Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies April 7, 2011

A more balanced growth going forward

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Global development

- The global recovery is on despite Japan's disaster, the Middle East's political turmoil, and the euro zone's debt crisis. Global GDP increased by 4.7% last year and will settle in at 4% this year and next as economic policies tighten.
- A backlash can still happen. Important challenges are rising commodity prices, overheated emerging markets, unsustainable sovereign debts, and fragile banks in many advanced countries, causing financial instability and new recessions.

Sweden

- The Swedish economy responded vigorously to the stabilising global conditions and growth reached 5.3% last year, amongst the highest in the advanced economies. In particular, employment picked up strongly but a large number of unemployed are having difficulties finding jobs.
- We expect investments to be the main driver of growth in 2011 and 2012, while household consumption is set to fall back as prices and interest rates are rising. Real economic growth is projected at 4% in 2011 and 2.6% in 2012. Monetary and fiscal policy will continue to provide support, although the Riksbank is gradually reversing its stance. The main economic policy challenge remains the labour market.

Estonia

- In 2010, the Estonian economy grew by 3.1%, driven mainly by exports. Towards the end of the year, domestic demand started contributing, and both investments and private consumption showed positive annual growth rates in the fourth quarter. The successful euro adoption and strong fiscal position added to the positive picture.
- In 2011 and 2012, we expect the Estonian economy to grow by 4.5%. Domestic demand will gradually replace exports as the main source of growth, with investments as the main factor. Private consumption will recover only slowly due to modest wage developments, increasing prices, and lingering unemployment.

Latvia

- The recovery in Latvia has continued to strengthen and widen. By the end of 2010, GDP had grown by 3.7% since the trough in the autumn of 2009. Economic growth and a more stable fiscal situation have helped raise Latvia's sovereign credit ratings.
- Somewhat disappointing post-election fiscal and structural policies will weigh down on growth, as higher taxes are undermining private spending. We still expect 4% economic growth in 2011 but are lowering the forecast for 2012 to 3.9% (4.2% before). Export growth is expected to slow due to capacity constraints, but investments will pick up.

Lithuania

- Recovery accelerated in the final quarter of 2010, when GDP grew annually by 4.6% and boosted last year's growth to 1.3%. Overall in 2010, only inventories had a positive impact on growth, but in the last quarter both investments and household consumption gave support.
- We expect this pace to continue this year and in 2012, and raise our GDP forecast to 4.2% and 4.7%, respectively. Recovery will be much more balanced as investments and household consumption will continue to contribute to growth. Due to global developments, inflation will be higher, jeopardising EMU entry. Budget consolidation is also a challenge.

The recovery takes hold – but headwinds are picking up

Sweden and the Baltic countries benefited from strong global tailwinds during last year, and the recovery has gained momentum, resulting in GDP growth of some 4-4.5% in all four countries this year. As stimuli from economic policy worldwide are abating, growth in external demand is slowing. Still, exports remain important for growth, not least as it spurs investments and employment.

Headwinds, however, are picking up due to higher commodity prices, which increase inflation and interest rates. While households will become more supportive of growth in the Baltic countries although inflation holds back developments somewhat, their importance will decline in Sweden as higher costs for energy and mortgages will slow consumption. GDP growth in the Baltic countries will stay at around 4-4.5 % or rise slightly in 2012, while Sweden's growth declines to 2.6%, which is still above trend growth.

Since our January forecast, global recovery has continued. Last year's global GDP is seen to have been somewhat stronger than expected at 4.7% (4.6% in January). Most important, commodity prices have risen further, and our assumption regarding the oil price has been raised US$20 to US$105 for 2011, and by US$8 to US$98 for next year. This means higher inflation and interest rates in many countries. While the democratization process in the Middle East has recently contributed to the higher oil price, the global recovery and the expansionary monetary policy are other important factors explaining the upturn.

In 2011 and 2012, the "two-speed world economy" continues, with global growth of 4% both years. This is a slight upward revision due to the faster recovery last year. Emerging markets will continue to make up the major share of global growth, while advanced countries still struggle with structural problems involving labour, credits, and housing. Fiscal austerity will slow demand growth, especially in Europe, while the US and Japanese consolidation plans have been postponed. In Japan, the combined effect of the earthquake, the tsunami, and nuclear power accident explains the change in the government's fiscal position. The disaster will slow growth this year, but increase it next year as reconstruction speeds up. Although Japan will be severely hit by the disaster, the effects on the global outlook will most likely be only mildly negative.

Even if external demand is still supportive of growth in Sweden and the Baltics, the headwinds facing the global economy are building up. The higher commodity prices risk creating both higher inflation and negative growth prospects. In the emerging markets, overheating risks will increase, and, in certain advanced economies, policy rates may be raised earlier than expected, despite the negative growth impact from the fiscal side. The sovereign debt crisis in the advanced countries is causing uncertainties with regard to growth, the banking sector, and political stability. Portugal is the third euro country requesting a rescue package, while Spain is likely to make it through the crisis without external support. The risk of an unorderly restructuring of Greek and Irish sovereign debt should also not be neglected. The euro zone is, despite problems with crisis management, struggling to improve the debt situation, while the US is not. If the US postpones its more ambitious plans for medium-term fiscal consolidation much longer, there would be risks for worldwide financial market turbulence and new recessions.

We have assumed that the European Central Bank (ECB) will start hiking policy interest rates this spring, while the Bank of England (BOE) will wait until autumn. These actions are sooner than in our previous forecast. The US Federal Reserve is still expected to wait to make monetary policy less expansionary until next year, but already this summer it will end quantitative easing (QE2) without putting in place any new easing. The dollar will strengthen vis-à-vis the euro. The Bank of Japan (BOJ) will not change its policy rates during the forecast period, and will try to weaken the yen.

The risks facing Sweden and the Baltic countries are mainly related to global developments. Domestic risks include political developments, the reform process, the labour markets, and

Macro economic indicators, 2009- 2012

	2009	2010	2011f	2012f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	-5.3	5.3	4.0	2.6
Estonia	-13.9	3.1	4.5	4.5
Latvia	-18.0	-0.3	4.0	3.9
Lithuania	-14.7	1.3	4.2	4.7
Unemployment rate, % of labour force				
Sweden	8.3	8.4	7.3	7.0
Estonia	13.8	16.9	13.5	12.7
Latvia	16.9	18.7	15.5	13.9
Lithuania	13.7	17.8	15.5	13.5
Consumer price index, annual change in %				
Sweden	-0.3	1.3	3.4	2.0
Estonia	-0.1	3.0	3.8	3.2
Latvia	3.5	-1.1	4.2	2.6
Lithuania	4.5	1.3	3.2	2.5
Current account, % of GDP				
Sweden	6.9	5.9	6.0	5.7
Estonia	7.3	6.8	5.7	4.9
Latvia	8.6	3.6	0.0	-2.5
Lithuania	4.3	1.8	-1.0	-1.7

Sources: National statistics authorities and Swedbank.

capacity constraints. Households face headwinds as their expenditures for energy, food, and mortgages rise. Debt levels in the public sector, especially in Estonia, are lower than elsewhere, while the private sector deleveraging has further to go. The Nordic-Baltic economic climate is positive, following a more resolute management of the crisis than in many other countries, and there is a commitment to build institutions that can make these economies – as small, open, and vulnerable to outside risks – more resilient to global turbulence.

After an increase of 5.3% last year, Sweden's GDP is now set to grow by 4 % in 2011 (3.3% in our January forecast) and 2.6% in 2012 (2.5 %). The stronger outlook is mainly due to an upward revision of investments and exports; household consumption is expected to grow slower due to higher inflation and, this year, a faster rise in interest rates. The Riksbank is seen as hiking policy rates to 2.50 % (2.25%) at the end of 2011, but we still expect the rate at the end of 2012 to be 3%. As the ECB will start raising its policy rates earlier than expected, the Swedish krona is no longer expected to strengthen. Fiscal policy will continue to support growth as the government plans new tax reductions. With the help of privatisations and economic growth, the debt ratio will fall to some 35 % of GDP. The main challenge for the government is the lingering high unemployment. Despite the positive growth outlook, we foresee that unemployment will average 7.0% next year – only a minor reduction compared with this year.

Estonia's economy picked up more markedly at the end of last year, with business investment as the main driving force. Last year's growth rate reached 3.1% (2.8% in our January forecast), and the economy is set to grow by 4.5% both in 2011 and 2012, which is an upward revision of 0.3 percentage point for this year. Exports support growth, and, increasingly, domestic demand will take over, although household consumption will remain modest. Higher inflation – of 3.8% this year and 3.2% next year – may also dampen the outlook for private consumption, although falling unemployment will counteract this trend somewhat. Already last year, the government attained a fiscal surplus due to the higher economic growth. The successful adoption of the euro is also contributing to the positive sentiment towards the Estonian economy. Apart from global risks, the main risk is the labour market, especially the combination of high unemployment and increasing labour shortages in certain sectors.

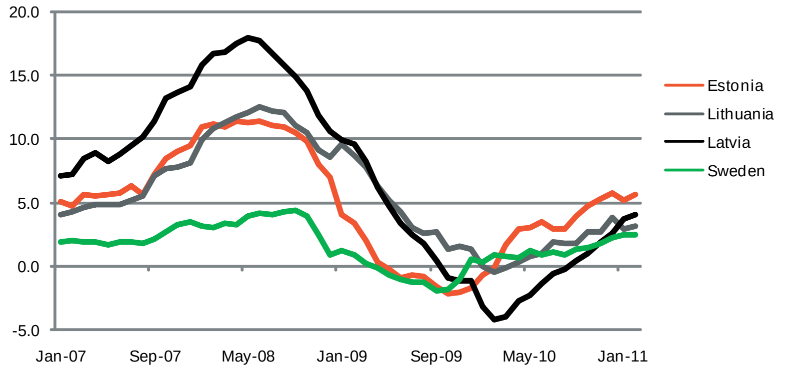
The Latvian economy has strengthened, and the recovery is broadening. By the end of last year, GDP had grown by 3.7% since the trough in the third quarter of 2009. Exports have increased, and inventories have been rebuilt. Recently, private consumption and investments have started to support growth. The recovery and the stabilising fiscal situation have also raised Latvia's sovereign credit rating. During 2011 and 2012, GDP is expected to grow by 4.0 % and 3.9%, respectively. This is a slight downward revision for next year as higher inflation and taxes are putting pressure on households, and the government has slowed in its progress with structural reforms. There is a great need for reforms, as the labour market is still struggling with sluggish job creation. The opportunity to introduce the euro in 2014 remains, but a growing risk is the inflation outlook, which requires government action to contain price growth. An upside risk in our forecast is that investments may increase faster than expected, as the capacity ceiling in many sectors has more or less been reached.

GDP growth in Lithuania for 2010 exceeded our expectations and reached 1.3 %. Hence, and as domestic demand is strengthening, our forecast for 2011 has been revised to 4.2 (3.0%). In 2012, we expect GDP to grow by 4.7 % (4.5 %). Our inflation forecast has been revised upwards as international commodity prices have increased, adding to growth risks. An internal risk is the parliamentary elections in 2012, which may generate more growth-restricting propositions. At the forefront is still the goal of introducing the euro in 2014, and there is a policy dilemma of balancing lower inflation with budget consolidation. The Lithuanian economy is moving in the right direction, as the fiscal position is strengthening and growth is becoming more balanced. However, challenges remain, and the reform agenda will need to be kept alive.

Global developments create opportunities for, and challenges to, Sweden and the Baltic countries. Export sectors are benefiting from higher growth, but, at the same time, competition is increasing. It is therefore important to continue supporting adaptation to the changing environment, and to enhance the employability and competence of the labour force, in order to strengthen competitiveness.

Cecilia Hermansson

Inflation (annual growth in %)



Source: Reuters Ecowin

Inflation and sovereign debt endanger the global recovery

The global recovery continues at good speed, and last year's developments surprised on the upside with GDP growth of 4.7%. Compared with our forecast one year ago, Germany, Japan, Brazil, China, and India performed better than expected, while the US, the euro zone (excluding Germany), the UK, and Russia were basically in line with our expectations.

Going forward, the world can be characterised as a "two-speed economy," with emerging markets as the main growth engine and the advanced economies lagging behind. All in all, GDP will be growing by 4% both in 2011 and 2012 – a small upward revision compared to our January forecast.

The US has postponed fiscal consolidation and has agreed on a stimulus during 2011, pushing up the budget deficit and worsening the sovereign debt outlook. Next year's presidential election is in focus. The recovery continues, but will be slow due to structural problems with labour, housing, and credits. Households are struggling, and, with higher energy prices, growth will stay at 3%.

