Swedbank

# Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

September 21, 2010

## Calmer waters for now – but headwinds on the horizon

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Global development

- The outlook for global GDP-growth has been revised up to 4.4% for 2010, mainly due to a stronger rebound than expected in April in Germany, Japan and emerging markets.
- After the inventory-led bounce back, industrial countries will continue to muddle through as deleveraging in the private sector continues and fiscal consolidation is intensified. Thus, global GDP growth dampens to 3.6% in 2011, before improving slightly in 2012 to 3.8%.

Sweden

- The economy has rebounded strongly in 2010, mainly on account of export growth, inventory restocking and public spending. The election result, with a possible minority government, creates uncertainties in the short run. At the same time, the medium-term economic situation is stable, although policy implementation can become complicated.
- We revise up our forecast for 2010 to 4.0%, after which the pace of expansion is set to slow in 2011 and 2012 as global demand weakens. The main risks are deteriorating external conditions, a domestic political crisis and increasing debt levels of Swedish households.

Estonia

- Stronger exports support economic growth, as well as increasingly also EU-funded infrastructure and machinery investments. Due to high unemployment and weak incomes, household spending will remain cautious. GDP-growth is expected at 2.2% this year, before increasing to 4.5% in both 2011 and 2012.
- Estonia's adoption of the euro is expected to lower risks and improve business activity in the medium term. The fiscal situation continues to be favourable, with a small and declining budget deficit. Supply shortages on the labour market could add to inflation pressures.

Latvia

- Economic growth in the first half of 2010 was stronger than expected, supported by restocking, export growth, and stabilization in household consumption as employment and incomes started to recover in the second quarter.
- We raise our outlook for GDP growth in 2010, but recovery is still uneven across sectors and growth fragile. Growth in 2011-2012 will depend on the structural reforms, which will take a clearer form after the parliamentary elections on October 2.

Lithuania

- After a weak first quarter, the economy rebounded strongly in the second quarter of 2010 on the back of a rapid recovery of exports. Domestic demand, however, remained under pressure.
- Given better-than-expected developments in the second quarter, we raise our forecast and expect GDP to grow by 0.5% this year. The economy is expected to expand by 3% in 2011, and 4.5 % in 2012, driven by net exports and a gradual recovery of domestic demand.

# Economic recovery in place – high time to step up the reform process!

The recovery of the Swedish and Baltic economies is taking hold, as growth rates have been revised up for 2010 and are expected to remain positive also in 2011 and 2012. The Nordic-Baltic export-oriented economies are highly dependent on global demand. At the same time, this region sees the need to achieve strong budget discipline and competitiveness in order to handle its increased vulnerability – which was revealed not least by how these countries were negatively affected in different ways by the global financial crisis and the "great" recession.

Economic growth in Sweden and the Baltic countries has been supported by a strong rebound in their main export markets so far during 2010. Because global demand is now set to grow somewhat more slowly during the rest of the year, and beyond – as stimulus effects fade and the restocking process ends – export growth is falling back, although remaining an important growth impetus. In many parts of Europe, the sovereign debt crisis will weaken growth as austerity measures are being introduced. Also in the US and Japan, the private sectors have had difficulties in taking over as the main growth engines when stimulus measures have been withdrawn. In order to sustain the recovery, new measures are being introduced, reinforcing the image of, on the one hand, a "muddling-through" scenario for the industrial countries, and, on the other, emerging markets as the real force of demand during the forecast period, i.e., 2010 – 2012. The combination of low growth and low inflation in the industrial countries – or deflation, as in Japan – makes central banks reluctant to increase policy rates as long as fiscal policy is made less expansionary. In emerging markets, there is still a risk of overheating and high inflation, but a soft landing is our main scenario, adding to the positive view of a continuation of the global recovery in 2011 and 2012, albeit at a more moderate pace.

Sweden showed a strong rebound in economic activity in the first half of 2010, driven by stronger exports and by increased domestic demand, including inventory restocking and household consumption. GDP in calendar-adjusted terms is expected to grow by 4% this year, which is a substantial upward revision from the April forecast. The rebound can be considered to be broad as investments are also picking up, not least in the residential sector. The labour market has started to improve as employment grows, and unemployment is set to fall during the next couple of years; however, the rate will not fall below 8% until the end of the forecast period, and youth unemployment will stay high.

**Macro economic indicators, 2009- 2012**

| | 2009 | 2010f | 2011f | 2012f |
|---|---|---|---|---|
| Real GDP growth, annual change in % | | | | |
| Sweden (calender adjusted) | -5.0 | 4.0 | 2.4 | 2.9 |
| Estonia | -13.9 | 2.2 | 4.5 | 4.5 |
| Latvia | -18.0 | -1.5 | 3.0 | 4.2 |
| Lithuania | -14.8 | 0.5 | 3.0 | 4.5 |
| Unemployment rate, % of labour force | | | | |
| Sweden | 8.3 | 8.5 | 8.4 | 8.2 |
| Estonia | 13.9 | 17.8 | 15.5 | 12.5 |
| Latvia | 16.9 | 19.5 | 17.5 | 15.5 |
| Lithuania | 13.7 | 17.0 | 15.5 | 14.0 |
| Consumer price index, annual change in % | | | | |
| Sweden | -0.3 | 1.2 | 2.0 | 2.7 |
| Estonia | -0.1 | 2.6 | 3.0 | 3.5 |
| Latvia | 3.5 | -1.2 | 1.5 | 2.5 |
| Lithuania | 4.5 | 1.0 | 1.0 | 1.5 |
| Current and capital account balance, % of GDP | | | | |
| Sweden (current account) | 7.2 | 6.4 | 6.3 | 6.4 |
| Estonia | 7.3 | 6.0 | 5.3 | 3.5 |
| Latvia | 12.0 | 8.6 | 5.5 | 3.1 |
| Lithuania | 7.2 | 4.2 | 3 | 2.8 |

Sources: National statistics authorities and Swedbank

Therefore, the labour market remains the main political challenge next parliamentary term. This is made more complicated by the lack of majority in the Riksdag. Although we do not expect a chaotic parliamentary period, policy making will not be as straight forward. A solid fiscal situation makes further stimulus possible, but we expect the policy mix to be less tilted towards supply side measures. Instead, there could be further stimulus measures through increased spending, but since all main parties agree on the importance of sound budget policies, the budget deficit is likely to be kept in check through revenue measures. As the rebound effects fade and global growth dampens somewhat, Swedish exports will grow at a slower pace during 2011 and 2012. We expect the Riksbank to continue to raise the policy interest rate, which will reach 3% at the end of 2012. Thus, highly leveraged households will become more cautious as consumers. All in all, GDP growth will dampen to 2.4% in 2011, and, as export performance improves during 2012, the slower consumption growth will be offset by better net exports, and GDP will increase by 2.9% in calendar-adjusted terms.

Estonia's GDP growth in 2010 has also been revised upwards, from 1.5% in the April forecast to 2.2%, due to the stronger global demand, improving export performance, and strengthening recovery of the domestic economy. GDP growth is projected to increase to 4.5% in both 2011 and 2012. The main driving forces going forward are exports and investments, but households will also start to raise consumption, although at a slow pace as the labour market continues to be weak. During the forecast period, unemployment will fall substantially, from just below 18% to about 12%, but challenges remain as wage growth could pick up in some sectors where there are supply shortages, generating higher inflation pressures in the medium term. The lack of capacity is also expected to slow export growth, and there is a need to increase investments further in order to alleviate capacity constraints. Fulfilling the Maastricht criteria, Estonia will become the 17th member of the EMU on January 1, 2011. The effects of euro adoption on short-term economic developments are expected to be modest, although foreign direct investments could increase more than expected. Policy challenges are mostly concentrated in the labour market, education, and infrastructure, as fiscal performance is strong and a balanced budget in 2014 is within reach. In the medium term, capacity constraints could put upward pressures on the inflation rate, challenging Estonian competitiveness from a euro area perspective.

Latvia's economy has started to grow, but in annual terms we expect GDP to shrink by 1.5% this year due to carryover effects. This is a somewhat better outlook than the one presented in April; however, for 2011, GDP will grow at a slightly slower pace than expected due to weaker global demand. GDP is expected to increase by 3% in 2011 and by 4.2% in 2012. As the labour market performs better in the years to come, when unemployment decreases from just under 20% this year to some 15% in 2012, households will become less pessimistic and consumption will increase slowly. The main driving forces, however, will be the export sector and increasingly investments. In Latvia also, there are capacity constraints in certain sectors, as the skills mismatch in the labour market is becoming more pronounced. A pickup in the inflation rate could put the fulfilment of the Maastricht price stability criterion, which must be met in 2012 in order for Latvia to become a member in 2014. Another risk is the fiscal situation; although government debt is expected to stay below 60% of GDP in the coming years, the budget deficit will only slowly fall towards 3%, as fiscal challenges remain. So far, the budget deficit is developing in line with the plan, and it also seems that Latvia will not need to borrow as much as envisaged under the IMF/EC-supported program. The parliamentary election on October 2 could be the start of new structural reforms, these are much needed in order to fulfil the Maastricht criteria, and to improve the overall functioning of the economy.

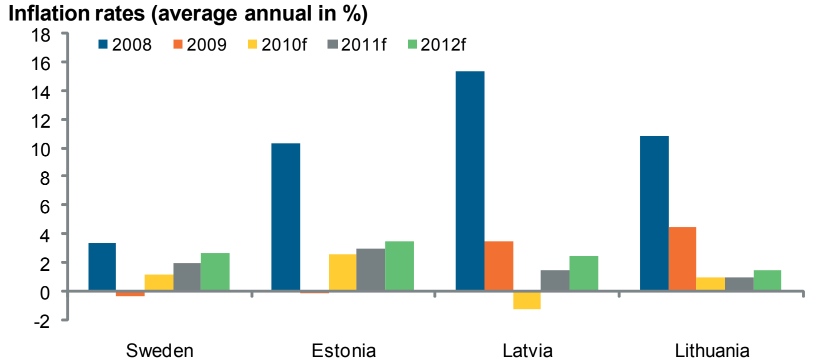
Lithuania's economy is no longer expected to shrink this year, as GDP growth is forecast to reach 0.5% in 2010. The export-oriented industrial sector is leading Lithuania out of the recession while domestic demand is still weak due to lingering needs for deleveraging in both the private and the public sectors. As global demand fades somewhat, the rebound in the Lithuanian export sector will also slow next year; instead, domestic demand, especially investments at first due to EU funds but gradually also consumption, is foreseen to take over as the main growth engine. GDP is expected to increase by 3% in 2011 and by 4.5% in 2012. The unemployment rate will not fall below 14% until the end of 2012; thus, there is a risk of households' facing higher energy and food prices through increased import prices at the same time that labour possibilities remain scarce and wage increases are at best modest. The main obstacle for Lithuania in reaching the Maastricht criteria is the budget deficit: the need to reduce this to 3% in 2012 puts budget discipline and structural reforms on top of the policy agenda - a difficult assignment not least because the deficit reached 8% last year. New austerity measures could weaken domestic demand, thus slowing growth while providing less support for budget consolidation – a dilemma that several countries in Europe will face in the years to come.

Forecast risks are concentrated in the global economy. Even though we are of the view that the risk of a new global recession has decreased, there is a relatively high risk of lower growth and even deflation in the US and Europe. However, commodity prices will continue to grow due to high demand from emerging markets, although not as strongly as during 2009. Higher import prices, as well as increasing capacity constraints on the labour market, could raise inflationary pressures more than we have forecast. Domestic forecast risks are centred on the labour market, as well as the fiscal situation, especially in Latvia and Lithuania, which have the goal of becoming members of EMU in 2014.

Apart from short-term forecast risks, there are medium- and long-term challenges for the whole Nordic and Baltic region. Globalisation is increasing competition, and it is essential for these countries to be able to attract capital, labour, and new ideas in order to enhance the business climate and entrepreneurship. It will become increasingly necessary to improve infrastructure, including taking climate change into account, to improve education systems, and to take into consideration the demographic situation, which is putting greater pressure on labour markets, welfare systems, and the fiscal situation, both nationally and in municipalities. To design tax systems that are robust from a globalisation and demographic perspective will be one of the major tasks for governments in the region.

*Cecilia Hermansson*

**Inflation rates (average annual in %)**




Sources: National statistics authorities and Swedbank.

# The global economy: “It’s not over yet”

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

| | | | September | | | April | | |
|---|---|---|---|---|---|---|---|---|
| | | 2009 | 2010 | 2011 | 2012 | 2010 | 2011 | 2012 |
| US | | -2.6 | 2.8 | 2.2 | 2.5 | 2.8 | 2.2 | 2.5 |
| EMU countries | | -4.1 | 1.4 | 1.1 | 1.6 | 0.9 | 1.3 | 1.9 |
| Of which: | Germany | -4.7 | 3.0 | 1.4 | 1.7 | 1.3 | 1.5 | 2.0 |
| | France | -2.6 | 1.3 | 1.5 | 1.7 | 1.5 | 1.8 | 2.2 |
| | Italy | -5.0 | 0.5 | 0.9 | 1.3 | 0.6 | 1.0 | 1.5 |
| | Spain | -3.7 | -0.7 | 0.5 | 1.6 | -0.5 | 0.7 | 1.7 |
| UK | | -4.9 | 1.1 | 1.6 | 1.9 | 1.1 | 1.6 | 2.2 |
| Japan | | -5.2 | 3.2 | 1.4 | 1.5 | 2.0 | 1.4 | 1.5 |
| China | | 8.9 | 9.8 | 8.5 | 8.1 | 9.5 | 8.8 | 8.0 |
| India | | 5.7 | 8.0 | 7.5 | 7.8 | 7.5 | 7.8 | 8.0 |
| Brazil | | -0.2 | 7.2 | 5.0 | 5.0 | 4.7 | 4.5 | 5.7 |
| Russia | | -7.9 | 4.3 | 4.5 | 5.0 | 4.3 | 4.5 | 5.0 |
| Global GDP in PPP | | -0.7 | 4.4 | 3.6 | 3.8 | 4.0 | 3.7 | 3.9 |
| Global GDP in US$ | | -2.0 | 3.5 | 2.8 | 3.1 | 3.1 | 2.9 | 3.2 |

Sources: National statistics authorities and Swedbank.

1/ Countries representing around 70 % of the global economy. The World Bank weights from 2009 (purchasing power parity, PPP) have been used.

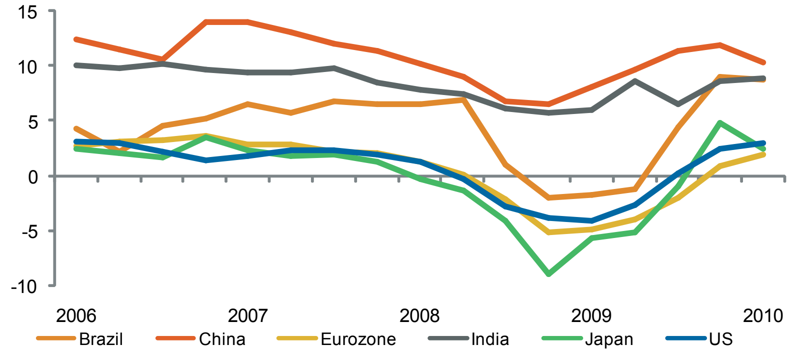
The recovery in the world economy continues as emerging markets drive growth while advanced countries muddle through. However, global conditions give mixed signals. Financial markets were somewhat calmed by the results of the stress tests performed on European banks in July, and by Germany’s positive growth in the second quarter. At the same time, interest spreads of the PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain) have risen to earlier high levels, and the US economy has slowed as stimulus effects fade and the bounceback due to inventory building is over.

