Swedbank

# Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

August 23, 2011

## Global headwinds pose policy challenges

**Table of Content:**



Global development

- Since our spring forecast, economic growth in the US and the Eurozone has slowed. Financial turbulence has increased, and confidence is falling. We have revised global GDP-growth for 2011 to 3.8% from 4.1%, and foresee it to remain just below 4% 2012-2013.
- As uncertainties are high, our main scenario has 60% probability, while the risk for a worse scenario with a new global recession is 30%. For growth to return to 5%, we need stronger political confidence, thus the probability of a better scenario is just 10%.

Sweden

- Economic growth continued to be strong in the first half of 2011, but we are seeing a significant slowdown for the remainder of the year. Exports will be affected by a slowing of global growth, and falling confidence of households and companies will limit consumption and investment growth.
- We revise the growth rate downwards for 2012 to 2.2%, and, for 2013, we expect growth to reach 2.3%. The current economic situation presents a policy challenge, and we expect monetary policy to scale back rate increases, but fiscal policy to become too tight. Thus, targeted, timely, and temporary actions will be required to push unemployment down.

Estonia

- The Estonian economy grew strongly in the first half of this year due to a stronger-than-expected recovery of domestic demand and solid export growth. Export growth is expected to slow during the second half of this year, while domestic demand strengthens further.
- Despite slowing global economic growth, Estonia is estimated to grow by 4.2% in 2012 and by 4.0% in 2013, fostered by domestic demand. Investment growth is supported by growth in industry, EU funds, and environment-related investments. Increasing employment and growing wages will support private consumption.

Latvia

- Economic growth picked up strongly in the second quarter of 2011, and was broad based. On the back of good data for the first half of the year, we are raising the annual GDP growth forecast to 4.2%.
- With the global outlook now weaker, we are cutting the 2012 growth forecast to 3.5% and anticipate 3.9% growth in 2013. Growth will remain export and investment driven. Euro entry in 2014 remains part of our main scenario, but policy action is needed.

Lithuania

- The Lithuanian economy grew by a healthy 6.5% in the first half of this year, but growth is likely to decelerate in the second half of 2011 and 2012. Investments and household consumption both were important factors of growth. Consumer prices increased faster than we forecast.
- We still expect the economy to grow by 4.7% next year and by 4.5% in 2013. Export and investment growth will fall back, but household spending is set to increase more rapidly. Slower global growth poses challenges in meeting the Maastricht criteria next year, but euro adoption is still part of our main scenario.

# Global instability – our main forecast risk

The economic situation in Sweden and the Baltic countries has been more positive than in most other advanced economies over the last year. The Baltic countries have successfully managed to return to growth after a severe recession, and confidence is improving. Sweden is back to the GDP level seen before the financial crisis and, after a forceful bounceback, is heading for trend growth. Government debt levels are low, budgets are already balanced or on their way to becoming balanced, and unemployment is falling, albeit slowly. After higher-than-expected growth was seen during the first half of the year, GDP forecasts have been revised upwards for 2011, to 4.3% and 4.2% in Sweden and in Latvia, and to 6.3% and 6.7% in Lithuania and in Estonia, respectively.

However, global risks could markedly worsen the Swedish and Baltic outlook for 2012 and 2013. Already in the spring we warned that headwinds were picking up. Since then, risks for a new global recession, financial instability, and more severe effects of the debt crises in the US and Europe have increased. On the other hand, inflationary risks through escalating commodity prices have decreased. There is – for economic and, not least, political reasons – less leeway to counteract a new recession if it were to occur, as policy interest rates are already low and fiscal stimulus is turning into austerity. The recipe for politicians is to create more confidence by agreeing on medium-term fiscal plans, and to carry out structural reforms to boost the growth potential.

As many of the important forecast parameters change daily, we realise that uncertainties are high at the moment. We therefore need to describe the world economy by setting up a main, a worse, and a better scenario.

Our main scenario has a global annual growth rate of 3.5-4% 2011-2013 and can best be described as a “muddling-through scenario,” both in terms of the economy and the political process. This scenario comes with a probability of 60% and growth has been revised downwards from our spring forecast by 0.3 percentage point per year, due to slower demand in the US and in the euro zone. A worse scenario, where global growth falls below 2%, comes with a probability of 30%. This scenario envisages a new global recession and more financial turbulence as debt in Italy, Spain, and even France cause instability on financial markets. We believe emerging markets will be able to counteract such a global slowdown somewhat, albeit not to the extent as during 2008-2009 because of their overheating problems. A better scenario, with a probability of 10%, sees global growth returning to last year’s rate of 5%. This scenario is made possible as greater trust in the political process spurs investment and recruitment, which, in turn, reduces uncertainties about the future.

In our main scenario, the US keeps its Fed funds rate at 0.25% until the second half of 2013. The ECB raises rates at a slower pace beginning in the second half of 2012 after a pause, while the Bank of England holds off on its first hike until 2013. The inflation outlook becomes friendlier, keeping monetary policy more expansionary as fiscal retraction starts to kick in. The US dollar is assumed to appreciate against the euro, but slower than we assumed in the spring. Commodity prices will start to fall, with an average oil price for the second half of 2011 at $107 per barrel and a continued drop to $97 and $94 in 2012 and 2013. Also, industrial materials and food prices are set to fall from their high levels, in line with a lower growth in demand and a better supply than last year.

Lower commodity prices mean lower inflation especially in the Baltic countries, where food and energy make up a larger share of the consumer price index (CPI). At the same time, slower growth in the advanced economies will reduce export demand, with the risk of a weaker domestic demand. GDP growth in all four economies has been revised downwards for 2012 in terms of quarterly growth, but, as 2011 growth has been revised upwards, the annual rates will stay about the same, or be just mildly reduced. In 2012, GDP growth will fall to 2.2% in Sweden, and to 4.4% in Estonia, 3.5% in Latvia, and 4.7% in Lithuania. With low external demand lingering in 2013, the outlook for that year will not be very different from that for 2012.

Sweden’s GDP increased by 5.4% last year. The bounceback was strong and continued into the first half of 2011, leading to a projected GDP growth of

**Macro economic indicators, 2010- 2013**

| | 2010 | 2011f | 2012f | 2013f |
|---|---|---|---|---|
| Real GDP growth, annual change in % | | | | |
| Sweden (calender adjusted) | 5.4 | 4.3 | 2.2 | 2.3 |
| Estonia | 3.1 | 6.7 | 4.2 | 4.0 |
| Latvia | -0.3 | 4.2 | 3.5 | 3.9 |
| Lithuania | 1.3 | 6.3 | 4.7 | 4.5 |
| Unemployment rate, % of labour force | | | | |
| Sweden | 8.4 | 7.5 | 7.2 | 6.9 |
| Estonia | 16.9 | 13.2 | 12.4 | 11.6 |
| Latvia | 18.7 | 15.9 | 13.9 | 11.8 |
| Lithuania | 17.8 | 15.5 | 13.0 | 10.5 |
| Consumer price index, annual change in % | | | | |
| Sweden | 1.2 | 3.1 | 2.3 | 2.4 |
| Estonia | 3.0 | 4.8 | 2.7 | 2.5 |
| Latvia | -1.1 | 4.5 | 2.4 | 2.5 |
| Lithuania | 1.3 | 4.0 | 2.5 | 3.0 |
| Current account, % of GDP | | | | |
| Sweden | 6.1 | 7.3 | 7.2 | 6.7 |
| Estonia (incl. capital account) | 6.3 | 6.8 | 3.0 | 2.2 |
| Latvia | 3.6 | 1.5 | -0.1 | -2.1 |
| Lithuania | 1.8 | -1.6 | -2.5 | -2.7 |

Sources: National statistics authorities and Swedbank.

4.3% this year. The economy is now coming back to more normal growth rates of some 2-2.5% during 2012 and 2013. The discussion of Sweden as a “tiger economy” is thus fading. Still, economic policy supports growth, and, in a worse scenario, stimulus could be enhanced. In our main scenario, export growth falls below 5% in 2012 due to slower demand and a stronger krona, while investment growth stays rather high, although losing speed as global growth slows. The labour market will improve, but not as fast as previously envisaged due to weaker demand and structural unemployment. The Riksbank will pause in its hiking of the policy rate in the autumn and will revise downwards its interest path, which will stay at 2% at the end of 2011, before rising to 2.75% and 3% at the end of 2012 and 2013, respectively. The government will postpone implementation of the fifth earned income tax credit, as it lacks a majority in the parliament and concerns about the economy is growing. It will thus avoid making a permanent tax reduction in uncertain times and maintain focus on political stability.

