Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies January 13, 2011

Recovery on track - next step is to entrench growth

Table of Content:

Global development

- The speed of global recovery in 2010 exceeded our September forecast, with GDP up by 4.6%. Tailwinds into 2011 are making us revise also 2011 upwards to just below 4%, while 2012 is marginally lower. Emerging economies are still in the driver's seat, while more advanced ones are struggling in the backseat with private and public deleveraging.
- The risk of a new recession and deflation has decreased, but many uncertainties linger: the euro zone crisis, slow recovery in the US, escalating commodity prices, and overheating in emerging markets.

Sweden

- The rapid recovery of the Swedish economy continued during the fall of 2010. Aided by rebounding external demand, household consumption and investments surprised on the upside, and we estimate real growth in 2010 at 5.3 %.
- The outlook for 2011 and 2012 is characterised by a slow-down in growth to 3.3 % and 2.5 %, respectively. Temporary boosts to activity, such as inventory restocking, will dissipate. To lift real growth over the medium term, renewed efforts to reform the economy are needed.

Estonia

- Economic growth in 2010 was stronger than expected on support of rapidly expanding exports. Although weak, domestic demand grew as unemployment declined and prices rose. The budgetary situation remained strong.
- The economy will expand by 4-4.5% in 2011-2012 as exports will remain the driving force, albeit domestic demand is gradually strengthening on support of investments and consumer spending. The major positive effects of the euro adoption will be lower risks and stronger confidence.

Latvia

- Recovery in 2010 has been stronger than expected both due to quick private sector adjustment and better growth in export markets – we estimate that during 2010 GDP has grown by about 4% from the trough in the fourth quarter of 2009.
- Faster than expected growth is forecast in 2011 (4%) due to stronger exports and investments, while the 2012 outlook remains unchanged (4.2%). Inflation will pick up, which is a major risk for euro adoption in 2014. This is still a muddling-through scenario, as the elections so far has not brought fast and comprehensive structural reforms.

Lithuania

- GDP grew in the second and third quarters 2010, indicating the end of the recession and the beginning of a new economic cycle. The recovery has relied on strong exports, but, in addition, gross fixed capital formation grown by 15% in the third quarter, mainly due to public investments .
- Growing exports, continuing restocking and strong pick up in investments will drive faster growth in 2011. Next year due to recovered household consumption GDP growth will accelerate further – from 3.0% in 2011 to 4.5% in 2012. Medium term challenges include public finances and structural unemployment.

Moving on to sustainable growth

After large falls in demand were experienced in 2008-2009 – especially in the Baltic countries, but also in Sweden – the recovery started to take hold last year. GDP increased more than in our September forecast, mainly due to a stronger global demand, but also, domestically, because of better performances of labour markets and improved confidence among companies and households. Sweden's growth also benefited from expansionary economic policies. In the Baltic countries, reforms focused on budget consolidation and competitiveness, as well as on improvement of credit ratings and the investment climate. The worst is over, and all four countries must now concentrate on creating better preconditions for sustainable growth.

For the export-oriented Nordic-Baltic countries, global demand is of the utmost importance. During 2010, global GDP seems to have grown somewhat faster (4.6% compared with 4.4% in our September forecast), as activity in the euro zone, the UK, and emerging markets like India, China, and Brazil strengthened more than expected. Overall, developments in the Baltic Sea region have been more favourable than in other parts of Europe, as the situation has stabilised faster in the Baltic countries; Germany, Poland, and the Nordics have been able to make the most of a stronger global demand. Russia, although still underperforming, has been fortunate because energy and metal prices have continued to increase.

Looking to this year, a large carryover for some of the countries, like Germany, will support growth in 2011. In the US, a new stimulus package will add to growth but, with the postponement of budget consolidation, risks are building up, affecting stability not only in the US, but also worldwide. Momentum in the emerging markets is set to slow somewhat, as the effects from stimulus measures fade and demand from the advanced economies weakens. We expect global GDP growth to stay slightly below 4% in 2011 and 2012: compared with our September Outlook, this represents an upward revision for 2011 and a slightly downward revision for 2012.

We foresee that major central banks will not raise policy rates until 2012, and will need to use more unconventional measures this year than expected in September. How to exit from these measures remains a large risk to stability, as do currency tensions, protectionism, and, most of all, the sovereign debt issues in the euro zone. Our main scenario includes a rescue package for Portugal, while similar packages for Spain and other countries are regarded as major forecast risks. Overall, the political risks are a big concern for forecasting, as political decisions – being uncertain and difficult to foresee – will have a large impact on the economies.

While Sweden's GDP level is already back at the pre-crisis level, there is still a long way to go for the Baltic countries, where deleveraging and/or budget consolidation are limiting the recovery. As demand fell by 15-20%, the recovery should have been stronger, but, as deleveraging is still in focus, new lending will be lower and domestic demand weaker than during normal recovery periods. There are three main domestic risks in the Baltic countries. First, political risks pose a threat to budgets and reforms. Second, inflation pressures are being generated by higher commodity prices. And third, labour market imbalances are worsening due to a combination of higher long-term unemployment and increased labour shortages in certain sectors, as economic structures are changing from loan driven to export oriented and as emigration continues. Swedish domestic risks are also geared towards the labour market, characterised by the same combination of lingering unemployment and higher labour shortages. Other domestic risks include the effects on households from making monetary policy less expansionary, as the debt ratio has increased, along with interest rate sensitivity. Even if house prices are not expected to fall dramatically, Sweden's credit and housing markets are becoming more vulnerable to external risks, and household consumption, especially, could face a larger slowdown than expected in our main scenario.

Sweden's rebound was even stronger than we expected in September, and, during the autumn, both domestic demand – including inventory restocking – and external trade recovered at top speed. GDP in calendar-adjusted terms is now expected to grow by 5.3% during 2010, creating a carryover to 2011 and thus resulting in an upward revision for that year to 3.3% (2.4% in

Macro economic indicators, 2009- 2012

	2009	2010e	2011f	2012f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	-5.2	5.3	3.3	2.5
Estonia	-13.9	2.8	4.2	4.5
Latvia	-18.0	-0.5	4.0	4.2
Lithuania	-14.7	0.5	3.0	4.5
Unemployment rate, % of labour force				
Sweden	8.3	8.4	7.7	7.5
Estonia	13.9	17.0	14.3	12.5
Latvia	16.9	18.9	16.5	14.5
Lithuania	13.7	17.7	15.5	14.0
Consumer price index, annual change in %				
Sweden	-0.3	1.3	2.2	2.4
Estonia	-0.1	3.0	3.7	3.2
Latvia	3.5	-1.1	3.0	2.5
Lithuania	4.5	1.3	2.0	2.5
Current and capital account balance, % of GDP				
Sweden (current account)	6.9	6.1	6.1	5.9
Estonia	7.3	7.0	5.5	4.5
Latvia	12.0	6.9	3.8	0.1
Lithuania	7.7	4.2	2.7	2.5

Sources: National statistics authorities and Swedbank.

September). However, the quarterly rate of expansion will slow after last year's bounceback. The main drivers of growth in 2011 are the higher household consumption, supported by a better labour market performance; the stronger confidence; and a further recovery of investments. Net exports will be marginally higher. In 2012, GDP growth is set to slow somewhat more than the September forecast, to 2.5% (2.9%). The most important reason for this is the slower growth of exports due to higher unit labour costs and a slightly stronger krona. The Riksbank will raise the policy rate marginally faster during the spring of 2011, reaching 2,25% at end- 2011 and 3% at end- 2012. Fiscal policy will become tighter, and there is still room for targeted reforms improving the functioning of the labour market.

Estonia's GDP growth has also been revised upwards for 2010, from 2.2% in the September Outlook to 2.8%. A stronger export performance explains most of the difference. For 2011 and 2012, we are keeping the overall GDP growth basically unchanged, but exports are now forecast to speed up in line with a stronger global demand, while domestic demand will increase more slowly than in the September forecast. A more subdued investment growth and the effects on households of higher inflationary pressures explain the downward revision of domestic demand. GDP will grow by approximately 4.5% in both years. Estonia has now become the 17th member of the Economic and Monetary Union (EMU). In the short term, price increases will add to inflationary pressures but these will dampen gradually. In the longer term, foreign support for investments in Estonia is likely to increase due to a perceived higher stability and predictability of the economy. Fiscal policy is disciplined, and the budget situation will be better than the government plans throughout the forecast period. The main fiscal risks are geared towards social spending and developments in labour markets and municipal budgets. Increasingly, higher inflation is likely to be a major challenge for policy makers, with possible negative consequences for growth and competitiveness.

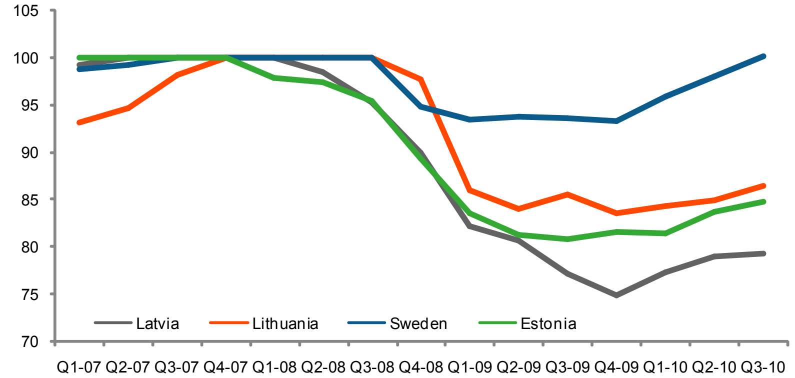
Latvia already experienced a recovery last year, despite the negative GDP growth, which was due to a carryover effect from 2009. During the first nine months of 2010, the economy grew by 3%, mainly due to stronger exports and inventory restocking. The labour market has also improved in line with the stronger growth climate, and unemployment is falling from the peak of above 20% at the beginning of 2010. Going forward, GDP will grow by 4% and 4.2% in 2011 and 2012, respectively. Growth in 2011 is stronger than the September forecast (3%) as a result of a better global demand situation, as well as stronger investments. Household consumption, although remaining subdued, will slowly pick up in line with lower unemployment and stronger confidence. Inflation is also increasing, but the government will focus on holding price pressures down as Latvia is still aiming to join the EMU in 2014. Fiscal improvements continue, and we expect the budget deficit to come down to 3% of GDP in 2012, thus satisfying the Maastricht criteria. Hence, inflation is expected to be the most difficult goal to fulfil.

Lithuania's recession has also ended, and GDP in 2010 is expected to have shown marginal growth of 0.5%. The outlook is improving as GDP will grow by 3% in 2011 and 4.5% in 2012. Exports explain last year's better performance, as well as inventory restocking, which added extensively to growth. For 2011, investments are set to grow somewhat faster, while general government consumption will decrease more than previously envisaged. We have revised upwards the inflation rate for 2011 and 2012 as commodity prices have increased more than expected, and excise duties on tobacco and diesel fuel will add to inflationary pressures. Like Latvia, Lithuania has the goal of becoming a member of the EMU in 2014, which means that all Maastricht criteria must be fulfilled in 2012. While we foresee that the government can manage to reduce the budget deficit to 3% of GDP in 2012 , the inflation rate could become a greater hindrance. Labour productivity will increase, but not as fast as during 2010, and more measures are needed to improve competitiveness.

Many challenges for sustainable growth remain, and all four countries should continue to focus on reforms that will add to longer-term competitiveness by supporting education and research and development, improving the functioning of labour markets, increasing competition on domestic product markets, and strengthening the business climate. The times when loan-driven economies could generate success stories are over. Only by creating an environment for companies that are dynamic and environmentally and economically sound may the standard of living grow in a sustainable way.

Cecilia Hermansson

Quarterly real GDP levels(quarterly peak =100) 1/



Sources: National statistics authorities and Swedbank.

1/ Each quarter of the year is compared to the highest level of that quarter's GDP.

Despite the many risks - global recovery is on!