The euro zone and the UK face slower growth, at around 1½ %. The sovereign debt crisis and the need to cut the budget deficits are in the forefront of economic policy. The policy mix is complicated by the fact that higher inflation also pushes up policy interest rates, with hikes starting already this spring (the European Central Bank) and later in the autumn (the Bank of England).

Germany will continue to drive growth, and the more negative outlook for Portugal, Ireland, Greece, and Spain remains.

Portugal is the third euro zone country requesting a rescue package, while a similar package for Spain is treated as a risk in our forecast which would potentially cause financial turbulence as the current rescue fund would be insufficient. Another risk is the unorderly restructuring of sovereign debt, causing increased strain on the banking system in the euro zone, with potential effects also on the real economy.

China is struggling with overheating in property markets and higher consumer prices. The goal is to make growth more coordinated, stable, sustainable, and balanced. During 2011-2015, growth should average 7%, but this goal may be hard to achieve, given the high growth rates during 2011-2012 of 8.8% and 8.4%, respectively. Anyhow, policy measures will try to restrict credit growth, in order to slow domestic demand, and, compared with last year, growth is slowing.

After the earthquake, the tsunami, and the nuclear plant accidents, Japan is facing major challenges. We expect the economy to grow slower this year, but faster next year when the damaged region will be reconstructed. Fiscal policy will become more expansionary as some US$300 billion will be needed according to preliminary estimations. Monetary policy will also remain supportive, with a focus on weakening the yen.

As in China, also in India, domestic demand is growing faster than what is sustainable with regard to supply constraints. Higher international commodity prices are also driving up domestic consumer prices and interest rates; thus, growth is slowing somewhat.

In Russia and Brazil, inflation pressures are similarly increasing, but, as resource-based economies, they will prosper from the upbeat commodity markets.

Our assumption regarding commodity and energy prices is that the Brent oil price will average US$105 this year, and US$98 next year, up from US$79 in 2010. This is a major upward revision from January, when our forecasts for 2011 and 2012 amounted to US$85 and US$90, respectively.

Also, metal prices will rise, by 12% and 5% respectively, which is lower than last year's 42% increase. The escalation of food prices that started in

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

		April 2011			January 2011		
		2010	2011	2012	2010	2011	2012
US		2.9	3.0	3.0	2.8	2.6	2.7
EMU countries		1.7	1.5	1.5	1.8	1.6	1.5
Of which:	Germany	3.6	2.4	1.9	3.6	2.5	2.0
	France	1.5	1.5	1.6	1.6	1.6	1.5
	Italy	1.1	0.9	1.0	1.1	1.0	1.1
	Spain	-0.1	0.3	1.0	-0.4	0.3	1.0
UK		1.4	1.5	2.0	1.7	1.8	2.0
Japan		4.0	0.6	3.0	3.2	1.5	1.3
China		10.3	8.8	8.4	10.1	8.5	8.1
India		9.1	8.0	7.5	8.8	8.2	7.5
Brazil		7.5	4.3	4.0	7.5	4.8	4.5
Russia		4.0	4.6	4.5	4.0	4.3	4.5
Global GDP in PPP		4.7	4.0	4.0	4.6	3.9	3.8
Global GDP in US$		3.8	3.1	3.3	3.7	3.1	3.0

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.

second half of last year will accelerate annual growth to 30% this year, and for 2012 we foresee an 8% increase.

All in all, headline inflation is therefore increasing in most parts of the world, but most noticeably in the emerging markets.

In advanced countries, one effect of higher inflation is that central banks will start hiking policy interest rates earlier than we expected in our January forecast. Second-hand effects from higher inflation and wage expectations are creating uncertainties and demand for hikes despite a low underlying price pressure.

In Europe, policy rates will be raised this year, while the US Federal Reserve waits till next year, and Japan postpones hikes till after the forecast period. In addition, longer-term market rates will show an upward trend due to continued growth, higher inflation, and the sovereign debt crisis; the increasing competition for capital arising from the Basel III bank regulation is another contributing factor.

A stronger US and a weaker Europe and Japan are creating a stronger US dollar over the forecast horizon, while the euro and the yen will weaken. Over time, if passivity still permeates fiscal policy, the risk for a larger fall in the US dollar will increase.

Interest and exchange rate assumptions

	Outcome	**Forecast**			
	5 Apr 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	1.25	1.75	2.25	2.50
Bank of England	0.50	0.50	1.00	1.50	2.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.42	1.45	1.30	1.25	1.25
RMB/USD	6.54	6.40	6.25	6.10	5.95
USD/JPY	85	87	90	95	100

Sources: Reuters Ecowin and Swedbank projections.

We expect that China will allow the yuan to strengthen some 5% per year vis-à-vis the US dollar in nominal terms, but in real terms the appreciation will be greater as labour costs increase faster in China going forward.

In an uncertain world, our main scenario presented above may not be realized due to certain risks for the world economy, such as the Japanese disaster, the democratization process in the Middle East, and the debt crises in the euro zone and the US.

Therefore, we have created four alternative scenarios: two weaker ones, where (1) stagflation with low growth, high unemployment, and high inflation comes through with a probability of 15%, and (2) a worsened sovereign debt crisis has a probability of 15%; and two stronger ones, where (3) a rebalancing of growth between China and the US speeds growth (5% probability) and (4) the risks of overheating are ignored, and more stimulus in both emerging markets and advanced economies creates higher, but more unsustainable growth (15% probability).

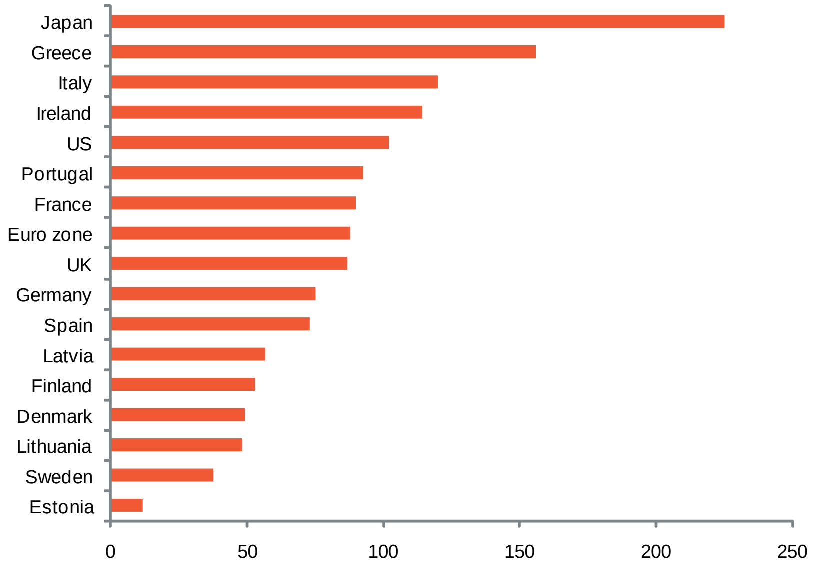
At this juncture, it is important for policymakers to search for the optimal economic policy. We emphasise the importance of consolidating budgets and carrying out more ambitious stress tests in banks in order to break the vicious circle between the sovereign debt crisis and the continuing fragility of the financial sector.

At the same time, central bankers should not rush to hike interest rates, as domestic demand will slow due to fiscal austerity. Growth risks will most likely outweigh inflation risks in Europe, US, and Japan in the years to come. Emerging markets, on the other hand, must put in more effort to restrain overheating.

That is the name of the game in a “two-speed world economy”!

Cecilia Hermansson

Public gross debt 2012 (% of GDP)



Source: EU commission.

Sweden: Households shift to a lower gear

With an economic growth rate of 5.3%, Sweden experienced one of the fastest recoveries among comparable developed economies last year. Partly this was the effect of the sharp drop in economic activity during the crisis (i.e., a rebound), but the Swedish economy also surprised in terms of its flexible response to the changing economic conditions. Not least was this evident in the labour market. Following a large increase in the number of unemployed when external demand collapsed in late 2008, the rebound in employment came much earlier than expected, in particular compared with previous crises experienced in Sweden. Also, economic policy was fast on its feet, with the quick enactment of fiscal stimulus and rapid slashing of monetary policy rates. Adding to the support for the recovery was the boost in exports following the falling value of the krona.

The economic recovery in 2010 was broad based, and mainly domestically sourced. Private consumption contributed to overall growth by 1.7 percentage points and investments by 1.1 percentage points. The buildup in inventories, reversing the sharp fall during 2009, added another 2 percentage points, while public consumption made up the rest, 0.6 percentage points. Despite the sharp increase in exports, the net contribution from external demand to growth was neutral due to the strong import demand.

We revise upwards our economic growth forecasts for 2011 and 2012 to 4.0% and 2.6%, respectively. In particular, investments are expected to drive growth, while the contribution from household consumption will fall. We expect the Riksbank to swiftly raise the monetary policy rate, with an additional four hikes this year, before slowing down in 2012 to reach 3.0% at end-year. Public finances remain sound and except for the already announced reductions of tax rates, we expect that the main fiscal initiatives will be directed at the labour market. Despite the rapid growth in employment, reducing the still-high unemployment rate remains the largest policy challenge.

The external environment for the Swedish economy is stabilising, and we expect global growth to reach 4.0% in both 2011 and 2012. The main risks relate to higher volatility in commodity markets, with increasing prices for, in particular, energy-related products. The already-high oil price is factored into our growth projections, but continued turmoil in the Middle East could raise prices even further, with negative effects on prices and profits in Sweden. The probability for renewed financial sector turbulence due to the sovereign debt crisis in Europe remains and is not negligible. Domestically, there is a risk that rapid expansion in some sectors could have economy-wide spill-over effects through wage demands and increased inflation expectations, forcing the Riksbank to raise policy rates even faster. Furthermore, shortage of qualified personnel is growing while at the same time the unemployment rate is high. The key will be an increased focus on structural reforms that encourage and prepare the unemployed to find employment.

Key Economic Indicators, 2009 - 2012 [1/]

	2009	2010	2011f	2012f
Real GDP (calendar adjusted)	-5.3	5.3	4.0	2.6
Industrial production	-17.9	15.0	10.5	5.0
CPI index, average	-0.3	1.3	3.4	2.0
CPI, end of period	0.9	2.3	3.2	2.2
CPIF, average [2/]	1.9	2.1	1.8	1.5
CPIF, end of period	2.7	2.3	1.4	1.6
Labour force (15-74)	0.2	1.1	0.9	0.6
Unemployment rate (15-74), % of labor force	8.3	8.4	7.3	7.0
Employment (15-74)	-2.1	1.0	2.1	1.0
Nominal hourly wage whole economy, average	3.4	2.5	2.8	3.3
Nominal hourly wage industry, average	3.0	2.8	3.0	3.5
Savings ratio (households), %	12.9	10.8	10.0	9.8
Real disposable income (households) [3/]	1.6	1.3	2.0	1.6
Current account balance, % of GDP	6.9	5.9	6.0	5.7
General government budget balance, % of GDP [4/]	-0.7	0.0	0.4	0.5
General government debt, % of GDP [5/]	42.8	40.3	37.4	35.2

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 criterion.

Rebound in exports despite a stronger krona

The recovery in Swedish exports continued at the end of 2010 and total export volume increased by 10.7% despite a significant appreciation of the krona. Strengthened global trade, particularly in the emerging markets but also in the OECD countries, has been favourable for Swedish exporters as the demand for investment and intermediate goods has been restored after the deep decline during the global financial crisis. The export increase was mainly driven by a strong rebound in goods like vehicles and machinery. Exports of services have also improved and are more or less at the same level as two years ago, which is not yet the case for manufacturing goods.

World market growth for Swedish exporters is expected to slow somewhat in 2011. We assume, however, that demand for investment goods will be relatively strong during the period, particularly in the emerging markets but also in OECD countries, when utilisation rates increase and old production facilities need to be renewed.

We revise up our export growth

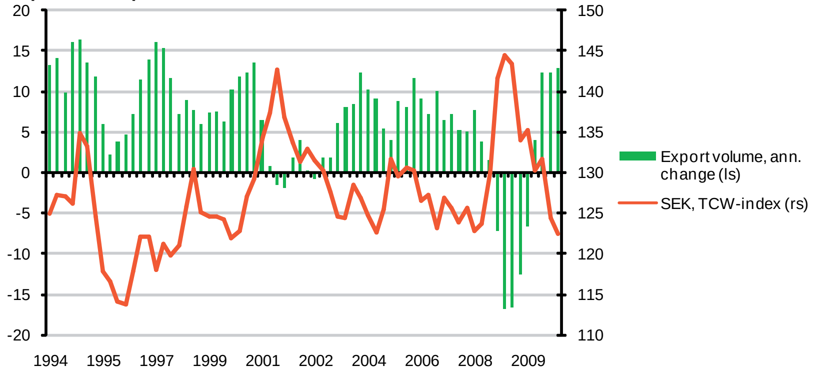
projection from 6.8% to 7.6% for 2011, still above the long-term trend of about 6.5%. This is due mainly to the better outlook for the composition of Swedish exports. According to the latest short-term statistics and business surveys, export performance is still improving. In January 2011, exports of goods from Sweden increased by 23% in nominal terms, and confidence in the manufacturing sector was strong.