Estonia’s recovery surprised on the upside in the first half of 2011; thus, we are revising GDP-growth upwards from 4.5% in our spring forecast to 6.7%. Exports remain the biggest contributor to growth, but investments will complement exports as a growth engine. Households have picked up their demand more than expected so far this year. Going forward, export growth is set to slow after the bounceback, in line with weaker global demand. As imports pick up even further, the trade surplus will decrease. Unemployment will fall to 11.6% in 2013, but, as activity rates are also higher, the speed of improvement will slow. The problem of long-term unemployment will remain, and the shortage of skilled workers in certain sectors will tend to increase wage growth. With inflation this year close to 5%, households’ real incomes have grown slower, but as inflation falls to 2.5-3% real wage growth increases, households are in for better times. Thus, private consumption growth will remain on the high side. One risk is that wage growth will be higher than productivity growth, and that inflation will stay higher than in competing markets, thus reducing competitiveness. The government will continue with its prudent fiscal policy, and Estonia’s debt-to-GDP ratio will remain among the lowest in the world.

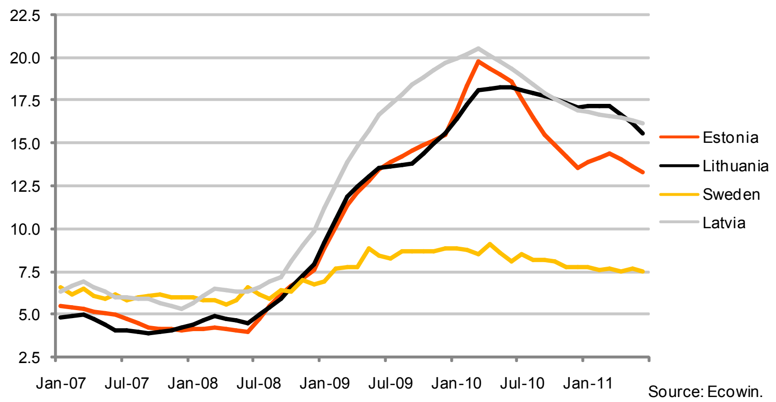
Although Latvia has grown slower than Estonia and Lithuania during the recovery, in the second quarter growth accelerated. We are revising GDP growth for 2011 upwards from 4% to 4.2% on the back of stronger-than-expected data for the first half of the year, even though weaker growth is now expected in the second half. We are reducing the forecast for 2012 to 3.5% (3.9% before), as export and investment growth will decelerate, owing to slowing global demand. The euro introduction in 2014 is still included in our main scenario, therefore lifting growth for 2013 (3.9%) due to confidence effects. However, there are considerable risks for the euro introduction, such as holding back inflation while cutting the deficit. In a worse global scenario, it may become more difficult to cut the deficit but easier to fulfil the inflation criterion due to lower commodity prices. Even if there is a political determination to fulfil the criteria, challenges will increase. The general elections in September raise uncertainties with regard to the budget and the structural reforms. The unemployment rate is falling, and we foresee it at 11.8% in 2013, thus slowly improving the situation of households. It is important that the wage bill not increase too fast at this early stage of the recovery, as this would endanger competitiveness going forward.

Lithuania’s growth also exceeded our expectations in the first half of the year, mainly due to a better investment performance. Households have picked up their demand faster than envisaged. Thus, we are revising GDP growth for 2011 upwards from 4.2% to 6.3%. Together with better lending conditions and lower unemployment – a 10.5% rate is foreseen for 2013 – the lower inflation forecast will strengthen the position of households. Also, government policy will become expansionary approaching the parliamentary elections at the end of 2012. During 2012- 2013, GDP will grow by 4.5% or just above. In a worse global scenario, it would be harder to fulfil the Maastricht criteria. Even under the main scenario, the upcoming elections may prevent fulfilment of the criterion of a deficit of 3% of GDP. There is thus a risk that the euro adoption will have to be postponed, and in order to fulfil the goal, budget consolidation needs to stay on track.

The world economy may be off track in its efforts to reach sustainable growth. This means negative risks for our open and export-dependent countries. Now is the time to ensure that we can face global instability, by remaining prudent on fiscal policy, continuing with structural reforms, and striving for political responsibility across party lines.

*Cecilia Hermansson*

**Unemployment rates (% of labour force)**




Source: Ecowin.

# The global recovery slows

Since our spring forecast, economic developments have disappointed. The recovery has slowed in the US, Japan, and crisis-struck countries in Europe, such as the UK and Portugal, Italy, Ireland, Greece, and Spain (PIIGS). Emerging markets and Northern Europe have kept up relatively well. However, purchasing managers' indices (PMIs) show that industrial production no longer is expanding in most parts of the world.

Above all, sentiment has worsened, as shown by the nervous developments in the financial markets and by business and household confidence surveys. Share prices fell sharply as growth pessimism rose and fear increased when the debt crises in the advanced economies worsened. The difficulties for US politicians in raising the debt ceiling and agreeing on a medium-term budget consolidation plan, caused a downgrade of the triple-A US credit rating. Together with the spreading of the euro zone debt crisis to larger countries such as Spain, Italy and even France, this has caused panic in the global financial markets. If continued – and with the underlying negative fundamentals – there is a risk that the worsened sentiment in itself can lead to a new global recession.

## Uncertain times – three scenarios are needed

The timing of our autumn forecast is by no means optimal, as forecasting parameters such as asset prices, currencies, commodity prices, and interest rates are changing daily without a clear trend. In addition, the world economy is dependent on politicians' and central bankers' decisions, and, as these also change daily, mainly in reaction to financial market actions, the uncertainties surrounding the forecast are larger than ever. Compared with our spring forecast, however, inflationary risks have decreased and sovereign debt risks have increased.

In our main scenario, to which we give 60% probability, global growth increases by 3.5-4 % per year over the forecast horizon, i.e. in 2011-2013. This is a muddling-through scenario, where annual growth in the advanced economies on average falls just below 2% but stays positive, and where up to two-thirds of the world economy's growth is driven by emerging markets. Commodity prices fall, and interest rates are kept at extremely low levels for an extended period of time in the US, Japan, and, although to a lesser extent, Europe. Economic policy tools are almost exhausted, as policy interest rates already are low, new quantitative easing – if used – are not as effective as before, and fiscal policy moves into a period of austerity. Volatility on the financial markets will continue on the high side. The politicians' response to the debt crises will be in a muddling-through mode as well. A full-blown collapse of the euro is avoided, however, as the larger euro zone economies speed up reforms to calm financial markets.

We give a 30% probability to a worse scenario, where the world economy enters a new recession, and with global GDP growth again falling below 2% next year. Already now, Japan – due to the earthquake, tsunami, and nuclear power plant accident in March – is experiencing a recession, and, if other advanced economies shrink, there is a risk that Japan will continue its subpar performance despite the rebuilding in the crisis-struck region. Although emerging markets will be negatively affected, they have room for stimulus and thus will counteract part of the slowdown. Many emerging markets still have problems of overheating, though, making it difficult for them to create the same amount of stimulus as during the last recession in 2008-2009. In this scenario, the social unrest that follows a period of slow growth and high unemployment increases, causing both economic and political instability. The PIIGS countries and the UK are particularly vulnerable, especially with austerity picking up and the risk of riots escalating.

The forecast risk profile is skewed, as the probability for a better scenario, i.e., reaching a global growth rate close to or above 5% next year, is seen at only 10%. The factors driving this scenario are the financial markets currently and only briefly holding an overly pessimistic view, growth slowing only temporarily, and companies facing lower costs due to recent lower commodity prices and an easing of price and wage pressures, enabling

**GDP forecast, 2010 - 2013 (annual percentage change)** [1/]

| | | August 2011 | | | | April 2011 | | |
|---|---|---|---|---|---|---|---|---|
| | | 2010 | 2011 | 2012 | 2013 | 2010 | 2011 | 2012 |
| US | | 3.0 | 2.1 | 2.3 | 2.7 | 2.9 | 3.0 | 3.0 |
| EMU countries | | 1.8 | 1.7 | 1.3 | 1.3 | 1.7 | 1.5 | 1.5 |
| Of which: | Germany | 3.6 | 2.9 | 1.8 | 1.6 | 3.6 | 2.4 | 1.9 |
| | France | 1.4 | 1.5 | 1.5 | 1.4 | 1.5 | 1.5 | 1.6 |
| | Italy | 1.3 | 0.8 | 0.7 | 1.0 | 1.3 | 0.9 | 1.0 |
| | Spain | -0.1 | 0.6 | 0.8 | 1.2 | -0.1 | 0.3 | 1.0 |
| UK | | 1.3 | 1.3 | 1.6 | 1.8 | 1.4 | 1.5 | 1.8 |
| Japan | | 4.0 | -0.2 | 2.8 | 1.4 | 4.0 | 0.6 | 3.0 |
| China | | 10.3 | 9.0 | 8.4 | 8.0 | 10.3 | 8.8 | 8.4 |
| India | | 10.4 | 7.8 | 7.5 | 7.5 | 9.1 | 8.0 | 7.5 |
| Brazil | | 7.5 | 3.8 | 4.1 | 4.5 | 7.5 | 4.3 | 4.0 |
| Russia | | 4.0 | 4.5 | 4.4 | 4.2 | 4.0 | 4.6 | 4.5 |
| Global GDP in PPP | | 5.0 | 3.8 | 3.9 | 3.8 | 4.9 | 4.1 | 4.2 |
| Global GDP in US$ | | 4.1 | 2.9 | 3.1 | 3.1 | 4.0 | 3.2 | 3.4 |

Sources: National statistics and Swedbank.