Global economic growth has surprised on the upside. Industrial production and foreign trade have shown strong signs of recovery, helped by stimulus measures and inventory correction.

Countries – where governments, companies, and households have been spared from repairing balance sheets, such as in most of northern Europe, and in many of the emerging markets – have recovered faster than expected. On the other hand, crisis-struck economies in southern Europe are continuing to struggle with austerity measures, wider interest rate spreads, and a lack of growth. The recovery in the US and the UK is also slower than what is usual after normal recessions, pointing to lingering difficulties on the labour, credit, and housing markets.

Compared with our September forecast, global growth is expected to be higher in 2011, as 2010 showed a stronger-than-expected recovery. The main difference is the strong German bounceback, where a large carryover into 2011 will motivate an upward revision. The disparity within the euro zone continues; hence, growth in some countries has been revised downwards. The extension of the Bush tax cuts and the unemployment benefits will add somewhat to US growth, and preparations for the election in 2012 may include some stimulus, thus – and not without risks – postponing the medium-term budget consolidation.

Emerging markets will continue to show strong growth, although losing some momentum when the bounceback and stimulation period end, and because many advanced economies will continue to show weaker demand. In some countries, like China and India, there is a need to combat overheating by tightening economic policies, and thus growth will slow. Although higher than in our September forecast, GDP growth will stay below 4% in both 2011 and 2012, slowing from 4.6% in 2010.

Even if the continued recovery has reduced the risk of a double dip and a deflation scenario, many other risks are contributing to forecast uncertainties.

First, the economic and financial situation in the euro zone could worsen as problems in Greece and Ireland spread to Portugal and Spain. In addition, the political situation will be affected, both domestically, with the risk of riots, and in the euro zone, if crisis management fails to provide a proactive and sufficient response. As austerity measures are implemented and credit growth is restrained, demand could weaken more than expected. An upside risk could materialize if structural reforms are carried out, improving confidence, productivity, competitiveness, and the functioning of markets.

Second, there is still a risk of a double dip on the US housing market, aggravating credit availability and unemployment. The local government fiscal situation may also worsen, which would threaten employment and overall growth. The political weaknesses on the federal level may also continue until the election in late 2012.

Third, the inflation risks in many emerging markets may force politicians to tighten economic policies more than desired, which could cause a hard landing. There are still asset bubbles that could burst, like on the Chinese real estate markets, where housing prices are increasing again despite tighter policies.

Fourth, large capital flows to emerging markets have caused some countries to introduce capital controls. Currency tensions have also increased, and the coordination among G20 countries has weakened, increasing the risks of protectionism and currency wars.

Fifth, major central banks are still creating entry strategies; thus, there could be problems with their exit strategies during the forecast period. Also, there is a risk of financial turbulence when terminating unconventional policies, and, in addition, central banks could lose independence.

Last, but not least, commodity prices have risen faster than expected, partly due to policy measures leading to higher liquidity like in the US, partly due to a faster global recovery. There is a risk that higher energy and commodity prices will dampen profit margins, raise consumer prices, and reduce growth in many parts of the

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

			January 2011			September 2010		
		2009	2010	2011	2012	2010	2011	2012
US		-2.7	2.8	2.6	2.7	2.8	2.2	2.5
EMU countries		-4.1	1.8	1.6	1.5	1.4	1.1	1.6
Of which:	Germany	-4.7	3.6	2.5	2.0	3.0	1.4	1.7
	France	-2.6	1.6	1.6	1.5	1.3	1.5	1.7
	Italy	-5.0	1.1	1.0	1.1	0.5	0.9	1.3
	Spain	-3.7	-0.4	0.3	1.0	-0.7	0.5	1.6
UK		-5.0	1.7	1.8	2.0	1.1	1.6	1.9
Japan		-5.2	3.2	1.5	1.3	3.2	1.4	1.5
China		8.9	10.1	8.5	8.1	9.8	8.5	8.1
India		5.7	8.8	8.2	7.5	8.0	7.5	7.8
Brazil		-0.2	7.5	4.8	4.5	7.2	5.0	5.0
Russia		-7.9	4.0	4.3	4.5	4.3	4.5	5.0
Global GDP in PPP		-0.7	4.6	3.9	3.8	4.4	3.6	3.8
Global GDP in US$		-2.0	3.7	3.1	3.0	3.5	2.8	3.1

Sources: National statistics authorities and Swedbank.

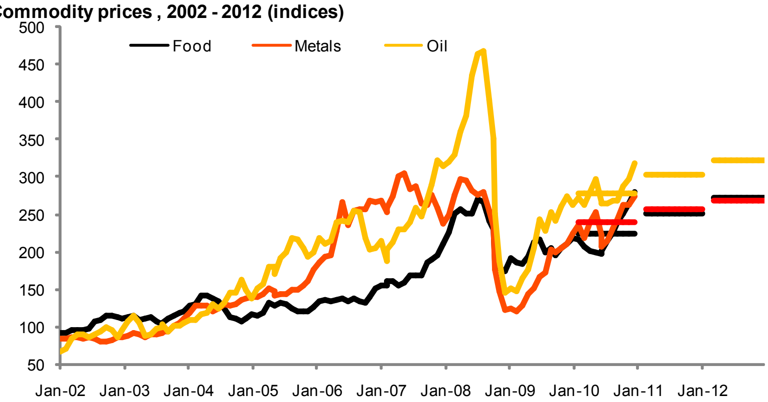
1/ Countries representing around 70 % of the global economy. The World Bank weights from 2009 (purchasing power parity, PPP) have been used.

world. The effects of higher commodity prices will be more severe in countries where food and energy make up a relatively large share of consumption, and where competition on product markets is weak.

Analysing our forecast assumptions, commodity prices – especially food prices, but also some metals - have increased faster than we expected in September. Our oil price assumption is raised from US$82 per barrel to US$87 in 2011, and kept unchanged at US$90 in 2012. Upside risks are involved as the oil price could continue above US$100 if oil producing countries do not increase production.

The inflation outlook varies between emerging and advanced countries, and is the foundation for monetary policy assumptions. Chinese inflation will slow from 5% to 3.5% in 2012. In India and Brazil, inflation will stay above 5%, despite tighter policies. Policy interest rates in many emerging countries will continue upwards. In the euro zone and in the US, inflation will be lower, around 1.5%, as domestic demand stays weak. Federal Reserve and the ECB will postpone their first policy rate hikes until 2012 and keep unconventional measures for a longer period. There is an uncertainty in the euro zone as higher inflation may

Commodity prices , 2002 - 2012 (indices)



Sources: Ecowin and Swedbank projections.

push up demand for earlier repo rate hike, not least among German policy makers.

The US dollar strengthens in 2011-2012 against the yen and the euro, as the situation in the euro zone is regarded as more uncertain by financial markets, and growth prospects are weaker there and in Japan than in the US. China continues with the appreciation of the yuan against the US dollar, but slowly, at some 4-5% per year. More important, though, is the higher Chinese wage growth and inflation, which will appreciate the yuan in real terms.

Hence, the muddling-through scenario we presented in September is still alive. The challenges for the world economy remain, not least in advanced economies with large deleveraging needs. During 2011 and 2012, global growth will be driven by emerging markets. Structural reforms should be added to stimulus measures, where these are still being introduced (like in the US), and also to austerity measures in crisis-struck economies in Europe. The best way to alleviate the debt burden is to enhance growth by improving productivity, entrepreneurship, and innovation, thus creating room for more employment. With stronger political leadership, chances of a stronger global outlook will improve.

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Interest and exchange rate assumptions

	Outcome	Forecast			
	11 Jan 2011	30 Jun 2011	31 Dec 2011	30 jun 2012	31 Dec 2012
Policy rates					
Federal Reserve, USA	0.25	0.25	0.25	1.00	1.50
European Central Bank	1.00	1.00	1.00	1.50	1.75
Bank of England	0.50	0.50	0.75	1.00	1.25
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.30	1.24	1.22	1.20	1.20
RMB/USD	6.62	6.50	6.35	6.20	6.05
USD/JPY	83	85	90	100	105

Sources: Reuters Ecowin and Swedbank projections.

Sweden: Rapid rebound – time for forward-looking growth reforms

The Swedish economy is recovering faster than we had earlier anticipated. During the autumn, both domestic demand and external trade rebounded sharply, resulting in a pronounced upturn of economic growth. In the third quarter of 2010, real growth reached 6.9%, compared with the same period in 2009. Short-term indicators suggest that growth continued in the fourth quarter, albeit more slowly in quarterly terms. We estimate that overall growth for 2010 was 5.3% (calendar adjusted), significantly higher than in our September projection. This outcome implies that the Swedish economy has, in only eight quarters, made up for the output loss sustained during the downturn; this compares favourably with the almost five years needed to recover from the financial crisis in the early 1990s.

We foresee that the quarterly rate of expansion will dampen during 2011 and 2012. A sizable share of the rebound in 2010 was due to temporary factors. Inventory restocking boosted growth, and private consumption grew against large declines of, in particular, consumer durables. In addition, the economic stimulus is being wound down as monetary policy rates are being raised and the impact from fiscal policy is dissipating. We also expect global economic conditions to loose momentum in 2011, although we have raised the growth forecasts somewhat from our September outlook. Factoring in the large statistical carryover from 2010, this implies annual growth rates of 3.3% in 2011. For 2012, the annual rate drops to 2.5% despite the slightly higher quarterly growth rates.

The risks to the forecast mainly stem from abroad, but strains are also building up domestically. A deterioration of the sovereign debt crisis in Europe would severely affect Swedish growth prospects through falling demand and financial sector turbulence. Domestically, the main risk can be attributed to eroding competitiveness. Labour market bottlenecks, with subsequent wage increases, together with a stronger krona, would weaken Swedish companies' positions on external markets. Household consumption and financial sector stability would also be negatively affected by rapid price falls in the housing market. On the upside, a faster international recovery would benefit well-positioned and stable Swedish companies.

Key Economic Indicators, 2009 - 2012 [1/]

	2009	2010e	2011f	2012f
Real GDP (calendar adjusted)	-5.2	5.3	3.3	2.5
Industrial production	-17.9	13.5	7.0	5.0
CPI index, average	-0.3	1.3	2.2	2.4
CPI, end of period	0.9	2.5	1.4	2.4
CPIF, average [2/]	1.9	2.1	1.4	1.6
CPIF, end of period	2.7	2.4	0.5	1.7
Labour force (15-74)	0.2	1.1	0.7	0.5
Unemployment rate (15-74), % of labor force	8.3	8.4	7.7	7.5
Employment (15-74)	-2.1	1.0	1.4	0.7
Nominal hourly wage whole economy, average	3.4	2.2	2.4	2.9
Nominal hourly wage industry, average	2.9	2.6	2.6	3.0
Savings ratio (households), %	12.9	11.6	10.4	10.2
Real disposable income (households) [3/]	1.6	2.4	1.5	1.7
Current account balance, % of GDP	6.9	6.1	6.1	5.9
General government budget balance, % of GDP [4/]	-0.7	-0.3	0.0	0.6
General government debt, % of GDP [5/]	41.9	39.9	37.7	35.5

Sources: Statistics Sweden and Swedbank.

1/ Annual percentage growth, unless otherwise indicated.
2/ CPI with fixed interest rates.
3/ Based on short-term earnings statistics
4/ As measured by general government net lending.
5/ According to the Maastricht criteria.

