3.0	0.4	0.4	0.8
External gross debt, % of GDP	129	155	167	158
General government budget (accrual basis), % of GDP	-4.1	-9.0	-8.5	-6.0
General government debt, % of GDP	19.5	36.1	59.0	66.0

Sources: CSBL and Swedbank.

1/ Annual percentage change unless otherwise indicated.

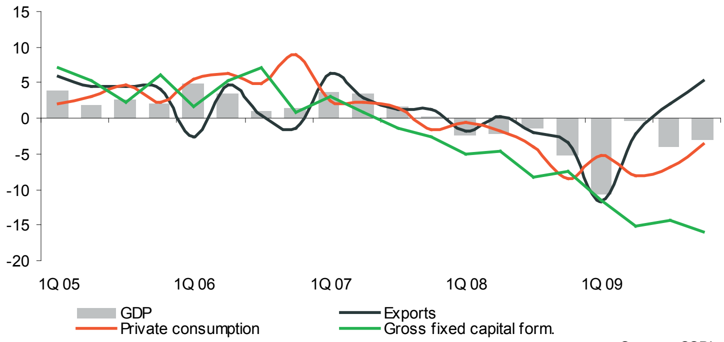
The recession in Latvia is likely to be over already in the first quarter of 2010 due to export growth and better-than-expected private consumption developments. However, the recovery path will be bumpy, and the growth will be fragile in the beginning.
The economy has become quite heterogeneous, with developments differing across sectors, and thus it is hard to forecast how they will interact in a particular quarter.

The seasonally adjusted quarterly GDP fall slowed to 2.9% in the fourth quarter of 2009 due to slower household consumption decline and stronger export growth. Last-quarter developments highly influence the 2010 forecasts due to substantial carryover effects (more negative for investments, less negative for consumption and imports, and more positive for exports vis-à-vis our previous forecast). For instance, assuming that seasonally adjusted GDP is flat throughout the year (i.e., the same as the fourth quarter of 2009 level), the economy would fall by 4.3% in 2010. We foresee that GDP will grow during the year mostly on account of exports, and thus the fall of 2-3% will be due solely to carryover effects. A stronger rebound is expected in 2011, with GDP growing by about 4%, supported by recovering domestic demand. Stronger exports and restocking will stimulate investments and, thus, imports in 2011.

The job seekers' rate is forecast to peak by mid-2010 at about 23% and start to diminish gradually afterwards, first due to emigration and rising inactivity, and in 2011 also due to slow job creation. However, the job seekers' rate will remain high for years to come. Deflation is in full swing, with the annual consumer price index (CPI) decline reaching 3.9% in March 2010, and it will continue during 2010 and early 2011. The small deficit in trade of goods and services in 2009 will turn into surpluses in 2010-2011, driven by export growth.

Domestic positive surprises in terms of GDP and sectoral developments seem to have become more likely than the realization of negative risks. However, the upcoming parliament elections in October pose risks of delay in implementing structural reforms. The risk of worsening tax collection may force the government to revise its 2010 budget to squeeze below the deficit cap of 8.5% of GDP and thus compress domestic demand even further. Exports might be weaker if competiveness gains do not become "cleverer," i.e., if productivity growth is poor. The global outlook is still favourable, although certain risks have

Seasonally adjusted quarterly real GDP (in %)



Source: CSBL.

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2008	2009		2010f[1]		2011f[1]	
GDP	-4.6	-18.0	(-18.0)	-2.5	(-3.0)	4.0	(4.0)
Household consumption	-5.5	-22.4	(-23.5)	-9.0	(-12.0)	2.0	(1.5)
General government consumption	1.5	-9.2	(-8.0)	-7.4	(-3.0)	-3.0	(-2.0)
Gross fixed capital formation	-15.6	-37.7	(-36.0)	-27.0	(-17.0)	7.0	(5.0)
Exports of goods and services	-1.3	-13.9	(-15.0)	6.0	(5.0)	8.0	(7.0)
Imports of goods and services	-13.6	-34.2	(-34.0)	-8.0	(-7.0)	8.5	(6.0)
Net export contribution to GDP	8.5	14.4	(13.8)	6.6	(5.6)	0.1	(0.6)

Sources: CSBL and Swedbank.
1/ These are averages of the forecast ranges, which are ca. 2 percentage points wide. Rounding and varying forecasts of the error term explains why some of the components do not always add up. The figures from our forecast in January are given in brackets.

become more visible. If trade-partner countries see weaker growth than currently expected, it would slow the recovery in Latvia.

Export growth stronger and broader

Although economic growth is expected to slow in the second half of 2010, the global outlook is still favourable. The forecast of weaker demand in euro zone countries will be compensated for by stronger growth in some other European countries and Russia, as well as by a weaker euro against the U.S. dollar. This, together with improving competitiveness (see below) and the growing market shares of Latvian exporters, continues to support growth. The market shares of Latvian exporters in the EU27 and Russia were rising during all of 2009. Although we expect faster real export growth due to carryover effects, we are keeping our nominal export forecast at about 10% for 2010 and 12-14% for 2011 due to slower deflator growth.

While in late 2008-early 2009, the fall in nominal goods exports was counteracted by services exports, by the end of last year goods exports became the driver of growth. Manufacturing growth is very fragile so far, and industry developments were quite disappointing in the first two months of 2010. Nevertheless, manufacturing confidence indicators continue to improve, suggesting that manufacturing growth is likely to gain strength later this year.