1/ Countries representing around 70 % of the global economy. The World Bank weights from 2010 have been used, which raises total figures by 0.1. to 0.2 percentage points compared with our Spring forecast when 2009 weights were used them to perform better, with higher profits leading to higher investments and more recruitments. Confidence in politicians must also strengthen in order for this higher growth scenario to be realised.

## Deleveraging means slower growth

Compared to our spring forecast, global growth has been revised downwards by 0.3 percentage points for each of the years 2011 and 2012. During 2011, while growth in the US and Japan has been revised downwards, Germany's and China's have been revised upwards due to developments at the beginning of the year. Next year, deleveraging in both the private and public sectors will reduce growth further, especially in the crisis-struck economies, although other countries will also be affected. We also foresee stronger growth in the US, Japan, and – not least – the emerging markets than in most parts of Europe.

The structural problems with regard to US labour, housing, and credit markets are lingering, and, together with the mistrust in politicians, are slowing the recovery. GDP grew by 1.8% in annual terms in the first half of this year, and much slower in annualized terms at 0.8%. We have revised 2011 growth downwards from 3% in our spring forecast to 2.1% – and are still

**Interest and exchange rate assumptions**

| | Outcome | Forecast | | | | |
|---|---|---|---|---|---|---|
| | 19 Aug 2011 | 31 Dec 2011 | 30 Jun 2012 | 31 Dec 2012 | 30 Jun 2013 | 31 Dec 2013 |
| Policy rates | | | | | | |
| Federal Reserve, USA | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 |
| European Central Bank | 1.00 | 1.50 | 1.50 | 1.75 | 2.00 | 2.00 |
| Bank of England | 0.50 | 0.50 | 0.50 | 0.50 | 1.00 | 1.50 |
| Bank of Japan | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| Exchange rates | | | | | | |
| EUR/USD | 1.44 | 1.42 | 1.38 | 1.35 | 1.35 | 1.30 |
| RMB/USD | 6.40 | 6.16 | 6.00 | 5.79 | 5.64 | 5.44 |
| USD/JPY | 77 | 80 | 83 | 85 | 87 | 90 |
| EUR/GBP | 0.87 | 0.88 | 0.85 | 0.83 | 0.80 | 0.77 |

Sources: Reuters Ecowin and Swedbank projections.

expecting some improvement in the second half of 2011 – and to 2.3% in 2012 and 2.7% in 2013. The Federal Reserve will keep the policy rate at 0.25 % until mid-2013 at least, but fiscal austerity will then kick in, and, without the extension of earlier tax cuts, could begin already next year. Although the US needs more fiscal stimulus in the short term, it should cut expenditures and increase taxes more than envisaged in the medium term.

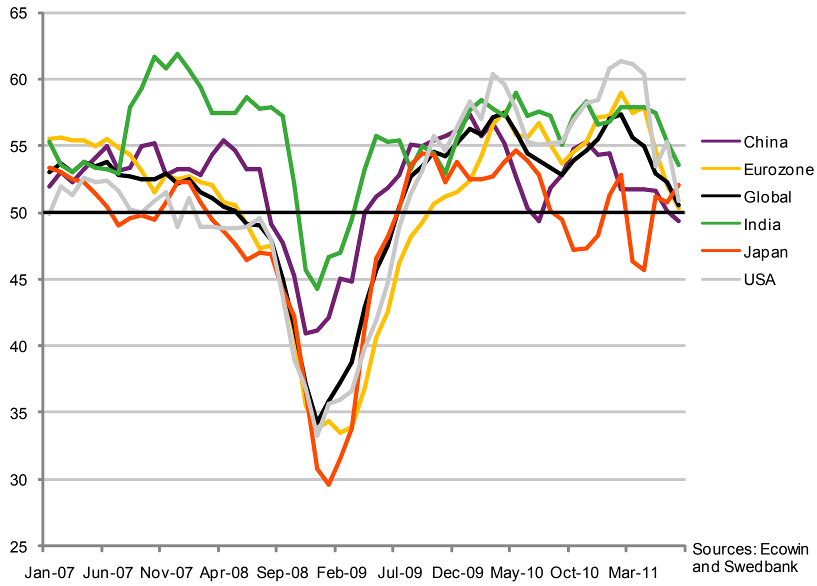
GDP growth in the euro zone will be revised upwards this year, mainly due to stronger developments in Germany in the first quarter, where growth was spurred by demand from emerging markets, the euro depreciation, and lower unemployment. After the bounceback effects, we foresee German growth slowing from 2.9% this year to 1.8% in 2012 and to 1.6% in 2013. Developments have been much more negative in the PIIGS countries, where deleveraging and higher unemployment are slowing demand. All in all, GDP growth in the euro zone is expected to slow from 1.7% this year to 1.3 % in 2012 and 2013.

We foresee that the pressures the ECB is putting on the larger economies, such as Italy and Spain, in order for purchases of these countries' government bonds to continue, will speed up the reform process. In addition, support mechanisms such as the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will be adjusted in terms of mandates and size. The coordination of fiscal policy will improve, as this crisis has proved such coordination is necessary in order to sustain the monetary union.

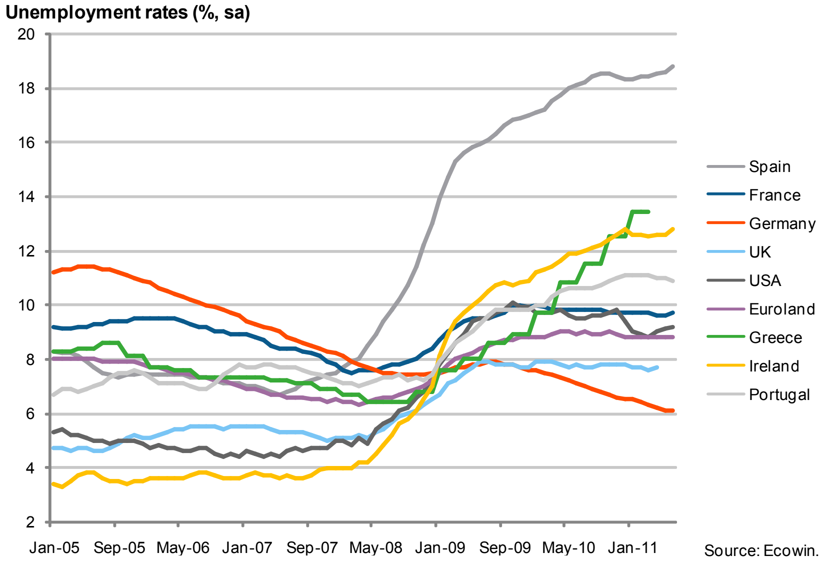
Japan's GDP fell during the first half of this year, and we now foresee GDP shrinking by 0.2% in 2011 before increasing by 2.8% next year, as reconstruction will take off later this year. In 2013, we expect growth coming back to around the trend of 1.5%. Prime Minister Naoto Kan is foreseen to leave office this month after a less-than-successful handling of the crisis. Also, Japan needs to speed up reforms to increase growth and reduce public debt in the medium term.

China has continued to surprise on the upside, thus prompting us to revise growth this year upwards to 9%.

**Purchasing managers' indices for manufacturing**




Sources: Ecowin and Swedbank




However, there are signs, albeit mild, of slower growth going forward, and growth is expected to slow to 8.4% in 2012 and 8% in 2013. China will continue to appreciate the renminbi by some 6% against the US dollar annually; this is also in line with its goal of stronger domestic demand and a drop in inflationary pressures from the current rate of 6.5%.