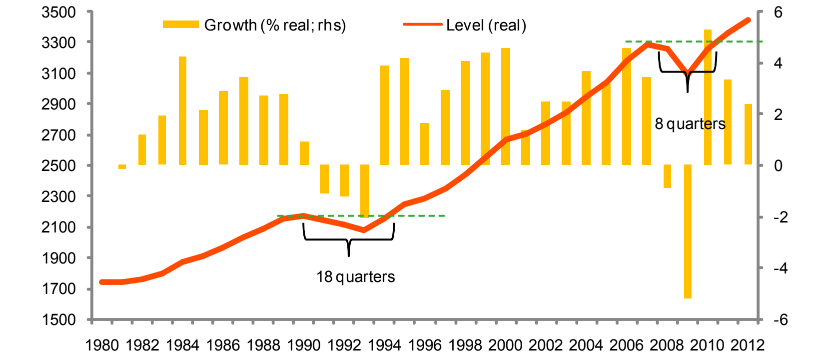
Exports make up lost ground

Swedish exports are picking up, and the loss of market shares in 2009 has, despite the appreciation of the Swedish krona, been restored faster than expected. Export volume for the first three quarters in 2010 increased by 9.9% in annual terms. To a large extent, the rebound in exports is being driven by growing demand for intermediate and investment goods – a situation that is favourable to Sweden.

In 2011, market growth for Swedish exports is expected to decelerate when the global rebuilding of inventories dampens and fiscal policy tightens. Export market growth for Swedish industry is, nevertheless, expected to be stronger in 2011 than we earlier anticipated, partly due to spillover effects from the strong rebound in 2010; meanwhile, development in 2012 has been revised slightly downwards due to a weaker momentum in the global economy. The projected world market growth for Swedish industry of 6½-6¾% in 2011 and 2012 is below the long-term trend. Continued deleveraging in several OECD countries will have a restraining impact on demand. The emerging markets are expected to account for the largest export market growth, although we anticipate a gradual deceleration there due to a more restrictive economic policy.

We foresee overall export growth in 2011 of 6.8% in volume terms. An improved outlook for global demand and decreasing unit labour costs due to a higher productivity growth will mitigate the impact of a stronger krona. For 2012, we foresee a weakening in export performance when the competitiveness of the Swedish industry worsens due to a stronger krona and rising unit labour costs. We expect export growth in that year of 5.5%, implying losses of market shares for Swedish companies. The growth contribution from foreign trade will be limited by the strong growth in imports. Following an expansion in 2010 of 12.5%, import growth in 2011 and 2012 is expected to decelerate to 7.3% and 6.4%, respectively.

Real GDP levels and growth, 1980 - 2012



Sources: SCB and Swedbank projections.

Broad recovery in fixed investment

The recovery in investments has strengthened in line with increasing production and a higher utilisation rate. Housing shows the largest pickup, together with the services sector, while industry investments are lagging. Large public investment projects in infrastructure also contributed more to the investment rebound in 2010 than we expected.

With private sector output continuing upwards, there will be a growing need to expand capacity. Together with strengthening confidence, favourable financing terms and rising profits will trigger an increase in business investments. Total investment is expected to grow by 8.2% in 2011 and 8% in 2012, which means that investments will exceed the pre-crisis 2008 level by the end of the forecast period. We expect an uptick in the momentum of industrial investment during 2011, followed by a deceleration in 2012 when the industrial capacity is larger.

The rebound in real estate investment in 2010 was more pronounced than we had anticipated. This will also have spillover effects in 2011. Because of this rebound, as well as an improving labour market and tax reductions for renovations, we foresee double-digit investment growth in real estate during 2011. For 2012, we anticipate a gradual slowdown in real estate investments when the interest rates will be higher. Supply constraints, such as a lack of qualified labour, are also expected to limit growth in real estate investment.

Ongoing and investments brought forward in infrastructure and new projects by local governments will boost public investment in 2011 before falling back in 2012.

Inventory restocking is expected to have contributed 2.3 percentage points to GDP growth in 2010, significantly more than expected. Companies' needs for growing stocks of intermediate and finished goods in industry explain to a large extent this boost from inventories. This is a sharp reversal from 2009, when the destocking process started and industrial production fell significantly. We foresee a further rebuilding of stocks during the forecast period due to the low current levels, growing industrial production, and higher investment growth. The momentum is, however, expected to slow, and the contribution to GDP growth from inventories will be zero during 2011 and slightly negative in 2012.

Sustained, but slow, labour market improvements

The labour market continues to recover, but at a slower rate than economic growth. By November of last year, the Swedish economy had added more than 90,000 jobs compared with the same month in 2009, and the unemployment rate had fallen to 7.8% (seasonally adjusted). However, compared with the rapid expansion of GDP, employment is lagging. Instead, the number of working hours is increasing. This suggests that slack that had accumulated is now being used up. Also, productivity levels have been rising quickly, and, in tandem with low wage increases, unit labour costs have fallen. As many companies now are faced with making new hirings

Swedbank's GDP Forecast – Sweden

Changes in volume, %	2009	2010e[1/]		2011f[1/]		2012f	
Households' consumption expenditure	-0.4	3.6	(3.0)	2.9	(2.6)	2.0	(1.8)
Government consumption expenditure	1.7	2.0	(1.7)	0.9	(1.0)	0.4	(0.4)
Gross fixed capital formation	-16.4	4.7	(4.3)	8.2	(5.5)	8.0	(6.7)
private, excl. housing	-19.1	1.4	(4.3)	9.4	(6.7)	10.9	(8.3)
public	4.2	3.5	(-3.6)	0.5	(-1.3)	-0.5	(-0.4)
housing	-23.3	19.7	(13.5)	11.7	(7.7)	5.5	(6.9)
Change in inventories [2/]	-1.7	2.3	(1.8)	0.0	(0.0)	-0.3	(0.0)
Exports, goods and services	-13.4	11.1	(11.2)	6.8	(5.6)	5.5	(6.4)
Imports, goods and services	-13.6	12.5	(13.5)	7.3	(6.7)	6.4	(6.4)
GDP	-5.6	5.6	(4.3)	3.3	(2.4)	2.1	(2.6)
GDP, calendar adjusted	-5.2	5.3	(4.0)	3.3	(2.4)	2.5	(2.9)
Domestic demand [2/]	-3.1	3.1	(2.7)	3.1	(2.5)	2.5	(2.2)
Net exports [2/]	-0.8	0.1	(-0.2)	0.2	(-0.1)	-0.1	(0.4)

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

instead of rehiring previously laid-off personnel or increasing hours, we expect employment creation to slow down.

The challenge to reduce the unemployment rate over the medium term is significant. Primarily, due to demographic factors the labour force is set to grow over the next couple of years. Furthermore, although the number of long-term unemployed has started to fall, the share of unemployment remains steady. Thus, as unemployment reduces employability it will be increasingly harder to reduce the unemployment rate. Employment expansion so far has also been uneven across sectors. This means that in sectors that are expanding, eg. construction and IT, it may become difficult to find qualified personnel, while many unemployed will not have the right skill set for those jobs that are created. This could lead to labour shortages despite high overall unemployment rates.

Based on recent developments, we are revising our labour market outlook. Employment is set to grow by 1.4% in 2011 before slowing to 0.7% in 2012. The stronger job creation is a result of the faster-than-expected economic recovery, and we now expect to reach pre-crisis employment levels by mid-2011. The annual average unemployment rate will fall to 7.7% in 2011 and 7.5% in 2012. At the end of the forecast period, we expect the unemployment rate to dip below 7%, significantly lower than during the height of the recession but still far from the estimated equilibrium level of 5-6%.[1] To continue to reduce the unemployment level, targeted policy measures, such as improved skills matching, tailored training, and skills enhancement, are necessary.

Productivity and unit labour cost, 2001 - 2012

Sources: SCB and Swedbank projections.

Restrained wage developments are continuing to benefit Swedish competitiveness, but this could be reversed when the wage agreements start to expire in 2012. Wage increases in the overall economy are estimated to have increased by 2.2% in 2010, below our expectations, while wages in the industry sector are likely to have exceeded our projection. With falling unit labour costs and strong productivity growth, Swedish competitiveness has improved significantly. Looking forward, however, we expect productivity growth to fall, while wage drift and rising wage demands will increase costs. Productivity in the Swedish economy was high prior to the crisis, in large part due to investments in IT and deregulation of the economy.

1 See Anders Forslund (Fiscal Policy Council, 2008).

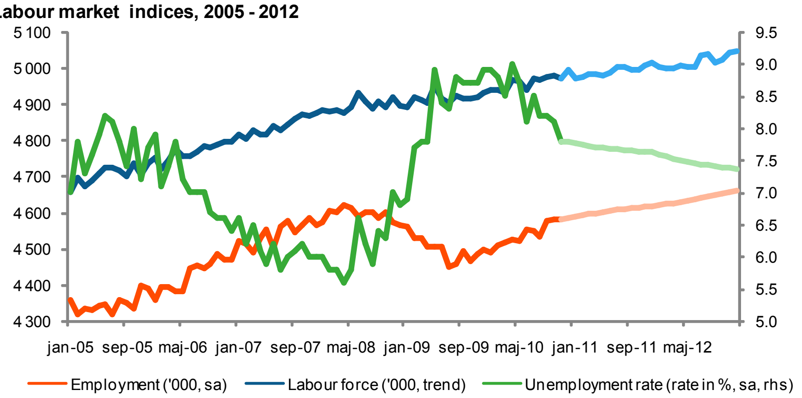
As the service sector, which often entails lower productivity levels, is growing as a share of the economy, renewed reform efforts are necessary to increase the growth dynamics of the Swedish economy. If not, there is a risk that competitiveness worsens and the growth potential becomes constrained.

Households continue to drive growth – at their own peril

Household consumption picked up in the third quarter, adding to the already significant growth contribution in 2010. While the contraction of real consumer spending for 2009 was revised upwards from -0.8% to -0.4%, third-quarter growth was 3.5% compared with the same period in 2009. Thus, the relatively strong expansion continues. At the same time, the limited growth of wages has dampened real disposable income growth, and households have dipped into their savings.

Looking forward, improved labour market performance is expected to raise real disposable income. The strong economic rebound has led to both increased employment and to growing numbers of hours worked. Despite a slightly higher inflation, this will lead to a stronger real wage development and work related income will increase. At the same time, the favourable policy mix that has so far supported household income and spending levels is about to be reversed. Apart from reduced tax rates on pensions, the pre-crisis lowering of in-work tax rates is unlikely to be continued in the same magnitude, although a another lowering has been

Labour market indices, 2005 - 2012



Sources: SCB and Swedbank projections.

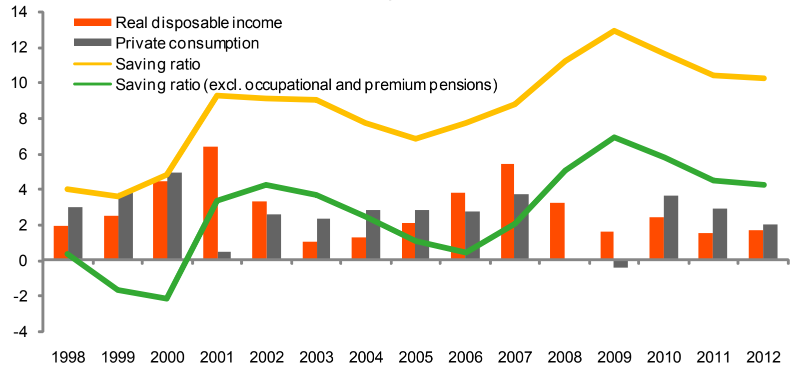
suggested for 2012, and transfers from the government will decline in line with falling unemployment and the tightening of health benefits. The minority government has strongly committed itself to fiscal policy restraint and does not seem to have parliamentary support for any major demand enhancing policies. Also, the normalisation of monetary policy will make a dent in household finances. As the share of mortgages at flexible rates was 59% in September 2010, compared with 43% in October 2008, increasing interest rates will reverse the beneficial impact that low rates have had on consumers' budgets.

Even though consumer behaviour has stabilized economic activity during the recent turbulent years, vulnerabilities are building up. We forecast household debt levels to reach close to 180% of disposable income and debt service to rise quickly with policy rate hikes. Increasing utility prices, in particular of electricity during another cold spell this winter, and rising inflation due to food and commodity prices will limit household budgets and curb consumption spending.