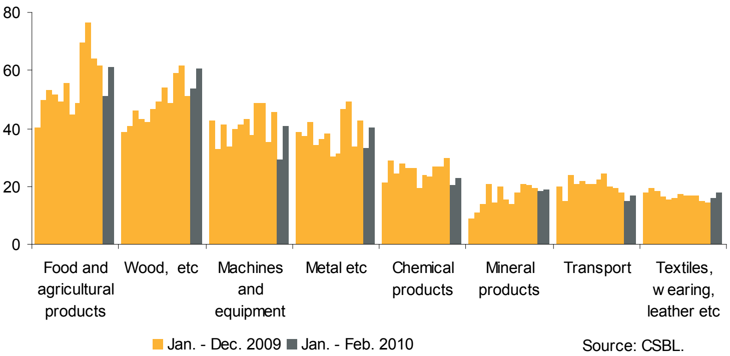
The situation also differs substantially across industries. For instance, the wood industry has become the growth engine both for manufacturing and exports in 2009, but this growth is expected to slow somewhat in 2010 with external competition for market shares increasing. The outlook for food, metal, and chemical industries is quite favourable, while on a clearly negative trend are still the textile industry and the manufacturing of transport vehicles and their parts.

Regarding services, tourism prospects remain relatively positive, due to a decrease in value-added tax (VAT) for accommodation services and several large-scale projects announced for tourist attraction in Riga. Business services developments have been also relatively good so far. In contrast, freight transportation started to decline in the second half of 2009 and remains under severe competition regionally.

The fall in imports slowed substantially and goods imports were quite stable in the second half of 2009. However, imports are still constrained by the substitution effect due to the growing difference between prices of locally produced and imported goods (see below) and by falling incomes. The part of imports used for domestic demand will thus continue to fall, albeit more slowly, but the growing need for imports of exporting sectors will outweigh this effect. Real imports will still fall in 2010, but we forecast nominal imports to be stable. A rebound is expected to follow in 2011 both in real and nominal terms due to growing investments and consumption, as well restocking.

The growing trade surplus will also keep the current account surplus high in 2010 at about 9%, but this will diminish to 5-7% in 2011 due to stronger import growth. The income account surplus will still persist in 2010 because of continuing foreign direct investment losses, but it will be substantially smaller than last year and will continue to decline in 2011. Current and capital transfer accounts will also be improved by EU funds inflows. Emigrant remittances are also likely to increase, thus raising income and current transfer account surpluses.

Exports by main product groups, millions of lats



Source: CSBL.

Investments to grow in 2011

The largest fall in investments is over now, as gross fixed capital formation is 60% down from its peak in the second quarter of 2007. However, investments will remain weak in 2010 due to continuing deleveraging, spare capacity, and expensive and hard-to-obtain financing.

On account of a steep fall in gross fixed capital formation during 2009, there are huge negative carryover effects for this year (-23%). Despite an expected stabilisation in the middle of the year and gradual growth afterwards due to increasing confidence, attractive asset prices, an inflow of EU funds, and lessening spare capacity, gross fixed capital formation is forecast to fall by 25-29% in 2010, almost solely due to the carryover effect. A rebound is then expected in 2011, with gross fixed capital formation growth reaching about 7%, mostly owing to the exporting sectors. Investments cofinanced by EU funds are estimated to constitute up to 7% of GDP in 2010 and remain at 5-6% of GDP in 2011.

Spare capacity in manufacturing is still large, at 42%, compared with 27% on average in 2005-2007. The growth in capacity utilisation accelerated at the beginning of 2010, and the rate is expected to rise further, but, as elsewhere in the economy, the difference between exporting- and domestic demand-oriented sectors is becoming more and more visible. Facing growing demand, exporting sectors need to rebuild their stocks in 2010, increasing their production, and, as spare capacity gets exhausted, their demand for investments will rise. For instance, the capacity utilisation rate in wood, food, and chemical industries is already close to pre-crisis levels, although it might be temporary, as the rebound in demand is likely to slow later on. In contrast, destocking in domestic demand-oriented sectors will continue, and the necessary deleveraging provides additional pressure.

Unemployment will peak soon

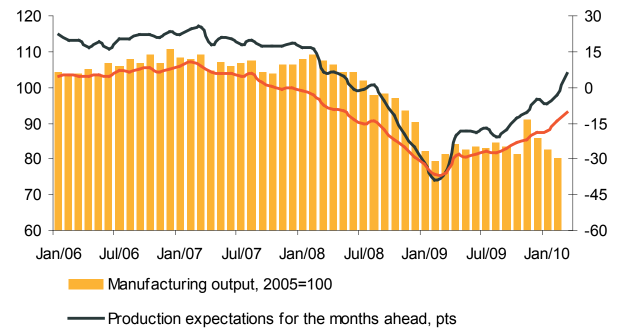
Although unemployment growth has stopped, the situation in the labour market remains difficult. So far, competitiveness gains have been achieved mostly through labour cost reduction.[1] The progress is remarkable – by the end of 2009 unit labour costs had declined by 21% since the fourth quarter of 2008. But the competitiveness adjustment should still continue. In order to reduce the pressure on the labour market and the rising negative domestic demand effects, further competitiveness gains need to come via productivity-enhancing structural reforms driving output growth.