We foresee the export volume growth to drop below trend next year, when the competitiveness of Swedish exporters is expected to fall as productivity growth weakens and unit labour costs increase. There will, thus, be a loss of market shares in 2012 after two consecutive years of gain. The trend of diminishing surpluses in the trade balance, which started in the middle of the 2000s, is expected to continue during 2011-2012 when domestic demand expands. On the other hand, the increasing importance of the exports of services in the Swedish export structure, with more value added and relatively smaller import content, will lead to a growing surplus in the services balance. This means the surplus in the current account will remain large during the next two years.

Investments become the main growth engine

Gross fixed investment increased by 6.3% in volume terms during 2010 after the sharp fall in 2009. The largest investment growth was concentrated in real estate, which was stimulated by

Export development and the Swedish krona



Sources: SCB and Swedbank projections.

tax reductions for renovation, higher housing prices, and better labour market conditions. However, the recovery is starting from low levels, and housing investment in Sweden, at 3.0% of GDP, is still among the lowest in the EU. In the private sector, excluding housing, investment activity went up by nearly 7%, driven mainly by service companies; meanwhile, development in manufacturing was more subdued despite strong production growth and an increasing utilisation rate. Public investments continued to grow for the seventh consecutive year and reached 18% of gross fixed investment in 2010, which is the highest level since 1998.

With output continuing upwards in the private sector, there will be a growing need for investment to expand capacity. In the fourth quarter of 2010, the utilisation rate in industry was 89.0%, which is above the average since 1990. In combination with strong confidence, relatively favourable financing terms , and rising profits are expected to trigger an increase in business investments. Total investment volume in Sweden is projected to increase by 9.7% in 2011 and 8.3% in 2012. This means that total real investment will be higher than the peak in 2008.

The strong rebound in real estate investment in 2010 will also have spillover effects in 2011. We foresee that, coupled with an improving labour market and tax reductions for rebuilding, investment in real estate will grow strongly during 2011. For 2012, we anticipate a gradual slowdown as interest rates will be higher. Although investment in housing is rising, there will still be an underlying need for new houses, particularly in regions with high growth and increasing population.

Labour shortages despite high unemployment

The strong recovery of the labour market has continued during early 2011. Employment is now back to the same level as prior to the crisis, although this conceals a shift from manufacturing to the services sector. At the same time, the growth of the labour force has been strong due to underlying demographic factors and reforms of the sickness benefit system. Thus, the unemployment rate has fallen at a slower rate, dropping from 7.8% in December to 7.6% in February, seasonally adjusted.

We expect a faster reduction of the unemployment rate than in our January forecast, to averages of 7.3% in 2011 and 7.0% in 2012. In

Swedbank's GDP Forecast – Sweden

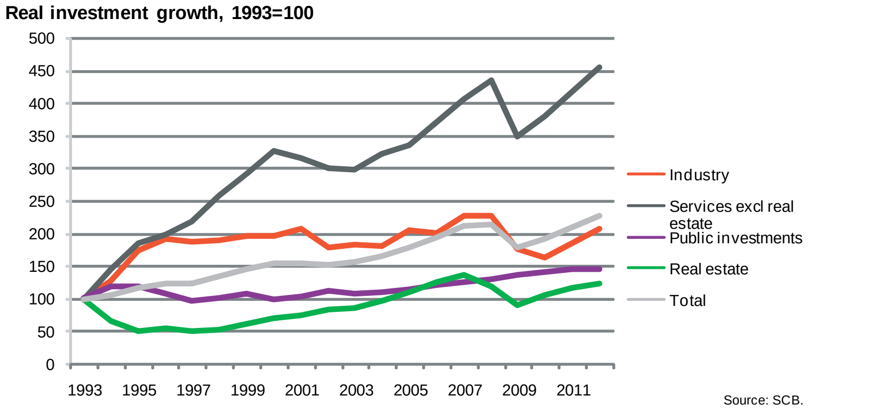
Changes in volume, %	2009	2010[1/]		2011f[1/]		2012f	
Households' consumption expenditure	-0.4	3.5	(3.6)	2.8	(2.9)	1.9	(2.0)
Government consumption expenditure	1.7	2.6	(2.0)	1.3	(0.9)	0.4	(0.4)
Gross fixed capital formation	-16.4	6.3	(4.7)	9.7	(8.2)	8.3	(8.0)
private, excl. housing	-19.1	4.5	(1.4)	11.3	(9.4)	11.2	(10.9)
public	4.2	4.3	(3.5)	2.6	(0.5)	-0.1	(-0.5)
housing	-23.3	16.0	(19.7)	11.4	(11.7)	5.3	(5.5)
Change in inventories [2/]	-1.7	2.1	(2.3)	0.0	(0.0)	-0.3	(-0.3)
Exports, goods and services	-13.4	10.7	(11.1)	7.6	(6.8)	5.6	(5.5)
Imports, goods and services	-13.6	12.7	(12.5)	7.5	(7.3)	6.6	(6.4)
GDP	-5.6	5.5	(5.6)	4.0	(3.3)	2.2	(2.1)
GDP, calendar adjusted	-5.3	5.3	(5.3)	4.0	(3.3)	2.6	(2.5)
Domestic demand (excl. inventories) [2/]	-3.1	3.6	(3.1)	3.5	(3.1)	2.6	(2.5)
Net exports [2/]	-0.8	-0.1	(0.1)	0.5	(0.2)	-0.1	(-0.1)

Sources: Statistics Sweden and Swedbank.
1/ The figures from our forecast in January 2011 are given in brackets.
2/ Contribution to GDP growth.

particular, employment has picked up more rapidly than expected, but also the number of hours worked points towards a growing demand for labour. As employers become more confident in the economic recovery and as many of those who reduced their work hours now have returned to fulltime, the unemployment rate is set to fall.

Despite the still-high unemployment rate, reports of labour shortages are becoming more widespread. This is particularly prevalent in construction, where 40% of companies surveyed claim to have difficulties in finding qualified personnel. Furthermore, the number of new vacancies and unfilled positions increased throughout 2010 and is now back to the levels that prevailed prior to the crisis. However, the labour market gap, as measured by the number of employees in relation to the long-term trend, still remains substantial, in particular for the manufacturing sector. This reflects the problem of matching jobs with qualified personnel in the Swedish labour market.

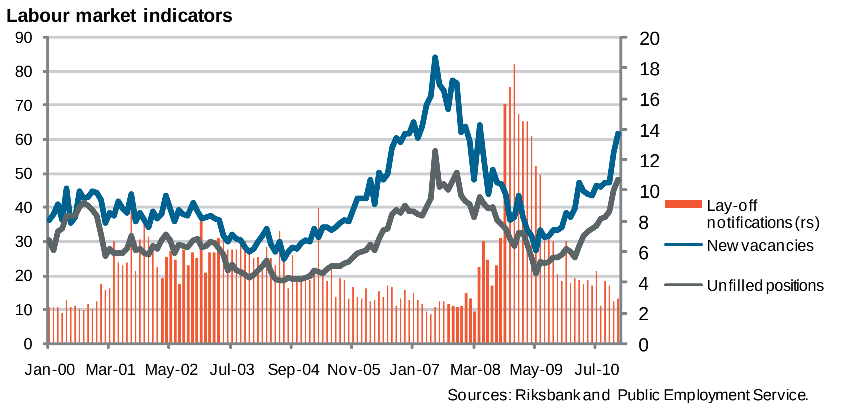
Following the relatively low wage increases during the crisis, expectations are now building for upward revisions during the coming years. Many trade unions agreed during the crisis to restrain wage development and, in the case of manufacturing, to reduce the number of hours worked. This helped preserve the competitiveness of production in Sweden. However, starting this spring, both blue-collar and white-collar workers in manufacturing will initiate wage negotiations. This will also set the benchmark for the collective-



bargaining agreements for more than 1.5 million employees, in retail and local governments that will run out before May of next year.

We expect nominal wages to increase somewhat faster in both 2011 and 2012, by 2.8% and 3.3%, respectively. Productivity picked up in 2010 as companies were able to increase production by utilising idle labour. As new employees are hired, productivity growth is set to slow in the coming years and be exceeded by nominal wage growth, thus raising unit labour costs. While productivity varies significantly with the business cycle, we do not expect the growth rate to reach previous years' trend levels. For the medium term, investments in technology and education will be necessary to provide a sustainable source of productivity and growth.

Reducing the unemployment rate in the medium term will also be a significant challenge. We estimate that 335,000 new jobs must be created between now and 2015 to bring the unemployment rate down to 5 %. In particular, the return of about 60,000 people who left the labour force during the economic downturn, and thus were not counted as unemployed, will increase the need for job creation. Also, the reduction in the number of people covered by the sickness benefit system will add to the number of job seekers in the economy, as will the reduction in the number of early retirees, in contrast to the early 2000s, when approximately 65,000 people per year (2003-06) entered early retirement schemes. Finally, a 3 percentage point reduction of the unemployment rate from 8% to 5%, excluding the underlying change to the labour force, will require in itself an additional 165,000 jobs. Thus, the main challenge for the government will be to enhance the skills of those currently unemployed, while providing the conditions for dynamic labour market development, which includes a strengthening of the matching process.



Increasing vulnerabilities in household budgets

Although household consumption continued to grow at the end of last year, there were signs of a slowing rate with real consumption growing by 1 % in the fourth quarter, compared with the 1.3% growth seen in the third quarter. Consumer durables sales remained strong, while overall turnover in the retail sector became more subdued. It was, in particular, cars sales that proved resilient, with a growth rate of almost 40% in the fourth quarter of 2010. The pent-up demand from the sharp drop during the financial crisis last year is being saturated . Consumption of retail goods continued to expand in the fourth quarter, but growth turned negative in the December- February period.

Household nominal payroll picked up in 2010, but disposable income was held back by growing interest costs, increasing tax payments and flat transfers. As disposable income grew by less than consumption, households continued to draw down on their savings, which fell to 10.8% of disposable income in 2010 from 12.9% in 2009. In the first months of 2011, inflation has exceeded wage increases, leading to falling real wages, further straining household budgets. In addition, mortgage rates (three months) rose to almost 4% at the end of last year from 1.5% at the end of 2009.

The household debt level has continued to rise, and the share of income spent on debt service has likely reached its low point. Debt as a share of disposable income rose to 171% at end-2010, a record level and also high in international comparisons. We expect household debt to continue to increase, although at a slower rate. However, as interest rates rise, interest payments as a share of disposable income will continue to grow, and the liquidity situation of households will become more strained. Increasing debt-service costs, compounded by rising energy costs and elevated inflation rates, are thus likely to dampen consumer spending.

We expect growth in private consumption to slow in real terms in 2011 and 2012 to 2.8% and 1.9%, respectively. An improved labour market outlook with continued strong employment and wage growth gives a positive impulse, compared with our January forecast. However, growing cost-of-living expenses for households, in particular from debt servicing and higher inflation, together with a slowing momentum in purchases of consumer durables, are dampening consumption growth compared with 2010. The growth of real disposable income is expected to continue to rise in 2011, before the growth rate dampens in 2012 to 1.6%. However, due to the faster growth of consumption, the household savings ratio will continue to decline.

Reducing inflation expectations without curtailing growth

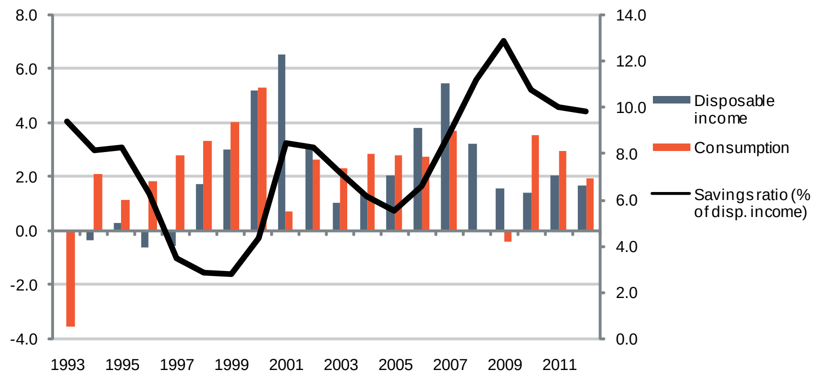
The Riksbank raised in its February meeting, as expected, the main policy rate to 1.50 %. Also, the policy path was revised upwards, according to which the Riksbank expects the policy rate to marginally exceed 3% by the end of 2012.The main arguments for tightening monetary policy are the growing underlying inflationary pressures and increased resource utilisation. Indeed, headline inflation increased to 2.5% in February, exceeding the Riksbank's and most others' expectations. It was mainly energy and food prices that lead to the increase, but a revision of the methodology also contributed. Underlying inflationary pressures (CPIF) grew by 1.3%.