Although consumer spending is expected to grow more slowly during the next two years, it will remain an important source of growth. A significant share of the increase in consumption during 2010 was due to pent-up demand for durables such as cars. As households are returning to their desired levels of consumption of capital goods, we expect real spending to increase at a slower rate in 2011 and 2012. At the same time, precautionary savings can be expected to fall off as household confidence improves, supporting increasing consumption levels.

Put together, we expect the household saving ratio to continue to decline in 2011 and 2012, but will remain at a relatively high level. It soared during the crisis as precautionary savings surged. A combination of increasing consumption, limited growth of disposable income, and improving confidence will lead households to draw down on savings. However, as interest rates increase, we expect amortisation to pick up, supporting a relatively high saving ratio and dampening consumption growth.

Household income , consumption and saving, 1998 - 2012



Sources: SCB and Swedbank projections.

Monetary policy – a balancing act

The Riksbank has continued on its path towards a normalisation of monetary policy. In October, the policy rate was raised to 1.0%, but the policy rate path was revised downwards at the same time amidst concerns over the international economic recovery. In December, another increase of 25 basis points took place, but with no change in the policy rate path. While referring to the strong economic growth and improvement in the labour market, the Riksbank noted that the underlying inflation rate was still low, despite higher utility and commodity prices.

Against the background of a stronger-than-expected economic recovery and rising food and energy prices, inflation began accelerating in 2010 and consumer prices (CPI) had increased by 2.5% at the end of the year. In light of this, we expect the Riksbank to raise policy rates at a faster pace, and to effectuate two additional hikes of 25 basis points during the first half of 2011. The output and employment gaps are closing faster than expected, which shortens the way toward a normalisation of monetary policy, which strengthen the krona and dampen inflationary pressures. The consumer price index with fixed interest rates (CPIF) is expected to reach 1.7% at the end of 2012. There have also been concerns that the exceptionally low interest rates are fuelling asset prices, including those in real estate. For 2012, the pace of rate hikes will slow, and we forecast a policy rate of 3% by the end of the year, i.e., unchanged from our September forecast.

The Riksbank will need to perform several balancing acts over the next couple of years. Primarily, as economic activity is again picking up, there is a risk that a too rapid normalisation of monetary policy will prematurely strain economic growth. The Swedish economy is likely to have become more interest rate sensitive as the debt burden has increased, in particular amongst households. Higher interest rates will affect consumption behaviour more now than before the crisis. Regarding whether the Riksbank should be more proactive in preventing asset price bubbles, we believe that there is a role for monetary policy to "lean against the wind" to prevent, e.g., housing prices from becoming too excessive. In that sense, the on-going normalization of the monetary policy is welcome. In general, balance-sheet concerns should also be addressed through financial supervision measures and appropriate fiscal policy measures. This way, policy interventions will be more targeted, through, e.g., loan-to-value ratios or mandatory amortisation of highly leveraged house purchases, or through a phase-in of a reduction of the mortgage interest tax deduction.

Fiscal policy – towards surpluses

The rapid economic recovery has improved fiscal balances. A better-than-expected income development and solid private consumption are supporting the revenue side, and expenditures are being limited by the reforms of the health insurance system, lower spending on unemployment policies, and reduced interest payments on the public debt. Following data revisions, the budget deficit for 2009 is now reported at 0.7% of GDP, among the lowest in Europe. For 2010, we estimate that the budget deficit was 0.25% of GDP, slightly less than in our September report. Public debt is estimated at 40% of GDP.

Fiscal policy is likely to become less supportive of economic activity. The government remains committed to restoring the public sector balances and reducing public debt to create buffers for a future crisis. Furthermore, a weak parliamentary situation will limit the scope for continuing the bold reforms on the income side, as well as the health insurance reforms that characterised the government's first term. We thus expect a balanced budget for 2011, followed by a surplus in 2012. The government is committed to reducing the tax rate on pensions, and on restaurant meals, but the effects on the budget will in our view be compensated for by the stronger economic development. In addition, we maintain that the spring budget bill is likely to include additional spending of SEK 15 billion. For 2012, the prime minister has suggested that further lowering of the income tax could be implemented provided there sufficient fiscal resources. We estimate an additional fiscal expansion for this year of SEK 10 billion. Public debt will, nevertheless, continue its downward path, aided by privatisation revenues. Estimating that privatisation will bring in about SEK 25 billion over 2011-2012, out of a potential SEK 100 billion, we foresee public debt reaching about 35% of GDP by the end of the forecast period.

Faced by increasing labour market matching problems and slowing productivity growth, the government should increase the priority of targeted labour market policies and structural reforms to enhance medium-term growth and reduce long-term unemployment. Currently, we see little need for broad-based policies to support demand, but rather for active labour market policies directed at resolving skills mismatch problems and strengthening the job skills of those currently unemployed. For the medium term, to maintain the competitiveness of the Swedish economy, in particular as the Swedish krona is strengthening, higher productivity growth will be essential. This is a challenge, but key reform policy areas would include continued liberalisation of product and labour markets, and renewed efforts to stimulate R&D and also to increase both quality but also the number of students in the Swedish education system.

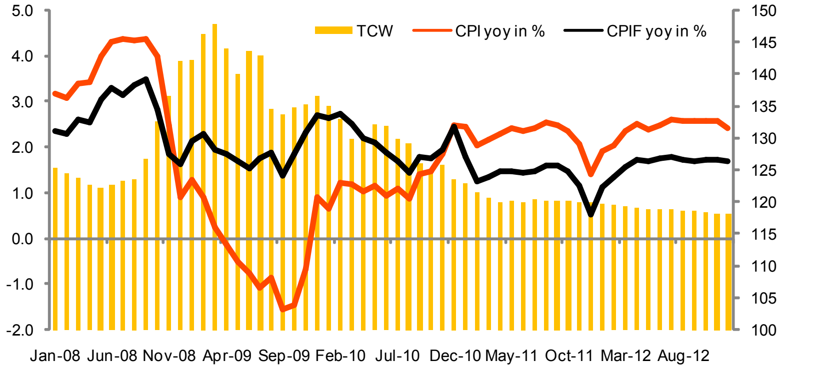
Magnus Alvesson
Jörgen Kennemar

Interest rate and currency outlook

	Outcome	Forecast			
	2011 11 Jan	2011 30 Jun	2011 31 Dec	2012 30 Jun	2012 31 Dec
Interest rates (%)					
Policy rate	1.25	1.75	2.25	2.50	3.00
10-yr. gvt bond	3.20	3.20	3.20	3.40	3.60
Exchange rates					
EUR/SEK	8.87	8.70	8.65	8.60	8.55
USD/SEK	6.85	7.02	7.09	7.17	7.13
TCW (SEK) [1/]	122.1	120.3	120.1	118.9	118.2

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

Inflation and exchange rate indices, 2008 - 2012



Sources: Riksbanken, SCB and Swedbank projections.

Estonia: First year in euro zone

The Estonian economy is recovering from the crisis faster than expected with the support of swift export growth. The unemployment rate has fallen more quickly than previously forecast; nevertheless, households are not eager to spend, even though consumption in recent months has been somewhat stronger than expected. Investment growth has been weaker than expected as public sector spending on investments has been smaller than planned. Headline inflation jumped to over 5% in November as fuel and food prices on global markets are growing rapidly;[1] base inflation – albeit rising – remains at a more modest level (November's annual growth was 1.2%). The budget situation is better than forecast, while lending growth remains below expectations.

Estonia has become the 17th member of the euro zone. We do not expect a strong immediate effect on economic developments from membership, but rather longer-term support for investments through an improved and more stable business environment. This support, in turn, will promote employment, income growth, and the recovery of domestic demand. The current status of the global economy does not allow us to expect as strong a positive effect as occurred after previous expansions of euro zone; however, an outcome better than currently expected is possible.

1 For a more detailed discussion on inflation, see the Swedbank November monthly report on Estonia.

The most significant risk for our scenario is global economic development. As Estonia is very open economy, external conditions, whether improving or deteriorating, will affect the economy through demand and prices.

Of medium-and long-term risks, companies' investment policies and labour outflows remain among the main risks that could affect the current growth outlook either positively or negatively. Of domestic risks we consider the price growth to be the greatest. The shortage of qualified labour is another domestic risk factor.

Exports continue to drive GDP growth

We have upgraded our GDP growth forecast for 2010 from 2.2% to 2.8%, as export growth has strongly exceeded our expectations. Growth expectations for 2011 and 2012 remain broadly the same, as exports are forecast to grow more than we expected this autumn, but domestic demand less. The main reason behind the latter projection is the weak gross capital formation in the third quarter of 2010; also contributing has been the early and snowy winter, which means that investment activity remains subdued through winter months.
In 2011, investment growth will be stronger, as successful sectors have reached already now their capacity constraints, and the public sector and its companies—it is hoped-- resume their stalled infrastructure investments.

Consumer spending at the end of 2010 was slightly stronger than previously estimated, but we expect the setback in early 2011 to be deeper and longer, due to the higher inflation compared to our autumn forecast. Price growth and unemployment rate will keep real incomes low and spending modest. Hence, we have lowered the consumption outlook for 2011 and 2012.

Export growth to recede in 2011

The second half of 2010 continued to surprise us with strengthening export growth rates – exports (in value terms) of goods expanded by 41% and services by 9% in August-October in annual comparison. The pre-crisis level of goods exports was exceeded in the third quarter although the exports of services remained slightly below that of the peak recorded in 2008. This rapid expansion is the main reason why we decided to increase our growth forecast for 2010.

The recovery of exports is strongly dependent on economic developments and demand in Finland, Sweden, and Germany, as most Estonian manufactures are subcontractors to companies in these countries. The production and exports of capital goods are expanding the fastest; hence, the positive investment outlook in those above-mentioned countries, but also in their export markets, is the key for being more optimistic about Estonian exports.

Key Economic Indicators, 2009 - 2012 1/

	2009	2010e	2011f	2012f
Economic growth	-13.9	2.8	4.2	4.5
GDP, bln euro	13.9	14.5	15.8	16.7
Average growth of consumer prices	-0.1	3.0	3.7	3.2
Unemployment level	13.9	17.0	14.3	12.5
Real growth of gross monthly wage,	-4.9	-3.0	0.0	2.7
Exports of goods and services	-19.9	22.5	11.5	10.5
Imports of goods and services	-30.6	22.0	11.5	11.5
Trade and services balance, % of GDP	5.9	6.5	6.0	6.0
Current and capital account, % of GDP	7.3	7.0	5.5	4.5
FDI inflow, % of GDP	8.7	7.5	10.0	10.5
Gross foreign debt, % of GDP	125.5	118.0	111.0	108.0
General government budget, % of GDP	-1.7	-0.3	-0.5	0.3
General government debt, % of GDP	7.2	7.0	6.7	7.8

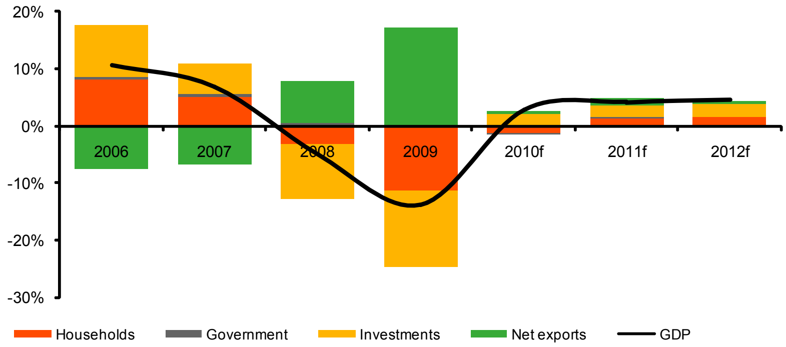
Sources: Statistics Estonia and Swedbank.

1/ Annual percentage change unless otherwise indicated.

Although exporting industries have shifted towards the production of higher-value-added products, relatively simple and cheap production still dominates. The major advantage of the Estonian exporting industry is still its low cost, but this advantage would not apply without other important factors, like quality, flexibility, transport costs (proximity to markets), and a favourable business environment. The cost advantage will erode gradually (but this process will take several years). Hence, the other factors named above are becoming increasingly important. This also means that companies will have to change their production and become even more efficient.