Global conditions have thus improved from last year, but the global economic crisis is not yet over as the challenges of private sector deleveraging, budget consolidation, and weak labor and housing markets continue to disturb the recovery in advanced economies. The major risks going forward are the sovereign debt crises in parts of Europe and their linkages to the banking sector, as well as the concerns about deflation not only in Japan, but also in the US and Europe. If emerging markets are not able to manage a soft landing in the struggle against overheating, the global growth outlook will be at risk, as many export-oriented advanced economies are supported by high growth in Asia, Latin America, and the Middle East. The adverse scenarios include a new recession (a double dip) and a Japanese-type scenario with low growth and deflation in the advanced economies. These scenarios are viewed as less likely to materialize and are given probabilities of 10% and 25%, respectively.

There is also a more positive growth scenario, to which we have given a probability of 15%, driven mainly by higher investments in the private sector. If confidence increases, the liquidity in companies and banks would be put to use, stimulating domestic demand and improving labor markets. This scenario would also see faster price increases, raising concerns about inflation in a medium-term perspective.

Our main global scenario (with a 50% probability) is a “muddling-through” scenario characterized by moderate growth – somewhat slower during 2011 but with a slow pickup in 2012. Fewer possibilities for new stimulus packages and a more restrictive fiscal policy will dampen growth. Global GDP growth has been revised up to 4.4% this year from 4% in the spring forecast, as the bounceback of growth after the recession has been more pronounced than expected. In 2011, growth will slow to 3.6% but

**Real GDP growth rates (annual in %)**




Sources: National statistical authorites.

will increase to 3.8% in 2012 – 0.1 percentage point lower in both years than in the previous forecast.

Economic policymakers are now struggling with large uncertainties and fewer policy options. If low or negative growth were to remain, more stimulus measures would be needed, and thus also a longer wait before interest rates could be raised. The amount of quantitative easing would then also have to be increased. Also, a restrictive fiscal policy in larger economies such as Germany, Japan, and the US would have to be postponed. If the recovery continues as expected and the risk of a new recession and/or deflation is reduced, monetary policy can slowly become less expansionary as budget consolidation is stepped up. In our main scenario, we now expect the US Federal Reserve and the Bank of England to start raising policy interest rates at the end of 2011, while the European Central Bank waits until 2012 and Bank of Japan keeps policy rates unchanged throughout the entire forecast period. We expect that long-term bond rates will remain low and only slowly pick up as growth and inflation increase at a similar slow pace.

We foresee a stronger US dollar against the euro and the yen as the US economy grows faster and policy rates are raised earlier than in the euro area and in Japan. The strong yen will continue this year as central banks and others diversify currency portfolios; however, when confidence in the US dollar slowly increases, the yen will weaken. Even though China’s administration made the exchange rate more flexible in June, the yuan depreciated against the dollar during August as the euro weakened; nevertheless, we expect the yuan’s appreciation against the US dollar to continue slowly over the forecast horizon.

With the global recovery in place, the oil price will increase but not as fast as during last year’s bounceback. The average oil price during 2010 is expected to be US$78.5 per barrel (US$75 in the spring forecast), and US$82 in 2011 and US$90 in 2012. Also, metal prices will continue their upward trend, albeit more slowly than during 2009. Higher food prices are expected, as wheat prices are affected partly by shortages due to the fires in Russia. The stock situation, however, is much better now than during the supply shock of 2008.

The muddling-through scenario is a positive outlook when the challenges in the world economy are considered. The medium-term outlook for advanced economies is not so bright, however, as private deleveraging and sovereign debt reduction will weaken growth for many years to come. In addition, demographics and increasing welfare costs will cause fiscal and economic risks. The debt situation is better in many parts of the emerging markets, including Asia, Latin America, and eastern and central Europe, which means a faster convergence of advanced and emerging economies in coming years. For the advanced countries, especially in Europe, but also US and Japan, structural reforms will be of the utmost importance, as higher growth will ease the deleveraging process. The main policy focus must therefore be on measures that can support the increase in productivity growth and participation on labour markets. For the EU, the functioning of the single market has room for improvement, not least in the services sector. Enhancing the incentives for innovation and entrepreneurship has never been more important than now!

*Cecilia Hermansson*

**Interest and exchange rate assumptions**

| | **Outcome** | **Forecast** | | | | |
|---|---|---|---|---|---|---|
| | 20 Sep 2010 | 31 dec 2010 | 30 Jun 2011 | 31 Dec 2011 | 30 jun 2010 | 31 Dec 2012 |
| Policy rates | | | | | | |
| Federal Reserve, USA | 0.25 | 0.25 | 0.25 | 1.25 | 2.25 | 2.75 |
| European Central Bank | 1.00 | 1.00 | 1.00 | 1.25 | 1.75 | 2.75 |
| Bank of England | 0.50 | 0.50 | 0.75 | 1.25 | 2.25 | 2.75 |
| Bank of Japan | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 |
| Exchange rates | | | | | | |
| EUR/USD | 1.31 | 1.30 | 1.26 | 1.23 | 1.18 | 1.15 |
| RMB/USD | 6.70 | 6.70 | 5.70 | 6.60 | 6.40 | 6.00 |
| USD/JPY | 86 | 87 | 90 | 92 | 95 | 100 |

Sources: Reuters Ecowin and Swedbank.

# Sweden: Strong rebound - economic and political challenges remain

**Key Economic Indicators, 2009 - 2012 [1/]**

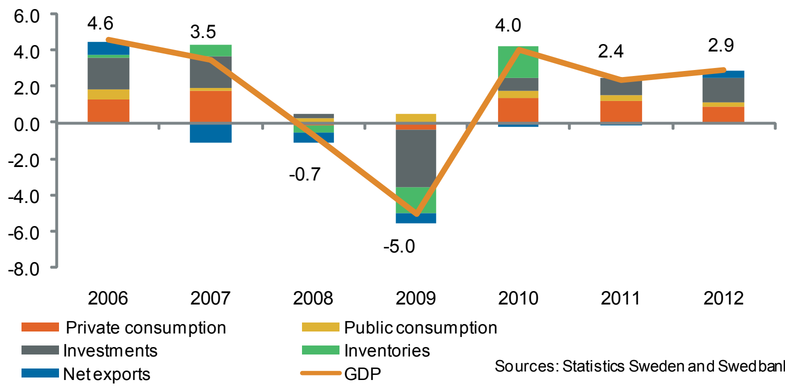
| | 2009 | 2010f | 2011f | 2012f |
|---|---|---|---|---|
| Real GDP (calendar adjusted) | -5.0 | 4.0 | 2.4 | 2.9 |
| Industrial production | -17.9 | 9.2 | 4.5 | 5.2 |
| CPI index, average | -0.3 | 1.2 | 2.0 | 2.7 |
| CPI, end of period | 0.9 | 1.6 | 2.2 | 2.6 |
| CPIF, average [2/] | 1.9 | 2.0 | 1.4 | 1.9 |
| CPIF, end of period | 2.7 | 1.5 | 1.6 | 1.7 |
| Labour force (15-74) | 0.2 | 1.3 | 0.6 | 0.5 |
| Unemployment rate (15-74), % of labor force | 8.3 | 8.5 | 8.4 | 8.2 |
| Employment (15-74) | -2.1 | 1.1 | 0.7 | 0.6 |
| Nominal hourly wage whole economy, average | 3.4 | 2.4 | 2.2 | 2.6 |
| Nominal hourly wage industry, average | 2.9 | 2.2 | 2.1 | 2.5 |
| Savings ratio (households), % | 12.5 | 11.6 | 11.0 | 10.9 |
| Real disposable income (households) | 1.0 | 1.8 | 1.8 | 1.7 |
| Current account balance, % of GDP | 7.2 | 6.4 | 6.3 | 6.4 |
| General government budget balance, % of GDP [3/] | -1.0 | -0.7 | -0.5 | -0.3 |
| General government debt, % of GDP [4/] | 41.6 | 40.5 | 39.3 | 37.9 |

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.

A strong rebound in economic activity in the first half of 2010 suggests that the recovery of the Swedish economy is well underway; however, the election result, with no clear majority in the parliament, could complicate policy implementation. The rebound follows one of the crisis' largest declines in Western Europe, but due the good fundamentals the Swedish economy is well positioned to take advantage of the turnaround in economic activity, both domestically and abroad. After a large decline in the manufacturing sector, forward-looking sentiment indicators are now strong, and the services sector has remained stable throughout the downturn. Indeed, Sweden, along with other export-oriented economies such as Germany, has shown one of the strongest growth rates in the first half of 2010 among industrial countries. The new political situation, with the centre-right wing coalition gaining in electoral support but loosing its majority position due the Sweden Democrat exceeding the 4 % threshold for parliamentary representation, will create challenges for economic policy in the coming years. Fresh elections cannot be ruled out. However, we expect the current coalition to remain in government, but the policy mix could change. Instead of a focus on supply side reforms, such as liberalisations, privatisations and further lowering of labour taxes, it is likely that demand side initiatives, such as increased public sector investments coupled with increases of environmental taxes, will become more prominent. However, we do not expect any fundamental change to the overall principals of economic policy, i.e., low fiscal deficits and focus on lower unemployment, to change. Thus, the impact on medium-term growth and inflation will be limited.

The economy grew in the first quarter of 2010 by almost 4% in annual terms, albeit from the very depressed levels during the same period in 2009. In particular, inventory restocking and public spending, but also a sharp increase in exports, were the main drivers. These factors are likely to be temporary and will not sustain a lasting momentum for growth. Thus, we expect the rate of expansion to weaken for the remainder of 2010 and real economic growth for the year is expected to reach 4.0% in calendar-

**Contribution to growth (Cal. Adj., %)**




Sources: Statistics Sweden and Swedbank

**Swedbank's GDP Forecast – Sweden**

| Changes in volume, % | 2009 | 2010f[1/] | | 2011f[1/] | | 2012f |
|---|---|---|---|---|---|---|
| Households' consumption expenditure | -0.8 | 3.0 | (2.4) | 2.6 | (2.8) | 1.8 |
| Government consumption expenditure | 1.7 | 1.7 | (1.6) | 1.0 | (0.6) | 0.4 |
| Gross fixed capital formation | -16.1 | 4.3 | (-2.0) | 5.5 | (4.0) | 6.7 |
| private, excl. housing | -19.0 | 4.3 | (-4.4) | 6.7 | (3.4) | 8.3 |
| public | 6.7 | -3.6 | (3.2) | -1.3 | (2.2) | -0.4 |
| housing | -23.4 | 13.5 | (1.2) | 7.7 | (8.7) | 6.9 |
| Change in inventories [2/] | -1.5 | 1.8 | (0.8) | 0.0 | (0.4) | 0.0 |
| Exports, goods and services | -12.4 | 11.2 | (3.8) | 5.6 | (4.8) | 6.4 |
| Imports, goods and services | -13.1 | 13.5 | (4.4) | 6.7 | (5.9) | 6.4 |
| GDP | -5.2 | 4.3 | (2.1) | 2.4 | (2.4) | 2.6 |
| GDP, calendar adjusted | -5.0 | 4.0 | (1.8) | 2.4 | (2.4) | 2.9 |
| Domestic demand [2/] | -3.2 | 2.7 | (1.3) | 2.5 | (2.2) | 2.2 |
| Net exports [2/] | -0.6 | -0.2 | (0.1) | -0.1 | (-0.1) | 0.4 |

Sources: Statistics Sweden and Swedbank.
1/ The figures from our forecast in April 2010 are given in brackets.
2/ Contribution to GDP growth.

adjusted terms.

The external economic environment is improving, but there are likely to be some rough patches in the near future. In particular, the economic recovery is stronger than expected in the euro area and emerging economies, and we have revised up our projection for global growth. This is contributing to Swedish external demand. However, looking forward, the rebound effect will fade and the impact from increasing fiscal retrenchment will be felt throughout all economies. For Sweden, we expect exports to grow at a slower pace in 2011 and, thus, limit the impact on overall growth.

Domestic demand -- and in particular household spending -- is expected to be the main component in the economic recovery in the early part of the 2011-2012 forecast period. Consumer expenditure is expected to grow by 2½-3% in real terms in 2010 and 2011 as households reduce their high savings ratio. However, as household debt levels have continued to increase throughout the recession and as market interest rates start to normalize, we expect to see the growth of consumption dampen significantly and fall below 2% in 2012. Capacity utilisation is still low in the manufacturing sector, but as production is recovering we expect investments to gradually recover.

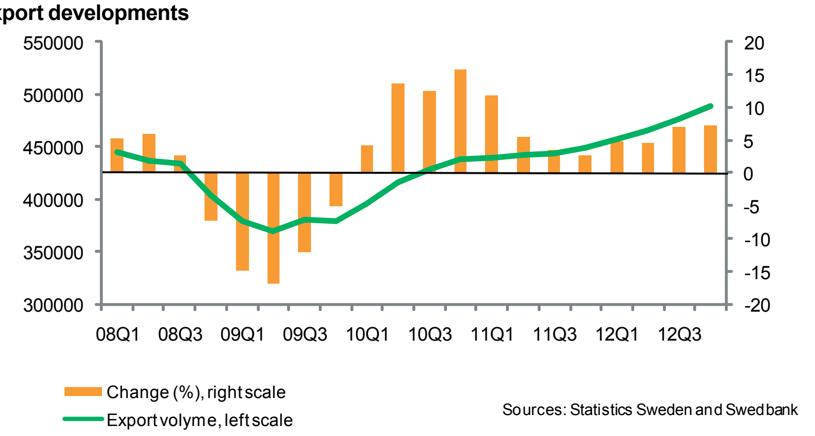
Although the macroeconomic situation is relatively benign, the new government will nevertheless face some growing risks and challenges that will have to be managed in a more fragile parliamentary situation. Fiscal balances are fairly solid, with a deficit of less than 1% of GDP in 2009 and a better-than-expected performance in early 2010. This provides room for further stimulus should it be needed. Household balances may prove weak. A growing mortgage debt, coupled with uncertainty about labour market developments and increased interest rates, could shift sentiments quickly. External developments are also highly uncertain. The Swedish export industry is in a strong position to gain market share but, with renewed financial sector turbulence, demand could erode rapidly.

## Export increase on fragile ground

The recovery in global trade significantly improved Swedish exports in the second quarter of 2010. In volume terms, exports increased by 13.5% at an annual rate, with the largest growth in goods (17.6%), while services had a more modest increase (5%). The export performance was stronger than we expected in our April forecast but is still lacklustre compared with pre-2009. To a large extent, the rebound in exports was driven by the rebuilding of inventories after a deep contraction last year, when global production fell sharply. The low levels in inventories have led to a growing need for intermediate and investment goods—a situation that has been favourable for Sweden. Final domestic demand (consumption and investment) is, however, still weak in several OECD countries.