Rising inflation expectations are emerging as a growing risk to maintaining price stability. Although it can be argued that largely externally induced price increases for energy and commodities are temporary, these impulses could lead to a general increase in inflation if they lead to compensation both from companies, in terms of maintained profit margins, and from employees, in the form of real wage adjustments. In March, the 12-month inflation expectations of households reached 3.1%.

The tightening of monetary policy by the Riksbank has contributed to a further appreciation of the Swedish krona. At the end of the first quarter of 2011, the krona has reached the strongest level in trade-weighted terms at 120 since the year 2000. Besides higher Swedish short-term interest rates, the appreciation of the krona is also driven by strong economic growth and solid public finances. We anticipate a further strengthening of the krona in the first half of 2011 as the Riksbank raises interest rates. In second half of 2011 and in 2012, when we foresee a tightening of monetary policy in Europe and the US, we expect the Swedish krona to weaken somewhat in trade-weighted terms. The US dollar is expected to strengthen more significantly against the euro as the US economy improves, while the krona is expected to be stable against the euro during 2012 as the Swedish economy continues to outperform the Eurozone, while the European Central Bank raises policy rates faster than the Riksbank.

We expect monetary policy rates to be raised more rapidly during 2011 than we forecast in January, but also that the rate of policy rate hikes will slow in 2012. For the remainder of the current year, we foresee an additional four hikes, while in 2012 we expect the Riksbank to raise rates only twice. The immediate task of the Riksbank will be to dampen inflation expectations, which would serve not only to reduce nominal demands in the upcoming wage negotiations, but also to limit pressures to increase prices in retail. However, as the demand pressure will ease and unemployment rates remain relatively high, we expect that the Riksbank will slow down the rate increases in 2012, and that the

Household savings and consumption (real change in %)



Sources: SCB and Swedbank projections.

repurchase rate will reach 3.0% at the end of the year.

Still a role for active fiscal policy

Government finances are improving rapidly, and the budget deficit is estimated to have been limited to 0.3% of GDP in 2010. The actual outcome was better than budgeted on the revenue and expenditures sides. Central government tax revenues exceeded the budget by SEK 58 billion, mainly on account of value-added and capital gains taxes. Spending came in lower by an amount of approximately SEK 20 billion. The main source of saving is found in spending on labour market programmes, following the better-than-expected labour market developments.

The relatively strong macroeconomic development expected over the next couple of years provides room for further fiscal policy initiatives. The government has indicated that, in addition to the lowering of tax rates on pensions and on restaurant meals that is already in the budget, it intends to continue to pursue reductions of the income tax, although there have been disagreements within the government coalition as to how much the top rates should be lowered. We expect that the government will in the spring budget bill propose additional spending of about SEK 10 billion in 2011, primarily to strengthen the labour market and to support education. For 2012, we expect the government to implement the fifth step in the reduction of income taxes, as pledged during the election campaign in 2010, at an estimated cost of SEK 15 billion. The government coalition also intends to further reduce public sector debt from the already low level of 40.3% of GDP in 2010. In early 2011, a stake in Nordea was sold, generating about SEK 20 billion. However, the recent blocking by a parliamentary majority of the privatisation of four mainly state-owned companies will limit the inflow of capital; as a result, we believe that overall privatisation revenues for 2011 and 2012 will amount to SEK 40 billion.

Interest rate and currency outlook

	Outcome	Forecast			
	2011	2011	2011	2012	2012
	5 Apr	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates (%)					
Policy rate	1.50	1.75	2.50	2.75	3.00
10-yr. gvt bond	3.28	3.30	3.30	3.40	3.50
Exchange rates					
EUR/SEK	9.00	8.85	8.90	8.90	8.90
USD/SEK	6.32	6.10	6.85	7.12	7.12
TCW (SEK) [1/]	120.6	118.7	122.1	122.5	122.9

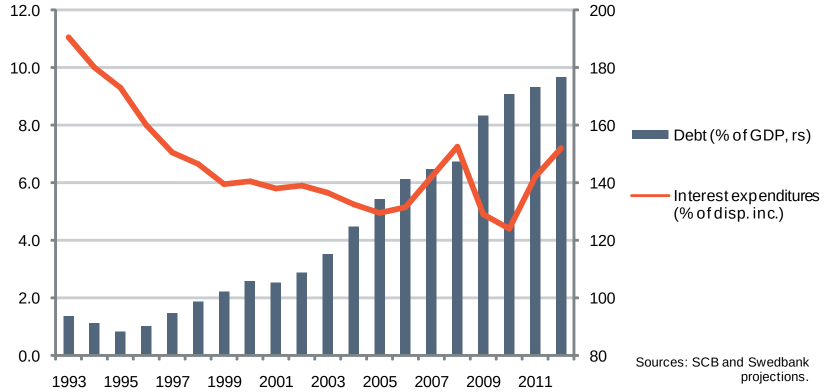
Sources: Reuters Ecowin and Swedbank.

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

We expect that, following two years of deficits, the public sector will reach surpluses of 0.4% in 2011 and 0.5% in 2012. This will put the public sector on the track of meeting the medium-term surplus target over the business cycle. In addition, the margin of spending under the expenditure ceilings would allow for further expenditure increases. We expect public debt to continue to decline, falling to 35.2% of GDP in 2012.

The key challenge for fiscal policy over the next two years will be in providing direct support in order to alleviate bottlenecks and structural impediments. Labour shortages in construction and in parts of the services sector risk a spillover into increasing wage drift, which, in turn, could fuel rising inflation expectations. These developments could mean that monetary policy needs to be raised faster than otherwise would have been the case, in effect applying the brakes to an economy that is being accelerated by fiscal policy. In order to balance the structural reforms implied by the general lowering of tax rates, which essentially spurs consumption, the government should also consider lowering corporate tax rates and capital gains taxes. This would stimulate an increase in private sector savings and provide financing for investments. An additional benefit would be a withdrawal of some stimulus through a corresponding stepwise lowering of interest deductions on mortgages, which would also serve to reduce the pressure on the housing market. However, the key role for fiscal policy at this stage of the economic recovery would be to improve the functioning of the labour market. By alleviating some of the structural impediments to increased employment, through improved matching and better skills enhancement, the government would simultaneously contribute to lowering unemployment while reducing inflation pressures stemming from labour shortages and the increasing potential for growth.

Household debt burden



Sources: SCB and Swedbank projections.

Magnus Alvesson
Jörgen Kennemar

Estonia: Recovering domestic demand supports economic growth

In 2010, the Estonian economy grew by a strong 3.1%, mainly due to the rapid growth of goods exports (35% over 2009). Domestic demand was still weak, but started to pick up in the second half of the year and showed 0.8% overall growth in 2010. At first, the growth of domestic demand stemmed from stockbuilding, but by the end of the year private consumption and investment growth had picked up as well. Overall, household consumption declined in 2010 by 1.9% (in the fourth quarter of 2010, however, it reached a positive annual growth of 2.6%). Similarly, although the overall growth rate of gross capital formation in 2010 was -9.1%, the fourth quarter saw a strong recovery as the year-on-year growth rate reached 11.9%, mainly due to companies' investments in machinery and equipment.

We estimate economic growth will be 4.5% for both 2011 and 2012. In the beginning of 2011, the growth of exports will contribute the most to economic growth, while in the second half of the year domestic demand will begin to pick up. In 2012, economic growth will stem from investment growth; private consumption growth will remain modest (although positive).

The main risks for the Estonian economy are external. As we expect the economy to grow mainly because of positive developments in the exporting sector, the well-being of the main trade partners is a key assumption of our forecast. Slower growth of the main foreign markets will affect the exporting sector, which will nevertheless be the main contributor in 2011.

Another set of risks involves the labour market – rapid developments are creating a need for certain qualifications in workers, but, as changes in the education system to acquire these qualifications will take time, the lack of qualified workers may impede further growth. In addition, domestic demand is affected by the number of wage earners. The high level of unemployment, which is affected by the qualifications mismatch, will therefore set boundaries to consumer spending growth. People who have been unemployed for a longer time, however, may feel discouraged and leave the labour market; in times of diminishing labour force, this resultant lack of labour may evolve into an even more serious problem if and when the smaller labour force becomes an issue.

A third set of risks concerns price movements, which are affected by both external and domestic factors. On the one hand, there is a risk of a further pickup in prices caused by political developments in the Middle East (oil), and by food price movements in the world market. On the other hand, weak domestic demand will still be a constraining factor, dampening the overall price increase. Strong growth in energy prices may affect domestic demand considerably via both the longer-term recovery of consumer spending and the higher prices of production inputs. In addition, many consumers may feel uncomfortable operating with the new unit of exchange, the euro, and it may take additional time to get used to the new currency. The cost-push effect from the labour market (the lack of qualified labour may induce another wage rally) may be considered another factor: this affects price developments and might occur, especially in 2012. Strong price growth will affect Estonia's competitiveness, which, in turn, means that there will be a continuing need to renew the production process and products/services.

Export outlook good, but growth to slow

Estonia's exports showed very strong growth numbers in 2010 – in real terms, exports of goods were up 35% and exports of services up 8%. While exports of goods have recovered to higher than boom-year levels, those of services still remain lower.

Exports will continue to show strong results, but growth rates will eventually start to slow, especially in the second half of 2011, due not only to the base effect but also to an expected slowdown in main export partners' economies. Strong export growth continues to stem from the manufacturing sector and export demand, which, in turn, is related to the good prospects of the main export markets. In addition to Sweden, Finland, and Germany, Russia, Latvia, and Lithuania will

Key Economic Indicators, 2009 - 2012 [1/]

	2009	2010	2011f	2012f
Real GDP	-13.9	3.1	4.5	4.5
Nominal GDP, billion euro	13.9	14.5	15.9	17.2
Consumer prices (average)	-0.1	3.0	3.8	3.2
Unemployment rate, % [2/]	13.8	16.9	13.5	12.7
Real gross monthly wage	-4.6	-2.0	1.6	3.0
Exports of goods and services (nominal)	-19.6	26.1	16.2	13.0
Imports of goods and services (nominal)	-31.2	24.9	16.8	14.6
Balance of goods and services, % of GDP	5.7	7.6	7.6	6.7
Current account balance, % of GDP	7.3	6.8	5.7	4.9
FDI inflow, % of GDP	8.7	8.3	9.1	9.7
Gross external debt, % of GDP	125.5	114.2	109.0	105.0
General government budget balance, % of GDP [3/]	-1.8	0.1	-1.2	-0.3
General government debt, % of GDP	7.2	6.6	6.5	7.0

Sources: Statistics Estonia, Bank of Estonia and Swedbank projections.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

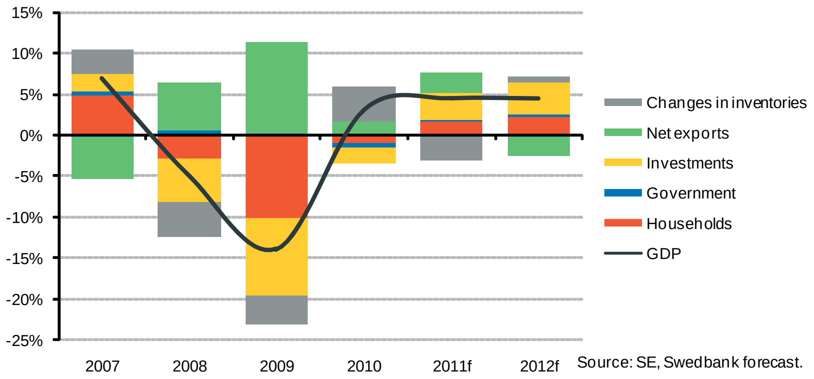
be of growing importance; the latter two are important in terms of energy exports. Russia's strengthening economy makes Estonian food export prospects better as demand for those exports in Russia will continue to grow. Of course, when discussing trade relations with Russia, political risk is always a possibility.

Exports of services will still grow, but more slowly than goods exports. While transport services have reached quite high levels, growth of other services should be accelerating, boosted by an increase in economic activity and the opening of the European services market. Tourism-related services, which have recovered healthily, will gain additionally from Tallinn's designation as this year's European Capital of Culture.

Investments supported by innovation and infrastructure projects

Because of the sharp fall in production during the recession was strong, a significant part of the production capabilities is now unused. Using those poorly maintained capabilities may thus be problematic, as production technologies might be outdated or unusable. However, data indicate that companies are probably ready and willing to renew their production processes and/ or machinery – investments, which started growing again in the last quarter of 2010, were largely founded on purchases of equipment and machinery for renewing production; also, the growth of new credit and leasing for enterprises has been accelerating for many months now. This uplift in loan growth may also indicate that improved economic confidence is allowing companies to execute those investments that were put on hold during the recession.