The gradual opening of services markets in the EU is widening the opportunities of Estonian services companies to expand business abroad. While exports of transport services are about to slow—because high level of cargo volumes and a possible setback from the increased activity of the Russian Ust-Luga port--we foresee stronger developments in other services, including tourism. The latter is expected to benefit not only from higher spending by individual tourists, but also from activities of the programme Tallinn – the European Capital of Culture in 2011. Other services are recovering as well, and we are seeing particularly rapid growth in construction services already now. The major obstacle for the expansion of Estonian services providers abroad are the informal barriers and different business environments facing these providers, which makes difficult to operate as Estonian company in these new, foreign markets.

Contributions to GDP Growth



Sources: SE and Swedbank projections.

Taken all together, we expect that export growth rates will slow in 2011 and into 2012 as well, although at a slightly lower rate. The main reason behind this expectation is the high level of export volumes, which makes it difficult to generate high growth rates. However, there is a positive risk: if Estonian companies succeed in moving up the value-added ladder, and/or are able to increase export prices more than currently forecast, exports will grow faster.

Technology investments up, infrastructure lagging

We cut our investments forecast for 2010 significantly because the third-quarter result was far below expectations, and the early and snowy winter keeps infrastructure investments weak in this winter as well. We maintain that companies will continue to increase investments in machinery and equipment, and, from 2011 onwards, in transport equipment as well. The major consideration behind this expectation is the shortage of capacities in fast-growing sectors, and the need to recover and replace idle capacities.

Infrastructure investments were weaker than forecast in nine months of 2010 – delayed investments will be made in 2011 and 2012, implying an upward revision of investment growth rates for these years. Here, we see a possible upside, if the EU structural funds' projects are handled better than in 2010-- especially taking into account the fact that most of the funds for the current budgetary period have not been used yet.

We see possible positive risks emerging from Estonia's euro zone membership if foreign investments turn out stronger than currently expected. These positive risks are motivated also by the expected lower risks in Estonia vis-à-vis those other countries (particularly in southern Europe) that have to employ unsupportive fiscal policies to handle their debt problems. Still, in the current situation, it is too early to say how strongly these motivators will work in 2011-2012.

The negative risks are related to problems in public infrastructure investments – due either to legal battles over state competitions or delays in making political decisions – and the weak lending activity of banks.

Swedbank's GDP Forecast – Estonia

Changes in volume, %	2009	2010e[1/]		2011f[1/]		2012f[1/]	
Household consumption	-18.4	-2.0	(-3.0)	2.8	(3.5)	3.0	(3.5)
Government consumption	0.0	-2.0	(-1.5)	0.2	(0.1)	0.3	(0.3)
Investments	-37.6	8.0	(11.5)	7.5	(6.5)	7.5	(10.0)
gross capital formation	-33.0	-12.5	(-6.0)	12.0	(11.0)	10.0	(10.0)
changes of inventories/GDP (current prices)	-2.9	2.0	(1.5)	2.7	(2.0)	2.5	(2.0)
Domestic demand	-22.2	0.7	(1.0)	3.4	(4.0)	3.8	(5.0)
Exports	-19.4	19.5	(14.5)	9.5	(6.0)	8.0	(6.2)
Imports	-32.9	18.5	(16.0)	8.2	(4.0)	8.0	(5.7)
Net exports, contribution to GDP growth	16.9	0.5	(-1.0)	1.4	(2.0)	0.5	(0.5)
GDP	-13.9	2.8	(2.2)	4.2	(4.5)	4.5	(4.5)

Sources: Statistics Estonia and Swedbank.
1/ The figures from our forecast in September are given in brackets.

While new loans to households have marginally increased in recent months, loans to the corporate sector are still flat and approximately at the 2004 level.

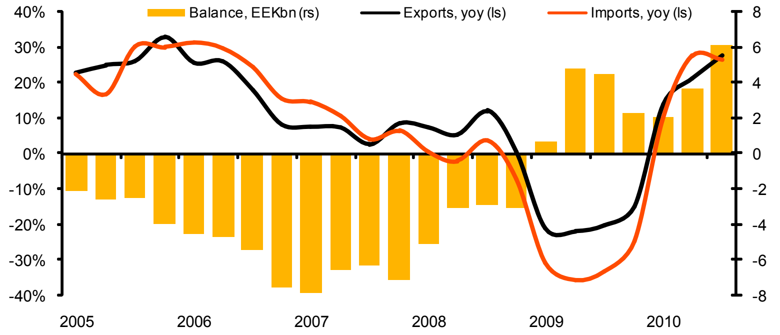
First consequences of high unemployment to be felt

We have lowered our unemployment rate forecast for 2010 and 2011 as its decline in the third quarter was stronger than expected. There were two factors behind: besides growing employment (according to our estimates, 1.3% in seasonally adjusted terms over the previous quarter), the number of nonactive persons increased by about 2%, as younger people moved (back) into the education system and older generations returned to retirement. We see this as an indication of an adjustment in the labour market faster and deeper than previously expected.

The structural nature of unemployment is the main reason why the unemployment rate cannot fall faster. Although the government is planning to extend its active labour market policies, we are of the opinion that these steps are not enough to make adjustment faster. We foresee that, together with the growing share of very long-term (i.e. over two years) unemployed, the qualifications and social abilities of the unemployed will erode, severely reducing their capacity to find jobs, especially in 2012.

The problem of the shortage of qualified labour is raising its head. Although the share of companies complaining about this problem is currently small, it may grow faster than commonly expected as the competence of the available unemployed workforce erodes and demands for qualifications increase. This will happen in few sectors/ professions during the forecast period, but the problem will gradually increase over time.

Export of Goods and Services



Source: EP, Swedbank calculations

This two-way development in labour supply and demand is manifesting itself in wages as well. While the positive annual GDP growth and profits surge has raised wage expectations in the whole economy, these expectations will be met in sectors/ professions with labour shortages and/or involved in successful export activities. Euro adoption might raise expectations and demands further. Rapid inflation is another factor pushing up wage expectations. Still, the high unemployment rate will keep wage growth for most professions low in 2010-11, and perhaps in 2012 as well.

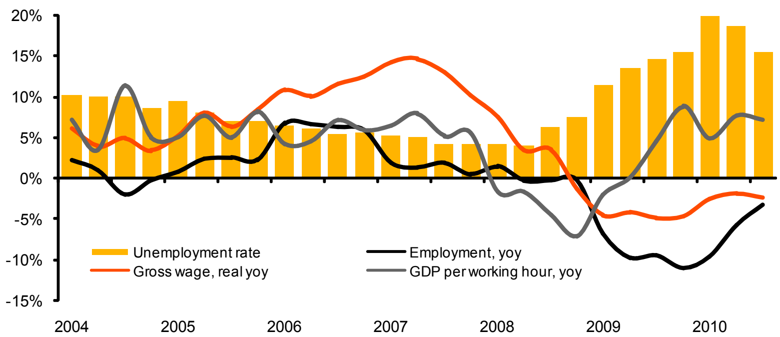
We have lowered our real wage growth forecast for 2010 and 2011, mostly because of the higher inflation rate, but we project an increase for 2012 as we expect the labour shortage to become stronger by then. The rather modest nominal wage growth rates (around zero for 2010, and 3.7% for 2011) are hindering the two-way developments in the labour market: rapid wage growth for qualified labour, mostly employed in the exporting sector, and very modest expansion for the most common professions and low-qualified jobs. While the latter group may see a decline of incomes even in 2011, the former may receive wage increases of over 10% this year.

There is a rather significant risk of faster-than-projected wage growth if the labour shortage turns out to be stronger than estimated, and if companies decide to welcome wage demands more generously. The labour outflow might be the main trigger for this development.

Two-way development in consumption

The two-way developments in the labour market are translating directly into consumption: we are already witnessing a growth in consumption of higher-paid professions who maintained their jobs during the crisis and/or are employed in the exporting sector, and a decline in spending among low-paid workers and unemployed.[2] While the former are behind the upward revision of consumption growth in 2010, the size

Labour Market Indicators



Source: SE

2 The main indication is different growth/decline rates in consumption: while spending on necessities declines, spending on other items is growing.

of the latter group caused us to cut growth prospects for 2011 and 2012. The low-income families are seriously affected also by price growth: this is forcing them to squeeze down their spending as prices are rising-- most of all in the category of necessities.

The high saving rate is another factor behind our cutting the spending forecast for 2011 and 2012. According to the survey,[3] 36% of families in all income groups are trying to save money, and there are no signs that this approach has changed. On the contrary, the deleveraging process and the resumption of the second pension pillar payments indicate that savings will actually increase from the 2010 level.

The euro changeover will have a short-term impact on consumption: while, at end-2010, some people probably increased their spending in fear of a rise in prices when Estonia joins the euro zone.

Inflation has short-term negative effect on consumption

We have increased our inflation expectations for 2011 because price growth in 2010 was stronger than assumed. The main reason behind this strong growth was the global price surge, which will affect price levels in 2011 as well. Still, in 2012 we foresee a slowdown in inflation as global supply-side effects weaken. However, as mentioned above, stronger-than-expected inflation is among our main risk factors, for two reasons. First, it would undermine domestic consumption, especially as it affects the main items of consumption. Second, it would increase wage demands, which would undermine the competitiveness of Estonian companies and, hence, affect exports. If wage demands are not translated into companies' selling prices, then profits of companies will be weaker, thereby affecting their investment ability.

Budgetary situation improving

Estonia's budgetary position will be better than forecast in the autumn. The budget deficit was 0.5% of GDP in nine months of 2010; hence it is possible that the budget balance will be much closer to zero for the full year than the government expects.[4] We foresee budget deficit to be somewhat bigger in 2011 due to increased spending (e.g. for resumption of the second pension pillar), but again close to zero in 2012. This improved outlook is based on a better-than-expected performance of the economy, as well as strict controls on spending.

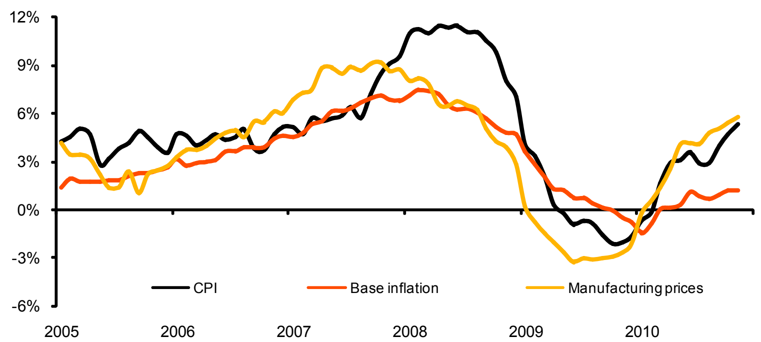
The main risks are related to higher-than-projected social spending needs in 2011 and 2012. The problems of unemployment, poverty, and health care financing may turn out to be more severe than currently assumed, requiring additional spending. The weakest areas in the public sector are municipalities, many of which may face financial failure due to low incomes (employment) and high social spending needs. This may force the government to step in. If the number of failing municipalities is significant, the costs for the budget will be large enough to cause the deficit to grow. Still, we are of the opinion that, if the economy develops according to our main scenario, a significant deterioration of the budget situation is unlikely.

Maris Lauri

3 A survey conducted by the Estonian Institute of Economic Research at the request of Swedbank's Institute of Private Finances.

4 In 2010 Estonia, sold Kyoto emission quotas for EUR 230m. In December two contracts were concluded. There are discussions going on with Eurostat about reporting how the sale income and the use of those revenues will be included into budgetary statistics. Hence the effect of the quota sales on the budget outcome may be different than currently assumed.