India and Brazil are also fighting overheating tendencies, as in both countries demand exceeds capacity and credit growth has been too high. For both, fiscal policy should be restrictive, and more investments in infrastructure and education are needed. Brazil and Russia will be negatively affected by lower commodity prices going forward, while India will benefit from a lower oil price.

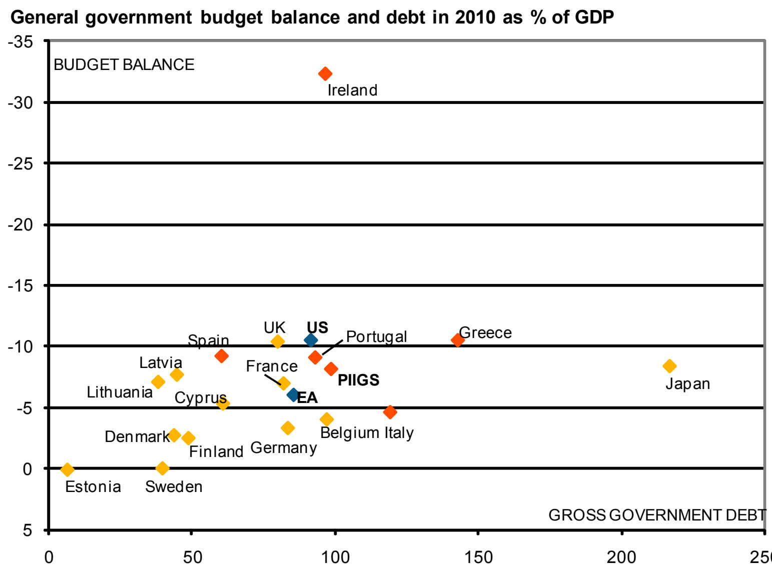
We expect the oil price to average $107 this year, which is, due to rapid increases in the beginning of the year, somewhat higher than in our spring forecast. It is then foreseen to fall to $97 next year and $94 in 2013, all in line with slower demand from advanced economies. Industrial metals and food prices will fall from the high levels seen so far this year due to higher supply and lower demand. As commodity prices fall, the concerns about high inflation will decrease. The inflation rate will abate in both advanced and emerging economies.

In advanced economies, the slow recovery of labour markets will ease wage pressures, and, together with weak demand, price pressures will be held back.

As the Federal Reserve explicitly indicated policy interest rates would stay exceptionally low until at least mid-2013, the large advanced economies will keep policy interest rates at zero or just above for a long time. This means that inflationary expectations can start to rise, thereby pressing down real interest rates. As the US is expected to have higher growth going forward, and the US dollar has already depreciated extensively, we foresee some appreciation against the euro, although not immediately. The yen will depreciate and the renminbi will appreciate against the dollar, and the pound will appreciate against the euro as UK growth outperforms euro zone growth.

In our main scenario, the recovery, although still on, will be slower than we expected in the spring, and the sentiment will be much more negative. The risk for a worse scenario is large and, going forward, should not be neglected. On the other hand, if confidence in the political process improves, the recovery could speed up again.

*Cecilia Hermansson*



# Sweden: Focus on economic policy

Despite volatile developments around the world, the Swedish economy continued to grow steadily in the first two quarters of 2011, and the full impact of uncertainties surrounding debt sustainability in the euro zone and the US is yet to be seen. The export sector benefited from higher demand and was also supported by improving competitiveness from strong productivity growth and moderate wage developments. Private consumption, however, unexpectedly slowed in the first half of the year as many households were struggling with rising prices and interest rates, and a slow recovery of the labour market. Investments grew, but still remained below levels seen before 2008.

We expect growth to slow in the remainder of 2011, and during 2012 and 2013. Increased uncertainty regarding future external and domestic demand is expected to lead to a hesitation on the part of both households and companies, limiting consumption and investment growth. We thus project the annual growth rate for 2011 at 4.3%, which, although higher than our April forecast, reflects the strong growth in early 2011 and significant carryover effects from 2010. Growth rates are projected to continue to decline in 2012 and 2013 to 2.2% and 2.3%, respectively, on the back of the slowdown in global growth.

Global economic volatility has flared up recently, with large drops in stock exchange values and significant rises in risks to future growth prospects. This greatly enhances the uncertainty that surrounds our main forecast scenario. Although we have lowered the overall global growth projections, the possibility of another freeze-up of the kind we saw in 2008 has increased. This would severely affect the Swedish economy as it remains very interconnected with the rest of the world, in terms of capital flows and export markets.

However, in a worst-case scenario, we do not expect developments in Sweden to be as severe as in 2008, but Sweden would not be spared. The main difference is that the financial sector today is less vulnerable to developments in the Baltic economies. Although banks today are better positioned than was the case in 2008, new liquidity constraints could arise. With the stability shown by Swedish fiscal policy, there is room for substantial measures to cushion a downturn, although it is not as likely that the krona would weaken as much this time. Domestically, the main risks originate from a significant worsening of the housing market, which could have a sharp negative effect on domestic demand. The Riksbank has the capability of limiting the downturn by easing monetary policy. In contrast to many other economies in the industrialised world, Sweden still has tools left in the toolbox.

**Key Economic Indicators, 2010 - 2013 1/**

| | 2010 | 2011f | 2012f | 2013f |
|---|---|---|---|---|
| Real GDP (calendar adjusted) | 5.4 | 4.3 | 2.2 | 2.3 |
| Industrial production | 14.3 | 11.8 | 4.5 | 3.0 |
| CPI index, average | 1.2 | 3.1 | 2.3 | 2.4 |
| CPI, end of period | 2.3 | 2.8 | 2.1 | 2.1 |
| CPIF, average 2/ | 2.0 | 1.6 | 1.7 | 2.0 |
| CPIF, end of period | 2.3 | 1.3 | 1.5 | 1.9 |
| Labour force (15-74) | 1.1 | 1.2 | 0.6 | 0.4 |
| Unemployment rate (15-74), % of labor force | 8.4 | 7.5 | 7.2 | 6.9 |
| Employment (15-74) | 1.0 | 2.2 | 1.0 | 0.7 |
| Nominal hourly wage whole economy, average | 2.5 | 2.4 | 3.1 | 3.3 |
| Nominal hourly wage industry, average | 2.8 | 2.5 | 3.3 | 3.3 |
| Savings ratio (households), % | 10.8 | 10.2 | 9.8 | 9.0 |
| Real disposable income (households) 3/ | 1.4 | 1.8 | 1.3 | 1.3 |
| Current account balance, % of GDP | 6.1 | 7.3 | 7.2 | 6.7 |
| General government budget balance, % of GDP 4/ | -0.2 | 0.3 | 0.4 | 0.6 |
| General government debt, % of GDP 5/ | 39.7 | 35.0 | 34.0 | 31.5 |

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

## Exports decelerate as global demand weakens

The Swedish export performance in the first half of 2011 was stronger than expected. This was mostly due to a sharp increase in the first quarter, while the growth rate decelerated in the following quarter. Global trade continued to be advantageous for Swedish exporters as the demand for investment and intermediate products continued to rebound after the deep decline during the global financial crisis 2008. Lower unit labour costs due to high productivity growth and limited wage increases strengthened the competitiveness.

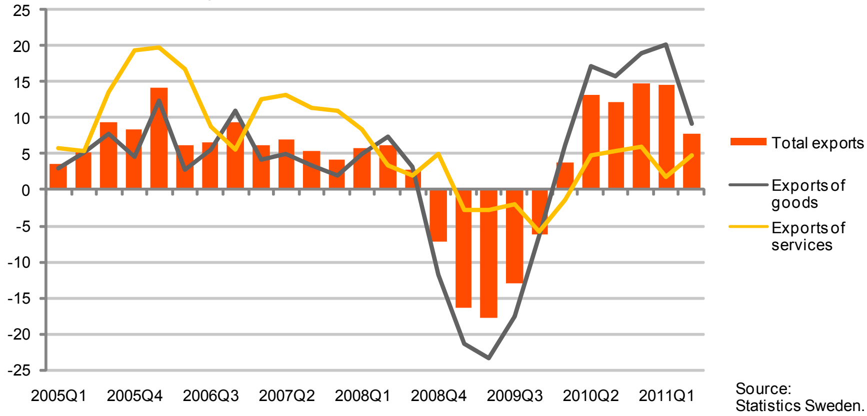
Export of goods like vehicles and machinery showed the highest growth rates, while growth of services was modest, due to weaker tourism and merchanting. The importance of the Asian market for Swedish exports continues to grow. However, although the export share to the European market is decreasing, it is still the largest market and accounts for nearly 70% of total Swedish exports. Export deliveries to the US market showed a surprisingly strong performance in the first half of 2011, mainly of cars and telecom products, despite the large domestic problems in the US. It is now the fourth-largest export market for Sweden.