Revised data showed a slower increase in the job seekers' rate, and it reached 20.3% in December 2009. Preliminary data show that registered unemployment rate seems to have peaked at the end of March. We thus keep our forecast that the job seekers' rate will peak at about 23%, stabilizing during the spring-summer and start falling very slowly later in the year due to emigration and a rising inactivity rate. Economic growth is expected to be productivity driven; thus, employment growth starting in 2011 will be weak. Furthermore, the first to gain from recovery will be those currently working part-time who will shift to full-time employment. This means that structural policies must be devised to support job creation and reduce the negative effects of long-term unemployment on the quality and size of the labour force.

Surveys show that majority of businesses are revising their remuneration packages in the beginning of the year. Therefore, the relatively small wage cuts in the private sector thus far most likely intensified in the first quarter of 2010 as unemployment is already very high. Further developments will depend on how strong productivity growth will be. Currently, we expect wages to stabilize by the end of the year and start growing slowly in 2011. Although government spending cuts will continue, most of the wage cuts in the public sector most likely are over in the first quarter of 2010. Net wages will also be reduced by the personal income tax rise from 23% to 26% as of January 2010, but deflation will lessen the fall in real incomes. Consequently, we forecast average net real wage to decrease by about 8% in 2010 and grow marginally in 2011.

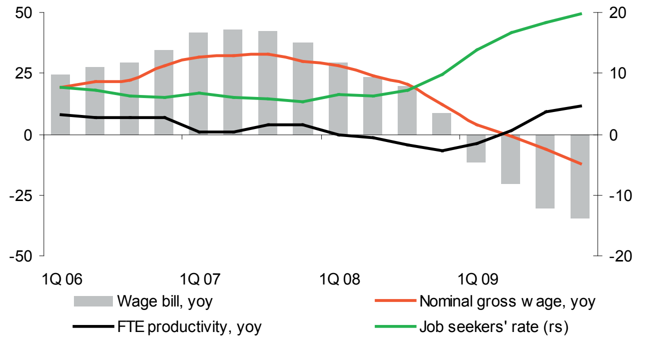
1 See our Swedbank Analysis for more details: "Competitiveness adjustment in Latvia: no pain no gain?" Available at http://www.swedbank.lv/eng/docs/materiali.php

Industry indicators, s.a.



Sources: Reuters EcoWin, CSBL.

Wage bill, productivity and job seekers (%)



Source: CSBL.

Deflation in local goods and services to continue

Monthly consumer price deflation eased in early 2010 mostly due to seasonal factors, but also owing to imported price increases. Higher global prices are raising consumer prices in Latvia, but this is expected to slow in the second half of 2010. Nevertheless, higher global oil prices will lead to increased gas and heating tariffs in Latvia in the second half of the year. Local deflationary pressure remains, supported by a weak labour market and continuing deleveraging. We thus forecast a 3% average deflation in 2010 and a by-and-large stable CPI in 2011.

Deleveraging is becoming more prevalent, and deflation is making the process more difficult. Falling wages and employment make debt servicing increasingly tough – a situation that is reflected in risen loan overdues in the market. Since late 2009, the pipeline of new overdues is gradually drying up, suggesting a certain stabilisation. Also, real estate prices, and thus collateral values, having dropped about 70% from their peak in mid-2007, are starting to show some tentative growth.

Credit stock is slowly falling, as the amount of newly issued loans cannot compensate for the amortization of existing loans. However, the debt service burden is increasing both for households and businesses as incomes are declining faster. This, in turn, is weighing down on consumption and investments.

Deflation also raises the real interest rate, thus making financing more expensive. In addition, euro policy rates are expected to start increasing in the first half of 2011. Deleveraging is unavoidable and it will take time – global experience shows that this process takes years. Banks are still cautious to lend, although mortgage lending is about to pick up as housing affordability has improved more than threefold since the real estate price peak, mainly due to lower prices. According to our estimations, currently one monthly average net wage buys 1 square meter, compared with to 0.3 square meter in 2007.

Household consumption to stabilise earlier than expected

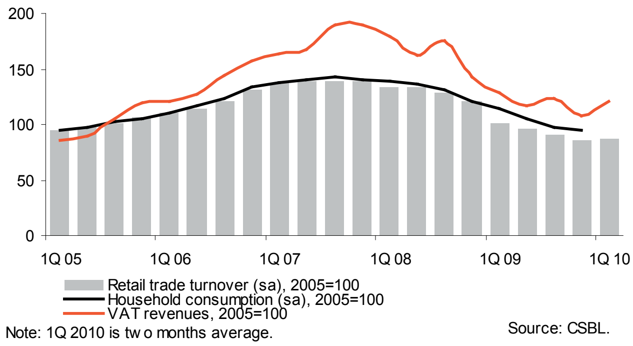
Household consumption will remain weak in 2010 due to falling incomes and continuous deleveraging pressure. The increase in consumer confidence since the second half of 2009 does not immediately translate into robust economic activity. However, recent retail trade turnover developments suggest that private consumption might have increased or at least been stable in the first quarter of 2010 (partly due to unusually cold and snowy winter). We forecast household consumption to fall by about 9% in 2010, almost fully due to the negative carryover effect, and grow by about 2% in 2011. Due to continuing deleveraging pressure, household consumption will fall more than total incomes (i.e., the wage bill plus pensions) in 2010 and grow less than latter in 2011.

The surprisingly strong retail trade performance in early 2010, together with some stabilisation in household deposits and the continuing fall in tax revenues as a percent of GDP (see below), suggests that the share of "envelope" income (i.e., the "grey" economy) has increased. For instance, The State Labour Inspectorate estimates that nearly one-fifth of officially registered unemployed actually are working. This increases the forecast error for private consumption for the upcoming years. As the consumption side seems to better measure the economic activity than the income side, true incomes might actually fall less than our forecast suggests.