Contributions to GDP growth



Source: SE, Swedbank forecast.

Investment growth is forecast at 15.4% this year and 13.6% in 2012. We revised growth for this year upwards even though many construction projects have been postponed due to the harsh winter, as well as to some legal disagreements (mainly related to usage of EU funds). However, overall prospects are good because available EU funds are mainly related to infrastructure investments, most of which are still not used (only about 15% of the funds available from the budgetary period of 2007-2013 are currently used). Thus, we expect this type of investment to increase, assuming that the legal disagreements will not linger and the weather will be more favourable than in recent years. At the same time, investments in the energy sector will grow during the forecast period, as Eesti Energia has announced several planned projects.

The upward revision is also supported by several planned investments in the retail sector (these include big projects to build hypermarkets in Tallinn). In addition, the government has obligations to make investments related to the carbon credit trade (AAU) contracts. Investments are also affected by foreign direct investment (FDI) inflows, which, in turn, are related to the growing profits of enterprises, the comparatively low level of asset prices, and the good prospects for future profits. The impact of Estonia's joining the European Monetary Union (EMU) may also be visible in foreign investments.

Residential investments will remain at a low level. There are several reasons behind this. First, because households' incomes are diminished, many who would like to finance their (new) real estate purchases with loans are not eligible for (additional) credit. Second, the level of unemployment is still quite high. This high unemployment, which is also related to incomes as well as to overall confidence about future developments, is dampening credit demand for those who can actually afford it. Third, conditions that households should meet to get loans from banks are somewhat stricter; therefore, not many can meet these conditions. Fourth, during the crisis, the value of assets has been decreasing – loans are already in many cases larger than the values of assets purchased during the boom and many households prefer not to swap their current homes. Although residential investments will remain low, nonresidents may find it more

Swedbank's GDP Forecast – Estonia

Changes in volume, %	2009	2010[1/]		2011f[1/]		2012f[1/]	
Household consumption	-18.4	-1.9	(-2.0)	3.2	(2.8)	4.0	(3.0)
General government consumption	0.0	-2.1	(-2.0)	0.5	(0.2)	2.0	(0.3)
Gross fixed capital formation	-33.0	-9.1	(-12.5)	15.4	(12.0)	13.6	(10.0)
Inventories [2/]	-3.4	4.2	(2.0)	-3.1	(-2.4)	0.9	(-1.0)
Exports of goods and services	-18.7	21.7	(19.5)	13.5	(9.5)	8.7	(8.0)
Imports of goods and services	-32.6	21.0	(18.5)	10.7	(8.2)	11.7	(8.0)
GDP	-13.9	3.1	(2.8)	4.5	(4.2)	4.5	(4.5)
Domestic demand (excl. inventories) [2/]	-21.8	-2.8	(0.3)	5.1	(5.2)	6.3	(5.0)
Net export [2/]	11.4	1.7	(0.5)	2.4	(1.4)	-2.6	(0.5)

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

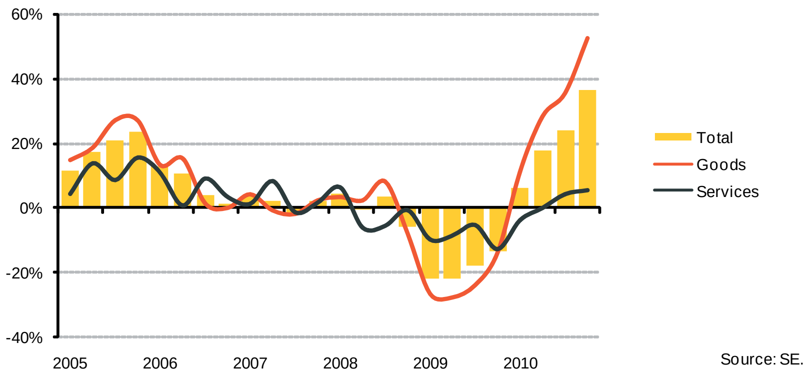
attractive to invest in real estate, like land and/or summer houses on the coast or apartments in Tallinn's Old Town.

Unemployment falling, but imbalances in the labour market remain

For the first time after the crisis, employment growth turned positive at the end of last year (+2.1% annual rate in the fourth quarter), mostly founded on the strong performance of the export-led manufacturing sector. The growth in employment shows that the economy is recovering – many firms are already hiring new workers to meet increased demand. The main problem, however, remains unemployment. Even though employment and the number of vacancies are growing, the supply of qualifications does not match the demand, i.e. structural unemployment will continue to be a problem for a longer period as re-education will take time. The qualifications mismatch, together with population aging, may induce another wage rally for some occupational groups in which the labour supply is the scarcest (e.g., ITC and skilled workers in electronics).

Unemployment will decline to 13.5% this year and further to 12.7% in 2012. Despite imbalances, unemployment will continue to decrease for two reasons. First, the growth in employment seen at the end of last year is expected to continue. Employment growth will be stronger in the middle of this year for seasonal reasons, but, at the same time, the number of permanent

Export sector, annual growth



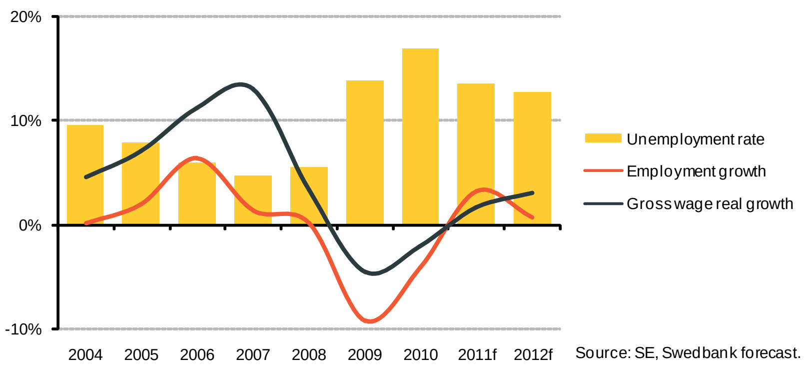
Source: SE.

positions will grow as well. This forecast is supported by the strong demand growth in the manufacturing sector and the steady improvement in domestic demand, especially construction-related jobs.

The second reason for declining unemployment is that long-term unemployed are becoming discouraged from seeking employment, or involved in the shadow economy. The activity rate will decline as many who counted themselves as actively looking for jobs are now leaving the labour market and becoming inactive (students, caretakers, pensioners, etc). In addition, many long term unemployed may feel discouraged and leave the labour market (become inactive) or (re-)start their studies: those that started their studies during the recession are still studying and are counted as inactive. Also, those who left educational institutions during the boom years may now return to their studies.

Real wage growth, which has now been negative for more than two years, will turn positive in the second half of this year. Growth of 1.6% is forecast for 2011 on average, accelerating further to 3% in 2012. This growth, however, will be uneven between sectors and occupations (skewed more towards export-oriented sectors like manufacturing, and IT and business services); therefore, some sectors might even continue to experience a slight decrease in growth, while others see stronger wage growth. In 2012, other sectors (including the public sector) will follow this upward trend.

Labour market indicators



Source: SE, Swedbank forecast.

Inflation mostly externally driven

Inflation picked up at the end of last year, mostly on external factors, as global food and oil prices continued to increase; these trends have continued at the beginning of this year. Although price increases slowed in January, they accelerated again in February. Weak demand has so far kept core inflation low, although some acceleration has recently been seen there as well. We are of the opinion that the so-called rounding effect has also been a factor: because the euro cash changeover changed the nominal values of prices, many entrepreneurs preferred to round prices up instead of down. However, we believe that this effect is temporary – consumers are becoming more accustomed to the new currency and may choose to "vote with their feet", i.e. do their purchases in stores that have been less keen to increase prices during the changeover process.

So far, firms have been able to maintain production with competitive prices as Estonia went through an internal devaluation – costs of labour and other inputs have decreased. However, this process is about to end (in 2009, labour costs did decrease on average 16%, and total costs decreased on average approximately 19%, while in 2010 labour costs decreased on average 6.2% and total costs grew by 7.5%).

We have raised slightly our inflation expectations for this year as well as for the next, to 3.8% and 3.2%, accordingly. The impact of tax increases on inflation diminished last year and will fade away in the first half of this year, thus leaving world price movements as the main contributor to inflation developments. However, labour shortages risk becoming an additional cost-push factor via wage increases, as companies will tend to transfer their costs into consumer prices.

Private consumption set to increase, but remains weak

We are of the opinion that private consumption growth will stay at a low level at the beginning of this year and then gradually accelerate to 3.2% on average in 2011 and 4% in 2012. The reasons for this forecast lay mostly in price and income developments, but also in deleveraging and the high savings rate: accordingly, spending will remain modest as consumers' purchasing power grows at a slow pace.

The growth in confidence, together with the more positive trends in the labour market, has encouraged people to spend more. The currency changeover definitely has had an effect as well – people used their remaining kroons for consumption (especially durables), as they were somewhat influenced by the widespread talk of a post-euro price surge.

The currency changeover has had different effects on spending. On the one hand, the uncertainty of the changeover has reduced consumers' willingness to consume while they allow themselves to become more comfortable with the new value of exchange. On the other hand, since consumers tend to look at nominal values of prices, they might be tempted to consume more as the prices on the price tags are considerably lower than they were before. We assume, however, that households will cut back on their consumption for several months at the beginning of this year, spending mostly on necessities, while they take time to familiarise themselves with the new currency.

Nevertheless, the continuing growth in prices will have a dampening effect on the cautiously recovery in consumption. Many households feel confident enough about the economy, as well as the labour market, to increase spending amidst rising prices. At the same time, there are households (including the long-term unemployed and the discouraged) that are still suffering under the conditions brought on by the recession; these will be even more budget constrained and forced to cut their spending, especially because prices of most necessities have grown, wage growth will be modest, and inflation expectations continue to be high.

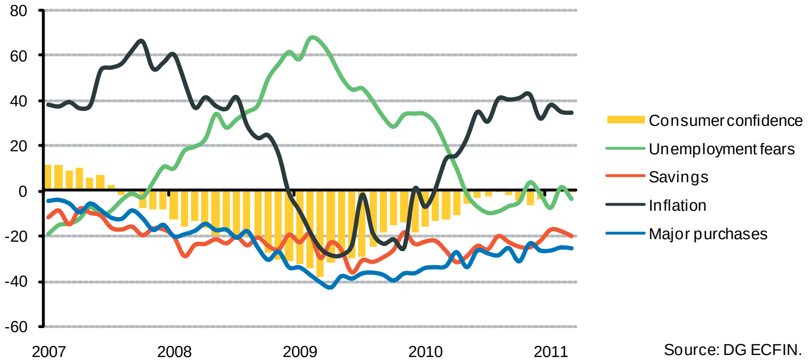
Fiscal policy stability reached

According to preliminary estimates, the general government budget managed to reach a surplus in 2010 (0.1% of GDP). This above-expectations improvement was partly supported by faster economic activity at the end of the year, which, in turn, increased tax revenues. At the same time, tight control over expenditures remained in place throughout the year. In addition, Estonia has been very successful in the carbon credit market (AAU), thereby adding about 1% of GDP in nontax revenues last year. However, it should be stressed that, as these revenues will transfer into investment expenditures mostly in 2011 but also in 2012, the deficit will rise during this period; our forecasts point to deficits of -1.2% and -0.3% of GDP, respectively. In addition, the goal of balancing the budget will be constrained by the resumption of payments to pension pillars, which were temporarily suspended during the crisis.

The parliamentary elections held on 6 March showed continuing support for the current coalition despite the austerity measures introduced during the recession. The new coalition (formed by the same two parties as the previous one) agreement includes strict rules on future fiscal policies as the budget balance requirement will be added to the budget law.[1] The tax burden will be reduced through lower labour taxes; however, major tax changes will not take effect until 2013 or later.

Annika Paabut
Elina Allikalt

Consumer confidence and expectations



Source: DG ECFIN.

1 The budget balances in 2011 and 2012 will be exceptional as they are affected by higher investment expenditure due to AAU trades. The new coalition agreement foresees a balance or surplus being reached again in 2014 and beyond.

Latvia: Stronger recovery, but lack of reforms cut into future growth

The recovery has continued to strengthen and widen. Initially driven by exports and inventory rebuilding, economic growth in the second half of 2010 was supported also by private consumption. Quarterly growth in gross fixed capital also started in the third quarter, although annual growth still was not present. By the end of 2010, the Latvian GDP had grown by 3.7% since the trough in the third quarter of 2009. Strengthening economic growth and the gradually stabilising fiscal situation have also helped to raise Latvia's sovereign credit ratings.