We foresee a further deceleration in Swedish exports in coming months due to weaker global demand. The latest statistics suggests the growth peak in Swedish exports has passed. In June, the value of exports fell by 5%, and growth in new orders has weakened. The Swedish purchasing managers' index (PMI) fell in July to 50.1, which is the lowest level since the spring of 2009. Strong export growth at the beginning of 2011 will, however, lift average export volume growth to nearly 9% this year, which is an upward revision from 7.6% in April.

The world economy is expected to grow at a slower pace in 2012 than we foresaw in the spring. We assume the demand for investment goods will be relatively strong in the emerging market but more subdued in several OECD countries, for which the restocking process is ending and fiscal policy is being tightened. Thus, world market growth for Swedish exporters is expected to decline over the next two years, and Swedish export volumes are anticipated to grow at below the long-term trend. We foresee a loss of market shares during the coming two years as competitiveness will be less favourable due to higher unit labour costs and a stronger krona. The value of the krona is expected to appreciate from current levels in our main scenario. In contrast to the crisis in 2008, the Swedish economy now seems to be perceived as more stable.

The growth contribution of foreign trade to GDP is expected to vanish in 2012 and 2013 from 0.8% in 2011; external demand will be weaker, while domestic demand will be relatively solid. We therefore foresee a reduction in the current account surplus to 6.7% of GDP in 2013 from 7.3% this year.

**Export sector, annual growth rate (%)**




Source: Statistics Sweden.

## Investments are losing speed

Gross fixed investment has increased since the end of 2009 but is still below its peak at the beginning of 2008. During the first six month of 2011, total investment volumes increased by 8.1% compared with same period last year. The highest growth rate was found in real estate, spurred by tax reductions for renovation, relatively low interest rates, and better labour market conditions. Investment in manufacturing also picked up strongly, particularly in the mining and auto industries, while private services grew less quickly. Public investment continued to expand, partly due to ongoing investments in infrastructure.

Since we published the Swedbank Economic Outlook in April, business confidence has deteriorated and the momentum in global growth has weakened. Thus, we are lowering our projected investment growth to 8.1% in 2011. While private sector investment are expected to grow slower than previously forecast, growth in real estate and public investment will become stronger.

Next year, we expect investment activity to decelerate further, and the utilisation rate to fall as profit margins in the private sector shrink. Although the increase in nominal interest rates will be smaller than we forecast in the spring, investment in real estate will gradually slow. Uncertainty surrounding housing prices, and a decreasing use of tax reductions for rebuilding after the strong growth in 2010 and 2011, will have a limiting effect on real estate investments. We are revising public investment upwards in 2012 and expect continued growth in 2013, as the government responds to a slowdown in economic growth. In particular, investment in road and railroad maintenance is expected to be prioritised.

## Labour market recovery uneven

The decline in the unemployment rate continued during the first half of 2011, albeit at a slower-than-expected rate. The seasonally adjusted unemployment rate reached 7.5% in June, down only marginally from 7.6% in February. Mainly, this is a result of a growing participation in the labour force. It suggests that the reforms of the sickness benefit systems and, more generally, the improvement of the economy are drawing an increasing share of the population back into the labour market. The strong growth in employment during the first half of the year has, thus, supported the recovery of the economy, but left the

**Swedbank's GDP Forecast – Sweden**

| Changes in volume, % | 2010 | 2011f[1/] | | 2012f[1/] | | 2013f |
|---|---|---|---|---|---|---|
| Households' consumption expenditure | 3.4 | 2.5 | (2.8) | 1.8 | (1.9) | 2.2 |
| Government consumption expenditure | 2.5 | 1.3 | (1.3) | 0.7 | (0.4) | 0.8 |
| Gross fixed capital formation | 7.1 | 8.1 | (9.7) | 6.7 | (8.3) | 4.8 |
| private, excl. housing | 4.7 | 7.3 | (11.3) | 8.7 | (11.2) | 5.8 |
| public | 4.4 | 4.7 | (2.6) | 1.1 | (-0.1) | 2.9 |
| housing | 20.0 | 14.3 | (11.4) | 5.3 | (5.3) | 3.2 |
| Change in inventories [2/] | 2.1 | 0.4 | (0.0) | -0.5 | (-0.3) | 0.0 |
| Exports, goods and services | 11.0 | 8.7 | (7.6) | 4.9 | (5.6) | 4.6 |
| Imports, goods and services | 12.8 | 8.0 | (7.5) | 5.5 | (6.6) | 5.2 |
| GDP | 5.7 | 4.3 | (4.0) | 1.8 | (2.2) | 2.3 |
| GDP, calendar adjusted | 5.4 | 4.3 | (4.0) | 2.2 | (2.6) | 2.3 |
| Domestic demand (excl. inventories) [2/] | 3.8 | 3.2 | (3.5) | 2.5 | (2.6) | 2.4 |
| Net exports [2/] | 0.0 | 0.8 | (0.5) | 0.0 | (-0.1) | 0.0 |

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

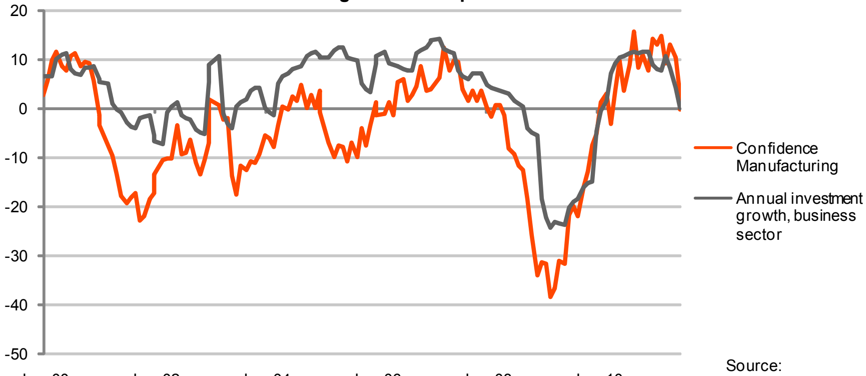
unemployment rate stubbornly high.

The expansion in employment has not, however, been equally distributed across the population, and it is becoming harder for certain groups to find permanent jobs. Young people have seen their unemployment rate increase at an alarming rate, and, in particular, it is significantly more difficult for the foreign born to find jobs. Lack of recognized qualifications and language skills, and few connections to the regular labour market, together with employer attitudes, explain the bulk of this outcome, but the importance of the challenge nevertheless remains huge. Prolonged absences from the labour market have life-long effects on employability and income, and the benefit of increasing the employment rate amongst all groups will also be substantial in an aging society like Sweden's.

Wage pressures were until end-May far lower than anticipated. Annual rates resumed their declining trend in early 2011 after stabilising at around 2% in mid-2010. However, the impact on total earnings and, thus, domestic demand, is partly offset by growing employment and a steady increase in hours worked, both of which continued to grow in the first two quarters of 2011. Growing labour supply and a still-high unemployment rate are likely to limit wage drift, but pressures are building up in anticipation of the broad wage negotiations that will start in early autumn. The limited wage increases so far, will allow real wages to increase without threatening the competitiveness of the private sector. However, the recent turmoil in global markets and the risks to global growth would argue for a flexible shorter-term agreement that could be adjusted as the global demand situation becomes clearer.

We expect that the unemployment rate will continue to decrease, but, given that structural unemployment is growing as a share of the remaining unemployment, each additional point of decline will become harder to achieve. Following the slower rate of decline in unemployment observed so far during 2011, we are revising our unemployment projection upwards for 2011 and 2012 to 7.5% and 7.3%, respectively. While we expect that the government will continue its reforms over the next two years, aimed mainly at increasing the labour supply, our assessment is that unemployment will only gradually decline to reach 6.5% at the end of 2013. Nominal wage growth will pick up slightly, and with inflationary pressures easing, real wages will turn positive. Productivity developments will remain supportive of a continued real, but stable, expansion of the Swedish economy in our main scenario.