Major Price Indices, yoy



Source: SE, Swedbank calculations

Latvia: Stronger than expected recovery, yet reforms are needed

Recovery continues, and in 2010 it has been stronger than expected. Since the trough in the fourth quarter of 2009, Latvian GDP has been growing every quarter; during the first nine months of 2010, it increased by about 3%. Export volumes have grown by 17% from the lowest point in the second quarter of 2009. This growth was also supported by inventory rebuilding throughout 2010, while the recovery of gross fixed capital formation started in the third quarter. There was quite a strong rebound in employment in the second and third quarters, which, together with improved consumer confidence (albeit flattened in the second half of 2010 after a sharp rise earlier in the year), has stabilised household consumption.

This so-far swift and smooth recovery is explained by both local and external factors. The private sector was quick to adjust by lowering labour costs and significantly raising productivity, while the stronger-than-expected economic growth of Latvia's main trading partners improved exports. Better global growth in 2010 has improved also the outlook for 2011.

Leading indicators suggest that GDP quarterly growth continued also in the fourth quarter of 2010. We now estimate GDP to have fallen by about 0.5% in 2010 due to a negative carryover effect, but, by year's end, to have risen by close to 4% from the trough. As with the global situation, stronger growth in 2010 implies larger statistical carryovers for 2011 (especially for exports and investments). Therefore, although the overall forecast story and anticipated GDP quarterly dynamics stay broadly unchanged from the September outlook, swifter economic growth of 4% is now forecast for 2011. Investment activity has been notoriously volatile so far and, if investments' rebound is stronger due to, e.g., better access to funding, GDP growth rate might be significantly higher. We foresee GDP growing by about 4.2% in 2012.

Due to the strong rebound in the labour market in the second and third quarters of 2010, we are lowering somewhat our job-seekers' rate forecast. However, job creation will be sluggish. From 18.9% in 2010, the average job-seekers' rate is expected to come down to about 14.5% in 2012. We now foresee higher consumer price inflation for 2011 (about 3%) partly due to value-added tax (VAT) increases, but retain 2.5% for 2012. The official target for euro introduction remains 2014, and we foresee that the government will try to contain price growth. Due to the better global outlook, exports are anticipated to grow stronger in 2011, but imports will keep up as well, as need for investments and inputs for exports will rise.

Global developments remain the main risk to our forecast – there are still many challenges regarding fiscal sustainability, inflation, protectionism, etc. Global growth remains very uneven, and, if some of the risks to the global outlook materialise, Latvian growth will be dampened as well. One of the main internal risks remains inflation, which might put at risk euro introduction in 2014. Imbalances in the labour market, entrenching inflation expectations might result in higher inflation. Our current forecast is still a muddling-through scenario in terms of structural reforms – if better progress is achieved with respect to, e.g., public sector reforms, growth from 2012 onwards is likely to be stronger.

Stronger export and import growth

The better-than-expected export developments in the second half of 2010 have generated strong positive carryover effects for 2011. We are thus estimating higher export volume growth in 2010 (9.5%) and raising our forecast to 10% in 2011, but are keeping 6% rate for 2012. The average quarterly growth rate in 2011 is now expected to be a bit stronger than in our September forecast, but slower than in 2010 due to increasing capacity constraints.

The country structure of Latvian exports is such that relatively faster growing countries have larger shares (e.g., Germany, Sweden, and the Baltics). The external environment will thus be quite favourable unless there

Key Economic Indicators, 2009 - 2012 [1/]

	2009	2010e	2011f	2012f
Economic growth	-18.0	-0.5	4.0	4.2
GDP, bln euro	18.5	18.0	19.1	20.5
Average growth of consumer prices	3.5	-1.1	3.0	2.5
Harmonised unemployment level	16.9	18.9	16.5	14.5
Real growth of average net monthly wage	-5.9	-6.5	1.0	2.4
Growth of exports of goods and services	-17.8	18.0	15.1	11.0
Growth of imports of goods and services	-37.6	16.2	16.6	14.6
Balance of goods and services, % of GDP	-0.3	0.4	-0.3	-2.2
Current account balance, % of GDP	9.6	4.6	0.8	-1.8
Current and capital account balance, % of GDP	12.0	6.9	3.8	0.1
Net FDI, % of GDP	0.4	1.0	1.9	2.2
External gross debt, % of GDP	157	159	149	141
General government budget (accrual basis), % of GDP	-10.2	-8.5	-5.0	-3.0
General government debt, % of GDP	36.7	48.4	50.8	49.7

Sources: CSBL and Swedbank.

1/ Annual percentage change unless otherwise indicated.

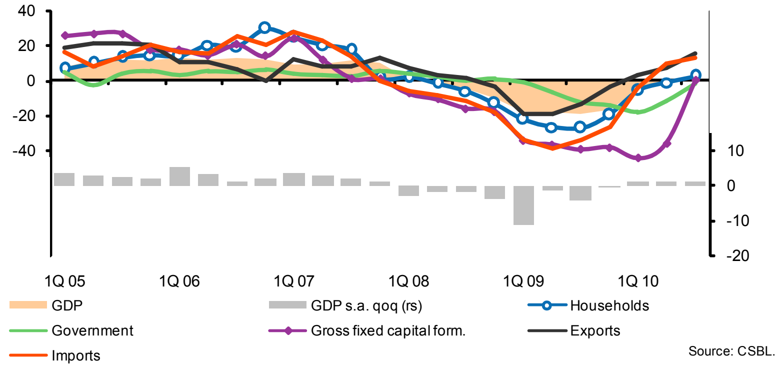
are extensive negative global shocks. The cost competitiveness of Latvian exporters has continued to improve – unit labour costs in manufacturing has continued to decline. Export market shares are growing. Bank-lending policy is also becoming increasingly supportive of exporting industries.

Although many exporting companies are already reaching capacity constraints to further increase production volumes, there is still potential for value-added increases. Manufacturers are continuing to diversify their product and country mix, and to invest in improving the effectiveness of their production to increase their turnovers; growing global commodity prices are making this somewhat easier. Exports in value terms reached historically highest levels in autumn 2010.

Growth prospects of services exports are less optimistic – in 2010 they were nearly flat. Although the number of both business and personal travellers continues to rise, freight carriage volumes are likely to grow very slowly in 2011. The largest part of international freight is by railway (including that through the ports), and the forecasts by the largest railway carrier suggest that freight volumes will be flat in 2011.

We now estimate import volumes to have grown by 8% in 2010 and we have raised our forecast to 9% in 2011 on account of stronger investments and exports. Imports are also expected to grow similarly in 2012. Import growth in 2010 was mostly driven by intermediate and capital goods (which constitute about two thirds of total goods imports). It is expected that, with the recovery of household consumption strengthening in 2011 (albeit slower than previously anticipated), import growth of consumption goods will somewhat accelerate. Meanwhile, the inventory cycle will run out of steam in 2011, thus undermining imports.

Annual GDP growth, %



Source: CSBL.

Investments have started to recover

The rebound in investments, although anticipated in the second half of 2010, was stronger than expected, and gross fixed capital formation is anticipated to have fallen by about 20% for the year overall. We are raising our forecast for gross fixed capital formation to about 15% for 2011, mainly due to larger positive carryovers, and are keeping the 14% forecast for 2012. The quarterly growth for 2011-2012 remains similar to our previous forecast.

Investments will be supported by European Union (EU) funds – the government plans to acquire them up-front – about 8% of GDP in 2011 and about 5% in 2012, most of them for infrastructure/transport and agriculture. In view of capacity constraints, exporting sectors will seek to invest in capacity and/or new product development. Although construction activity started to rebound in the third quarter of 2010, its growth is expected to be slow due to weak demand and either still excessive supply or lack of funding.

Foreign investors' activity has started to increase slowly. Together with inflows of new equity capital, reinvested earnings from foreign direct investment (FDI) were positive in the third quarter of 2010 for the first time in two years. Standard & Poors has revised Latvia's sovereign country rating one notch upwards – although this is still below investment grade, the revision shows the improvement of confidence. Further upgrades of the ratings are expected in the first half of 2011, which will promote investments.

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2009	2010e[1/]		2011f[1/]		2012f[1/]	
GDP	-18.0	-0.5	(-1.5)	4.0	(3.0)	4.2	(4.2)
Household consumption	-24.1	-1.0	(-2.0)	2.5	(2.0)	4.5	(4.5)
General government consumption	-9.2	-8.0	(-4.3)	-1.8	(-1.1)	0.1	(0.2)
Gross fixed capital formation	-37.3	-20.0	(-27.0)	15.0	(7.0)	14.0	(14.0)
Exports of goods and services	-14.1	9.5	(9.0)	10.0	(6.0)	6.0	(6.0)
Imports of goods and services	-33.5	8.0	(7.5)	9.0	(5.0)	9.0	(9.0)
Inventories contribution to GDP, pp	-1.5	5.9	(6.7)	-0.7	(-0.5)	0.0	(0.2)
Net export contribution to GDP, pp	14.2	0.5	(0.5)	0.3	(0.4)	-1.8	(-1.7)

Sources: CSBL and Swedbank.

1/ The figures from our forecast in September are given in brackets.

Labour market improves on the surface

The labour market rebound in 2010 was stronger than expected – in the second and third quarters, employment increased by 37 thousand (net of active labour market programmes); in the first nine months of 2010, seasonally adjusted nominal gross wages had grown by 4%. The job-seekers' rate decreased from its peak of 20.4% in the first quarter of 2010 to

18% in the third quarter.

We are of the opinion, however, that the pace of improvement will decelerate. The registered unemployment rate was flat in October-December. Businesses are still very cautious in their employment plans, and job creation is expected to be slow. The rapid improvement in 2010 may to a large extent have been a one-off rebound after excessive job destruction in 2009. The 2011 government budget consolidation measures do not effectively support and in some cases – e.g., the increase in the minimum wage – even hamper job creation by increasing labour costs.

We are lowering somewhat our job-seekers' forecast for 2011 and 2012 due to the better 2010 developments, reaching on average 14.5% in 2012. If opening of German and Austrian labour markets significantly spur emigration, decline in unemployment might be faster, but it would also exacerbate, e.g., pension system sustainability problems. Structural challenges in the labour market remain, and part of the cyclical unemployment is very likely to turn into structural unemployment.[1]

The gap between real wages and productivity has nearly disappeared[2] and with labour productivity growth continuing, there are grounds for moderate wage rises. Another factor behind wage growth will be structural imbalances (e.g., a skills mismatch) that effectively reduce unemployment's ability to hold down wage rise. Wage developments will differ among industries with exporting industries leading the way. In 2011 we expect only marginal increases in hourly wage rates and most of the wage increase to come from reintroduction of motivation schemes that were put on hold during the recession.

Although due to the above factors we have raised somewhat the nominal net wage forecast for 2011, higher inflation will eliminate most of this gain and real wage growth is forecast at just 1%. Higher inflation in 2011 is not expected to be a driver to raise wages. We are keeping our real net wage forecast of 2.4% for 2012; however, there is a risk it will be stronger if no policy action is taken to prevent structural unemployment.

Higher inflation due to tax increases

We are forecasting higher consumer price inflation in 2011, mostly due to VAT increases.[3] We expect average consumer price growth to be about 3% in 2011 (1.5% previously) and are keeping a 2.5% forecast for 2012. We believe that such inflation is not yet competitiveness destroying due to productivity improvements.