Although economic developments have been broadly in line with our January forecast, two major factors have brought changes to our outlook. First is the more rapid growth in global commodity prices, which also raises Latvian inflation. Second is the somewhat disappointing post-election fiscal and structural policy in Latvia – the government did not use the opportunity to carry out comprehensive structural reforms, and, as last year, the consolidation was mostly based on tax increases. We expect this policy to weigh on economic growth, mostly through weaker household consumption. While tax hikes and inflation due to global factors will undermine private consumption mostly in 2011, diminishing average quarterly growth, these factors will reduce the annual 2012 growth rate because of a statistical overhang. We thus keep our GDP growth forecast of 4% for 2011 and reduce the 2012 forecast to 3.9% (4.2% before).

Owing to the stronger-than-expected fall in the job-seekers' rate, we are lowering our forecast for the coming years – from 18.7% in 2010, the average job-seekers' rate is expected to fall to about 14% in 2012, due to emigration and a shrinking participation rate. We are not altering our employment forecast and still expect sluggish job creation. We now foresee 4.2% consumer price inflation for 2011 (3% before), due to stronger global commodity price growth and planned tax hikes in the summer. The 2012 inflation forecast is nearly unchanged at 2.6%. There is still an opportunity to introduce the euro in 2014, but government action is needed to reduce inflation expectations and contain price growth. Because of increasing import prices and somewhat stronger import growth in late 2010, we now forecast moderately larger trade deficits for 2011-2012.

Global developments remain the main risk to our forecast, with the largest uncertainty surrounding global commodity price growth. Our base forecast for Latvia remains a muddle-through scenario, but with less immediate post-election progress regarding structural reforms than in our previous outlook. The positive risk to our forecast remains stronger investment activity due to, e.g., better access to funding, which would also raise GDP growth rates.

Key Economic Indicators, 2009 - 2012 1/

	2009	2010	2011f	2012f
Real GDP	-18.0	-0.3	4.0	3.9
Nominal GDP, billion euro	18.539	18.047	19.604	21.189
Consumer prices (average)	3.5	-1.1	4.2	2.6
Unemployment rate, % 2/	16.9	18.7	15.5	13.9
Real net monthly wage	-5.6	-6.6	0.8	2.3
Exports of goods and services (nominal)	-16.4	19.2	16.5	12.4
Imports of goods and services (nominal)	-35.5	16.9	18.1	15.5
Balance of goods and services, % of GDP	-1.1	0.3	-1.1	-2.8
Current account balance, % of GDP	8.6	3.6	0.0	-2.5
Current and capital account balance, % of GDP	11.1	5.5	2.2	-0.6
FDI inflow, % of GDP	0.3	1.5	4.0	3.9
Gross external debt, % of GDP	156	165	153	144
General government budget balance, % of GDP 3/	-10.2	-8.5	-5.2	-2.6
General government debt, % of GDP	36.7	48.0	49.8	47.7

Sources: CSBL and Swedbank.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

Export growth will slow

Despite an increase of uncertainty in the global environment, the outlook on demand growth in our main trading partners remains broadly the same. We thus keep our previous forecast regarding export volumes – average quarterly growth will nearly halve in 2011 compared with 2010, due mainly to the increasing influence of local constraining factors – the main one being capacity utilisation – but also due to somewhat slower global growth than last year. The high annual figure for export volumes will be a result of statistical carryover effect. We expect export volumes to sustain a similar average quarterly growth rate in 2012.

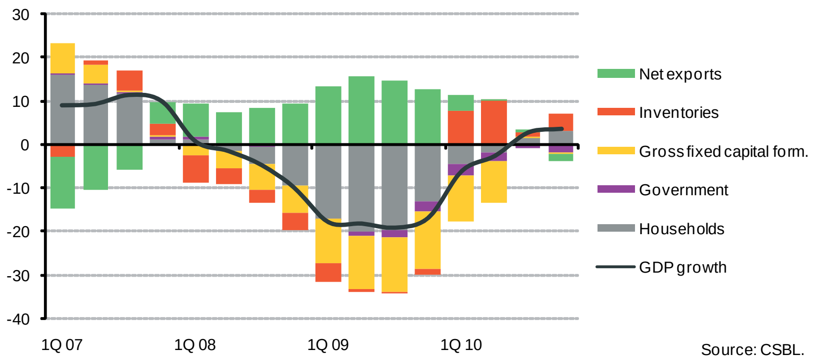
The cost competitiveness of Latvian exporters continued to improve throughout 2010. For instance, unit labour costs fell by about 14% last year. Rising commodity prices and energy tariffs are pushing companies to continue rationalisation, and energy effectiveness issues are becoming more important. Many exporting companies are already working at maximum capacity, which requires investments in production facilities. Among factors limiting production, demand and financing are becoming less binding, while equipment and labour constraints are increasing.

In line with our expectations, the product structure and country mix of Latvian exporters are gradually changing. The growth driver in manufacturing is slowly shifting from the resource-constrained wood industry (where investments can help to increase value added, rather than physical volumes) to metal products, machinery, equipment, and transport. The latter industries together constituted about one-third of goods exports in 2010. Moreover, companies in these industries continue to move into new markets, e.g., Algeria, India, and Turkey. Exports to those countries rose from 0.5% of total goods exports in 2008 to 5% in January 2011 (mostly due to the metal industry).

Developments of services exports continue to disappoint, though. Services exports are expected to grow much slower than goods exports in the coming years. Political infighting and the lack of a consistent and common strategy, as well as increasing regional competition, undermine freight flows through Latvian ports. However, transport by road and rail is slowly increasing – there is a tendency to choose more expensive but faster and more flexible road transport when possible. Meanwhile, the favourable developments in business travel and passenger air transportation are expected to continue.

In volume terms, the forecast for imports remains broadly unchanged. Import growth is largely influenced by capital and intermediate goods and will continue to be so (see below). Imports of consumption goods are expected to accelerate somewhat in 2011-2012, but, with household real incomes still rising feebly, growth of imported items will remain sluggish. However, as faster-growing global prices are increasing the value of imported goods, nominal import growth is now expected to be somewhat stronger, especially in 2011, compared with our January forecast.

Contribution to annual GDP growth, pp



Source: CSBL.

Investments to gain strength

We are keeping our forecast that in two years gross fixed capital formation will rise by about one- third. Somewhat disappointing developments of the last quarter of 2010, when recovery stalled, can be partly explained by the relatively snowy and cold weather – this might also have undermined investment growth in early 2011. We expect growth to pick up, partly corresponding to capacity constraints in exporting sectors. Quite a few investment projects have been announced (mostly private) in the industry, transport, and energy sectors.

The planned acceleration of acquisition of EU funds in 2011 (the Ministry of Finance plans for about 8% of GDP in 2011 and 5% in 2012, together with cofinancing) does not necessarily mean that projects will actually be started and executed in the same year. Large projects last several years, which makes forecasting the timing of investments tricky. For instance, the new power unit of the cogeneration power plant TEC-2 is planned to be commissioned in 2013 (total costs about EUR 355 million), purchases of passenger trains are expected to last until 2015 (total costs about EUR 215 million), purchases of air planes will continue until 2013 (about EUR 1.4 billion, beginning already in 2010). It is difficult to anticipate how much of these investments will fall into 2011 and 2012, and the forecast error is thus fairly wide.

Companies (especially exporters) have good cash flows, and their profit margins are rising; however, uncertainty regarding fiscal consolidation measures remains. Confidence indicators have flattened out, signalling that companies are quite hesitant about future developments. The rapid increase in deposits of nonfinancial corporations (of LVL 250 million during the fourth quarter of 2010, 36% year on year) is thus quite natural. Financing of investments is slowly becoming easier, as banks increase their lending activity, but the expected rise in the euro interbank rate (EURIBOR) may hold back new demand for loans.

Improved Latvian sovereign credit ratings (currently, the investment grade is given by Moody's and Fitch; Standard and Poor's is anticipated to follow soon) provide more opportunities for foreign investors. Foreign direct investment inflows are continuing to increase slowly, both of new equity capital and reinvested earnings.

Job creation to remain slow

The job-seekers' rate shrunk rapidly during 2010 – from 20.4% at the beginning of the year to 16.9% at the

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2009	2010		2011f[1/]		2012f[1/]	
Household consumption	-24.1	-0.1	(-1.0)	2.5	(2.5)	3.5	(4.5)
General government consumption	-9.2	-11.0	(-8.0)	-3.0	(-1.8)	-0.1	(0.1)
Gross fixed capital formation	-37.3	-19.5	(-20.0)	12.0	(15.0)	16.5	(14.0)
Inventories [2/]	-1.5	5.8	(5.9)	-0.5	(-0.7)	-0.1	(0.0)
Exports of goods and services	-14.1	10.3	(9.5)	10.5	(10.0)	6.0	(6.0)
Imports of goods and services	-33.5	8.6	(8.0)	8.5	(9.0)	9.0	(9.0)
GDP	-18.0	-0.3	(-0.5)	4.0	(4.0)	3.9	(4.2)
Domestic demand (excl. inventories) [2/]	-30.7	-6.7	(-6.9)	3.6	(4.4)	5.8	(6.0)
Net export [2/]	14.2	0.6	(0.5)	0.8	(0.3)	-1.8	(-1.8)

Sources: CSBL and Swedbank.
1/ The figures from our forecast in January are given in brackets.
2/ Contribution to GDP growth

end. However, as expected, a rebound in employment in the middle of the year lost momentum in the fourth quarter of 2010. We are lowering our job-seekers' rate forecast for 2011-2012 based on the better situation in 2010, but we are not altering our employment forecast. Job creation will remain slow, and the more rapid decrease in unemployment will not support economic growth more than was projected in our previous forecast, as it will be due to emigration and a lower participation rate.

There are both positive and negative risks to our labour market forecast. On the one hand, several large investment projects may boost employment. On the other hand, there is a risk of larger emigration (not least as Germany, Austria, and Switzerland will open their labour markets in May 2011). The population census begun in March 2011 is likely to reveal a smaller population and labour supply than current figures suggest, and thus possibly also a smaller number of employed and unemployed.

Increased productivity provides grounds for wage growth, especially in manufacturing, where productivity now exceeds the real wage level by over 10% (using 2005 as a reference year). Structural imbalances in the labour market (like skills mismatches) make wage growth possible despite high unemployment. We forecast nominal wages to grow, mostly on the resumption of bonus schemes in 2011, as well as on an increase in the official minimum wage at the beginning of this year. Inflation will nearly eliminate the gain in purchasing power, however.

Despite an anticipated slowdown in productivity growth, real wage growth is still expected to be broadly in line with productivity gains. As a result, companies will avoid a deterioration in competitiveness.

Inflation driven by taxes and commodity price growth

Taking into account the stronger-than-expected global commodity price growth and the additional tax rises planned for July of this year[1], we are raising our average consumer price index (CPI) inflation forecast for 2011 to 4.2%. This is mostly supply-side inflation, owing to increasing costs of businesses. Producer prices for locally sold production were steadily rising during 2010, implying upward pressures also for consumer prices. The rising inflation aggravates social problems (as first-necessity items become more expensive, hitting poorer households harder) and poses risks to competitiveness.

With private consumption recovering slowly and inflation expectations strengthening, we do not expect a rapid decrease in inflation rates in 2012. We forecast average CPI inflation of 2.6% in 2012, which implies a 12-month average inflation rate exceeding 2% at the beginning of 2013. Unless action to hold back inflation is undertaken by the government, there is a risk of exceeding the Maastricht inflation criterion for introducing the euro in 2014. The Minister of Finance recently announced a need to create a plan for reducing inflation some time soon. We have not yet incorporated the effect of such a plan on our outlook, as it is still unclear what particular measures could be included in it. The current, somewhat simplistic, suggestions include agreements with social partners to contain wage growth. We believe that there are two other broad areas where action should be undertaken.

First, inflation inertia should be reduced, including improvements in competition – for instance, by strengthening the Competition Council, by making the price-setting mechanism more transparent, by expanding the voucher system in the public sector to improve cost efficiency and quality, and by making public procurements more transparent. Second, energy efficiency should be improved to hold back an increase in public utilities' tariffs. Furthermore, taxes that directly hit CPI (like value added or excise tax) must not be raised before the euro entry. Social agreements between the government and social partners are possible, but for this clear communication is necessary about how the budget consolidation is done, about which reforms are pursued, as well as how and when they are implemented. The government should then follow the agreement strictly to build trust in its policy.