**Business confidence and investment growth in the private sector**



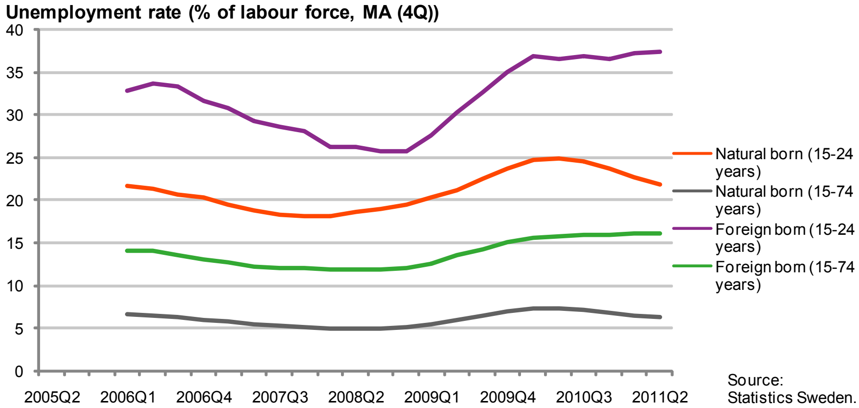

Source: Statistics Sweden.

## Households are holding back

Despite an otherwise solid economic recovery in the first half of 2011, households showed a weak inclination to scale up consumption. Higher energy prices, together with growing interest costs, weakened growth in real disposable income. Wage increases have been muted, and disposable income has not provided sufficient room for consumers to maintain the expansion seen in 2010. In particular, households cut back on durables following the significant bounceback seen late last year. In addition, lending to households increased at a slower rate. In the summer months, however, consumption of both consumables and durables were again mildly picking up.

Households' sentiment is rapidly becoming less optimistic and the recent turmoil in the global markets and on the stock exchange is likely to further increase consumer anxieties. We, thus, expect overall consumption growth for 2011 to be more moderate than in our April forecast. Although the renewed worries about global economic developments could lead to falling short-term interest rates, such an outcome would also lower consumer confidence, reducing the willingness to spend. In particular, consumers have already lowered their assessment of the overall macroeconomic conditions in Sweden, while so far maintaining a steady view of their own financial situation, including employment. This suggests that, while personal finances remain stable in our main scenario, external conditions will continue to weigh down

**Unemployment rate (% of labour force, MA (4Q))**




Source: Statistics Sweden.

on consumption in 2011.

Looking forward, we expect that the households' financial situation will improve moderately in 2012 and 2013, when real disposable income increases by 1.3% in both years. In our main scenario, real disposable income growth falls back in 2012 due to weaker labour market developments. In addition, and in contrast to our April projections, we do not expect the fifth step of the earned income tax credit to be implemented in 2012, and also not in 2013. This implies that household consumption growth is to increase modestly in 2012, and that the savings ratio will fall but by less than in our previous projections. This is consistent with growing uncertainties among households and in financial markets. In 2013, we expect consumption growth to pick up moderately as labour market conditions improve and uncertainties are reduced. Consequently, the household savings ratio should drop to towards 9% of disposable income.

Households' balance sheets are still vulnerable, in particular, against swings in the housing market. A worsening of international conditions with a subsequent rapid increase in unemployment could trigger a correction in housing prices, and put downward pressure on private consumption. Household debt is still high, but we expect a slower rate of increase in our base scenario, reaching about 180% of disposable income in 2013. The debt burden could, however, become onerous should the economic situation worsen.

## Monetary policy actions headed for a pause

The Riksbank has continued to tighten monetary policy since our April report, and by the end of July the policy rate had been raised twice to reach 2%. This follows the preannounced policy path and is in line with the stated intention to gradually normalise monetary policy. Headline inflation (CPI) has exceeded 3% at an annual rate, but, excluding the effects of interest costs (CPIF), inflationary pressures have decreased.

The recent large swings in global markets, together with the downward revision of global growth projections, calls into question future policy rate increases. Although the Swedish economy has recovered relatively rapidly, the experience from the 2008 crisis illustrates how vulnerable it is to shifts in external demand. We therefore believe that the Riksbank, as a precaution, will put on hold further increases during 2011.

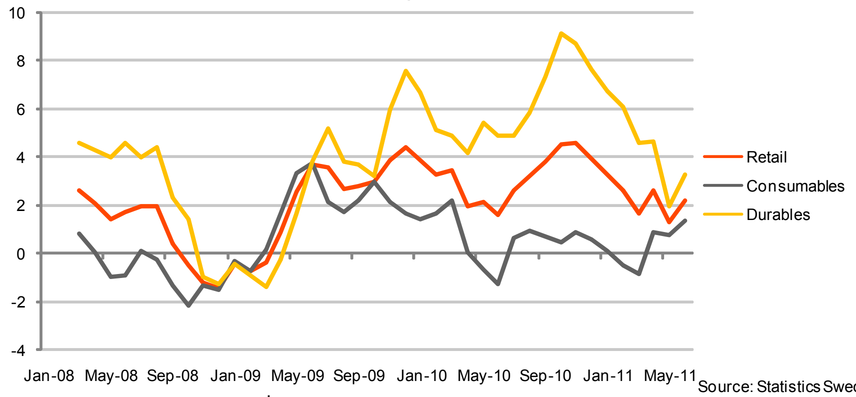
Besides inflation expectations, a key question for monetary policy is the extent to which the economy is operating at full capacity. This is usually measured through estimations of the output gap, i.e., the difference between how much is actually produced in an economy and what could be produced without creating inflationary pressures. The calculations of the output gap are often imprecise and vary amongst sources. For example, this spring the Ministry of Finance estimated the output gap for 2010 to be 3.8% of potential GDP, while the Riksbank's calculation ranged from 2.5% to 3.6% of potential GDP. The gap was even larger, according to the National Institute for Economic Policy Research (NIER) (4.3%) and OECD (4.5%), while the IMF estimated it to be around 3%. The estimate of the output gap guides the rate at which monetary policy should be tightened, and the wide range of estimates illustrates the uncertainty that surrounds future policy rate increases. In our view, the recent slowdown in global growth and our downward revision of Swedish growth for 2012 suggest that monetary policy tightening will enter a slower phase; we expect the policy rate to reach 2.75% by the end of next year, compared with 3% in our April forecast.

At the forefront of the Riksbank's considerations is, however, the inflation outlook. Lower inflation expectations, together with projected slower growth in commodity prices and a modest increase in wages imply that CPIF inflation is expected to drop to around 2.0% at end-2013. Mainly, underlying inflation is driven by food and transport related expenses, while CPI is also affected by increasing interest rates. A projected appreciation of the krona will limit import prices, and lessens the need for future rate increases. Thus, we anticipate the repurchase rate to be raised to 3.00% by the end of 2013, following one rate hike that year.

## Weak government – too-tight fiscal policy?

The implementation of fiscal policy in Sweden throughout the global financial crisis has in large part been a success. Some critics, we included, argued for a larger and more rapid fiscal stimulus during the nadir of the crisis, but, given the uncertainty of the severity of the downturn at the time and the lag of fiscal policy effects on the real economy, the hesitation of the government was understandable. As concerns over global economic developments are again rising and their impact on the Swedish economy is uncertain, policymakers are again faced with a difficult trade-off. On the one hand, fiscal balances could

**Household consumption patterns (annual change, 3m ma.)**




Source: Statistics Sweden.

**Interest rate and currency outlook**

| | Outcome | Forecast | | | | |
|---|---|---|---|---|---|---|
| | 2011 19Aug | 2011 31 Dec | 2012 30 Jun | 2012 31 dec | 2013 30 Jun | 2013 31 Dec |
| Interest rates (%) | | | | | | |
| Policy rate | 2.00 | 2.00 | 2.25 | 2.75 | 3.00 | 3.00 |
| 10-yr. gvt bond | 2.00 | 2.55 | 2.65 | 3.15 | 3.40 | 3.35 |
| Exchange rates | | | | | | |
| EUR/SEK | 9.20 | 9.20 | 9.05 | 8.95 | 8.90 | 8.80 |
| USD/SEK | 6.39 | 6.48 | 6.55 | 6.62 | 6.60 | 6.76 |
| TCW (SEK) 1/ | 124.0 | 124.0 | 123.0 | 122.0 | 121.5 | 121.0 |

Sources: Reuters Ecowin and Swedbank.

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

worsen significantly should a global slowdown hit the Swedish economy, and the government should therefore be careful in proposing reforms that could weaken the fiscal position. On the other hand, the Swedish economy is still recovering from the 2008 crisis, and, facing a renewed slowdown, there is room and a need for stimulus to speed up the reduction of unemployment.

Despite a slight downward revision of the fiscal balance for 2010 to a deficit of 0.2% of GDP, the fiscal accounts have remained resilient, and the fiscal policy goals have largely been met. The solid development continued in the early parts of 2011, although somewhat weaker than expected, private consumption limited growth in indirect taxes. We do not believe that the recent turbulence in global markets will have a major impact on the fiscal balances in 2011, and we expect a surplus of 0.3% of GDP and a continuing fall in public debt to 35% of GDP, partly aided by already realised privatisation revenues corresponding to approximately 0.6% of GDP.