The geographic diversification of Swedish exports to fast-growing emerging countries in Asia and Latin America is contributing to the strong export performance. The importance of emerging markets has gradually grown during 2000-2010, and we expect this

**Export developments**



trend will continue. During this period, Swedish exports to countries outside the OECD have increased from 20% of total exports to 30%. The largest export firms have set a clear strategic goal to increase their presence on the emerging markets, particularly in Asia.

For 2011, we foresee that the growth rate in world trade will decelerate when the global rebuilding in inventories dampens and fiscal policy tightens. A low utilisation rate in the private sector and lingering high unemployment rates in several OECD countries will have a negative impact on final domestic demand. We expect the world market for Swedish exporters to weaken in 2011, after a strong rebound in 2010. For 2012, we foresee an improvement, when domestic demand in the OECD is again strengthening.

Over the 2010-2012 period, export growth in Sweden will be strongest in 2010, partly due to base effects and to temporary stockbuilding when global production recovers. Despite uncertainties about the strength of the global economy, there are no clear indications of deceleration in export performance yet. According to Swedbank's Purchasing Managers' Index (PMI), new orders to the industry are still increasing. We foresee a total export increase of 11.2% in 2010, driven mainly by a substantial increase in goods, particularly in minerals and vehicles.

The momentum in export performance is expected to soften in 2011, when world market growth decelerates and the composition of demand will be less favourable for Swedish firms. We foresee a stronger krona and rising unit labour costs, which will result in a deteriorated competitiveness and losses of market shares. Services exports, which account for 30% of the total, will recover when the demand for transportation and business services increases. We expect export growth of 5.6% during 2011, followed by growth of nearly 6.4% in 2012, when global growth conditions strengthen.

The rebuilding of inventories and a strong export performance explain to a large extent the sharp rebound in imports of goods. In volume terms, total imports increased by 11% at an annual rate during the first half of 2010. This is a significant change from last year, when import volumes fell by 13.5%. During 2011 and 2012, we anticipate import growth will fall when the stockbuilding process slows and export performance weakens. A relatively robust domestic demand and a stronger currency mean that the growth contribution to GDP from net exports will be small or slightly negative during 2011 and 2012.

## Investment recovery from low levels

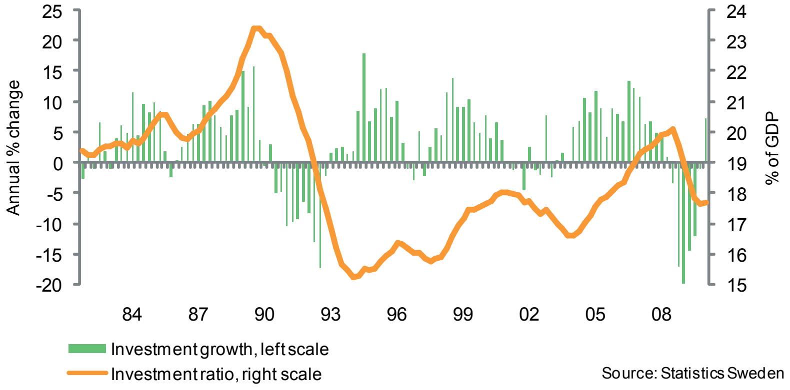
Business sector investments, excluding housing, dropped sharply in 2009 to a level that would be unsustainable in the long run. With the subsequent rapid rise in business sector output, particularly in manufacturing, capacity utilisation has started to rise from very low levels. In combination with strong expectations for the future, more favourable financing terms, and rising profits, this triggered an increase in business sector investment during the first half of 2010. In the second quarter of 2010, fixed investment increased for the first time since the beginning of 2008, by 6.9% annually. This was mainly driven by housing and machinery, which had fallen sharply in 2009. More activity in the private business sector has also led to an upward revision in investment plans. Total investment is expected to increase by 4.5% in 2010 and to continue to gradually expand during 2011 and 2012.

With output continuing upwards in the private business sector, although at a slower rate, there will be a growing need in 2011 and 2012 for investment to expand capacity. Uncertainties about the sustainability of the global recovery, particularly for next year, will have implications for Swedish investment plans in 2011. The momentum in investments is expected to pick up in 2012, when the utilisation rate in the business sector will be higher and the need to increase production capacity larger.

Housing investment will continue to recover after plunging last year. We expect the number of dwelling starts in new construction to increase strongly in 2011 (from 16,000 in 2010 to 25,000). Total investments in housing will grow by double digits and then gradually dampen in 2011 and 2012. The high growth rates derive from a fundamental underlying need for new houses during the coming two years. Higher disposable income and a stronger labour market are creating a growing demand for houses, particularly in regions with large immigration. Factors that could dampen this investment are higher nominal interest rates and a more restrictive lending policy. Supply constraints, such as a lack of labour and a postponement in land planning, could also limit growth in real estate investment.

Public investment growth, which was faster than average in 2008 and 2009, is to fall back during 2010-2012. This will mainly be

**Investments**




Source: Statistics Sweden

due to more limited public sector infrastructure investments. Local government investment, on the other hand, is expected to increase when municipalities in Sweden cofinance public-private partnership investment in infrastructure.

## A stronger labour market – but many remain outside

We have seen a clear bottoming out of unemployment since late last year, but there is still a long way to go before normal labour market conditions are restored. By mid-2010, the unemployment rate was down to 8.5% (seasonally adjusted), but this rate is still significantly above the 6% level that prevailed prior to the crisis. In total, about 400,000 people were unemployed in the second quarter of 2010, which is about 130,000 more than during the same period in 2008. In addition, approximately 520,000 people were on sick benefits or in early retirement. This is about 45,000 fewer than a year ago.

Employment is, however, picking up. Since the third quarter of last year, employment has increased on a seasonally adjusted basis, after contracting during the five previous quarters, and the number of employed has increased by 30,000 since mid-2009. However, compared with mid-2008, employment levels are still 72,000 lower. In particular, employment in the manufacturing sector has been slow to pick up, while employment in the services and public sectors has expanded.

Many short-term labour market indicators confirm that the labour market is strengthening. Layoff notifications were down to less than 3,000 in July, and the number of advertised positions in that month reached almost the level of the same period in 2008. Despite the high unemployment rate, unfilled open positions have continued to increase. This could indicate that there is a growing mismatch between supply and demand, which, in turn, suggests that the labour market is not functioning sufficiently well.

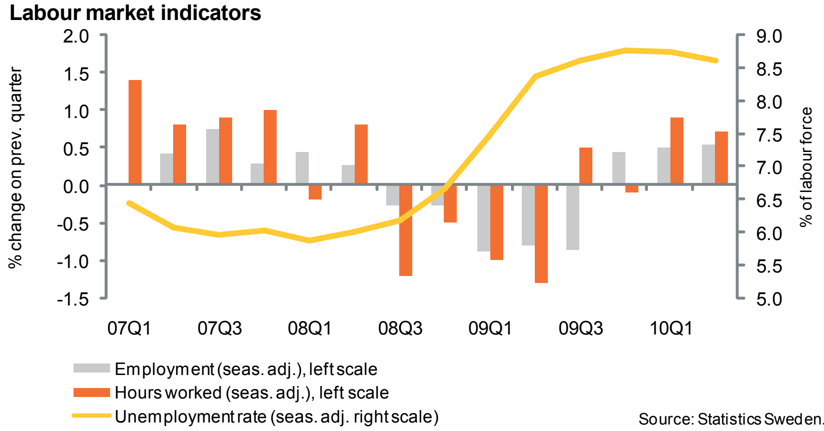
We expect the labour market to continue to improve but with a weakening momentum in 2011. The unemployment rate will remain above 8% on average during 2010-2012, but drop towards 7½% at the end of the period. Despite increased employment levels, a growing labour force will delay a reduction in the unemployment rate. The labour force is growing partly due to demographic developments, and partly due to changes in the incentive structure. The in-work tax credit and less generous social and unemployment insurance policies could compel more people to enter the labour force, while the improvement in employment also is motivating previously discouraged people to return to the labour market.

After the sharp decline last year, the strong rebound in real economic growth in early 2010 provided a boost to productivity levels. The stronger-than-expected employment growth will, however, limit the upturn this year to about 2½%. Looking forward, the low capacity utilisation in Swedish manufacturing and a slowdown in the international recovery will delay a return to the productivity levels that prevailed prior to the crisis. Instead, we do not expect to see productivity growth exceed 2% over the next two years. This is below the productivity growth levels that prevailed during 2000 – 2007: on average 2½%. That relatively high rate is partly explained by the return on investments in IT that took place in the late 1990s and early 2000s. Without further reforms and increased investments levels, lower productivity growth will impair potential GDP and real economic growth rates over the medium term.

Cost competitiveness in the Swedish economy is expected to deteriorate slightly over the forecast period. The strong productivity growth in 2010 is lowering unit labour costs, and this trend is further supported by modest wage increases following the restrained wage agreements earlier in the year. However, the stronger-than-expected labour market demand could lead to somewhat higher wage growth later in the period, and, as real economic activity slows, per unit costs will again increase. This development would be exacerbated by emerging bottlenecks in construction and IT. Swedish companies will, thus, need to renew efforts to make efficiency gains in order to preserve market share both at home and abroad. This need will be further reinforced by the appreciation pressures on the krona.

In the medium term, structural unemployment is likely to become a bigger problem in the Swedish labour market. The manufacturing sector bore the brunt of the economic downturn, and, although it has started to rehire some of those that were laid off during the crisis, it is likely that employment will not reach pre-crisis levels. Thus, there is a risk that the financial crisis will be followed by a structural change of the economy. In that case, many who have lost their jobs may need to retrain and possibly relocate to reenter the workforce. Labour market reforms will, thus, continue to dominate the

**Labour market indicators**




Source: Statistics Sweden.

economic policy debate in Sweden for this governmental term.

## Consumption - the backbone of the recovery, but risks emerge

Household consumption resumed growing at positive rates in the first two quarters of 2010 on the back of a contraction of about 1 % cumulative in 2008-2009. Lower interest costs-- particularly important as an increasing share of mortgage loans runs at flexible interest rates-- lower taxes, and an improving labour market support the turnaround in household spending. Many households unaffected by unemployment had nevertheless harboured concerns about future income security. These concerns are now dissipating.

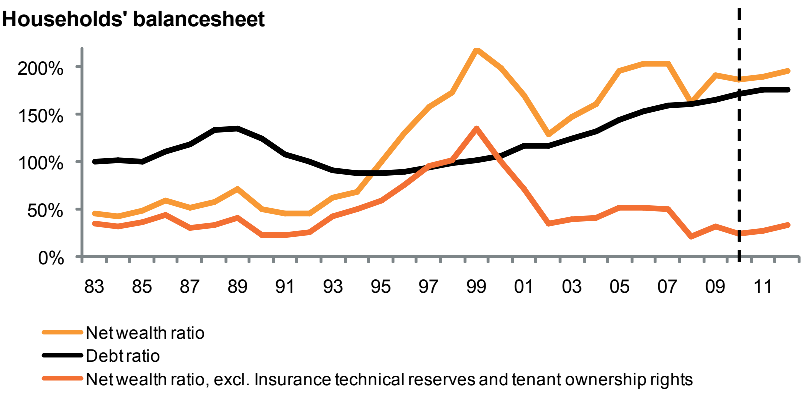
Along with improved labour market prospects and already high savings, we expect household consumption to provide the main impetus to real growth over the next 2½ years. The savings ratio (savings in relation to disposable income) reached 12.5% in 2009, and is still very solid. As household confidence is continuing to strengthen and household income is supported by low interest rates, private consumption is set to expand by about 3% in 2010 (compared with our April forecast of 2.4%).

Increased indebtedness among households is, however, expected to limit the growth of consumption in 2012 and beyond. Consequently, real economic activity will be constrained. Lending to households has continued to expand during the economic downturn, while overall financial intermediation has stagnated. Household borrowing grew annually by almost 10% through 2009, mainly for housing, while lending to business plunged. As a result, the household debt ratio is increasing and household debt is set to reach 170% of disposable income in 2010.

For 2011 and 2012, we thus expect private consumption to continue to grow but more slowly than during the rebound in 2010. A slow improvement of the labour market will limit growth in disposable income. Pension payments are expected to decline, although this will be compensated for by a reduction of the tax rate. More important, however, the rise in market interest rates will increase households' debt-service burden, and, as the household debt ratio rises, projected to about 180% in 2012, we expect that consumption growth will fall back. Therefore, the growth of real private consumption is projected to weaken to about 2½% and 1¾% in 2011 and 2012, respectively.

The Riksbank, as well as the Financial Supervision Authorities (FSA), face a growing challenge in balancing the impact of their decisions on household behaviour when formulating monetary policy and financial sector prudential rules. As the share of flexible mortgage rates has increased, the feedthrough from the policy rate to household interest costs has amplified. This development has mitigated the impact on household consumption from last year's economic downturn, but could at the same time impede the recovery. We do not expect any significant movement in house prices. However, the loan-to-value ratio on mortgage lending imposed by the FSA (85% of assessed value), which will take effect in October, could, together with increasing interest rates, weaken the housing market, in particular in and around the big cities.

**Households' balancesheet**




Sources: Statistics Sweden and Swedbank.

## Monetary policy rates up – but not as fast as envisaged by the Riksbank

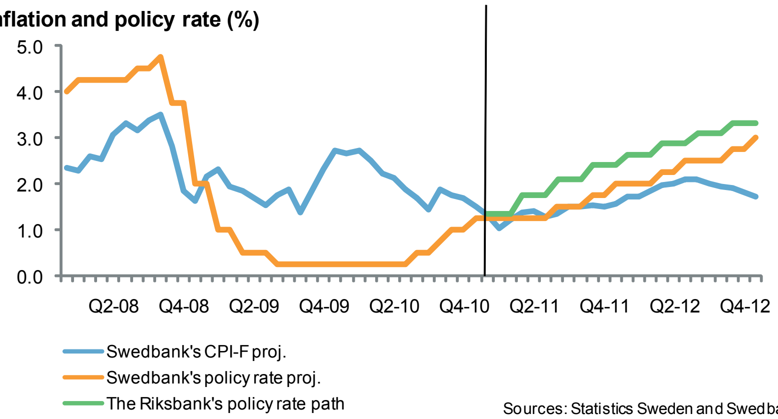
The Riksbank, as was widely expected, raised the policy rate in its September meeting from 0.5% to 0.75%. This move is seen as a continuance of the normalisation of the monetary policy stance, although the speed of the process and top rate to be reached during the cycle is still debated. The policy rate path was left unchanged from July, when it was revised up in the short end, but lowered for later in the period, indicating that the Riksbank is expecting a fairly rapid recovery of economic activity that will then lessen. Taking into account the recent pickup in real economic growth, we do not see any reason to alter our expectation that there will be an additional two-step rate hike during 2010, and that the policy rate will reach 1.25% at end-2010.

Inflation has developed largely as expected. In August, the annual consumer price (CPI) inflation ran at 0.9%, while CPI-F (CPI with fixed interest rates) was 1.4%. Looking forward, we see marginal changes to our inflation projections. Due to the better-than-expected labour market performance, it is expected that wage demands will edge up, but the still very low resource utilisation levels in the Swedish economy will limit price pressures in the short run. Later in the forecast period, headline inflation (CPI) is expected to exceed the inflation target of 2% due to increasing interest rates, while CPI-F, the core measure, will hit 2% in mid-2012 before falling back as policy rates are raised.