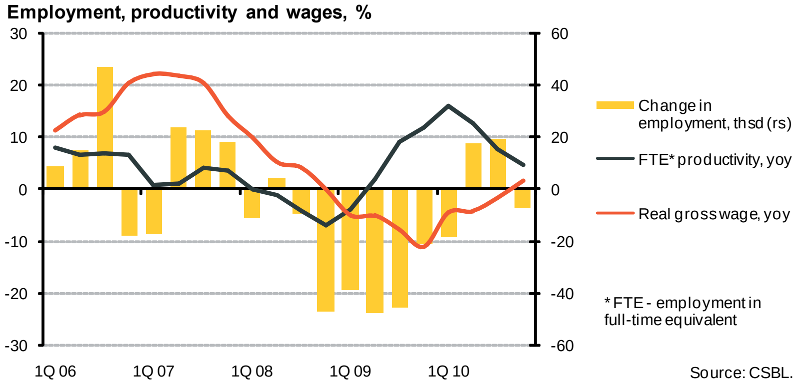
Sluggish household consumption growth

The disappointing post-election fiscal policy (see below) is forecast to undermine economic growth through smaller household consumption. Higher taxes in the middle of this year and inflation due to global factors are expected to reduce the average quarterly growth of household consumption in 2011, although annual growth stays the same. Due to a statistical overhang, the more modest quarterly growth of consumption in 2011 will be reflected in a lower annual figure for 2012, even though the same quarterly dynamics will be in play as in our January forecast.

The increase in employment and wages will support consumption; however, improvements are expected

1 For example, higher value added tax for natural gas, excise for fuel and natural gas.

Employment, productivity and wages, %



Source: CSBL.

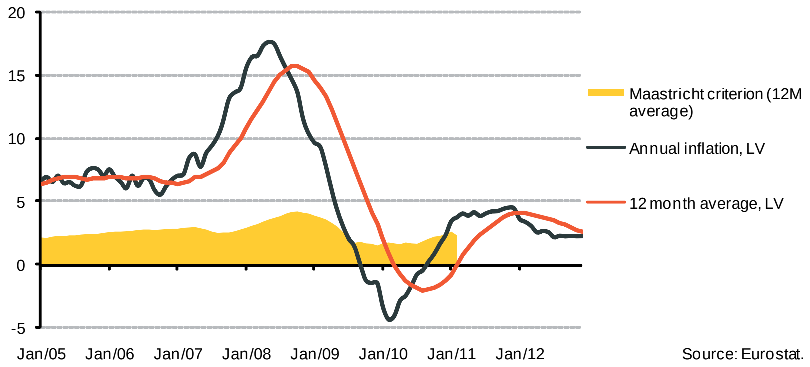
to be slow. New bank lending is to become more active as the economic situation and bank profitability improves. On the other hand, consumer confidence continues to stagnate, implying cautious spending.

A highly discussed topic in the media recently has been the sustainability of the social budget. Its expenditures comprise about one-third of the general government budget, and pensions are the largest part of it. The current structure is unsustainable, taking into account emigration, demographics, and larger pensions for the newly retired. Opinions on how to deal with this problem are conflicting, and it is hard to anticipate the outcome (e.g., cutting pensions, or revising the social benefit mechanism). Our forecast does not include a decrease in pensions in any form – this remains as a negative risk for the household consumption outlook, but it might also diminish inflation pressures in 2012.

Fiscal and structural policy disappointing

Fiscal consolidation so far has been relying too much on tax increases and across-the-board expenditure cuts rather than on well-thought-through and balanced structural reforms. The post-election opportunity to pursue reforms in the 2011 budget was by and large wasted. Instead, the additional consolidation of "high-quality measures" worth EUR 70 million (about 0.4% of GDP) that the IMF and the EC demanded was again based mostly on tax hikes (nearly two-thirds of the total).[2] These measures will weaken economic growth by hitting households' consumption, increasing incentives for tax evasion, and strengthening inflation inertia.

Harmonized consumer price inflation, %



Source: Eurostat.

Reducing the shadow economy does remain one of the government's key areas of focus. However, the raising of taxes in fact has done the opposite, while appropriate actions to improve tax administration and collection so far have been weak and slow in coming. Despite the tax increases, the ratio of tax revenues to GDP has decreased. This can partly be explained by the expansion of exporting sectors, which are less tax intensive; however, tax revenues as a percent of domestic demand have declined as well.

If fiscal discipline is retained at any reasonable level, the deficit is anticipated to be below 6% of GDP this year, not least because we forecast stronger GDP and price growth than does the Ministry of Finance. The larger-than-usual deficit in the first two months of 2011 is mostly explained by the volatility in incoming flows of the EU. Tax revenues have been exceeding the plan at the beginning of the year.

Previous consolidation to some extent has been achieved through measures that have temporary effects. For instance, payments to the second pension pillar (reduced to 2% of gross wage) are to be brought back to 6% in 2013. This will imply smaller revenues and will widen the budget deficit, going forward. The recent suggestion of the Ministry of Finance to postpone increasing the second pension pillar payments is a short-term measure and does not solve the problem in the long term.

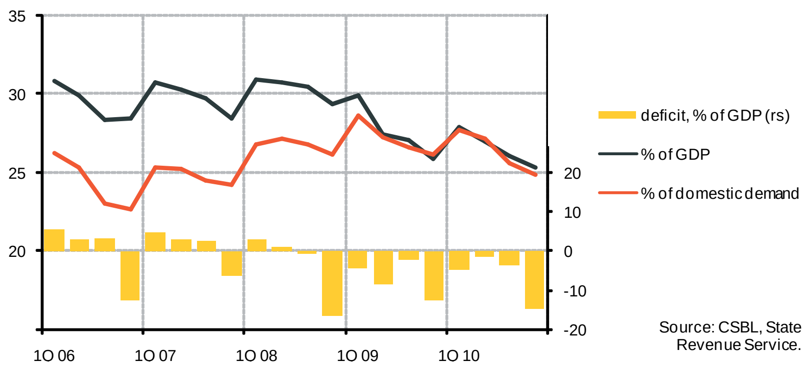
The size of consolidation for the 2012 government budget will depend on the success in reducing the shadow economy, improving fiscal discipline, and implementing the 2011 supplementary budget consolidation measures. The 2012 government budget should be planned with a deficit well below 3% of GDP, considering the sustainability of public finances beyond 2012 (which is taken into account when evaluating compliance with Maastricht criteria).

The improvement in Latvia's sovereign ratings provides the opportunity to start issuing government bonds in international financial markets for a more acceptable price. However, this does not mean that the government no longer needs to reduce the budget deficit – it is crucial to return public finances to a sustainable footing and be able to introduce the euro.

Lija Strašuna
Mārtiņš Kazāks
Dainis Stikuts

2 The supplementary budget was submitted to the Parliament on April 5th 2011.

Tax revenues and budget deficit, %



Source: CSBL, State Revenue Service.

Lithuania: Growth accelerates and it's more balanced

Growth in 2010 reached 1.3% and exceeded our expectations – mainly due to a stellar performance in the fourth quarter, when seasonally adjusted GDP grew by 1.8% compared with the previous period. This rapid quarterly growth pace is likely to decelerate, but the economy is expected to grow at a much faster annual rate in 2011 – we increased our GDP forecast from 3.0% to 4.2%.

After eight quarters of decline, household consumption increased in the last quarter of 2010, but the annual growth was still negative. Meanwhile, after a strong pickup in gross fixed capital formation in the second half of last year, the annual result was unchanged from year ago. The biggest impact on growth came from stockbuilding, which accelerated in the last quarter and reflected higher expectations for future consumption and investment.

Growth of mining and quarrying, manufacturing, and electricity, gas and water supply accelerated at the end of 2010, and the annual growth of industry reached a solid 5.6%. Most other sectors, however, were still declining in 2010 or showed only very modest annual increases.

This year and in 2012, the growth will be more balanced. We expect a positive contribution from household consumption and a significant pickup in gross fixed capital formation – we increased our forecast of investment growth from 8% to 16% in 2011 and from 8.5% to 13% in 2012. Unlike in 2010, this year and next all sectors will recover and will contribute positively to economic growth.

We increased our forecast of inflation in 2011 from 2% to 3.2% – annual inflation picked up at the end of 2010 and is expected to stay around current levels throughout this year. Factors behind the faster price increases are mainly external – unfavourable price developments for oil and food in international markets are having a direct and strong impact. We expect that this will be temporary, and inflation should decelerate to 2.5% next year.

Despite the more positive outlook, many internal and external risks remain. The nonorderly restructuring of the sovereign debt of peripheral euro zone countries may cause higher interest rates and lower expectations, and could undermine Lithuanian exports' growth in EU markets. Unrest in northern Africa and the Middle East could further raise oil prices and cause higher inflation. The upcoming parliamentary elections in 2012 may evoke many growth-restricting propositions.

Key Economic Indicators, 2009 - 2012 1/

	2009	2010	2011f	2012f
Real GDP	-14.7	1.3	4.2	4.7
Nominal GDP, billion euro	26.508	27.405	29.270	31.259
Consumer prices (average)	4.5	1.3	3.2	2.5
Unemployment rate, % 2/	13.7	17.8	15.5	13.5
Real net monthly wage	-7.2	-4.3	0.0	2.5
Exports of goods and services (nominal)	-25.2	30.3	17.0	12.0
Imports of goods and services (nominal)	-36.1	28.9	18.0	13.0
Balance of goods and services, % of GDP	-1.2	-0.7	-1.5	-2.2
Current account balance, % of GDP	4.3	1.8	-1.0	-1.7
Current and capital account balance, % of GDP	7.7	4.5	2.0	1.3
Net FDI, % of GDP	0.5	1.7	2.5	3.0
Gross external debt, % of GDP	87.2	86.1	83.0	80.0
General government budget balance, % of GDP 3/	-9.2	-8.0	-5.5	-3.0
General government debt, % of GDP	29.5	38.7	40.0	42.0

Sources: LCD and Swedbank.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

Exports are still key, despite many risks

After 16.3% real growth in exports last year, there is enough steam left for 2011 and 2012. Although growth is expected to decelerate, recent developments show no signs of weakness; thus, we increased our forecast to 12.5% in 2011 and 9.4% in 2012. Monthly exports of goods (at current prices) exceeded all time highs in the last months of 2010 and have continued growing in the first months of this year. Exports of goods produced in Lithuania also recovered last year and almost reached pre-crisis levels.

In 2010, refined petroleum products remained the main export products and made up 22.5% of all exports of goods. Furthermore, the export growth of these products was the fastest, exceeding 50% in nominal terms. The next-best performers were in a higher-value-added chain – exports of motor vehicles grew by 46%, machinery by 43%, and computer, electronic, and optical products by 42%. The biggest export product groups behind refined petroleum products – chemicals and foodstuffs – grew slower, at 26.6% and 18.9%, respectively, but, due to increased competitiveness and growing foreign demand, they are expected to contribute significantly to growth this year.

The economic recession did not change the direction of Lithuania's exports – the biggest share still goes to its closest neighbours – Russia, Germany, Latvia, and Poland. This year, the CIS – and especially Russia, which will receive a strong boost from increasing oil prices – is expected to be an important driver of export growth.

Despite the very strong performance of the transportation sector, which makes up almost two-thirds of all exports of services, the growth of exports of services is still lagging behind exports of goods, and is expected to stay behind this year. Exports of higher-value-added services, such as construction, communications, financial, IT, and consulting, contribute only around 10% of total exports of services; hence, their faster growth will have only a small effect on total exports.

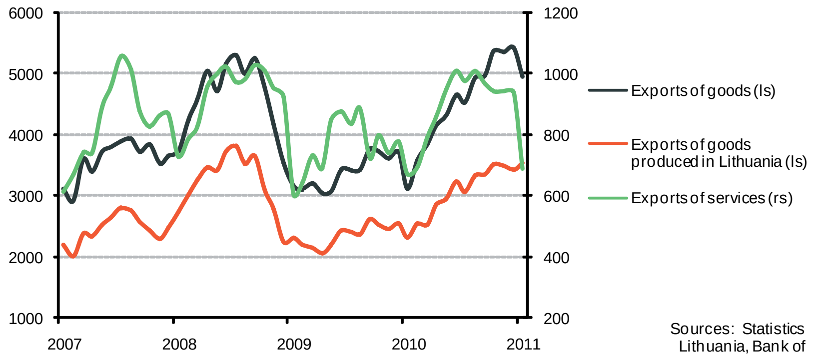
So far, the economic recovery has relied on foreign markets; any significant dent in foreign demand could tip the economy back into recession. However, despite the high density of adverse global developments – the sovereign debt crisis, upheavals in North Africa and the Middle East, and the tsunami and nuclear crisis in Japan – we do not expect the current growth trend to change direction.

Private sector investments to pick up

Despite strong annual growth of 15% and 13.9% in the last two quarters of 2010, gross fixed capital formation ended up being flat in 2010. Nevertheless, the upward trend is likely to continue, and investments are projected to be the most important source of growth this year and next. Gross fixed capital formation is expected to grow by 16% and 13% in 2011 and 2012, respectively.