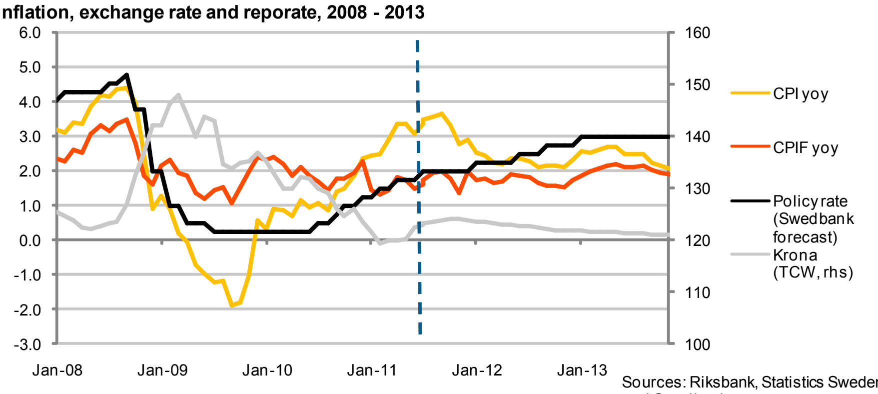
The 2012 budget is likely to be characterised by belt and braces. The Ministry of Finance has announced that planned reductions in tax rates on labour and pensions will be postponed citing concerns over the impact of the global economic turbulence on the Swedish fiscal balances. The weak parliamentary situation for the government likely also plays a role. Instead, buffers are to be maintained so that the fiscal policy goals are not threatened. We believe that this is likely to lead to a fiscal policy in 2012 that is not supportive enough and expect a fiscal surplus of 0.4% of GDP, including the effects of a slowing real economy. There are, in our view, room for measures that support domestic demand in Sweden next year. This could include reductions of tax rates, increased investments and more spending on programmes that aim at reducing long-term unemployment.

The budget process for 2013 will be equally difficult. The opposition parties are likely to continue to oppose the government's plans for a fifth step of the earned income tax credit and raising the tax bracket for state income taxes. The conservatives, the largest party in the government, has suggested that income tax rate reductions will be delayed towards the end of the government term. That would raise the fiscal surplus in 2013 to 0.6% of GDP. Furthermore, the privatisations of state assets will continue, but at a slower pace. In addition to the already realised sales generating SEK 20 billion in 2011, we expect another cumulative SEK 20 billion in 2012 and 2013. At the end of the forecast period, we project gross public debt to correspond to about 31% of GDP

Fiscal policy in the current circumstances has to strike a balance between, on the one hand, supporting the recovery from the 2008 financial crisis to accelerate the reduction of unemployment, and, on the other, making preparations for a significant deterioration in real economic development due to worsening external conditions. While we support the focus on employment, the marginal benefits of the proposed composition of the tax rate reductions are likely to be limited and are also difficult to reverse. Instead, we would argue for increasing spending on growth-enhancing public infrastructure while leaving sufficient room to support local governments without jeopardising the fiscal rules, should economic growth turn out worse than expected. Fiscal measures in times of uncertainties should focus on being temporary, targeted and timely, and aim at keeping down unemployment.

*Magnus Alvesson*
*Jörgen Kennemar*

**Inflation, exchange rate and reporate, 2008 - 2013**




Sources: Riksbank, Statistics Sweden and Swedbank.

# Estonia: Domestic demand supports growth

Economic developments during the first half of this year were very strong, overshooting our expectations in most areas – economic growth reached above 8% on average during the first half of the year. The economic recovery continued to be based on export growth, which amounted to 54% during the first half-year. Manufacturing production, as the main source for exports, grew by 36% during the same period. Higher-than-expected domestic demand growth was supported by recovering investments (37% growth in the first quarter), fuelled by growing investments in machinery and equipment, as well as construction. In addition, an earlier-than-expected pickup in private consumption (5% growth in the first quarter) added positively to economic growth. Also, government consumption has resumed positive growth after two years of decline.

We have raised our economic growth forecast for this year from 4.5% to 6.7%, due to better-than-expected developments during the first half of the year and, consequently, an improved outlook for the second half. Exports remain the biggest contributor to growth, although their impact will weaken during the second half of the year as the global headwinds build up. Economic growth in 2012 and 2013 is estimated to reach 4.2% and 4%, respectively, with domestic demand (especially investments) taking over as the biggest contributor.

The main risks for the Estonian economy continue to be external. In addition to a bigger-than-expected slowdown in the economic growth of the main export partners, possible setbacks to the global economic recovery introduce another set of risks. The negative global developments of 2008-2009 notably affected the Estonian economy, which was then already in the beginning of internally launched recession; however, the consequences for the local economy of a possible global downturn of the same magnitude would be much weaker now because the economy is more balanced. Even though less liquidity in financial markets, together with decelerating export growth, will have an impact on domestic demand, the effect will not be as huge as it was during the previous crisis. Nevertheless, a widespread slowdown of global economy could reduce export volumes; lower investments (especially those of foreign-owned companies) which in turn could dampen job creation and consumption and thus have a negative effect on domestic demand as well.

Another set of external risks involves developments in the global commodity markets. Inflation during the first half of the year was driven by growing food, transport and housing costs, which have had the biggest negative impact on the already budget-constrained households. A further pickup in global food and energy prices from their current high levels would dampen the private consumption recovery, which, despite being above expectations, continues to remain fragile.

The biggest internal risks are connected with labour market developments. Although job creation has been able to match employment growth so far, there are signs of an uneven recovery. Many sectors (e.g., ICT, construction, and health care) are affected by a lack of qualified workers, which, in turn, puts additional pressure on wage growth. A wage rally that outpaced productivity gains would lead to a loss in competitiveness, which has so far been a significant factor in the economic recovery.

**Key Economic Indicators, 2009 - 2013** [1/]

| | 2010 | 2011f | 2012f | 2013f |
|---|---|---|---|---|
| Real GDP | 3.1 | 6.7 | 4.2 | 4.0 |
| Nominal GDP, billion euro | 14.5 | 16.2 | 17.5 | 18.8 |
| Consumer prices (average) | 3.0 | 4.8 | 2.7 | 2.5 |
| Unemployment rate, % [2/] | 16.9 | 13.2 | 12.4 | 11.6 |
| Real gross monthly wage | -2.0 | 2.0 | 3.5 | 3.4 |
| Exports of goods and services (nominal) | 25.5 | 27.3 | 5.0 | 6.1 |
| Imports of goods and services (nominal) | 24.8 | 28.0 | 8.5 | 7.8 |
| Balance of goods and services, % of GDP | 7.3 | 7.9 | 4.8 | 3.4 |
| Current account balance, % of GDP | 6.3 | 6.8 | 3.0 | 2.2 |
| FDI inflow, % of GDP | 8.0 | 9.1 | 8.6 | 8.5 |
| Gross external debt, % of GDP | 114.2 | 102.0 | 95.0 | 92.0 |
| General government budget balance, % of GDP [3/] | 0.1 | 0.1 | -0.8 | 0.0 |
| General government debt, % of GDP | 6.6 | 5.4 | 5.4 | 5.2 |

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.

### Export growth about to decelerate

So far, Estonia's economic growth has been mainly export driven, and the growth in the first half of this year was considerably stronger than we expected (38.9% in real terms). Therefore, we have revised our forecast upwards, also because export growth was more broad based – during the second half of 2010, the main contributor to export growth was machinery and equipment, but this year other sectors have been picking up as well (e.g. wood, food, and metal production). This growth has been supported by stronger-than-expected growth in foreign demand, especially in non-euro area countries like Sweden, Latvia, and Lithuania. Trade with Sweden is mainly related to subcontracting (in machinery and equipment production), while Latvia's and Lithuania's importance to Estonia is growing in energy-related exports. In addition, Russia is gaining importance (mainly, machinery, with about 20% of total exports to Russia; chemicals, 14%; and food products, 12%).

The assumption behind our export growth forecast is that the volumes of machinery and equipment will remain large (and that export sales of electronics will grow more strongly), although the growth rates will wane due to the base effect. Export growth for this year is expected to reach 21.9%; in coming years, the growth rate will be considerably lower (4.9% in 2012 and 4.1% in 2013). We expect the growth rate to decrease somewhat in 2013 as the global economy slows down. Nevertheless, there is a positive risk related to the export growth as Estonia's main export partners are doing relatively well. This is especially true of Latvia, Lithuania, Finland, and Sweden, where Estonian firms have consistently been increasing their market shares. Competitiveness gains will play a role, too, as wage growth is expected to be subdued, and current investments will make future production more effective and less labour intensive.