Tax collection to be improved

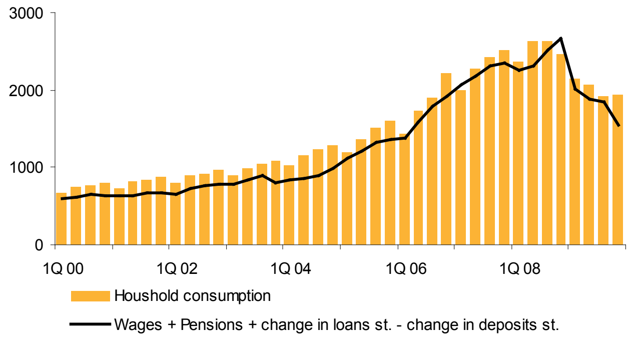
Despite a slight slip in fiscal discipline at the year's very end, the 2009 budget deficit stood at 9% of GDP (accrual basis), i.e., below the 10% target. The current government budget plan includes 4.2% of GDP fiscal consolidation for 2010. Data on the first quarter of 2010 show the fiscal situation developing by and large in line with the plan. We see no need for the government to seek additional consolidation measures to meet the 8.5% budget deficit target set by the IMF and the EC. The overall economic situation has developed more favourably than initially foreseen, and the Treasury has accumulated reserves of 7% of GDP. An additional 10% of GDP is held for financial system stabilization needs. In March, the government announced plans to split Parex Bank into a so-called

Household consumption, retail trade and VAT revenues



Note: 1Q 2010 is two months average. Source: CSBL.

Household consumption, income and savings



Sources: CSBL, LaB, Swedbank estimates.

good and a bad bank to sell it. This would free some of the financial sector resources for other needs, e.g., debt rollover, economic stimulus, or to reduce the borrowing requirement within the EC- and the IMF-supported programme.

The Prime Minister said in mid-March that Latvia may ask to postpone the disbursement of new funds from creditors or ask the arrangement to be turned into a credit line and access it only when necessary in order to avoid storing excess reserves and paying interest on them. The stabilisation has been noted by rating agencies, which recently raised Latvia's credit rating outlook from negative to stable. We expect further improvement in the outlook and perhaps in the rating itself later this year.

We see tax evasion as the key risk that may force the government to draft a supplementary budget with more fiscal consolidation already in 2010. During 2009, tax revenues as a percent of GDP declined to 25.7% in the last quarter (the 2005-2008 average is 29.9%). While automatic stabilisers certainly played a role, such a sharp drop, along with the significant tax rate increases, clearly points to tax evasion. This hypothesis is also supported by anecdotal evidence and public surveys. Although weak tax administration is unlikely to cause severe short-term fiscal stress, it will certainly add unwelcome pressure to exercise deeper expenditure cuts. A total consolidation of about 7% of GDP is still necessary to cut the budget deficit to the 2012 target of 3% of GDP to achieve the authorities' goal of euro adoption in 2014.

Reforms must go on

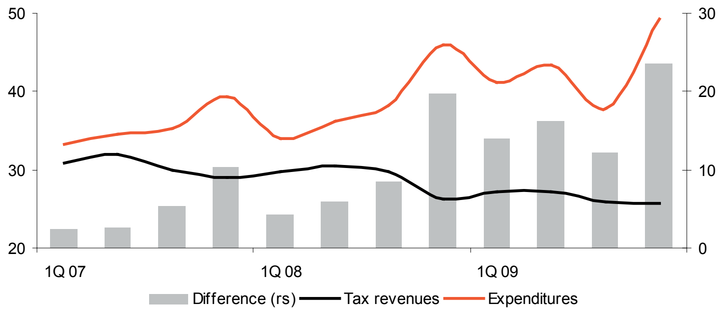
The deep fiscal consolidation and the global recovery have improved confidence and reduced financial market risks. The decision of the ruling coalition's largest member, the People's Party, to leave the government on March 15, 2010 was taken calmly by financial markets. It is widely expected that the incumbent Prime Minister Dombrovskis will remain in the office until the parliament elections this October, heading a minority government. Hence, such short-term political risks as, e.g., the government's falling apart, are very slim.

One should not, however, be lulled by the somewhat better than expected outcomes. The economic situation still poses critical problems. Latvia has formally fulfilled most of the structural benchmarks set out in the IMF- and EC-supported programme so far, but the underlying structural adjustment is far from over. Many key structural reforms are still to be designed, and few have fully been implemented. The drafting of the fiscal responsibility law is lagging, as is the implementation of civil service wage reform. The design of the education system reform is far from clear – the rising pressure to maintain as much of the status quo as possible will deeply harm future competitiveness. The development of alternative financial markets, such as venture capital and a stock market, must be stimulated to reduce dependence on banks as the sole source of financing. These are just a few structural adjustments from the long "to-do" list that must be completed to support a return to a sustainable and healthy growth path.

The upcoming elections do pose the risk that implementation of quality structural reforms might be postponed. If so, the current government should at least prepare the blueprints that are ready to be implemented when the next government takes over. Otherwise, Latvia risks experiencing slow medium-term growth, which will deepen other structural problems, such as emigration and pension system sustainability. With the global recovery, the government's moves to implement structural reforms must become bolder (particularly after the elections) – a growing economy may "forgive" small mistakes in economic policymaking as long as the general trend is towards structural adjustment supporting sustainable growth.