For 2011, we believe that, after keeping rates flat in the early part of the year due to the global slowdown, the Riksbank will raise the policy rate at a slightly faster pace than we expected in April. The Swedish economy has rebounded faster--and the labour market is improving with growing employment and somewhat higher resource utilisation--than we expected in April. However, the external environment is looking somewhat bleaker, which will lower inflationary pressures in Sweden. Thus, we expect a policy rate of 2% at end-2011, and thereafter an increase of 1 percentage point to 3% at the end of 2012. The policy rate path of the Riksbank will be closer to 3½% at end-2012 as the Riksbank expects a faster recovery than do we.

We expect the krona to strengthen further against the euro, while depreciating against the US dollar, despite in the short term being affected by the political turbulence. The Swedish economy is recovering faster than its main trading partners' in the euro area, and the Riksbank is normalising policy rates faster than the ECB. On the other hand, a dollar strengthening against the euro is also likely. As measured by the trade-weighted exchange rate (TCW), the krona will strengthen by approximately 3% over the forecast period, implying that competitiveness due to exchange rate movements of Swedish production will deteriorate only marginally over the period.

**Inflation and policy rate (%)**




Sources: Statistics Sweden and Swedbank

## Election results could affect fiscal policy composition

Fiscal performance in Sweden continues to be strong. Following the bounceback in consumption, but also due to improvements in the labour market, tax revenues are expected to come in stronger than expected in 2010. Also, the expenditure side will benefit from lower spending on social transfers, such as unemployment insurance. We therefore are revising our deficit projection for 2010 from -1.9% of GDP to -0.7% of GDP. The upward revision of the nominal GDP projection is also contributing to a lower debt-to-GDP ratio, 41.2% of GDP compared with 42.8 % of GDP in April.

The centre-right government promised in the run-up to the elections that the budget cost of various reforms proposed would amount to at least to SEK 12.8 billion. The bulk of this, SEK 10 billion, relates to increased spending, such as additional transfers to local governments of SEK 3 billion.

In addition, the government promised a reduced tax rate on pensions, estimated to cost about SEK 2.5 billion. The net effect would correspond to about 0.4% of GDP.

A new parliamentary situation and a persistently high unemployment rate could lead to further fiscal policy expansion in 2011. The government indicated during the election campaign that, provided the economic conditions so permit, it would undertake further stimulus measures. We expect that these will be implemented in an amount of about an extra SEK 15 billion in 2011, yielding a total of about SEK 28 billion (or 0.8 % of GDP). Instead of mainly taking the form of reduced taxes, such as expanded in-work tax credits, the election result and the possible collaboration with the Red-Green alliance could lead to more expenditure increases. As this is likely to be compensated by revenue measures, we do not expect the deficit to be significantly affected by the electoral outcome. Nominal GDP growth, which will be higher than was expected in April, will furthermore reduce the impact on fiscal balances. We project a budget deficit of -0.5% of GDP in 2011, and a narrowing to -0.3% in 2012.

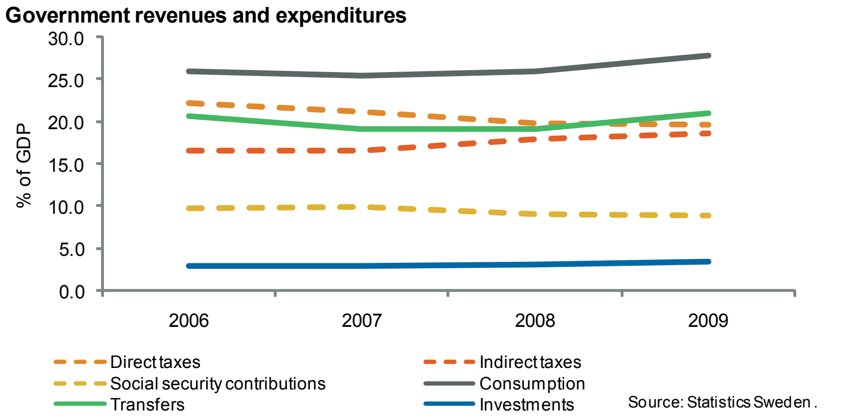
Positive debt dynamics will continue to reduce public debt. Higher-than-expected real growth and low financing costs are contributing to a falling debt-to-GDP ratio, despite the fiscal deficits. For 2011, we expect a Maastricht debt of 39.9% of GDP and, for 2012, 38.4% of GDP. The public debt ratio

**Interest rate and currency outlook**

| | Outcome | Forecast | | | | |
|---|---|---|---|---|---|---|
| | 2010 | 2010 | 2011 | 2011 | 2012 | 2012 |
| | 20 Sep | 31 Dec | 30 Jun | 31 Dec | 30 Jun | 31 Dec |
| Interest rates (%) | | | | | | |
| Policy rate | 0.75 | 1.25 | 1.25 | 2.00 | 2.50 | 3.00 |
| 10-yr. gvt bond | 2.7 | 2.7 | 2.9 | 3.2 | 3.4 | 3.8 |
| Exchange rates | | | | | | |
| EUR/SEK | 9.1 | 9.1 | 9.0 | 8.9 | 8.9 | 8.9 |
| USD/SEK | 7.0 | 7.0 | 7.1 | 7.3 | 7.6 | 7.7 |
| TCW (SEK) 1/ | 126 | 125 | 124 | 123 | 124 | 124 |

Sources: Reuters Ecowin and Swedbank.

1/ Total Competitiveness Weights (TCW: i.e. trade-weighted exchange rate index for SEK).




in Sweden remains one of the lowest in Europe. The government had earlier indicated that it intended to sell stakes in companies such as Nordea, Telia Sonera, and Vattenfall if market conditions improve. However, we do not expect that it now will be politically feasible to follow through with such a policy given the current parliamentary situation.

Due to the projected fiscal expansion, we see some risk that the predetermined fiscal rules will come under threat. Spending so far during 2010 is lower than expected, and there is room during the remainder of the forecast period for making further increases without breaching the expenditure ceilings. However, the prospects of reaching a 1% of GDP surplus over the business cycle will be more constrained. Should the economy perform worse, the need could arise for fiscal retrenchment to meet the surplus target at the end of the forecast period. Also, the zero-balance condition on local governments will be difficult to attain. During this and the next fiscal year, the central government will increase transfers, which will aide in meeting the target. Thereafter, however, there is a risk that local governments will need to reduce spending or increase taxes, which could negatively impact economic activity.

During the recent years of economic turmoil, lowering taxes has benefited economic activity, but as the economy is turning the government may find that restoring fiscal balances will be harder than expected. We reiterate our concern that, while the economic downturn is temporary, many of the measures that stimulated the economy are of a more permanent nature. Some progress has been made in savings in the social transfer system, but it is likely that both central and local governments will face hard choices between increasing taxes and lowering expenditures in the years to come.

The elections resulted in increased support for the centre-right coalition government, while at the same time removing the parliamentary base for a majority government. We expect that the coalition will be able to stay in power, either as a minority government seeking support on an ad hoc basis, or through a more formalized collaboration with other parties. In any case policy implementation will be made more difficult, although the rules surrounding the budget law makes it possible to pass the budget law with a minority unless there is a majority supported alternative. However, other much needed reforms are likely to be postponed or watered down in order to prevent a government crisis. Thus, for example, a much needed comprehensive tax reform will be more difficult to initiate. In the medium term, this could reduce the dynamics of the Swedish economy and, thereby lower real economic growth rates in the future.

*Magnus Alvesson*
*Jörgen Kennemar*

# Estonia – Structural change to continue

**Key Economic Indicators, 2009 - 2012** [1/]

| | 2009 | 2010f | 2011f | 2012f |
|---|---|---|---|---|
| Economic growth, % | -13.9 | 2.2 | 4.5 | 4.5 |
| GDP, bln euro | 13.9 | 14.3 | 15.3 | 16.3 |
| Average growth of consumer prices,% | -0.1 | 2.6 | 3.0 | 3.5 |
| Unemployment level, % | 13.9 | 17.8 | 15.5 | 12.5 |
| Real growth of gross monthly wage, % | -4.9 | -1.0 | 2.0 | 2.5 |
| Exports of goods and services, % | -19.9 | 18.0 | 8.5 | 9.0 |
| Imports of goods and services, % | -30.6 | 21.0 | 9.5 | 10.5 |
| Trade and services balance, % of GDP | 5.9 | 4.5 | 4.0 | 3.0 |
| Current and capital account, % of GDP | 7.3 | 6.0 | 5.3 | 3.5 |
| FDI inflow, % of GDP | 8.7 | 6.0 | 9.5 | 10.0 |
| Gross foreign debt, % of GDP | 125.5 | 122.0 | 117.0 | 114.0 |
| General government budget, % of GDP | -1.7 | -1.5 | -1.5 | -0.5 |
| General government debt, % of GDP | 7.2 | 7.5 | 8 | 8.5 |

Sources: Statistics Estonia and Swedbank.

1/ Annual percentage change unless otherwise indicated.

After seven quarters of decline, the Estonian economy began to grow again in the fourth quarter of 2009, as revised statistics show. The recovery is based on exports, which are benefitting from revived global trade and the regained competitiveness of local producers. Consumption has remained weak due to declining incomes; however, it has shown a slight pickup lately, as consumers' moods have turned positive. After an intensive period of destocking, inventories are now growing again.

Estonia received an invitation to become the 17th member of the European Monetary Union (EMU), as a reflection of fulfilling the Maastricht criteria, accomplished during height of the global financial crisis. Also, Estonia signed a membership agreement with the OECD in early June, and, after the final ratification in the Parliament (planned for this year), Estonia will become the 34th full member of the organisation.

We have changed our forecast based on the better growth and worse employment pattern reported so far in 2010, as well as the changed global outlook. We expect the Estonian economy to grow by 2.2% in 2010, and by 4.5% in 2011 and 2012. We have raised our inflation expectations, as global price growth has caused prices in Estonia to rise more than we expected in the spring. Due to very slow job creation in the first half of 2010 and a high activity rate, we foresee that the average unemployment rate will remain only marginally below 18% this year. This will keep household consumption low and the savings level high, despite the growing optimism.

Of the more significant risks for our scenario, the biggest is related to global economic development. As the Estonian economy is very open, external conditions, whether improving or deteriorating, will affect the economy in Estonia through demand and prices.

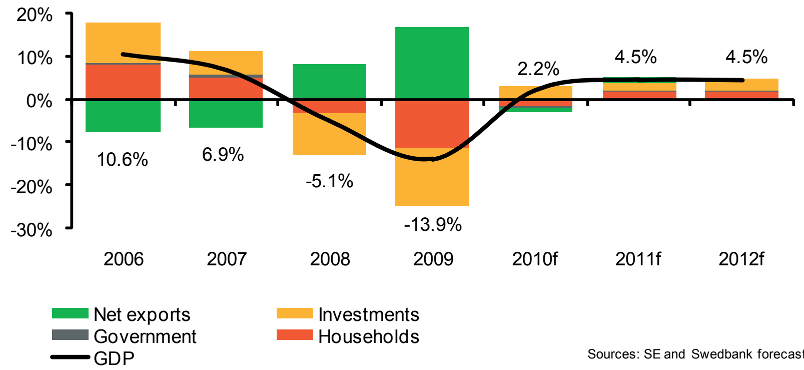
Looking at previous countries' experiences, we see that euro adoption has had strong positive effects on their economies. Nevertheless, taking into account the current global economic situation and outlook, we have not included a significant positive impact on Estonia's economy stemming from the adoption of the euro. Hence, it is possible that foreign investments and production growth will turn out to be higher than we currently forecast. This, in turn, would have a positive effect on the labour market, consumption, and budget revenues.

Regarding medium- and long-term risks that might affect economic developments in 2012, companies' investment policies and labour outflows remain among the main risks that could affect the current growth outlook, either positively or negatively.

## Economic growth based on exports and investments

In 2010, we foresee the Estonian economy growing by 2.2%, supported

**Contributions to GDP Growth**




Sources: SE and Swedbank forecast.

**Swedbank's GDP Forecast – Estonia**

| | 2009 | 2010f | | 2011f | | 2012f |
|---|---|---|---|---|---|---|
| Household consumption, % | -18.4 | -3.0 | (-4.0) | 3.5 | (4.0) | 3.5 |
| Government consumption, % | 0.0 | -1.5 | (-1.5) | 0.1 | (0.4) | 0.3 |
| Investments, % | -37.6 | 11.5 | (13.0) | 6.5 | (12.5) | 10.0 |
| gross capital formation, % | -33.0 | -6.0 | (0.0) | 11.0 | (10.0) | 10.0 |
| changes of inventories/GDP (current prices), % | -2.9 | 1.5 | (1.0) | 2.0 | (2.0) | 2.0 |
| Domestic demand, % | -22.2 | 1.0 | (0.5) | 4.0 | (5.5) | 5.0 |
| Exports, % | -19.4 | 14.5 | (3.5) | 6.0 | (5.5) | 6.2 |
| Imports, % | -32.9 | 16.0 | (2.0) | 4.0 | (5.5) | 5.7 |
| Net exports, contribution to GDP growth, % | 16.9 | -1.0 | (1.5) | 2.0 | (-0.1) | 0.5 |
| GDP, % | -13.9 | 2.2 | (1.5) | 4.5 | (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 April are given in brackets.

mostly by exports. However, a positive effect on growth will come from stock building as well. After approximately 1% growth this year, we expect domestic demand to grow by 4% in 2011 and close to 5% in 2012. Investments will be the most dynamic component of domestic demand in the forecast period as both public and private investments will grow. While household investments in new housing will grow modestly and the real estate sector will still be feeling the consequences of the crisis, companies will increasingly invest in machinery and equipment.

Household consumption will decline this year by 3%, but grow by 3.5% in the following two years. Government consumption will decline in 2010, but in 2011-2012 slight growth will be seen, as the public sector will be able to expand spending.

Export growth will slow next year due not only to weaker growth in Estonia's main export markets, but also because capacities will be fully employed in the rapidly growing export sectors already in late 2010 and early 2011. The investment process will require time, and access to financing will remain somewhat limited at this early period of economic recovery.

Imports have been gathering speed, together with exports, as Estonian export products include a substantial share of imported inputs. Buoyed by the growing optimism, companies have started to invest and rebuild inventories – hence, imports will grow stronger than exports already this year.

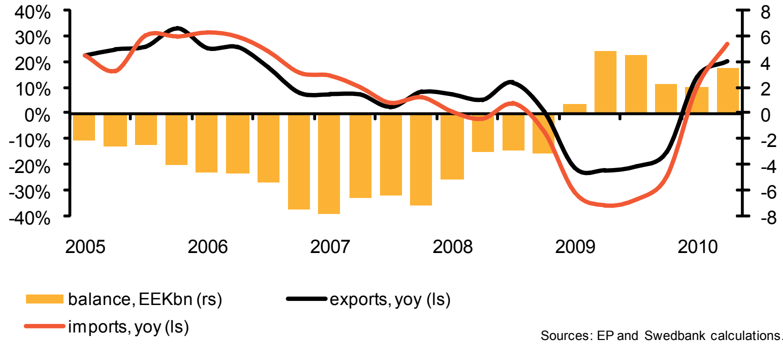
## Strong export growth to recede in 2011

The recovery of Estonian economic growth is strongly dependent on external demand. As most of Estonia's main trading partners have recovered from the crisis faster than expected, Estonian exports have grown more than we forecast in April. This allows us to increase our expectations regarding export growth in 2010. We expect this to slow substantially in 2011, mostly due to a slowdown of growth in European markets but also due to capacity constraints in Estonian companies. Supported by the reviving global economy, we foresee Estonian exports' growth to increase in 2012.