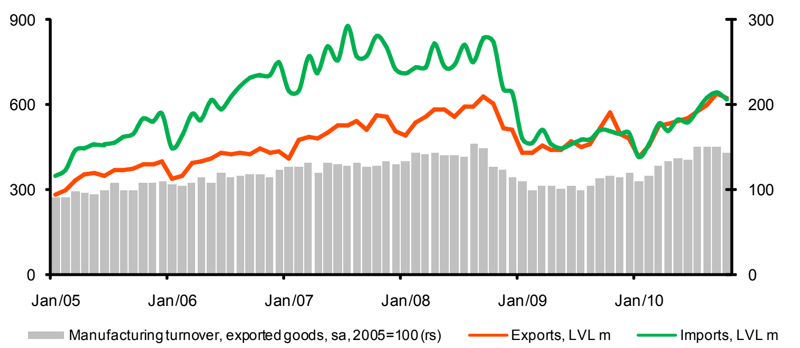
Global commodity price growth (although slower in 2011) remains one of the main inflation drivers. However, local price pressures are slowly strengthening – domestic competition seems to have weakened during the crisis[4], the skills mismatch in the labour market might yield faster wage growth, 2011 tax increases may give grounds for further price rises. Consumer inflation expectations have grown, attributed to concerns about food prices in early autumn and announced tax rises. We believe that improving competition and taking action to reduce the imbalances in the labour market are crucial in order to keep inflation under control. The government has confirmed its commitment to introduce the euro in 2014 and will try to contain price growth; however, it might turn out that, even if – as currently planned – there are no more tax increases in 2012, inflation might still turn out higher than anticipated.

Uneven household consumption development

Household consumption growth will remain slow and fragile in 2011. Its development so far is best characterized as "two steps forward, one step back" – after a rebound at the end of 2009–beginning of 2010, it inched downwards in the second and third quarters. Due to past data revision, we now estimate a smaller fall in household consumption in 2010 of -1%. From its trough in the third quarter of 2009, however, it will be up by about 3% by the end of the year. We are lowering the forecast somewhat for 2011 to 2.5%, as household consumption will be undermined by tax increases and higher inflation; meanwhile, it is expected to grow by 4.5% in 2012 (same as in our September's forecast).

Slowly increasing incomes are supporting household consumption – during the first three quarters of 2010, real net wages had grown by nearly 1% and employment by about 3% since the end of 2009 (seasonally adjusted). Residential household deposits started to retreat in the

Trade in goods and services



Source: Bank of Latvia.

1 See our latest Swedbank Analysis (December 2010) for more details

2 See our monthly newsletter on the Latvian economy (September 2010) for more details

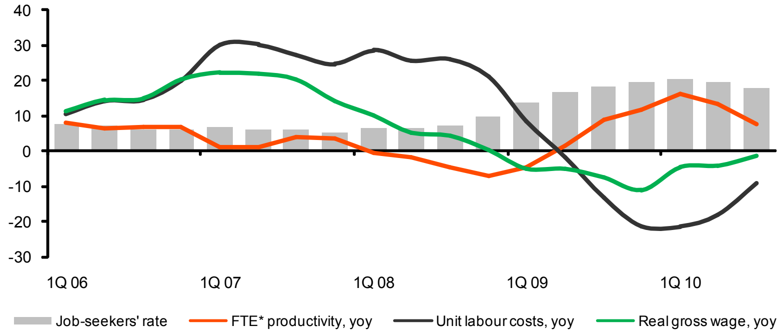
3 The base VAT rate was raised from 21% to 22%; the reduced rates are up from 10% to 12% (for electricity, from 10% to 22%).

4 According to Global Competitiveness Report 2010-2011 by the World Economic Forum, Latvian rank on domestic competition declined from 57 (out of 134) in 2009 to 74 (out of 139) in 2010.

second half of 2010, which, together with risen consumer confidence, might suggest that households chose more to spend rather than to save. This supposition is supported by the fact that retail trade turnover has been growing somewhat faster than incomes (up by about 8% in constant prices during the same period).

The ongoing deleveraging and tax increases, as well as emigration and high unemployment, will continue to dampen the recovery in household consumption in 2011. Also, the improvement in confidence has slowed. On the other hand, real incomes will continue to grow slowly.

Job seekers, productivity and wages, %



* FTE - employment in full-time equivalent

Source: CSBL.

Better short-term growth puts at risk structural reforms

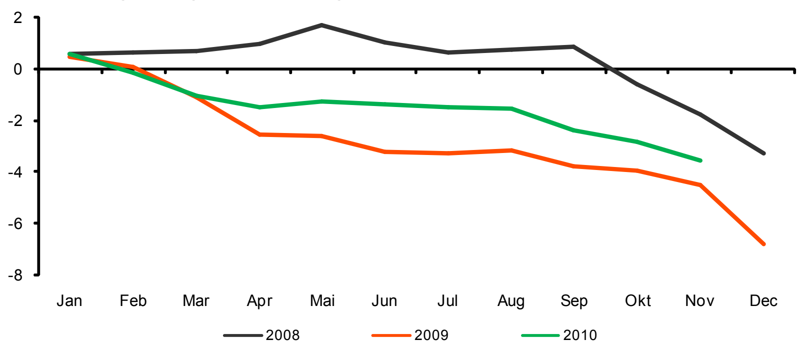
In the first 11 months of 2010, tax revenues exceeded the plan by about 2% as economic growth was stronger than assumed. Spending was increased during the year, and the planned budget deficit nearly doubled since the beginning of the year, reflecting fiscal discipline issues. Nevertheless, current cash-flow data suggest that the 8.5% budget deficit target most likely will be met (the key uncertainty is regarding the extent of the losses to be posted by the state-owned financial institutions, e.g., Parex bank).

The stronger-than-expected economic growth in 2010 reduced the size of necessary fiscal consolidation in 2011. The approved 2011 budget is planning a 5.4% of GDP deficit (ESA methodology), which is below the 6% cap set out in the agreements with external donors. The consolidation measures amount to LVL 292 million, or about 2.2% of our forecast GDP, of which two-thirds will come on the revenue side, mainly by increasing taxes and certain temporal revenues; only one-third will come via expenditure cuts. To our view, the 2011 budget aims to maintain the status quo as much as possible and consolidation measures lack structural reforms. Accordingly, the IMF and the EC have called for additional high-quality structural measures of at least LVL 50 million in 2011.

We forecast significantly higher GDP and inflation than the Ministry of Finance (i.e. forecast on which the 2011 budget is based). It implies that the budget is likely to perform better and the size of consolidation to squeeze in below deficit caps in 2011 and 2012 is smaller. Given that structural reforms in politicians' rhetoric so far had been linked to consolidation figures, there is a risk that it would reduce the pressure to carry out reforms thereby reducing medium term growth potential. Latvia needs structural reforms per se – not just to consolidate the budget, but to improve the overall business environment, efficiency of public sector and quality of its services. It is of the utmost importance that the authorities focus on structural policy to raise medium-term growth – making tax policy employment friendly, improving the quality and effectiveness of tertiary and vocational education, enhancing competition, reducing grey economy, etc. The Latvian economy could be flying, but as of now it risks to only duck walk along.

Mārtiņš Kazāks
Lija Strašuna
Dainis Stikuts

Accumulated general government budget deficit, % of annual GDP[1]



[1] cash-flow basis

Sources: State treasury, Swedbank forecasts.

Lithuania: Recession is over, investments key to sustainable recovery

GDP in both the second and third quarters of 2010 grew by 1.1% compared with the same period a year ago. Seasonally and working-day-adjusted growth in both quarters compared with previous periods was positive and equal to 0.5% and 0.6%, respectively, thus technically ending recession and indicating the beginning of a new economic cycle. Behind the recovery were strong exports, restocking, and, in the third quarter, an increase in gross fixed capital formation of 15% from the same period a year ago. Investments in fixed tangible assets in the public sector have been growing since the second quarter of 2010; however, in the private sector, they were still declining last year.

Households and the government continued to reduce their spending in the third quarter; however, households did so at a much slower pace – their consumption decreased by only 0.9% in the third quarter, compared with the same period last year, and probably grew slightly in the fourth.

In the fourth quarter, the economy probably grew at the fastest pace of the year, and we expect this trend to continue – in 2011 and 2012, the economy will grow by 3% and 4.5%, respectively--the same rates we forecast in September.

We increased our forecast of consumer price inflation to 2.0% for this year and to 2.5% for 2012. The main factors behind the price increases this year will be external – we expect that average prices of food and agriculture commodities will increase by 15% and oil prices will go up by 12.8% (in EUR). An increase in excise duties on diesel fuel and tobacco will put upward pressure on prices and potentially promote smuggling. Already next year other internal factors are expected to materialize: lower unemployment and higher wages will exert upward pressure on consumer prices.

The biggest contribution to GDP growth in 2010 came from rebuilding companies' inventories. In 2011, however, the main engine of growth will be investments, especially in the private sector. Inventories, consumption, and net exports will all contribute to growth, whereas government consumption is expected to keep declining.

We revise upwards our forecast for growth in gross fixed capital formation this year and also expect this trend to continue into 2012. We expect household consumption to increase slightly from last year, but more significant growth will start only in 2012.

Exports will reach new highs

In October, exports not only exceeded the pre-crisis level, but reached an all-time high. We forecast record highs will be achieved as exports will continue to grow in nominal terms this year, although at a much slower pace – 12.2%, compared with the 27% projection last year. Slower growth will be recorded only because of a much larger comparative base. Otherwise, the prospects are positive: all the main export markets – Poland, Latvia, Russia, and the other CIS countries will grow faster than in 2010 (Germany and the Nordics will grow slower, but still much faster than the rest of the euro zone).

Despite a strong pickup in transport services, exports of services are still below the level reached in 2007 – mainly due to the slower recovery in the tourism sector. This year, growth of exports of services will be higher, not least because the European Basketball Championship will be held in Lithuania; this alone is expected to contribute 5 percentage points of growth to exports of travel services. This year, the deficit of goods and services will be slightly higher (at current prices) – up from 1.5% in 2010 to 1.7% of GDP this year. However, prices of imports are expected to grow faster than prices of exports; thus, the contribution of net exports to GDP growth this year will be positive. After being in surplus in 2009 and 2010, the current account is expected to move back into deficit this year.

Key Economic Indicators, 2009 - 2012 [1/]

	2009	2010e	2011f	2012f
Economic growth	-14.7	0.5	3.0	4.5
GDP, bln euros	26.5	26.8	27.9	29.6
Growth of consumer prices	4.5	1.3	2.0	2.5
Unemployment level	13.7	17.7	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	27.0	12.0	9.5
Growth of imports of goods and services	-36.1	27.0	12.2	9.4
Balance of goods and services, % of GDP	-1.2	-1.5	-1.7	-1.7
Current account, % of GDP	4.3	1.2	-0.3	-0.5
Current and capital account, % of GDP	7.7	4.2	2.7	2.5
FDI inflow, % of GDP	0.5	-0.5	1.0	1.5
Foreign gross debt, % of GDP	87.2	89.0	87.0	84.0
General government budget position, % of GDP	-9.2	-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.

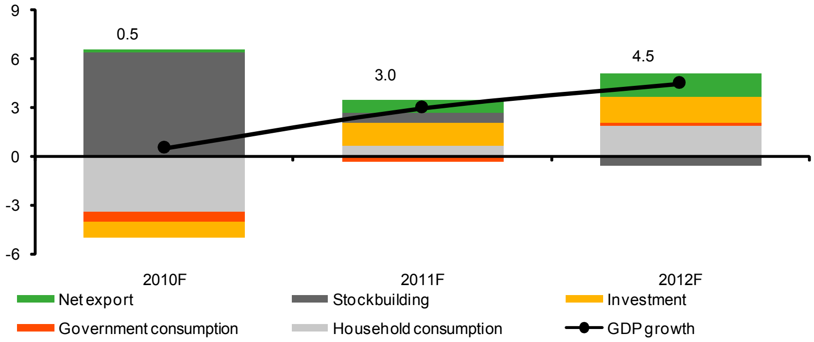
Investments will drive recovery and competitiveness in longer term

Lithuania will not be able to rely on public investments in fixed tangible assets in 2011. Government investment spending was cut by 23.8% - from the plan of almost LTL 5 billion in 2010 to LTL 3.8 billion in 2011. Admittedly, LTL 1 billion of nonrealized investments from the 2010 budget will be transferred to this year, but this will not be enough to ensure growth. The private sector, on the other hand, has been lagging in investments in fixed tangible assets – they have been declining since the third quarter of 2008 and in nominal terms are around levels not seen since 2001. This trend cannot last – subdued investments in machinery and equipment dent competitiveness and sustainable growth. Increasing profits, capacity utilisation, and slightly better lending conditions will underlie a change in trend.