Mārtiņš Kazāks
Lija Strašuna
Dainis Stikuts

General government budget, % of GDP



Note: accrual basis.

Sources: State Treasury, Swedbank estimates.

Lithuania: Fiscal consolidation is rewarded

Key Economic Indicators, 2008 - 2011 1/

	2008	2009	2010f	2011f
Real GDP	2.8	-15.0	-2.0	3.0
GDP, m euros	32 203	26 747	26 081	27 132
Consumer prices	10.9	4.5	1.0	1.0
Unemployment level, % of labour force	5.8	13.7	16.0	15.5
Real net wage	10.1	-7.5	-5.0	0.0
Exports of goods and services (nominal)	25.5	-25.2	6.0	8.5
Imports of goods and services (nominal)	18.9	-35.8	6.5	7.5
Balance of goods and services, % of GDP	-10.9	-0.7	-1.0	-0.5
Current account, % of GDP	-11.9	3.8	1.2	0.0
Current and capital account, % of GDP	-10.1	7.2	4.2	3.0
FDI inflow, % of GDP	3.9	0.9	1.0	1.5
Foreign gross debt, % of GDP	71.6	86.0	88.0	86.0
General government budget position, % of GDP	-3.2	-8.9	-8.0	-6.0
General government debt, % of GDP	15.6	29.3	38.0	42.0

Sources: LCD and Swedbank.

1/ Annual percentage change, unless otherwise indicated.

The economy appeared to stabilize during the second half of 2009 after very sharp declines in output. Lithuanian GDP increased by 0.5% quarter on quarter in the fourth quarter of 2009, thus growing for two consecutive quarters, with the annual rate of contraction easing to 12.8%. For 2009 as a whole, the economy is estimated to have declined by 15% and thus performed in line with our expectations. The economic recession in the second half of the year was considerably softened by export growth, which has been improving since last autumn owing to the recovery in the EU economies. No signs of improvement, however, were observed in the non-tradable sectors, as domestic demand stayed anaemic in the second half of the year.

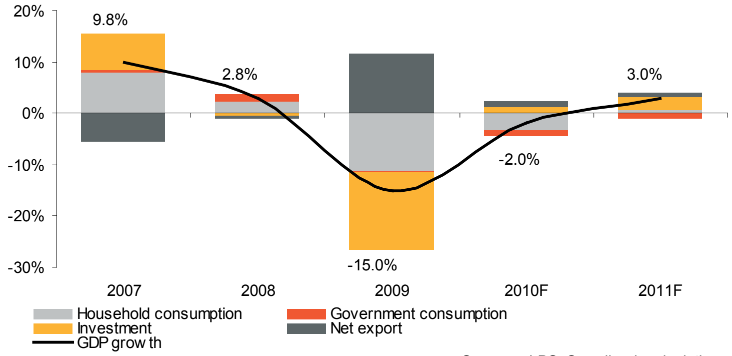
We expect, however, that the economy will fail to expand during the first half of this year. Some leading indicators show that the slow recovery observed in the second half of 2009 stalled during the beginning of this year. Due to slower recovery in the EU, industrial production results were worse than anticipated and orders were growing considerably slower than at the end of last year

Retail sales results indicate that household consumption kept on falling. Even though consumer confidence has been gradually improving, labour market developments allow us to forecast a very cautious approach to spending this year.

We are more optimistic than in the last outlook published in January about the ability of the government to return the public finances to a sustainable path and about its commitment to carry out the proposed structural reforms (including making some savings permanent). The set of consolidation measures adopted for the 2010 budget, which included reducing funding for the vast majority of social benefit programmes and cutting wages for public sector servants, has already yielded some initial positive results. The fact that the government appears to have regained control of the public finance situation was acknowledged by the international institutions and ratings agencies, which, together with the stabilization of the Baltic economies, lowered the risk assessments for the country.

Even though the government faces significant challenges going forward, as revenues are still falling, the most vulnerable element in the public finance system is the social security system. The majority of the proposed reforms, even if their adoption is

Contributions to GDP Growth



Sources: LDS, Swedbank calculation.

Swedbank's GDP Forecast – Lithuania

Change in volume, %	2008	2009		2010f 1/		2011f 1/	
Household consumption	3.6	-17.0	(-18.0)	-5.0	(-5.0)	1.0	(1.0)
General government consumption	7.9	-2.3	(-5.0)	-4.5	(-5.0)	-5.0	(-2.0)
Gross fixed capital formation	-6.5	-39.1	(-42.0)	-3.5	(-4.0)	8.0	(8.0)
Export of goods and services	12.2	-15.5	(-18.0)	4.5	(1.1)	6.5	(6.8)
Import of goods and services	10.5	-29.3	(-27.0)	2.2	(-4.2)	5.0	(4.0)
Net exports contribution to GDP growth	-0.5	11.6	(8.8)	1.2	(2.9)	0.8	(1.4)
GDP	2.8	-15.0	(-16.0)	-2.0	(-2.0)	3.0	(3.0)

Sources: LDS and Swedbank.
1/ These are averages of the forecast ranges, which are ca. 2 percentage points wide. Rounding and varying forecasts of the error term explains why some of the components do not always add up. The figures from our forecast in January are given in brackets.

accelerated, are not likely to yield the necessary results in the short term.

Given the developments at the beginning of this year and the global growth outlook, we have retained our January forecasts for economic growth for 2010 and 2011. Our main scenario thus sees Lithuanian GDP falling by 2% in 2010. The economy will most likely contract in the first quarter, with growth gradually picking up after the second quarter of 2010. Overall domestic demand will fall this year. We are slightly more optimistic compared with the January forecasts regarding export growth.