Cost cutting has increased the cost competitiveness of producers of low-priced products and services, but we foresee that this current cost advantage will diminish faster than many producers and investors expect. Although Estonia will be the country with the lowest price and cost levels in the euro zone, there will be countries with lower cost levels in the EU and Estonia's neighbourhood. Energy prices are on the rise, particularly those of natural gas and electricity. The main reason for the strong price growth is the isolated market, but for electricity the opening of the market, i.e., deregulation, we believe could in the case of Estonia also be important. Labour costs will also increase, as labour supply will diminish due to demographic developments, labour outflow, and structural problems.

Consequently, low cost production cannot survive in Estonia for long. While this year--and maybe in the first half of 2011--exports will grow also due to expansion of low value-added sectors, we foresee another structural shift coming as cost growth forces low-cost producers to close their production or shift to higher-priced products. We also see that companies now rapidly expanding their production will soon face capacity constraints because during the crisis too few investments were made.

**Export of Goods and Services**




Sources: EP and Swedbank calculations.

These developments, together with slowed growth in Estonia's main export markets, will slow Estonian production and export growth rates substantially in 2011. However, we expect a recovery of growth rates at the end of 2011, when external demand is expected to pick up and some of the capacity constraints are alleviated through growing investments.

Import growth will be stronger than we expected in the spring. Faster-growing exports also need more imported inputs (energy, raw materials, and details). Imports are growing also because of rising company investments, which require more machinery and equipment. Additionally, companies are recovering their exhausted inventories – the process has been much more intensive this year than we foresaw. Growing consumption will increase demand for imported goods in 2011-2012.

An important reason why we are less optimistic regarding exports and imports is related to services. While, during the crisis, exports of Estonian services performed very well, this seems to have changed in the second quarter of 2010. Hence, we lower our expectations regarding the growth of services exports and increase for services imports. Although services are partly substitutable, there are higher barriers in place than for the goods market, as in some cases the number of services providers might be very low or the situation very close to monopolistic. Consequently, the success or troubles of one company may affect the macro picture and how services are distributed between exports and imports.

We still expect that Estonia's current and capital account will be in surplus throughout the forecast period, but we foresee it to diminish faster than we did in the spring. Besides a smaller trade and services surplus, we expect the income account deficit to be bigger as company profits are growing much faster than anticipated in our spring forecast. We also foresee workers' remittances as being somewhat bigger, as more people are moving to work abroad, and interest payments to be smaller as interest rates will remain low for a longer period than previously expected.

## Infrastructure and technology investments to grow

We expect investments to grow by approximately 11.5% this year as stocks are rising after a sharp correction in 2009. Gross fixed capital formation will continue to decline this year, although annual growth is expected to resume in the third quarter. Gross fixed capital formation will expand more than 11% next year, with growth then slowing to 10% in 2012.

Gross fixed capital formation will start to grow as public sector investments are rising, supported by EU financing, and companies are increasing their investments in technology. Public investments will increase as big infrastructure investments are on the rise. Companies are being forced to increase investments in machinery and equipment to tackle the issue of rising costs and maintain competitiveness. Although these types of investment have been growing since the beginning of this year, we expect this growth to accelerate in the second half of 2010.

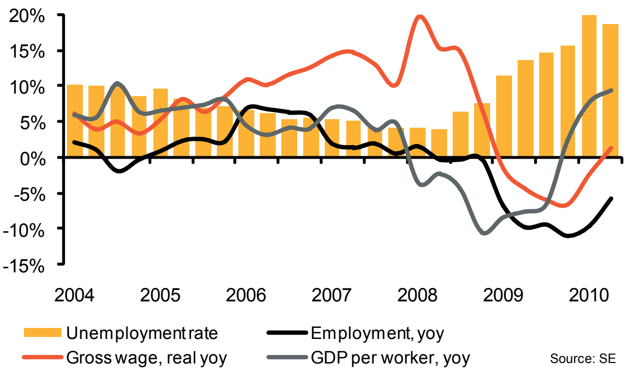
Construction of houses will remain weak throughout the forecast period, although slight growth will be seen next year. Public sector investments in this area will remain low due to budget constraints, and households will not be eager to buy new real estate. We expect that some development projects will start next winter or spring, but we foresee that overall activity in real estate development will remain subdued for some time owing to weak demand.

Public investments will mostly be financed from different EU funds. Stronger companies will rely on own funds, but we foresee that the use of foreign private funding will increase as well. Borrowing from parent companies will be the most widespread, but we expect that bigger companies will borrow directly from abroad. Local lending will remain relatively small, and loan portfolios of local banks will continue to decline in 2010 and at least into the first half of 2011, due to tightened credit terms and the deleveraging process.

## Wages growing despite high unemployment

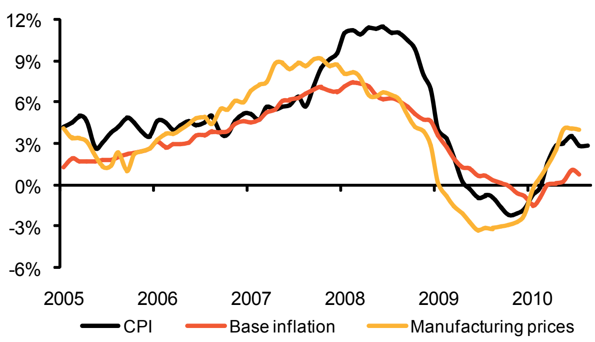
The average unemployment rate in 2010 – approximately 17.8% - will be higher than forecast in spring; however, we expect it to decline to 12.5% by 2012. We have increased our unemployment expectations

**Labour Market Indicators**




Source: SE

**Major Price Indices, yoy**




Sources: SE and Swedbank calculations.

mostly for two reasons. First, because the activity rate of the working-age population has remained unusually high, and we do not foresee it declining throughout the forecast period. Second, job creation in the first half of 2010 was not as strong as expected.

The official job-seekers' rate has been falling since spring, suggesting that more people are looking for jobs themselves, are employed in the hidden economy, or are abroad. As surveys show, the regular unofficial wage payments have not grown much during the crisis in Estonia; hence, we are of the opinion that short-time and temporary unofficial jobs are on the rise. Working abroad, including through local companies, has grown in 2010, as shown by the growth of workers' remittances received, and we expect this to intensify in 2011-2012.

The slow job creation is being offset by growing productivity and an increasing number of working hours. We estimate that, at least this winter, companies will have to start to employ more workers as there are limits for expanding production by increasing working hours.

We expect the average monthly gross real wage to decline by 1% this year and grow by 2% in 2011 and 2.5% in 2012. This upward revision is the result of a slightly better than expected outcome in the second quarter of 2010 and sharply stronger productivity.

However, wage growth may turn out to be stronger than we currently assume. The labour shortages in specific areas may lead to stronger wage growth in these sectors, which will then spread into other sectors. If this happens, the average wage growth will accelerate in the second half of 2011 or in 2012.

## Inflation to pick up in winter before receding

We have upgraded our consumer price growth expectations for this year and the next due to stronger-than-expected growth last spring. We expect prices to grow by 2.6% in 2010, followed by 3% and 3.5% growth in 2011 and 2012, respectively. Still, annual growth rates during the upcoming winter could reach 4% or even higher due to the small base, increase in energy prices, and recovering demand.

The underlying price growth is the result of the convergence process, which most likely will intensify after Estonia enters the EMU. The euro makes it easier to compare prices in Estonia with those in other EU countries, particularly those in Finland, and, hence many companies will find excuses to increase prices (e.g., for some food products), although consumers will find also reasons for complaint in several other cases (e.g., industrial goods). The euro zone entrance coincides with the economic recovery, which itself will generate price growth. We expect external pressure on Estonia's price level to be modest in the future; nevertheless, it was strong this spring and summer, and this was one reason for our inflation forecast upgrade. Negative surprises are possible if global prices – particularly for energy and food – grow faster than currently projected.

Administrative price growth in coming years will be slower than in 2009-2010: as of now, only an increase in tobacco excises is planned for 2011 and 2012. Other regulated prices have come under much tighter scrutiny than previously after changes were made to the regulatory process.

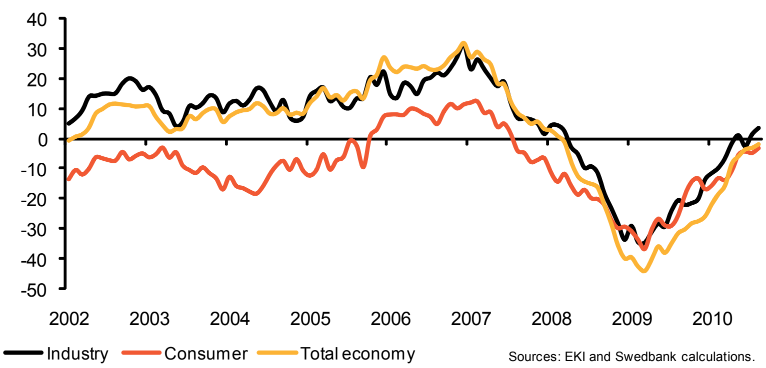
Two factors are at work to lower inflation pressures in 2010 and in the first half of 2011. First, weak consumption demand makes it difficult to increase prices substantially. However, due to low competition in some sectors, owing to the limited number of companies present, this effect will be not very strong. Second, the price controls related to euro adoption, which have captured much media attention, might at least postpone some of the price increases to the second half of 2011. It is normal to expect that, due to price convergence, the inflation rate in Estonia will be higher than in the richer euro zone countries for several years. However, it is important that this difference does not become too big, as faster inflation would undermine households' spending and weaken companies' competitiveness.

## Households to keep their spending low

Household consumption will decline by 3% this year, but grow by 3.5% in both 2011 and 2012. The major factors keeping consumption subdued are high unemployment, low incomes, and growing savings. As inflation rises - particularly for primary necessity goods and services (such as food and housing) -- we also see that price growth will become a limiting factor for spending growth in late 2010 and 2011 as it will take place at a time when incomes are not yet growing.

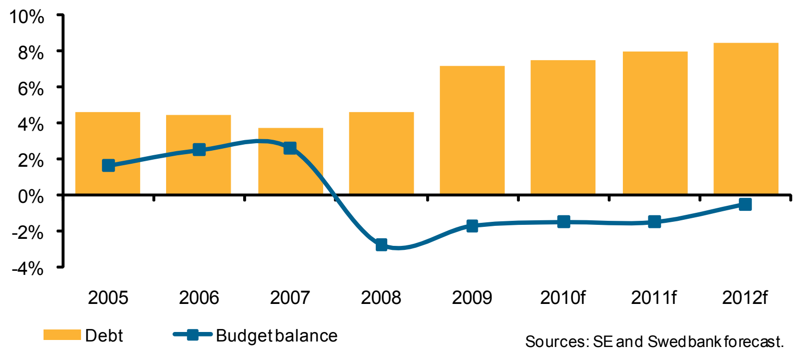
While consumer confidence has already been improving for more than a year, being above the long-term average for several months, this improvement has not brought with it a substantial recovery of consumption. The purchases of most goods and services are still declining compared with last year as households try to adjust their spending and increase savings. However, a slight shift

**Confidence Indices, s.a.**




Sources: EKI and Swedbank calculations.

**General Government Finances, % of GDP**




towards higher spending levels has taken place recently, as our analysis shows. We are of the opinion that this recovery will remain subdued, at least until the middle of 2011.

Despite gradually rising incomes, the household savings rate will remain high. One reason is the deleveraging process, and another is the shift in household behaviour in 2008. We are of the opinion that this behaviour will not change in our forecast period. Weak household demand will suppress local small companies and employment, while growing prices and the relatively high price level of certain goods (e.g., clothing and electronics) will encourage Estonians to shop abroad, thus worsening the situation for local companies.

## Euro adoption to have a modest short-term impact

Estonia will become the 17th member of EMU at the beginning of 2011. The preparation period will bring costs to companies; however, it will also bring beneficial effects to some companies through increased demand (e.g., IT services). Also, the preparation period will most likely slow a possible price increases because price controls are being put in place that, it is hoped, will work effectively. These controls are getting wide media coverage as prices are the biggest public concern regarding euro adoption.

The pre-introduction period also includes the alignment of Estonian monetary regulations with those of the euro zone. The biggest change is that the reserve requirement will be lowered from 15% to 2%. The first cut took place on September 1 (to 11%), the next is scheduled for November 1 (to 7%), and the final one takes place on January 1, 2011. The central bank estimates that approximately EEK 40 billion (EUR 2.6 billion) of additional liquidity could be injected into the economy as a result. However, it is highly probable that banks will use a portion of these sums to redeem loans and to keep additional reserves. Hence, we do not expect any substantial effect of this monetary easing on banks' lending policies.

Euro adoption will lower risks and bring a more stable economic environment. We foresee increased capital inflows into the economy; however, we are not projecting these to be at the levels seen in Slovenia or Slovakia, as the current global economic situation is not very favourable for investments. However, a better outcome is possible. This would, in turn, increase not only production, jobs, incomes, and consumption, but also prices and wages more than expected in our current scenario; bigger tax revenues would allow the government to reach its balanced-budget target earlier than currently projected.

## Budget to remain in deficit

The likelihood of the government's policy changing is low, and we are of the opinion that the government will succeed with its ambition to reach a balanced budget by 2014. We foresee that the public sector budget deficit will gradually decline throughout the forecast period. This development, however, means that the government will have to continue with the consolidation of the public services, as commitments taken in spring 2009-- at a time of heavy cuts--will increase compulsory spending from 2011 onwards significantly. The conservative budget planning, in which lower revenue expectations - rather than average or positive ones – are taken as the base, makes it possible to overshoot the budget revenue plans not only in 2010, but most likely in 2011 and 2012 as well (if global economic developments remain in line with expectations).

Significant tax changes are unlikely to take place during the forecast period. Excise rates on tobacco products are scheduled to be raised in the beginning of 2011 and 2012. Lowering the unemployment insurance payment rate from the current 4.3% is the most likely change to take place, but this has not yet been scheduled. It is possible that some other changes in the tax system will be enacted in 2012, but this will depend on the coalition that takes office after the general elections in March 2011. As of now, the current government coalition has a good chance to continue in office after the elections because the economy is on the rise. If it stays in power, the shift from direct taxes toward indirect taxation will continue.

The government's structural policies will include steps aimed at improving the business environment, encompassing mostly public investments in infrastructure and particularly the energy sector and transportation. The reform of general education started in September, and we are of the opinion that the government should now substantially intensify its work on other important structural issues related to education. Because unemployment is becoming more and more long term, decisive steps to re-educate and retrain the unemployed are required.