Exporting sectors are among the first that are approaching full capacity utilisation (e.g., the production of furniture, wood, and wearing apparel); thus, future competitiveness and growth will depend on investments. A positive sign is that imports of investment goods and industrial transport equipment increased by 37% last year and annual growth has

Export of goods and services, LTL millions



Sources: Statistics Lithuania, Bank of

accelerated in the first months of 2011.

Growth in investment in tangible fixed assets eased in the last quarter of 2010, mainly due to the early and cold winter, which caused construction and repairs of buildings to decline by 10.6% after 14.3% growth in the third quarter. Acquisition of equipment, machinery and transport vehicles increased by 10.1% in 2010.

However, the increase in total investment in tangible fixed assets was mainly due to the public sector. Private companies were dominant only in the acquisition of equipment, machinery, and transport vehicles, which is the main source of productivity and competitiveness. This trend is expected to continue its strong growth this year and next. Unlike last year, the private sector in 2011 and 2012 will drive the growth of investments.

Acquisition of EU funds will be an important driver of investments in the coming years. Of the total funds allocated for 2007-2013, which amount to LTL 25.6 billion, 31% have already been paid out. More than 58% of the LTL 2.17 billion allocated to increasing business productivity have already been paid out; however, the acquisition of funds allocated for R&D for competitiveness and growth of business is lagging, as only slightly more than 9% of LTL 2.08 billion has been paid out. Nevertheless, we expect the acquisition of these funds to accelerate this year and next, thereby positively affecting potential output in the future.

Labour market remains challenged

Unemployment will remain high throughout 2011 and will start declining more rapidly only in the second half of the year. Average annual unemployment is expected to decline from 17.8% in 2010 to 15.5% in 2011 and to 13.5% in 2012.

From 2005 to 2009, competitiveness was declining, as net real wage growth exceeded the growth of labour productivity. This adverse development was reversed in 2010, when productivity increased by 6.4%, while real net wages declined by -4.3%. Although his was not enough to offset the loss of competitiveness during the past five years, we expect this recovery of competitiveness to continue this year and in 2012; nevertheless, the positive gap between productivity growth and wage growth will narrow. The competitiveness index, which measures the difference in real growth between productivity and wages, is still 11% below the 2005 level.

Employment is expected to grow by

Swedbank's GDP Forecast – Lithuania

Changes in volume, %	2009	2010		2011f[1/]		2012f[1/]	
Household consumption	-17.7	-4.1	(-5.0)	2.5	(1.0)	4.5	(3.0)
General government consumption	-1.9	-3.0	(-3.0)	1.0	(-1.5)	1.0	(1.0)
Gross fixed capital formation	-40.0	0.0	(-5.0)	16.0	(8.0)	13.0	(8.5)
Inventories [2/]	-5.9	7.8	(6.4)	-0.2	(0.6)	-0.7	(-0.6)
Exports of goods and services	-12.7	16.3	(13.4)	12.5	(6.5)	9.4	(7.7)
Imports of goods and services	-28.4	17.6	(12.1)	11.8	(5.0)	9.1	(5.5)
GDP	-14.7	1.3	(0.5)	4.2	(3.0)	4.7	(4.5)
Domestic demand (excl. inventories) [2/]	-24.1	-4.7	(-6.1)	4.8	(1.6)	5.8	(3.7)
Net export [2/]	15.3	-1.8	(0.2)	-0.4	(0.8)	-0.4	(1.4)

Sources: CSBL and Swedbank.
1/ The figures from our forecast in January are given in brackets.
2/ Contribution to GDP growth

1.6% this year and accelerate to 2.0% growth in 2012. The high structural unemployment implies slower job creation, but, due to increasing investments and labour productivity, its impact on potential GDP growth will remain muted. Some sectors (e.g., transportation and manufacturing) are already signalling their lack of labour force, some of which emigrated during the severe contraction of 2009.

Another reason behind the persistence of unemployment is the high unemployment trap,[1] which, according to the latest available data, increased to 86% and is well above the EU average of around 75%. Due to low minimal and average net wages, which sometimes are very close to or below unemployment benefits, some unemployed have opted out of official employment and are participating in the unofficial labour market. Liberalising the labour market could help solve at least some of these structural problems. Current propositions to increase the minimum wage from LTL 800 to LTL 900 would slightly reduce the unemployment trap but could further retard the creation of workplaces, as a majority of the approximately 300,000 unemployed are unskilled. Reducing social benefits to the long-term unemployed, especially to those who refuse to participate in public works, would be another, albeit not popular, alternative.

1 The unemployment trap measures the percentage of gross earnings that are „taxed away" through higher tax and social security contributions and the withdrawal of unemployment and other benefits when an unemployed person returns to employment.

Household consumption is recovering

We revised upwards the forecast of household consumption growth, which is expected to increase by 2.5% this year and 4.5% in 2012. The real growth of the wage bill this year is expected to increase by only 1.6%, i.e., not enough to justify consumption growth. However, negative real interest rates may discourage savings this year and, together with decreasing unemployment, will prompt the allocation of a larger fraction of disposable income to consumption. A shift in this perception is already evident in the changing structure of household deposits – more than 45% of all household deposits are held in their current accounts, compared with 36% during the height of the crisis, and 55% during booming years.

In 2009, the gross household savings rate (gross savings as a share of gross disposable income) spiked to 7.9% after being negative in 2007 and 2008, reaching the highest rate since Statistics Lithuania started keeping records in 1995. It probably stayed around this level in 2010 but will decline somewhat this year and next, thus supporting the recovery in household consumption.

Consumer confidence started increasing at the beginning of 2010 but has been stalling since last August. The slower improvement in expectations may have been caused by the longer and colder winter (and higher housing costs), as well as by higher food, gas, and fuel prices. Retail trade confidence was positive beginning in the middle of last year, but unexpectedly plunged in January. The main reason behind this drop was the unfulfilled expectations of retailers about holiday-season sales and possible overstocking. This will have some temporary negative effects on first quarter growth, but they are expected to be temporary. The planned increase of pensions in 2012 will additionally boost confidence and partially offset the negative effects of higher inflation.

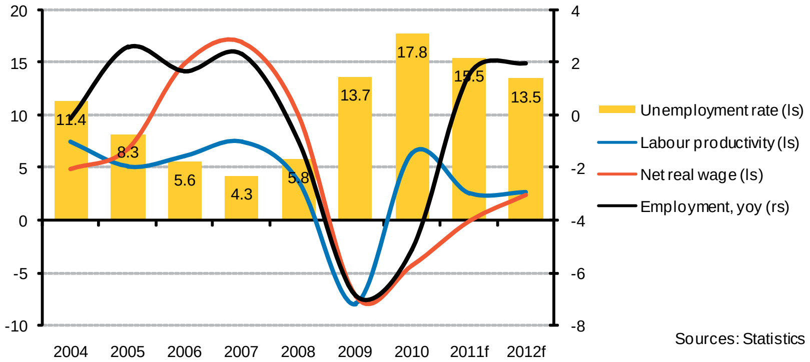
The main growth in household consumption will be in nonnecessities, as well as durable and leisure goods. This trend is already visible now – in the first two months of 2011, the annual retail growth rate reached 18.7% – the fastest growth rate since early 2008; even retail trade, except for motor vehicles, was accelerating, and annual growth in February reached 6.1%. Although annual household credit growth has remained negative, we expect slightly better lending conditions this year, and especially in 2012.

Inflation will weigh on purchasing power…

Average annual inflation last year remained low (1.3%) but accelerated in the last quarter. The current pace of price growth will continue for the rest of 2011, and average annual inflation will be 3.2% this year.

The current growth of prices was caused by only three groups of products in the Lithuanian consumer basket, which became dearer because of the adverse developments in international markets – prices of oil, gas, wheat, sugar, and other food products are much more expensive than they were a year ago. Of the three groups, food and non-alcoholic beverages make up 26.6% of the CPI basket; housing, water, electricity, and gas account for 12.9%; and transport expenditures – 11.5%. The prices of other products had negative impact on CPI growth.

Labour market, %

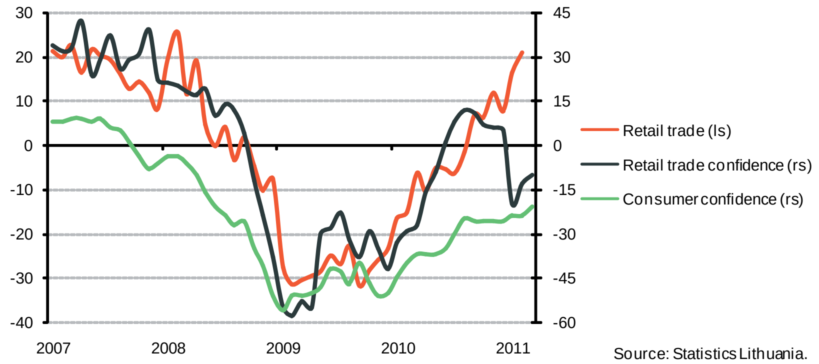


Sources: Statistics

It is still hard to expect a quick recovery in the real growth of household consumption because of the higher inflation, which will have a negative impact on purchasing power. It will have an especially strong impact on poorer households, since expenses on transport, food, and housing have much larger weights in their consumer baskets – for many, these are the only goods they consume.

The external price shock is unlikely to have a persistent effect on inflation – the impact on consumer prices is likely to be one-off, and we expect inflation to decrease to 2.5% in 2012. High unemployment and slow nominal wage growth are not likely to create inflationary expectations. However, in 2011, some internal factors – increased pensions, improving labour and credit market conditions, and insufficient capacity in underinvested sectors – may provide upward price pressure. Although inflation will decelerate to 2.5% next year, it is likely to be above Maastricht criterion and obstruct adoption of euro.

Retail trade sales (% yoy), consumer and retail trade confidence



Source: Statistics Lithuania.

…but will help government finances

Increasing prices may have a short-term positive impact on government finances – higher prices and nominal GDP growth will increase value-added tax (VAT) and, to some extent, excise tax income. This may ease some of the tensions in public finance this year, and the budget deficit is expected to decline to 5.5% of GDP.

One of the main consolidation measures this year was supposed to be the generation of additional tax income from the reduction of the shadow economy, amounting to LTL 1 billion. This ambitious objective is not likely to be achieved, since measures for tackling the shadow economy are still being discussed. Some of the measures are being implemented (e.g., the installation of cashiers in food markets), but they are likely to bear fruit only next year.

Despite the very strong state budget revenue in January, the result for the first two months of 2011 is slightly disappointing – it is 14% better than in 2010, but 5.6% behind the plan (which was admittedly very optimistic, founded on hopes of reducing the shadow economy). Expected annual growth in nominal GDP of almost 7% and consequent strong tax revenue growth are likely to help the government meet its budget consolidation plans.

A bigger challenge could be next year's fiscal consolidation. As some of the measures implemented in 2009 and 2010 were temporary, the government has the "obligation" to return the pensions to the pre-crisis level, which will generate additional spending of at least LTL 700 million in the general government budget. Due to the parliamentary elections in the autumn of 2012, there will be more pressure to increase other spending. Recent propositions to introduce a progressive personal income tax are popular but would have no practical value, as only 2.5% of employed have gross wage exceeding LTL 5,500. Asset taxes would be more effective but are not likely to be introduced before the elections, as they would influence a large fraction of population (more than 90% of households own their homes). In general, as any news taxes would have negative impact on growth, further consolidation should focus on reducing government spending (especially via not transparent and inefficient public procurements). Despite all the risks and uncertainties, we expect this government to survive until the elections and to pursue the target budget deficit of 3% of GDP in 2012.

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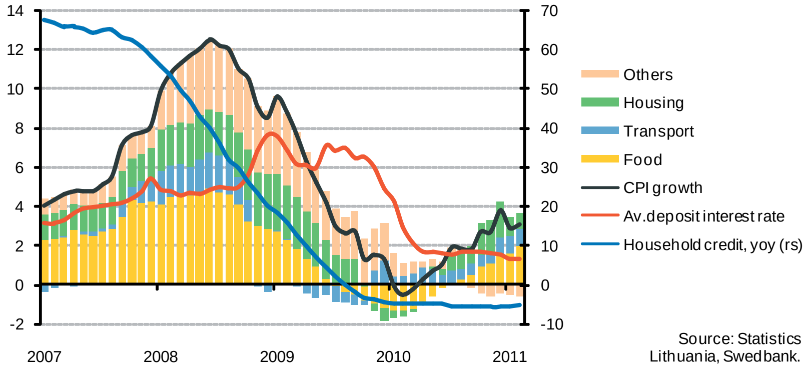
Contribution to annual CPI growth, pp



Source: Statistics Lithuania, Swedbank.

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