We do not completely rule out the possibility of a modest positive GDP growth this year, which will largely depend on a faster than currently forecasted recovery of exports. Thus, both in terms of positive and negative risks, global developments will be the most crucial factor affecting the performance of the economy this year. The economy should grow by 3% in 2011, as domestic demand, driven by investments, starts to recover.

Export recovery to continue

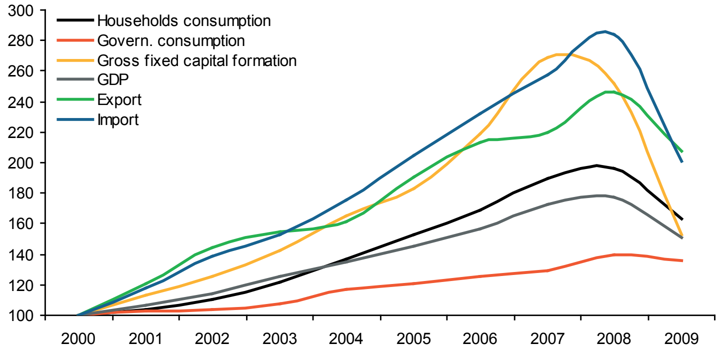
Export volumes picked up faster than we anticipated, owing to economic stimulus packages adopted in the main export markets. Based on the assumption that the positive trend observed in the second half of 2009 is likely to continue, we are more optimistic than in the last outlook in January regarding export growth. While in January we expected exports to grow only marginally during 2010, we currently forecast exports to grow by approximately 4.5% in real terms over the year. The main risk to the improvement in exports is a significant slowdown in the recovery of foreign demand, especially in the EU. Admittedly, after showing steady signs of expansion, export results in the first two months of 2010 were slightly disappointing. Nevertheless, the sectors that took the lead in export recovery at the end of 2009 – plastic and rubber goods and chemical products, as well as wood, paper, and furniture – continued to perform well.

We are also raising our forecast for imports and expect them to grow by 2.2% this year in real terms, as a faster recovery of exports will subsequently increase imports. Import growth will also move into positive territory due to an increase of energy imports after the shutdown of the Ignalina nuclear plant, especially in the first half of 2010. The net export contribution to GDP growth will remain positive, though slightly more subdued than was assumed in January; net exports nevertheless will remain the principal factor limiting the fall in GDP this year.

The correction of the external imbalances during 2009 was swift – the surplus of 3.8% of GDP recorded in the current account balance was higher than we had anticipated, primarily due to the rise in the surplus of the income account balance. We are of the opinion that most of the adjustments have already occurred, especially regarding the trade balance account. We have thus retained our forecasts and expect the current account to reach 1.2% of the GDP surplus this year and to be balanced in 2011. Export growth should outpace import growth, and thus the deficit in the trade balance will not deteriorate this year and next year.

The improvements in the income account are not likely to continue during 2010 as the losses observed this year are likely to be significantly smaller than the ones registered in 2009. The surplus in the net transfers

GDP, 2000=100



Source: LDS.

account, which reached 4.1% of GDP in 2009, should continue improving this year due to the faster implementation of the EU assistance.

Investments to turn around

In line with our expectations, investments (excluding inventories) showed no signs of recovery during the last quarter of 2009. The situation will remain problematic all of this year, particularly in the first half. Compared with the January outlook, expectations have improved somewhat as the risk estimates of the Lithuanian economy have declined and the atmosphere in the financial sector has eased considerably after the market's favourable reaction to the fiscal consolidation measures. The results of the improved risk assessments - cheaper and somewhat larger capital inflows, more lending to certain economic activities, will become visible only by the end of this year/beginning of 2011.

We anticipate investments (excluding inventories) to fall by 3.5% this year, and expect them to grow by 8% during 2011. During 2010, one crucial source of investments remains the EU structural funds. In addition, starting from the beginning of this year, corporate profit tax rates were lowered for small and medium-sized enterprises (SMEs) and brought back to the 2008 level for other companies. Even though this measure has only improved expectations so far, we expect that it will also provide the impetus for the investment recovery starting in 2011 in line with the economic recovery.

The government stimulus plan, apart from the faster adoption of the EU structural funds, is being implemented slowly, and its impact so far remains ambiguous. For instance, the allocation of funds for the SMEs and exporting companies began only in the second half of last year, and many companies might not have the opportunity to use the funds as of yet. The renovation of old apartment blocks has not yet begun and faces significant challenges going forward for numerous reasons, including bureaucratic hurdles and the serious flaws in the design of the renovation model itself. The renovation of public sector buildings seems to have stalled as well, mostly for bureaucratic reasons, such as, for instance, the inability to enact public procurement processes on time.