Maris Lauri
Annika Paabut

# Latvia: Uneven and still fragile recovery

**Key Economic Indicators, 2009 - 2012 1/**

| | 2009 | 2010f | 2011f | 2012f |
|---|---|---|---|---|
| Economic growth, % | -18.0 | -1.5 | 3.0 | 4.2 |
| GDP, mln euro | 18 067 | 17 194 | 17 733 | 18 922 |
| Average growth of consumer prices, % | 3.5 | -1.2 | 1.5 | 2.5 |
| Harmonised unemployment level, % | 16.9 | 19.5 | 17.5 | 15.5 |
| Real growth of average net monthly wage, % | -5.9 | -6.9 | 1.5 | 2.5 |
| Growth of exports of goods and services, % | -17.8 | 15.5 | 10.0 | 11.0 |
| Growth of imports of goods and services, % | -37.6 | 13.0 | 10.5 | 14.0 |
| Balance of goods and services, % of GDP | -0.3 | 0.5 | 0.3 | -1.3 |
| Current account balance, % of GDP | 9.4 | 6.2 | 2.4 | -0.6 |
| Current and capital account balance, % of GDP | 12.0 | 8.6 | 5.5 | 3.1 |
| Net FDI, % of GDP | 0.4 | 0.4 | 0.8 | 2.2 |
| External gross debt, % of GDP | 157 | 162 | 156 | 147 |
| General government budget (accrual basis), % of GDP | -9.0 | -8.5 | -6.0 | -3.0 |
| General government debt, % of GDP | 36.6 | 49.0 | 53.0 | 51.0 |

Sources: CSBL and Swedbank.

1/ Annual percentage change unless otherwise indicated.

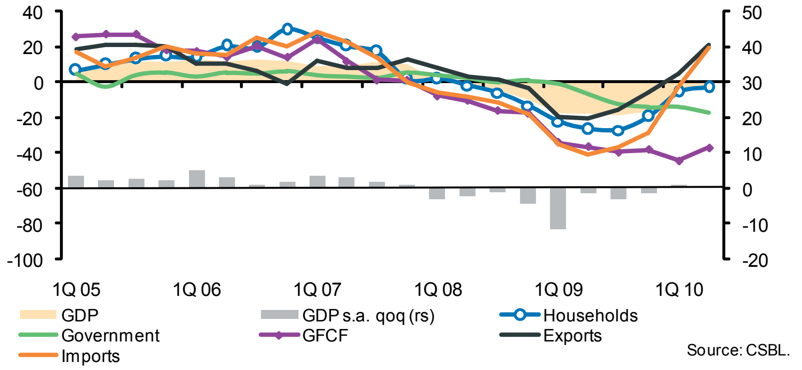
The recession is over, and, although the recovery is still uneven across different economic sectors, the turnaround is evident. In the first half of the year, the biggest contributor to growth was the rebuilding of inventories. Export growth and stabilisation in household consumption, driven by stronger household confidence and rising wage incomes, supported the overall economic activity. Growth, however, is still fragile, and the recent run of good data (e.g., GDP up by 0.9% and 0.8% quarter on quarter and seasonally adjusted in the first two quarters) is encouraging but does not imply yet that sustainable strong growth has resumed.

Compared with our April report, the global growth outlook has improved for 2010, but weakened for 2011-2012 because of the upcoming fiscal consolidation and the inventory cycle's running out of steam. This global outlook has improved Latvian exports for this year but will dampen next years' growth.

We now expect a smaller fall in Latvian GDP for 2010 of about 1.5%, i.e., an underlying growth of about 2% and a contraction due only to a large negative carryover from 2009. In turn, somewhat slower growth than earlier expected is now forecast for 2011 (3%), with the expansion strengthening to 4.2% in 2012. Because the labour market recovery already commenced in the second quarter, we are lowering our average job-seekers' rate forecast to 19.5% this year (21.5% before). We believe that unemployment peaked this spring and, after a temporary rise in autumn as seasonal jobs fade away, it will continue to retreat slowly over the coming years. The deflation period has turned out to be shorter and shallower than anticipated due to stronger global price pressures and improvements in household confidence. We now foresee about a 1.2% average consumer price deflation in 2010, and 1.5% and 2.5% inflation in 2011-2012, respectively. However, inflation will be higher if the currently discussed fiscal consolidation measure to eliminate the reduced value-added-tax (VAT) rates is implemented. With import intensity somewhat stronger than we anticipated, imports are rising faster, which means smaller surpluses in the trade account for 2010-2011 and a deficit already in 2012.

Thus, we see the short-term prospects as relatively upbeat, but over the medium run we see certain risks to the forecast. On the downside, we point to two main risks. The first is weaker global demand. This would hit Latvian exports and undermine recovery, particularly if structural reforms in public and private sector lag, thus constraining improvements in export competitiveness. The second is a persistent labour market

**Annual GDP growth, %**




Source: CSBL.

**Swedbank's GDP Forecast – Latvia**

| | 2009 | 2010f[1] | | 2011f[1] | | 2012f[1] |
|---|---|---|---|---|---|---|
| GDP | -18.0 | -1.5 | (-2.5) | 3.0 | (4.0) | 4.2 |
| Household consumption | -24.0 | -2.0 | (-9.0) | 3.0 | (2.0) | 4.5 |
| General government consumption | -9.2 | -4.3 | (-7.4) | -1.1 | (-3.0) | 0.2 |
| Gross fixed capital formation | -37.3 | -27.0 | (-27.0) | 7.0 | (7.0) | 14.0 |
| Exports of goods and services | -15.5 | 9.0 | (6.0) | 6.0 | (8.0) | 6.0 |
| Imports of goods and services | -35.5 | 7.5 | (-8.0) | 5.0 | (8.5) | 9.0 |
| Inventories contribution to GDP, pp | -2.1 | 6.7 | (4.8) | -0.5 | (1.8) | 0.2 |
| Net export contribution to GDP, pp | 14.8 | 0.5 | 6.6 | 0.4 | 0.1 | -1.7 |

Sources: CSBL and Swedbank.

1/ These are averages of the forecast ranges, which are about 2 percentage points wide in each direction. Our April forecast is given in brackets.

skills mismatch. If not adequately addressed, this may lead to wage growth in excess of that of productivity, which thereafter spills over into inflation, putting at risk fulfilment of the Maastricht price stability criterion for euro accession in 2014. While such labour market developments may initially produce faster GDP growth, they would worsen competitiveness, widen macroeconomic imbalances, significantly undercut future growth and increase the risk of stagnation. Of the upside risks, stronger global demand would support exports and strengthen recovery.

## Spurt in export growth to slow down

We now expect stronger export volume growth in 2010, but a somewhat slower increase in 2011 compared with our April forecast. The global outlook for 2010 has improved, especially for such countries as Germany and the Nordics, which are among Latvia's key trade partners. We have raised our forecast to about 9% for 2010. In turn, the weaker global outlook for 2011 undermines export performance, and we forecast real exports to grow by about 6% annually in both 2011 and 2012.

We expect export growth to be supported by the country and product mix becoming more diversified: also distribution networks are turning increasingly diverse (e.g., optimizing supply chains and targeting niche segments). The dramatic fall in demand during late 2008 and 2009 pushed manufacturers to search for new markets, and this process is set to continue, especially to countries outside the EU. For instance, the metal industry has found demand in Algeria, thereby growing its export share to this country to 2.2% of total exports in the first half of 2010 (up from 0.2% in 2007). The wood industry has widened its product mix by extending its supply of higher-value-added items (e.g., the company Bau-How), as well as by partially returning to lower-value-added segments that appeared to show more resilient demand in the recession. Expansion into lower-value-added products may come with more sophisticated distribution networks that help to extract more value indirectly (e.g., the company Latvijas Finieris).

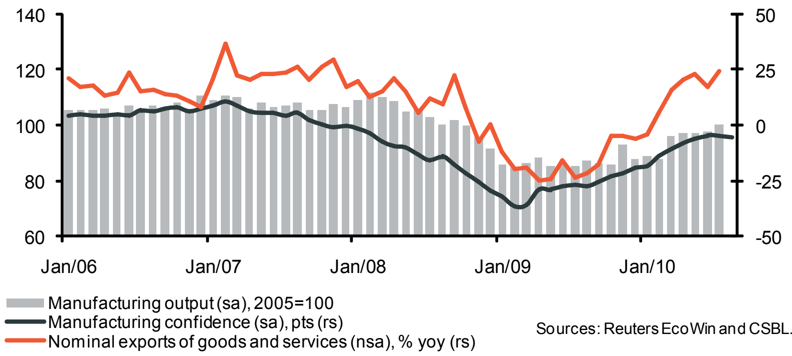
Rising global competition and emerging local resource constraints (e.g., timber supply for the wood industry and rising labour costs for the whole economy) will maintain the pressure on exporters to shift towards higher-value-added products. A shift to such products will, of course, be a challenge, as it will demand investments and skills .

## Stronger import growth in 2010

Stronger exports and consumption have boosted imports. However, our estimates suggest that import growth has been swifter than exports and household consumption would warrant. There are several possible reasons for this: (i) import substitution during the deflation period has turned out to be weaker than initially estimated, (ii) we had underestimated import sensitivity to exports, and (iii) we had overestimated inventory levels. Perhaps it is a mix of all three possibilities, but the first one seems most likely. Discussions with businesses do not support the latter arguments and suggest neither an increased need for imports for exporting companies in addition to that of larger production volumes, nor an unforeseen rapid restocking by manufacturers.

In this context, we are significantly raising the forecast for import growth for 2010, but we believe that it will slow in 2011 as the rebuilding of inventories will be by and large over and export growth will slow. With

**Industry and exports**




Sources: Reuters EcoWin and CSBL.

reviving domestic demand, import growth is expected to accelerate again in 2012. Higher imports imply smaller trade account surpluses in 2010-2011, and a small deficit is anticipated in 2012. Consequently, current account surpluses are expected to vanish in 2012. Although gross external debt might therefore start to rise in 2012, the debt-to-GDP ratio, with economic activity expanding, will continue to decline.

## Contraction in investments to bottom out in 2010

Our investment outlook has remained largely unchanged from the April report. We forecast investments to bottom out in the second half of this year. The decline in gross fixed capital formation slowed in the first half of the year, and there are signs of a turnaround. Many exporting companies are running close to their capacity constraints. Confidence has improved, asset prices remain attractive, and interest rates have declined. Building permits for export-related facilities started to rise in the second quarter of 2010.

However, investment demand remains weak. Companies still need to deleverage before engaging in new investment projects. For those able to invest, assessment of projects may have been delayed until after the Parliament draws the next year's budget and changes in tax policy become known. Appropriation of EU funds lags – in the first half of the year, only 21% of the funds planned for 2010 were paid out. The government is aiming to accelerate acquisition of these funds, but results have yet to be seen.

A confidence boost to international investors was provided by Fitch ratings, which recently improved its outlook for Latvia's sovereign risk rating to stable from negative. A rating increase by Fitch, as well as by Standard&Poors, from speculative to investment level (Moody's is the only major rating agency to have kept Latvia at investment grade) is likely to follow after the 2011 budget has been approved and its implementation supported by external donors – i.e., perhaps in the first quarter of 2011.

## Structural challenges in the labour market

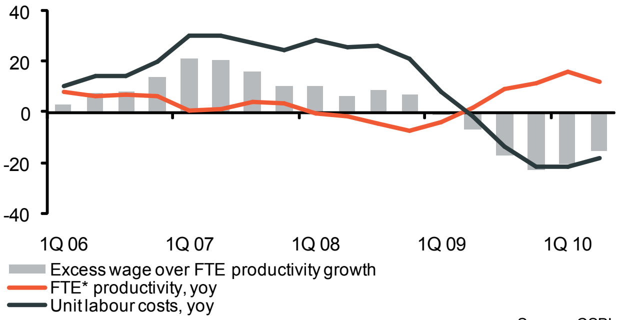
The labour market has started to improve earlier than expected. Unemployment peaked in the first quarter and has been declining since. The inflow of new unemployed has slowed considerably, whereas emigration and active labour market programs have cut the number of those already unemployed. More important, the second quarter witnessed the first increase in the number of employed via both seasonal and new permanent job creation. The number of vacancies has risen. While we expect the unemployment rate to rise again this autumn as seasonal jobs disappear, it will not reach the peak seen in March. Given the early improvement in the labour market, we have lowered our average job-seekers' rate forecast for 2010 and the following two years by 2 percentage points annually.

By and large the wage cuts seem to be over – average monthly wages even grew marginally in the second quarter compared with the first, owing to seasonal factors. Despite marginally growing wages (and rising consumer/producer prices), external competitiveness was still improving vis-à-vis Latvia's main trade partners. According to Bank of Latvia data, by the first quarter of 2010 the real effective exchange rate deflated by unit labour costs in manufacturing had corrected about 80% of its boom-time appreciation. Unit labour costs also continued to decline in the second quarter of 2010.

Despite better-than-expected labour market dynamics thus far, challenges that may undermine the quality/ quantity of the medium-term labour supply remain. For instance, the rising duration of unemployment (currently more than 40% of job seekers have not worked for more than a year; this proportion is growing) points to deepening structural unemployment. Especially vulnerable are youngsters – the job-seekers' rate for the 15-24-year-old group is about twice as high as the average for the entire labour market. This age group is most mobile and prone to emigrate, resulting in a largely permanent labour loss.

Our forecast assumes slow wage growth for 2011-2012, but shrinking labour supply and severe skills mismatch may kick off processes that lead to imbalances akin to those experienced a few years ago. Media

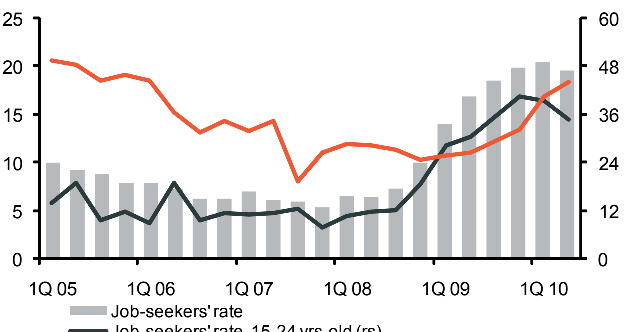
**FTE* productivity, real gross wage and unit labour costs, %**




* FTE - full-time equivalent

Source: CSBL.

**Job-seekers' rate, %**




Source: CSBL.

reports point to an increasing number of cases in which employers face difficulties in finding a qualified worker despite still high unemployment (e.g. construction companies hire workers from abroad – a sector that has seen one of the largest job losses during the recession). Such a skills mismatch may push wage growth above that of productivity – i.e., as the economy expands, so does labour demand, which cannot be matched by supply as those unemployed lack the required skills. This may again cause competitiveness problems. Long-term unemployment amplifies social problems such as income inequality and pension system instability, as living incomes would rise for one part of the population and stagnate/decrease for the other.

The lesson to be learnt from the past for the private sector is that wage increases should be based on productivity improvements. The same applies also to the public sector, where the remuneration policy should be performance based and linked to that in the private sector to improve motivation. The migration policy should be adjusted to address labour market problems (e.g., an immigration policy to attract well-educated labour to ease undue wage pressures). Tax policy that favours job creation is vital – e.g., lower social insurance payments for targeted groups like long-term unemployed or youth. And last but not least, reform of higher education is crucial to supply the labour market with skills demanded by the employers.

## Shallower and shorter deflation period

Stronger-than-expected upward price pressures from abroad (especially of energy and food) has hastened the end of the deflation period. Consumers' inflation expectations have risen, making it easier for businesses to raise prices, an opportunity that they seem to be quick to exploit. During the first eight months of the year, monthly deflation in the consumer price index (CPI) was observed only in May and August. The current trends suggest that CPI will continue to rise through the rest of the year and annual inflation is likely to resume already in September.