In the first half of 2010, corporate profits increased more than fivefold from a year ago, which, admittedly, was a very bad year. Although profits are below the levels seen in 2008, the growth trend is expected to continue throughout this year and into 2012. In the first half of 2010, the pre-tax profit margin widened to 3.5% but is still below the 2005-2008 average of 6.2%.

Capacity utilisation is at 68% – still below the booming years – but the trend is upward pointing, and some sectors (wearing apparel and wood) are already at pre-crisis levels. The upward trend of the industry confidence indicator also suggests an imminent increase in investments.

Contributions to GDP growth, %



Source: LDS, HBM forecast

Sources: Statistics Lithuania, Swedbank

The inflow of foreign direct investment to Lithuania this year will amount to 1% of GDP. More than half of this will be reinvestment of profits made in 2010, but new foreign investments will also contribute. The current Prime Minister and the Minister of the Economy spent some time last year wooing foreign companies to invest in Lithuania, mostly in the high-tech and IT sectors. These efforts bore fruit in 2010 and, along with the stabilised economic environment, are expected to have positive effects this year.

Labour market remains challenged

Our forecast for labour market developments remains the same: the recovery in the labour market will be slow – both in terms of new workplaces and net real wage increases. We expect that 40,000 workplaces, mostly in the private sector, will be created this year, bringing unemployment down by 2 percentage points to 15.5%. The trend will continue into 2012, although at a slower pace – unemployment will continue declining along with the total labour force. The biggest issue with the labour market is that most unemployed have not suitable qualifications or relevant skills and have been unemployed for more than one year. At the end of 2009, every 10th jobless had been unemployed for longer than one year; by the middle of this year, almost every other will qualify for the status of "long-term jobless." The persistence of joblessness is intensified by widespread unofficial employment. Last year, the Personal Finance Institute of Swedbank conducted market research that indicated that more than half (54%) of officially registered jobless have work-related incomes. If the government finds ways to nudge these unofficially employed into the official labour market, the unemployment rate will drop faster than currently forecast. Some of these measures include requiring long-term jobless to perform public works, in order to identify "fake" jobless who claim the benefits but are not looking for employment. Other temporary changes in legislation (which will expire in July 2012) introduced social tax breaks for companies who employ workers who have never been employed before.

We are keeping our forecast that net real wages will be flat this year, after declines of 7.2% and 5.0% in 2009 and 2010, respectively, and will grow by 2.5% next year. On the other hand, labour productivity, which grew by approximately 5% last year, is likely to go up by around 1.5% this year and 3-4% in 2012. The growth of labour

Swedbank's GDP Forecast – Lithuania

Changes in volume, %	2009	2010e		2011f		2012f	
GDP	-14.7	0.5	(0.5)	3.0	(3.0)	4.5	(4.5)
Household consumption	-17.7	-5.0	(-5.0)	1.0	(1.0)	3.0	(3.0)
General government consumption	-1.9	-3.0	(-3.0)	-1.5	(-1.0)	1.0	(1.0)
Gross fixed capital formation	-40.0	-5.0	(-9.0)	8.0	(7.0)	8.5	(8.5)
Export of goods and services	-12.7	13.4	(10.5)	6.5	(6.5)	7.7	(7.7)
Import of goods and services	-28.4	12.1	(8.8)	5.0	(5.0)	5.5	(5.5)
Net exports contribution to GDP growth	15.3	0.2	(0.6)	0.8	(0.8)	1.4	(1.4)
Stockbuiding contribution to GDP growth	-5.9	6.4	(6.4)	0.6	(0.6)	-0.6	(-0.6)

Sources: LCD and Swedbank.
1/ The figures from our forecast in September are given in brackets.

productivity has been below that of wage increases between 2004 and 2009; a reversal of this relationship would have a positive influence on Lithuanian competitiveness, going forward. This is especially important now that peripheral euro zone countries will be embarking on internal devaluation strategies and will intensify the competition, at least within the EU.

Consumers are ready but careful

Disposable income will remain close to current levels; thus, consumption recovery this year will be driven by a slightly lower savings rate and better expectations. During two years of economic recession, households accumulated additional savings of almost LTL 2 billion. In 2012, an increase in net real wages, employment, and consumer confidence, as well as better lending conditions, will give a stronger boost to household consumption. We are keeping our forecast of household consumption growth of about 1% this year and 3% next year.

Lithuanian consumers, unlike most citizens in most other developed countries, need not undergo a long and painful process of deleveraging and fixing their balance sheets. Total household debt is less than 30% of GDP – one of the lowest in Europe. A bigger drag on consumption in recent years has been decreasing disposable income and uncertainty about the future. The risk of unemployment has declined and consumer confidence has been increasing for more than a year now. The latter indicator has stabilised now in a negative area, slightly below the level seen at the onset of the global financial crisis and subsequent economic recession.

The confidence of retail and services sectors is above zero now, indicating that the outlook for consumption is more positive. However, we expect that spending on necessities will be flat this year, and households will spend more on nonnecessities, i.e., the first households to increase consumption will be the ones that never actually faced any challenges in terms of decreasing disposable income. This trend was already visible in 2010 – retail sales of transport vehicles and entertainment goods rose, whereas sales of food and wearing apparel continued to decline. Furthermore, higher inflation this year will put a cap on spending of lower-income households.

Prices will rise faster, euro may have to wait

The average annual increase of the producer price index spiked to 10% in 2010, after declining by 13% in 2009. This was caused mainly by higher energy prices, which went up by about 24%. The average price of oil went up by 27%, whereas, after the shutdown of the Ignalina nuclear power plant average price of electricity rose by more than 30%. Producer prices will keep increasing this year, but the pace will be only half of that seen in 2010.

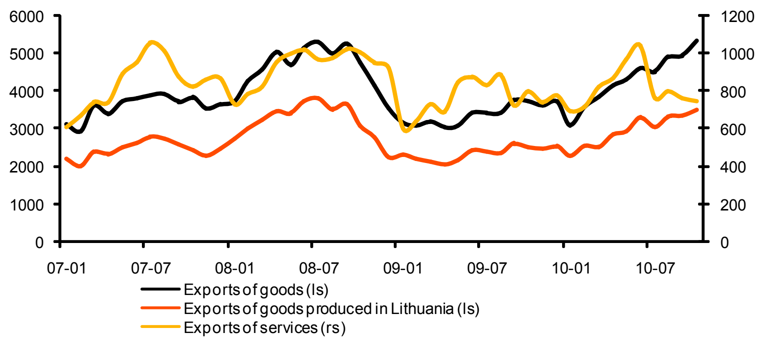
Faster producer price increases last year and further projected increases in commodities, food, and energy prices have prompted us to update our forecast on consumer prices. We expect average annual consumer inflation to be 2% this year and 2.5% in 2012, up from 1.3% in 2010. The biggest increase is expected in prices of food and non-alcoholic beverages, housing, water, electricity, gas, and transport.

Consumer price inflation will be the main hurdle Lithuania will have to clear to become a member of the Economic Monetary Union. Although we do not expect price increases to be anywhere near the levels seen during the pre-crisis economic boom, even 2.5% inflation could be high enough to block fulfilment of this Maastricht criterion. There is a high probability that, in the next couple of years, of the 27 European Union (EU) member countries, at least a few will have close to zero inflation – probably the PIIGS countries (Portugal, Ireland, Italy, Spain, and Greece), the ones that will be undertaking severe austerity programmes. This would set the inflation criterion threshold at around 1.5%, which would be very difficult for Lithuania to meet in 2012 (given that upward price pressure in the country will be caused by not only external but also internal factors).

Public finances to remain strained

The biggest internal risk in the short-to-medium term will be the health of public finances and the slow pace of structural reforms. The budget deficit is likely to be lower this year – at around 6% of GDP – but still above the Maastricht criterion of 3% of GDP and well above a comfortable level for a balanced budget. Although the national budget this year is exactly the same as in 2010 – LTL 29.4 billion – government consumption will be lower, mainly due to higher debt-servicing costs, which will amount to LTL 1.9 billion. The ratio of general government debt to GDP almost tripled in three years from 15.6% in 2008 to 42% in 2011. Although still below the threshold of 60% of GDP, the steep accumulation of debt is nevertheless

Export of goods and services, LTL millions



Sources: Statistics Lithuania, Bank of Lithuania, Swedbank disconcerting.

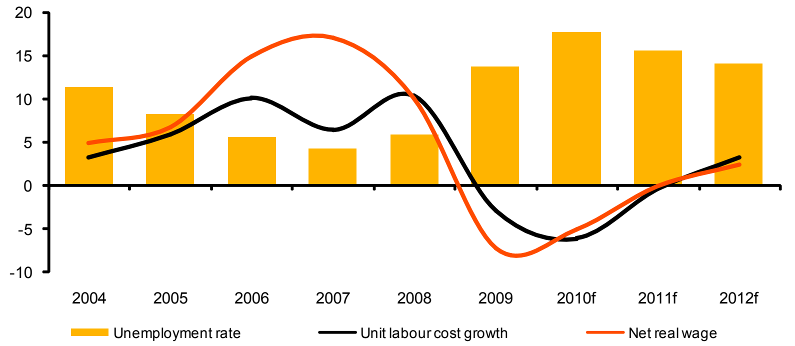
The tax changes in 2011 are basically designed to improve the business environment or are related to the commitments to the European Union (excises). There are two main changes: the rate of the personal income tax levied on income from individual activities has been reduced from 15% to 5%, and the excise duty rates on diesel fuel and tobacco have been raised in line with EU commitments.

There were no significant changes in taxes and the government plans to cut spending only in investments. Economic growth alone will not be sufficient to reduce the budget deficit in 2011 from 8% to 5.8% of GDP. The intention to collect additional tax revenues (LTL 1 billion, or around 5% of national budget tax income) by reducing the size of the shadow economy is commendable, but a specific plan for accomplishing this has not yet been presented. Some market estimates show that last year's excise duty and value-added-tax losses due to cigarette smuggling alone amounted to LTL 477 million. Fighting such a phenomenon as the shadow economy, which amounts to 27% of GDP, or around LTL 30 billion, requires a complex approach and will take years, not months (for more information on the shadow economy in Lithuania, see Swedbank Analysis from December 2010).

In 2012, meeting the budget deficit criteria will be a difficult task, given the upcoming parliamentary elections and growing euro scepticism. It is not unexpected that some political parties might ride the elections on slogans like "people are more important than the euro" and will propose increasing spending. Already before the local elections, to be held this year, many proposals have been made to increase pensions and other spending. The pensions were lowered only temporarily (for 2010 and 2011) – thus they will be brought back to the pre-crisis level in 2012. The main challenge for this government remains to implement structural reforms that could generate sustainable income or make spending more effective (doing more with less).

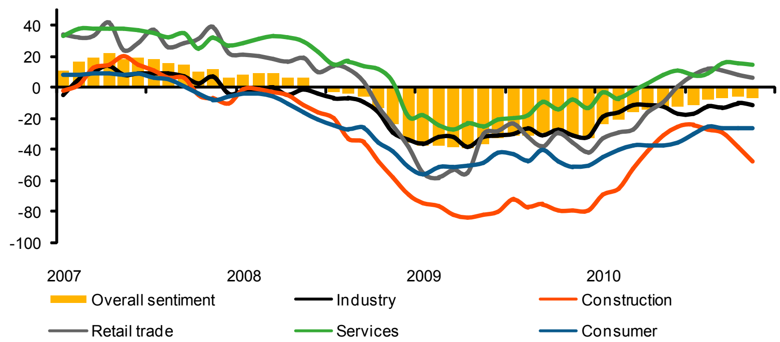
Nerijus Mačiulis
Lina Vrubliauskienė

Labour market, %



Sources: Statistics Lithuania, Eurostat, Swedbank

Confidence indicators, %



Source: Statistics Lithuania

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