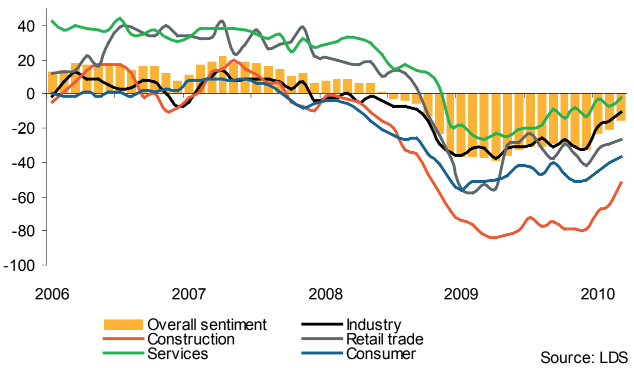
Some positive developments have been visible in the residential real estate market at the beginning of the year. The decline in prices appears to have slowed, and the majority of market players believe that prices and rents on residential property have either recently bottomed out or will hit bottom in one-two months. Thus, the most favourable time to buy is considered to be now, although developers and owners are no longer eager to offer significant discounts. Despite these two contrasting forces, the volume of transactions has increased at the beginning of the year. Buyers are not only interested in the capital city of Vilnius, but are also looking at properties in the outskirts, where prices are assumed to have dropped the most. Most of these investments, however, are financed by own funds - given the uncertain labour market developments, buyers in need of greater financing still remain cautious and/or are unable to receive financing.

Despite the somewhat higher activity in the last few months, we are of the opinion that residential real estate prices will still decline overall this year, although not by more than 5-10%. We anticipate that property prices stabilize during late 2010 - 2011.

During last year, housing prices are estimated to have dropped by about 30%, and from their peak in December 2007 by about 40%, while the output of the construction sector declined by 43% during 2009. Residential real estate prices in Lithuania are about 20% higher than those in Latvia and Estonia; also, oversupply remains high – a considerable amount of newly built residential units are still vacant, and these need to be sold before the real estate market starts a steady recovery.

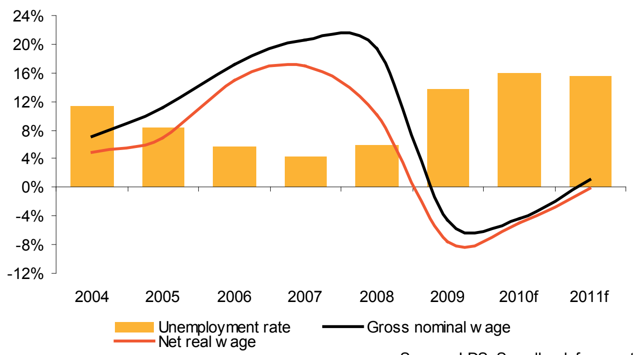
The outlook for the commercial real estate sector, however, remains dire – there are no signs of improvement as of yet; given the considerable oversupply and high vacancy rates, we anticipate this sector to bottom out approximately in the middle of 2011.

Confidence Indicators



Source: LDS

Labour Market



Source: LDS, Sw edbank forecast

Labour market: internal devaluation to continue

As anticipated, the unemployment rate was still increasing and the number of vacancies declining in the fourth quarter of 2009. The largest wave of job reductions, however, occurred in the first half of 2009, while in the second half of 2009 the rise in unemployment subsided slightly. Employment, however, continued to decline at an alarming rate - the number of full-time employees fell by 15% over the year in the fourth quarter of 2009. Unemployment rose to an average of 13.7% over 2009, up from 5.8% in 2008.

We expect that the unemployment rate will reach a peak and stabilize most likely in the second quarter of 2010. Job creation will be slow initially. Companies are likely to remain cautious and will first try to increase the workload of existing workers (currently working part-time.

Poor employment opportunities are encouraging a new wave of emigration, particularly among the younger generation, which significantly undermines medium- and long-term economic growth prospects. Even though the shortage of labour, especially qualified, is not felt at present, the problem could become acute in the medium term. We have not altered our forecast compared to January and expect the unemployment rate to increase to 16% over 2010 and decline to 15.5% in 2011.

Wages will continue to decrease. In the fourth quarter of 2009, gross wages and salaries were down by 8.6% per cent year on year. Real wages and salaries look set to shrink by roughly 5% in 2010 and then stay flat in 2011. Due to administrative decisions, the decline of wages in the public sector in 2010 will be considerably faster than in the private sector, which started adapting to the changes earlier. As companies started adjusting by initially cutting workforce and working hours, total wage bill in the beginning of 2010 was about 20-25% lower compared to the end of 2009. Wage bill is expected to decline by a further 7-10% during 2010.

Even though it has been improving for a couple of months, consumer sentiment remains weak by historical standards. This shows that household spending recovery is not imminent and will be modest at best. While well above its lowest point at the beginning of 2009, the index has been fluctuating for three or four months, and the improvement noted has not been large enough to be considered significant or sustainable.

Available data for the first quarter, such as retail sales, have been disappointing and suggest that household spending is still shrinking. Given the meagre employment prospects and still-falling wages, prospects do not look much better for the remainder of the year. We thus retain our January forecast and expect household consumption expenditure to decline by 5% this year. Only a slight improvement - 1% growth - is expected in 2011.

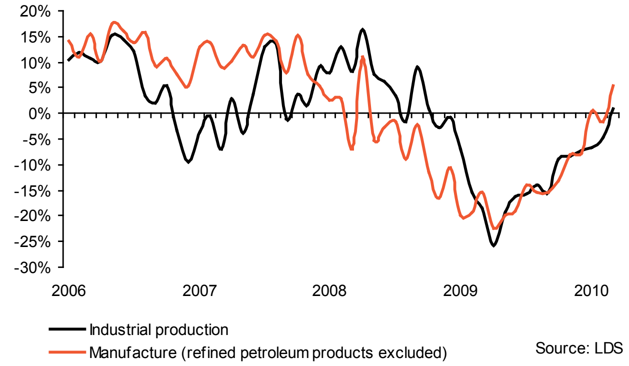
Price growth depends on global forces

Any significant upturn in consumer prices is very unlikely this year. In fact, the situation will remain rather similar to 2009, especially the first half, when weak domestic demand resulted in clear deflationary tendencies. The only prices that increased during 2009 were prices for products or services affected by the raises in the excise taxes and value-added tax (VAT) rates, or those influenced by global developments.