Monthly core inflation (i.e., CPI excluding unprocessed food, administratively regulated prices, and fuel) has so far been negative, but, if adjusted for seasonality, it has been reporting positive monthly increments since April (except in August). The underlying pressures are thus for prices to rise, and it seems that household perception rather than strength of the economy is the key driver for it. Inflation will add to government tax revenues and ease deleveraging for companies if they can boost their margins, but it will hit the purchasing power of poorer households as (i) the prices of first necessities rise most, and (ii) due to their lower skills, poorer households have not seen their incomes rising yet. It seems that the adjustment of cost competitiveness through deflation will mostly be over by the end of this year, and further gains will need to come via productivity growth.

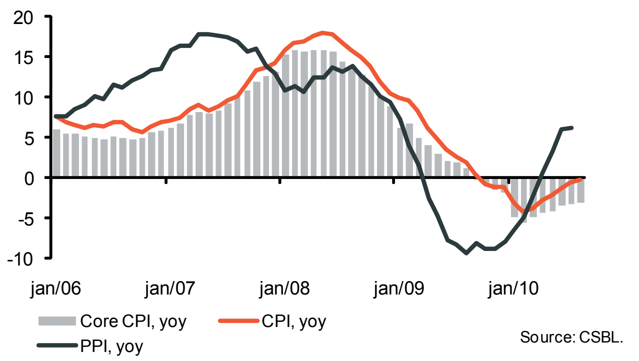
We forecast CPI to shrink by 1.2% in 2010 (due to negative carryover effects) and to grow by 1.5% and 2.5% in 2011 and 2012, respectively. The currently discussed possibility of eliminating the reduced VAT rate would add an additional 1 percentage point to annual CPI inflation. This may lead to weaker consumption in 2011, but at the same time it may also put the upward pressure on nominal wages to compensate for inflation (made possible due to the skills mismatch in the labour market). But a VAT rise as such would not worsen external competitiveness, as it affects imported and locally produced goods equally, while exporters do not pay VAT at all.

There is a risk of higher inflation than our base scenario assumes if the sustainable wage-productivity relations outlined in the previous section are not firmly established. This becomes particularly important in the context of the euro introduction aimed for in 2014, as it puts at risk the fulfilment of the Maastricht price stability criterion, especially if inflation in the euro zone remains low, as is currently expected. In addition, the timing and effect of fiscal consolidation measures must be carefully assessed – for instance, if elimination of the reduced VAT rate is unavoidable, this can be done only in 2011 and not in 2012, as it would raise inflation above the target.

## Household consumption has bottomed out

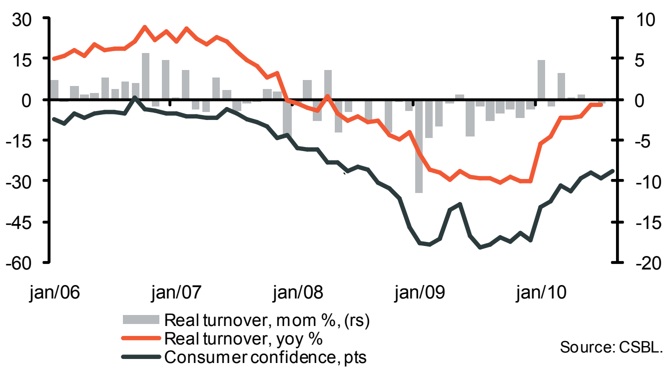
Household consumption started to recover somewhat earlier than we

**Consumer and producer prices, %**




Source: CSBL.

**Retail trade and consumer confidence, %**




Source: CSBL.

anticipated, owing to higher consumer confidence and better overall situation in the labour market. There are indications that consumption may inch down somewhat in autumn, however. The sharp increase in consumer confidence in the beginning of the year has halted, and the upcoming elections, along with the likely rise in the unemployment rate in autumn, may temporarily cut it back.

We now forecast a significantly smaller fall in 2010 household consumption, owing to a better first half of the year, i.e. -2% and negative only due to the base effect. Under the base scenario, household consumption will grow by a further 3% in 2011 and 4.5% in 2012. A lesson from the crisis is that a “safety cushion” is necessary, and households will increase their precautionary savings and reduce their leverage through earlier repayment of their debt. This is seen in the growth of deposits. On the other hand, bank lending is likely to gradually become more forthcoming, adding to consumption.

2010 budget deficit in line with the plan

The budget deficit in 2010 is expected to be just below the 8.5% of GDP cap, i.e., in line with the agreements with the external lenders. In the first eight months of 2010, tax revenues exceeded the plan by about 2%, reflecting not only the improving economic situation but also conservative budget planning. Measured using cash-flow methodology, the budget deficit in the first seven months of the year was only about 1.5% of the annual estimated GDP. If the past is any indicator for the future, expenditures will rise towards the end of the year and pick up most of the slack in the deficit. Fiscal discipline is still an issue – for instance, recently an additional LVL 26 million was assigned for the needs of hospitals (from emergency funds). Implementation of a functioning fiscal responsibility law (entailing, e.g., limitations to raise expenditures during the fiscal year) is thus crucial.

The draft of the 2011 budget is still to be seen. In the run-up to the general elections held on October 2, parties are avoiding speaking on specific consolidation measures. The Ministry of Finance’s view is that LVL 350 million of consolidation is necessary (about 2.8% of GDP) for 2011 to cap the deficit at 6% of GDP. Only a general vision on tax policy changes is available so far, but the dominating view seems to be to shift the tax burden from labour towards property (e.g., residential real estate). It is also expected that the regressive nature of the tax system will be reduced by, e.g., a higher tax-free allowance on personal income. It is clear, however, that the overall tax burden will increase in 2011. Currently, we do not see a high risk of exceeding the Maastricht criteria on the budget deficit and public debt in 2012.

## Structural reforms – waiting until after elections

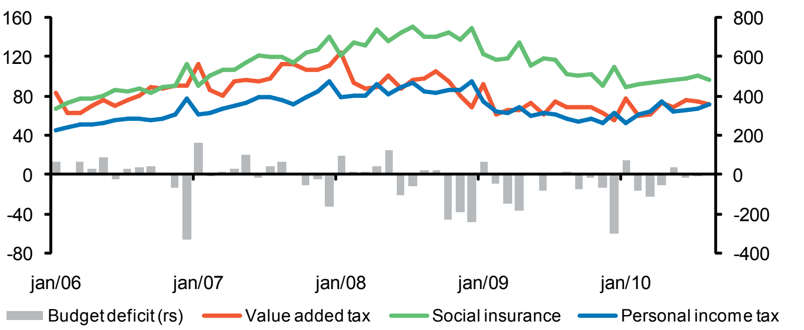
It is impossible to speculate with a reasonable degree of certainty on the election results and thus specific economic policy actions that may follow after the elections – past experience shows that opinion polls are not a good indicator of election outcomes. Although some of the parties talk about Hungary-type radical changes to the IMF/EC-supported program, we believe that the risk of such moves is extremely slim if not nonexistent. A radical change would only raise uncertainty and cost of funding; no alternative plan to that currently pursued has been presented even to discuss it. Certain renegotiations are likely though; for instance, Latvia is expected to borrow less than initially planned.

With elections approaching, policymakers have become more reluctant to make unpopular decisions, and social concerns have tended to overshadow the structural aspects of economic policy. For instance, the excise tax on natural gas was raised in July 2010, but, just a moth later, its implementation was then postponed for a year, with the aim of easing the financial situation of households. We believe that targeted transfers to poorer households to compensate for the higher cost of gas (and thus heating) would have been more efficient socially and cheaper for the budget; meanwhile, the excise tax for natural gas would have stimulated the use of renewable resources and potentially reduced import dependency.

The Latvian economy has seen the first green shoots of recovery, but is not yet on firm ground for a sustainable and strong recovery. Less painful temporary fixes tend to be chosen over sustainable solutions. We believe that to a large degree this has been a pre-election “cautiousness,” which is likely to change when the October elections pass. The next elections are for the municipalities in 2013 – for decisive politicians, this gives ample time to implement unpopular but necessary reforms and to reap their benefits before the 2013 elections.

Lija Strašuna
Mārtiņš Kazāks
Dainis Stikuts

**Tax revenues and budget deficit, LVL m**




Source: State Revenue Service.

# Lithuania: First steps on the long and winding road to recovery

**Key Economic Indicators, 2009 - 2012** [1/]

| | 2009 | 2010f | 2011f | 2012f |
|---|---|---|---|---|
| Economic growth, % | -14.8 | 0.5 | 3.0 | 4.5 |
| GDP, m euros | 26 650 | 26 970 | 28 057 | 29 760 |
| Growth of consumer prices, % | 4.5 | 1.0 | 1.0 | 1.5 |
| Unemployment level, % | 13.7 | 17.0 | 15.5 | 14.0 |
| Growth of real net wage, % | -7.2 | -5.0 | 0.0 | 2.5 |
| Growth of exports of goods and services, % | -25.2 | 22.7 | 12.0 | 9.5 |
| Growth of imports of goods and services, % | -35.8 | 23.0 | 11.2 | 9.4 |
| Balance of goods and services, % of GDP | -0.7 | -1.0 | -0.5 | -0.5 |
| Current account, % of GDP | 3.8 | 1.2 | 0.0 | -0.2 |
| Current and capital account, % of GDP | 7.2 | 4.2 | 3.0 | 2.8 |
| FDI inflow, % of GDP | 0.9 | 1.0 | 1.5 | 2.0 |
| Foreign gross debt, % of GDP | 86.5 | 89.0 | 85.0 | 82.0 |
| General government budget position, % of GDP | -8.9 | -8.0 | -6.0 | -3.0 |
| General government debt, % of GDP | 29.5 | 38.0 | 42.0 | 43.0 |

Sources: LCD and Swedbank.

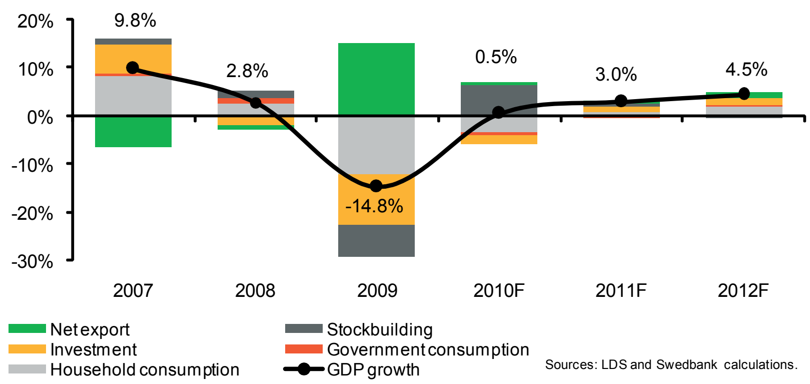
1/ Annual percentage change, unless otherwise indicated.

Second-quarter GDP results confirmed that the Lithuanian economy was recovering: the economy grew by 3.2 % (seasonally and calendar-day adjusted), while the annual GDP growth rate reached 1.3%, thus moving into positive territory for the first time since the third quarter of 2008. Although a rebound was expected after weak first-quarter results, the GDP growth recorded in the second quarter nevertheless exceeded our expectations. The economy continued to be driven out of the recession by the large, export-oriented industrial sector, the performance of which has been gradually improving since autumn 2009, owing to the sustained pickup in demand in the EU economies. Meanwhile, domestic demand has remained under intense pressure. Despite robust second-quarter results, GDP over the first half of the year was nonetheless down by 0.7% from the same period a year ago due to the sharp 4% contraction on a quarterly basis recorded in the first quarter.

We expect that the rate of expansion during the third and fourth quarters will weaken somewhat for three reasons. First, even though exports will remain the main driver of economic growth, we do not anticipate a jump in volumes compared with the first half of this year. Second, household consumption and investments are unlikely to rebound swiftly. Despite a gradually improving consumer confidence since last autumn, the adverse labour market developments have thus far prevented this confidence from translating into an increase in spending. The only significant source of investments this year remains the EU funds, which, due to administrative and other hurdles, are being absorbed more slowly than was initially planned. For other private sector investments to materialize, a larger fall in the overall perception of risk of the economic climate of the country and/or a further decline in asset prices are needed. Third, the rapid rebuilding of stock levels is nearly over. Stockbuilding is expected to contribute positively to GDP growth in the upcoming quarters, especially during 2010, but also somewhat during 2011.

Instead of the 2% GDP contraction projected in April, we foresee the Lithuanian economy growing by 0.5% this year. Better-than-expected second-quarter developments altered our outlook for the economy, while the stronger global growth expected this year also contributed to the revision

**Contributions to GDP Growth**




Sources: LDS and Swedbank calculations.

**Swedbank's GDP Forecast – Lithuania**

| | 2009 | 2010F | | 2011F | | 2012F |
|---|---|---|---|---|---|---|
| GDP | -14.8 | 0.5 | (-2.0) | 3.0 | (3.0) | 4.5 |
| Household consumption | -16.8 | -5.0 | (-5.0) | 1.0 | (1.0) | 3.0 |
| General government consumption | -1.2 | -3.0 | (-4.5) | -1.0 | (-5.0) | 1.0 |
| Gross fixed capital formation | -39.1 | -9.0 | (-3.5) | 7.0 | (8.0) | 8.5 |
| Export of goods and services | -14.3 | 10.5 | (4.5) | 6.5 | (6.5) | 7.7 |
| Import of goods and services | -29.4 | 8.8 | (2.2) | 5.0 | (5.0) | 5.5 |
| Net exports contribution to GDP growth | 15.2 | 0.6 | (1.2) | 0.8 | (0.8) | 1.3 |
| Stockbuiding contribution to GDP growth | -6.5 | 6.4 | (3.1) | 0.6 | (1.3) | -0.6 |

Sources: LCD and Swedbank.
1/ The figures are for illustrative purpose only. These are averages of the forecast ranges, which are as wide as ca 2 percentage points in each direction. The figures from our forecast in April are given in brackets.

of our forecast. As in the first half, the recovery during the rest of the year will be driven by exports and restocking, while domestic demand will remain under pressure and is forecast to contract overall this year.

The economy should grow by 3% next year, driven by the positive contribution of net exports and the slow recovery of domestic demand. Stockbuilding will contribute positively to GDP growth, although to a much lesser extent than this year. Compared with our April forecast, government consumption in 2011 is now expected to contract by less; meanwhile, the revival in investments will be slightly slower next year than was forecast in April. Despite the improved outlook for export and import growth for this year, the forecast for next year remains the same as in April because of the recent revision downwards of the global outlook. Our main scenario sees the economy expanding further by 4.5% in 2012 as household consumption and investments become more significant drivers of economic growth; net exports will continue to support GDP growth as well.

In terms of both positive and negative risks, global developments remain one of the most crucial factors affecting the economy in the forecast period. In addition, a protracted recovery in domestic demand, especially household consumption, will pose a significant obstacle to the Lithuanian economy over the forecast period. Given the adverse labour market developments, it is not surprising thus that even those less affected by the downturn have so far remained overly cautious regarding spending. Unemployment has continued to rise this year, reaching 18.3% in the second quarter, and, even though the decline in wages seems to have ceased, wages are still likely to face downward pressures going forward – even if an increase were to materialize, it would not be significant.