During the first quarter of 2010, electricity price increases also pushed prices upwards. As expected, consumer prices jumped up by 1.3% month on month in January after the electricity tariff increase of nearly 30% for household consumers; however, the price decline resumed in February and inflation was marginal in March. The consumer price index (CPI) increased 0.3% month on month (-0.4% year on year) in March, resulting in annual average inflation slipping to -2.2%**.** In our opinion, the indirect effects of electricity price increases are quite modest. Due to weak domestic demand, it is hard to pass the cost increase to consumers. At the same time, the rise in electricity prices tends to crowd out the consumption of other goods and thus exerts downward pressure on the prices of other goods.

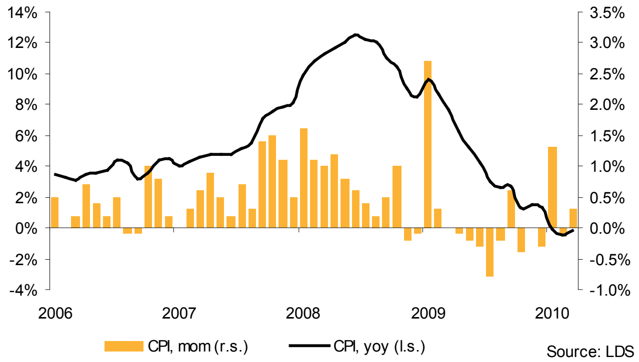
As was mentioned in the previous outlooks, global price developments will be the only major sources pushing prices upwards, especially in the second half of the year. As the

Lithuania's Industry



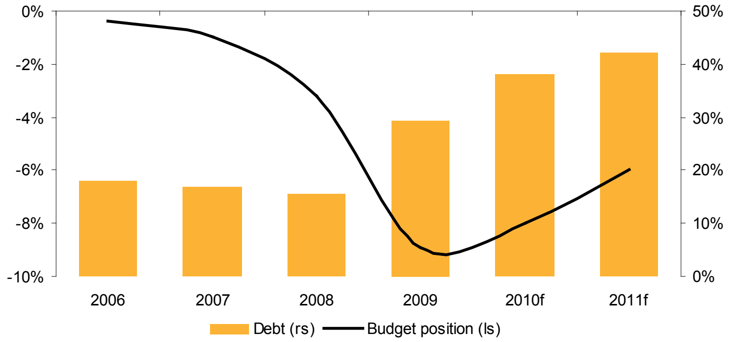
Source: LDS

Consumer Prices



Source: LDS

General Government Finances, % of GDP



Sources: Lithuanian MoF and Swedbank calculation.

developments so far have been in line with our expectations, we retain our forecast that CPI inflation will reach 1% this year and in 2011.

Some stabilization in public finances

The stringent budget consolidation package adopted at the end of last year has already brought some positive developments, so far mostly in the recognition of the government's efforts by international institutions and ratings agencies. The S&P and Fitch ratings agencies have raised their outlook for Lithuania's sovereign rating from "negative" to "stable," basing their decision on the country's fiscal policy. Encompassing both budget cuts and very much needed structural reforms is likely to lay the foundations for long-term growth and a sustainable economic recovery. In January 2010, the European Commission (EC) also acknowledged that Lithuania has taken adequate measures to counteract the deterioration in its public finances and therefore approved shifting the deadline for correction of the excessive deficit from 2011 to 2012. The atmosphere in the financial sector has eased considerably as well, as the markets have responded to the government measures and successful emissions of the bond issues. Interbank rates have returned to the levels registered before the crisis.

We also feel more comfortable than in January regarding the sustainability of public finances, especially because the government has agreed to a plan with the EC to reach a deficit not higher than 3% of GDP in 2012. Even though the government will face significant challenges going forward, as the export-based recovery will result in higher revenues only in 2011, we have changed our forecast and expect the deficit to reach only about 8% of GDP in 2010, and 6% of GDP in 2011. This allows us to expect government debt to reach only 38% and 42% of GDP in 2010 and 2011, respectively. Were it to materialize, this scenario would make Lithuania eligible for euro adoption in 2014. There remain some pitfalls, however. In our view, there is a risk that some structural reforms are not going to be implemented. For instance, some savings may not be made permanent, while resources for tax collection need to be enhanced. Fiscal prudence could also be undermined by the parliamentary election in October 2012.

The cost of borrowing has so far been high – during February, Lithuania's 10-year Eurobond issue, amounting to US$2 billion, was sold, with a yield of 7.6%. However, the successful emission of this bond issue can be credited with lowering risk assessments in the financial markets. About 60% of government borrowing in 2009 was raised from foreign lenders, including two Eurobond issues. This year, the country is continuing to finance its fiscal gap from private sources, nevertheless, after the improvement in risk assessments, the yield is going to be lower.

At present, the social insurance fund (Sodra) is the most uncertain and vulnerable part of public finances. Sodra's deficit has dramatically widened recently due to rising unemployment, a fall in employment, and the worsening financial situation of households. The government is holding discussions about reforming the social insurance system (including such measures as increasing the pension age, and transferring the cost of the first seven sick days to the employer), which could increase its revenues and improve its control of expenditures. The reforms, even if adopted in a timely manner, would yield the results only in the medium term.

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