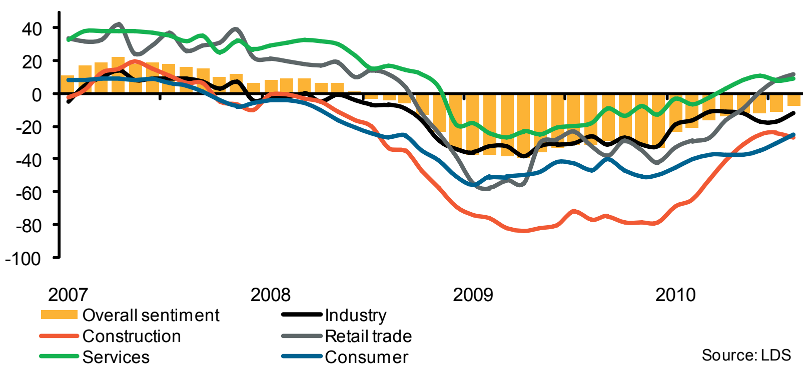
## Export growth to slow somewhat

Export volumes recovered faster than anticipated during the first half of the year, owing to the sustained pickup in demand from the EU. Based on this stronger-than-expected performance, as well as the upward revision for this year in the outlook for the main export markets in the EU (Germany and the Nordic countries in particular), export recovery during 2010 is likely to be much faster than was anticipated in our April forecast. Exports are likely to increase by 10.5% during 2010 in real terms, instead of the 4.5% projected in April.

During 2011, however, the stronger-than-expected recovery in the EU economies recorded this year is projected to fade out. We thus expect export growth to weaken next year, easing to 6.5% in real terms. Even though the actual numbers projected remain unchanged from our April forecast, the reasoning behind the forecast differs – the numbers now reflect a deceleration of export growth in line with the more pessimistic outlook foreseen for Lithuania's main trade partners. In our April forecast, we underestimated how quickly the export recovery would materialize this year. If the April global outlook were still in place, our forecasts for export and import growth would have had to be raised for next year as well.

The traditional large manufacturing, lower- and medium-value-added industries, such as chemicals and plastics, as well as paper and wood, have so far been leading the export growth. The rebound of the transport services sector is notable as well, even considering the drastic contraction in 2009 and thus the much smaller

**Confidence Indicators**



comparative base. The sector appears to be surprisingly resilient despite some adverse factors, including cost increases at the beginning of this year.

Given the still-short recovery period, neither a more notable diversification in products and export markets nor a move to higher-value-added production has yet taken place. Some signs that these are beginning to happen are, however, visible: Lithuanian export companies, e.g., have begun discovering new export markets in Southeast Asia and Africa. Because emerging economies are expected to drive global economic growth, at least in the near future, they certainly cannot be ignored. Diversification of products and, especially, moving up the global value chain require, however, more time – we expect signs of such structural changes in the economy to become visible only in a few years. The government has stepped up efforts to attract the "right" investments to higher-value-added sectors, especially in the IT services sector, and aims to foster university and company collaboration in R&D, which could accelerate the process.

Imports this year have been primarily driven by export growth. We have thus also raised our import growth forecast and expect these to increase by 8.8% in 2012 in real terms, instead of the 5% projected in April. During 2011, import growth will slow to 5%. Imports next year are anticipated to continue to be driven by export growth; however, household consumption will slowly start to be a contributing factor as well. The net export contribution to GDP growth is to remain positive both this year and next.

We expect the Lithuanian current account to reach a surplus of 1% of GDP this year and to be balanced in 2011, as import growth should be largely driven by the growth in exports. A small deficit in 2012 is likely, given that investments will rebound somewhat from their complete absence of them during the economic downturn, as well as because of the recovery in household consumption.

## Investments to remain weak

The results of the improved risk assessments of the country's economic climate following the successful stabilization in public finances have yet to materialize. In our previous outlook, we anticipated that cheaper and larger capital inflows and an improvement in credit conditions would occur towards the end of the year – this forecast remains unchanged, and we expect genuine improvement in investments to commence at the end of 2010 or beginning of 2011. Even though investments (excluding inventories) increased in the second quarter from the first, the seemingly large rebound is mainly due to the smaller base of the first quarter; the absolute volumes of investments (excluding inventories) remain below those of any quarter in 2009.

The projected slow rate of recovery is mainly due to the fact that companies are still trying to reduce their debt and are tending to abstain from borrowing additional funds for expansion given still-low capacity-utilisation rates and the uncertain recovery both in global and domestic demand. In addition, although asset prices have fallen considerably, they are still viewed as high by investors, especially foreign companies. We anticipate gross fixed capital formation to decline by 9% this year instead of the 3.5% foreseen in April. We also expect investments to rebound somewhat more slowly during 2011 --by 7%, instead of the 8% anticipated in our previous outlook.

The implementation of EU structural funds, which are the main source of investments this year and a lifeboat for some companies, especially small and medium-sized enterprises (SMEs), is lagging behind. Approximately only one-third of the planned funds have been allocated to companies so far. An even smaller percentage of the planned funds were allocated through government institutions, such as for roads and other infrastructure developments. The effect of the economic stimulus plan on economic growth thus far remains highly ambiguous, and is likely to be rather minuscule this year. The renovation of old apartment blocks has also come to a complete halt – the government is even considering starting the renovations without the consent of all the owners of the buildings, and/ or imposing sanctions on the owners' associations that are refusing to start the renovations.

Stockbuilding continued to grow rapidly during the first two quarters of the year as companies were quickly rebuilding their inventory levels depleted during the downturn. Inventory restocking thus made an enormous positive contribution to GDP growth during the first half of the year, accounting for about 8 percentage points of annual growth. This factor should continue to support growth going forward, although to a much lesser degree.

**Growth of export and import of goods and services in current prices, yoy %**

## Challenges to linger in the labour market for some time

The unemployment rate reached a record 18.3% during the second quarter of this year, up by 0.2% from the first quarter. Employment has continued to decline rapidly, while long-term unemployment has also been rising, reflecting both permanent job losses in industries like construction and the length of the economic downturn. We nevertheless anticipate that the unemployment rate has peaked and should start declining slowly, beginning in the third quarter of the year. Given the somewhat worse than anticipated developments in the first half of the year, we have altered our forecast and expect the unemployment rate to reach at least 17% this year (instead of the 16% forecast in April). Job creation is likely to slowly commence at the beginning of next year; a looming large wave of emigration and an increasing number of discouraged workers are also likely to improve unemployment statistics next year, resulting in a slow decline of the unemployment rate to 15.5%.

In our opinion, public policy overall will play a vital part in alleviating labour market strains going forward. Some solace can already be found in the fact that the government introduced measures that could increase flexibility in the labour market and protect the most vulnerable groups. Some of the protected workers' privileges, such as the length of the termination notice, were made more flexible, making it easier and less costly for businesses to restructure. Especially welcome is the decision to allow temporary contracts of two years to be used for permanent positions. Enterprises, especially SMEs, are likely to be extremely cautious about increasing employment and, therefore, need the greater flexibility in the labour market to be able to see that another round of restructuring, if necessary, is doable. Subsidies for firms choosing to employ younger workers were introduced starting this August and are valid for two years. The government also subsidises the employment of workers who have completed their training and changed occupations, and is implementing programs to accelerate the appropriate retraining of workers.

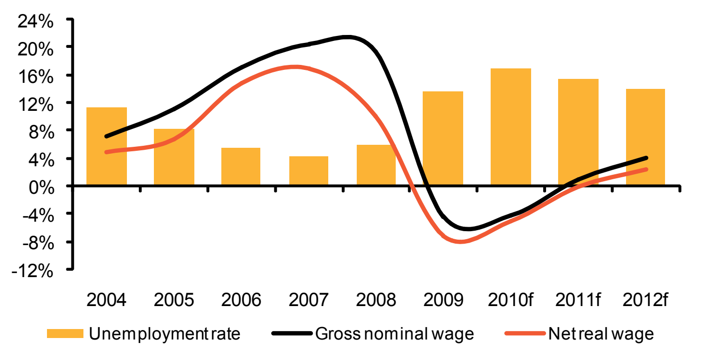
We expect real wages and salaries to shrink by roughly 5% in 2010 and then stay flat during 2011. The decline in wages seems to have ceased during the second quarter in line with our expectations – this certainly augurs well for the long-awaited improvement in consumption but nevertheless raises questions as to whether competitiveness has truly been restored.

Household consumption expenditure is likely to decline by 5% this year. Only a slight improvement - 1% growth - is expected in 2011. The rebound in industrial activity this year is likely to translate into job creation and thus encourage consumption somewhat, but only starting at the end of the year at best. Even then, the recovery will be gradual and extremely fragile, given the labour market developments. Even those unaffected by the downturn are remaining cautious regarding spending. The pervasive cautiousness towards spending can be best illustrated by the fact that the volume of deposits by households has reached its highest point since the series began to be recorded, while the volume of loans is on a gradual, but firm, downward trend.

## Price growth to stay subdued

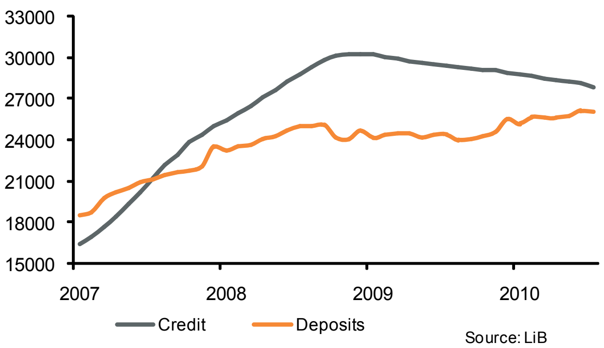
Consumer price inflation is not an area of major concern and is unlikely to surface as such during the forecast period. For some time, weak domestic demand will continue to place a ceiling on how much prices can rise. Thus, most of the inflation will be imported. This year, prices were pushed upwards by global developments (such as fuel prices) in the first half of the year; a positive influence was exerted also by the rise in gas tariffs for households during July. Meanwhile, the seasonal food price increases expected this autumn will not allow deflation to take place during the second half of the year. In the beginning of 2011, prices will be pushed upwards by the increase in excise duties for cigarettes, which will contribute not more than 0.2 percentage point to inflation. As inflation developments have so far been in line with our expectations, our forecasts remain unchanged from the outlook in April – we anticipate consumer prices to increase by 1% during 2010 and 2011, and to reach about 1.5% in 2012. Even when domestic demand contracted severely last year, the deflation period did not last very long. Deflation risks thus remain very low going forward as well – although domestic demand

**Labour Market**




Sources: LDS and Swedbank forecast.

**Household Credit and Deposits, outstanding amounts, mLTL**




Source: LiB

will remain weak, it is about to start a gradual recovery, with downward pressures abating.

## Fiscal policy to stay prudent

We have not altered our forecast and expect the budget deficit for 2010 to reach 8% of GDP. Mostly due to conservative budget planning, tax revenues have so far exceeded the plan. On the one hand, this raises the risk that government spending could be increased more than necessary next year – something that should be avoided, especially considering that, in terms of absolute numbers, revenues have still been falling. On the other hand, the government appears to be firmly set to adopt yet another austerity budget in 2011, with some small changes in the tax policy.

The exact plans for the 2011 budget, however, remain unclear at the time of writing. It is certain that excise taxes for cigarettes and diesel are to be raised to comply with the EU requirements; the income tax or value-added tax (VAT) rates are unlikely to be altered. There is a possibility that a real estate tax will be introduced; this is under discussion. Further significant cuts in spending are also unlikely – that is, public sector wages and benefits are unlikely to decrease further, which will boost the confidence and expendable income of the affected consumer groups. Similarly, businesses that supply the government can also expect fewer problems with public purchasing volumes next year.

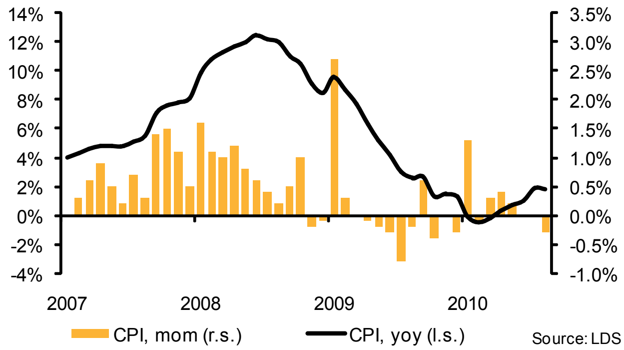
There is some risk that fiscal austerity will be maintained less stringently than desired due to the upcoming 2012 elections. However, even though some relaxing of the tight fiscal policy of the last few years is possible, the current government since the start of its term has been a vocal advocate for austerity measures and has praised itself for stabilizing the economy by implementing such a policy. We foresee that the 3 % budget deficit target (consistent with the Maastricht criterion) will be met; however, there are risks as fiscal challenges will remain.

As expected, the government has continued borrowing on the open market this year; the yield has been decreasing gradually, given the successful implementation of fiscal policy since the beginning of the year and the general decline in the risk assessments of the sovereign debt. At end-June 2010, central government debt amounted to EUR 9,146 million, accounting for 33.7% of the GDP projected for 2010. The debt developments have so far been in line with our expectations, and, given the generally adhered to rhetoric on budget discipline, we maintain our forecast on general government debt and do not expect it to overshoot 42% of GDP by the end of 2012.

The government has recently introduced a plan to restructure the government-owned enterprises in all sectors, including energy, wood, and transport, which are currently claimed to be inefficiently run and frequently require large subsidies from the budget to be kept afloat. The restructuring began with an in-depth assessment earlier this year of the value of the assets, which are estimated to stand at approximately EUR 5 billion, as well as the establishment of an institution that would coordinate the process. The restructuring of government enterprises by, among other proposed measures, streamlining their operations and establishing a board independent from political influences should increase their efficiency substantially, and some companies will be privatized. The increase in efficiency in turn would bring, according to the government, an estimated EUR 400 million (approximately EUR 220 per year to each citizen) per year to the government budget in the form of dividends. We firmly approve of this initiative and its goals – not only will the restructuring be a significant boost to the public finances, the listing of the companies on the stock exchange will increase the liquidity in the Lithuanian capital market, thus making it more attractive for foreign investors and more accessible for local companies that seek to raise capital.

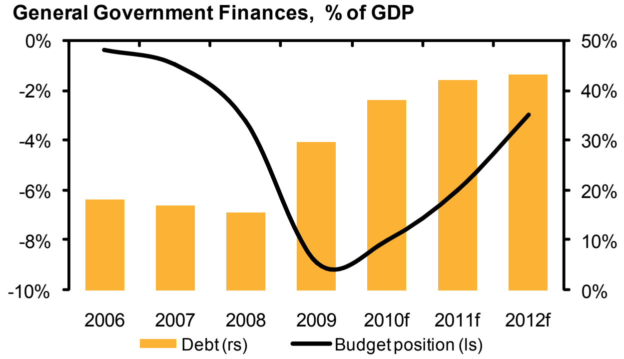
Lina Vrubliauskienė
Ieva Vyšniauskaitė

**Consumer Prices**




Source: LDS

**General Government Finances, % of GDP**




Source:s Lithuanian MoF, and Swedbank calculations.

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