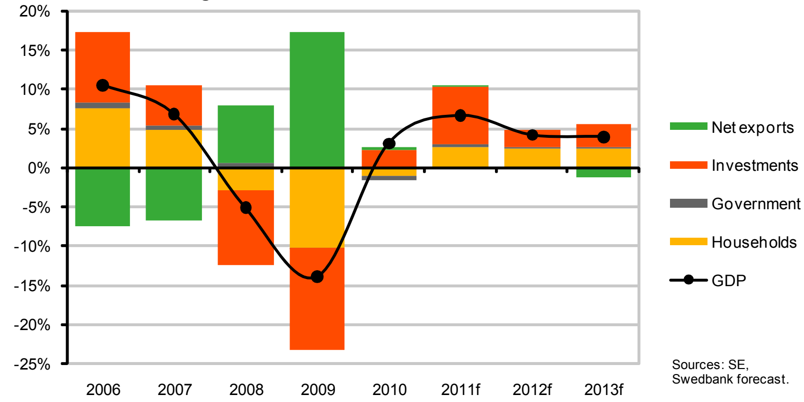
Exports of services will grow more slowly than exports of goods, but the growth rate will be less volatile.

Despite strong external demand, the effect of net exports on economic growth will be only slightly positive, as import growth is also picking up. Imports of goods and services are expected to grow by 21.5% in real terms this year, mainly influenced by strengthening domestic consumption and the increasing need for inputs for exports. Within the next two years, imports will grow faster than exports, reducing the trade surplus during the forecast period.

## Investment growth picking up

Investments decreased considerably during the recession years, showing large negative growth rates in 2008-2010, but strong positive growth rates

**Contributions to GDP growth**




were already present by end-2010. We have revised our forecast upwards due to stronger developments in manufacturing.

Strong growth in industrial production has been supporting the growth in investments – many ill-stayed production technologies have been or are about to be renewed. In addition, there is an increasing need for greater efficiency in the production process; in an environment of rising input prices, a lack of efficiency will harm the competitiveness of exporting enterprises. Accordingly, many firms are already trying to replace and/or renew their outdated production technology and rebuild their production to become less labour intensive, as one of the restrictions on the further growth of firms is the shortage of labour. At the same time, the growth in investments in transport equipment, which was strong already at the end of last year (up almost fivefold from the previous year) and continued to increase rapidly in the first quarter of this year (up almost threefold), will gradually decrease due to the base effect. The inflow of EU funds will also contribute to investment growth throughout the forecast period (so far, only approximately 20% of available funds have been used for the 2007-2013 program period). And, as discussed in our April forecast, we assume that the legal problems affecting the public procurements needed to implement these funds will be solved this year.

Because the net cash flows of enterprises have increased, and this is usually followed by growth in investment and the number of jobs, we estimate that gross fixed capital formation will grow by 23% this year and 12.8% the next. In 2013, this growth will decelerate to 8.9%, due to the base effect and rising uncertainty (see global developments).

In addition, investments will be supported by stronger foreign direct investment (FDI) inflows because the profits of foreign-owned enterprises will have risen. Additionally, this expected increase in inflows of FDI is supported by the relatively good outlook for the development of small-scale production, together with low asset price and wage levels.

Residential investments are about to rise as well – even though the number of transactions in the real estate market will stay modest this year, we predict that interest in rebuilding current housing to be more energy efficient will increase. This interest is affected by the expected increase in energy prices (the electricity market will be open in 2013[1]) and by weather conditions – the

1 Since April 1, 2010, 35% of the Estonian market has been open for large consumers,

**Swedbank's GDP Forecast – Estonia**

| Changes in volume, % | 2010 | 2011f[1/] | | 2012f[1/] | | 2013f |
|---|---|---|---|---|---|---|
| Household consumption | -1.9 | 4.9 | (3.2) | 4.7 | (4.0) | 4.7 |
| General government consumption | -2.1 | 1.4 | (0.5) | 1.6 | (2.0) | 1.3 |
| Gross fixed capital formation | -9.1 | 23.0 | (15.4) | 12.8 | (13.6) | 8.9 |
| Inventories [2/] | 1.3 | 2.5 | (-3.1) | 1.3 | (0.9) | 1.3 |
| Exports of goods and services | 21.7 | 21.9 | (13.5) | 4.9 | (8.7) | 4.1 |
| Imports of goods and services | 21.0 | 21.5 | (10.7) | 5.0 | (11.7) | 5.3 |
| GDP | 3.1 | 6.7 | (4.5) | 4.2 | (4.5) | 4.0 |
| Domestic demand (excl. inventories) [2/] | 0.9 | 6.6 | (5.1) | 5.0 | (6.3) | 5.6 |
| Net export [2/] | 0.3 | 0.2 | (2.4) | -0.1 | (-2.6) | -1.3 |

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

last two winters have been extremely cold. The harsh weather conditions have boosted energy-related costs and, in light of the expected increase in electricity prices in the autumn of 2011, together with the higher price for heating oil (in June 2011), there is a need to improve the energy efficiency of dwellings.

Housing sales will rise next year, along with a rise in incomes and a slowdown in price increases, because there is still a demand for high-quality dwellings. This demand is driven by the relatively small floor area size (30.1 square meters per inhabitant in 2011) and the increase in the number of graduates who entered the labour market a couple of years ago and are now eligible for loans. Moreover, we expect heightened interest from nonresident buyers.

In addition, the next couple of years will be affected by the government's obligation to make several infrastructure- and environment-related investments, to be financed by the revenues from the CO2 (carbon) quota trade. Those investments are planned to increase energy efficiency of state owned institutions' buildings (like kindergartens, schools etc).

or open consumers (an open consumer is a company that uses more than 2 GWh of electricity a year through one connection point, which gives it the right and the obligation to choose its own electricity seller). The choice can be realised through bilateral contracts, direct purchase, or a broker in the Estonia price area of the Nordic power exchange, Nord Pool Spot. The law foresees that the electricity market will be opened fully to all customers in 2013.

**Contributions to annual export growth**


Sources: SE, Swedbank

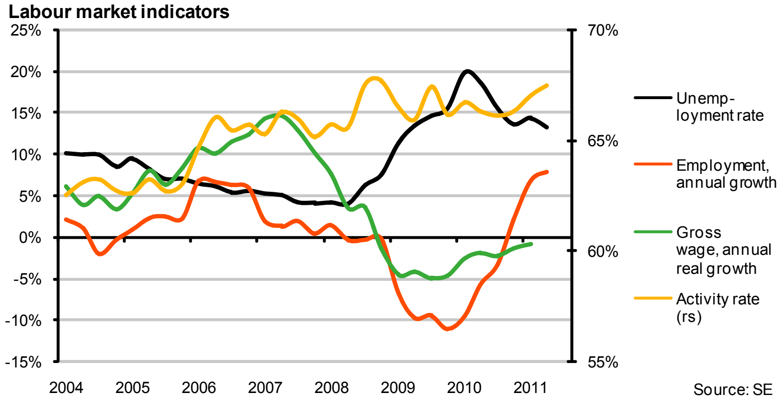
## Employment growing while activity rate remains high

During the recession, both employment and working hours decreased. Developments in the labour market tend to lag economic developments, and we observed an increase in employment and working hours already at the end of last year. Even though the unemployment rate was slightly up in the first quarter of this year (14.4%), developments have since been encouraging – employment grew by a strong 7.8% in the second quarter while the unemployment rate fell to 13.3%; at the same, however, registered unemployment declined from 10.2% to 8.8%. This shows that one should be especially careful in comparing Estonia's unemployment rates with other countries' – in Estonia, the activity rate has been sustainably high, reaching 67.5% in the second quarter, which might be influenced by demographics, as well as by changes in retirement laws (the retirement age for women is gradually raised). This means that there are more people in the labour market (either looking for a job or employed) and fewer inactive (e.g., students, pensioners, caretakers, etc.). And as those who were previously inactive are entering the labour market as unemployed, the share of those looking for jobs is increasing faster than is the total labour force. We forecast unemployment to reach 13.2% this year and 12.4% and 11.6% in 2012 and 2013, respectively. The assumption behind such high unemployment rates is the high activity rate – because of this, even though employment is growing, the unemployment rate will not decrease as fast. In addition, even though the number of unemployed is decreasing, the problem of long-term unemployed will continue to pose a problem for the social system in the long run.

The Estonian labour market of the last few years could be partially characterised by the increase of pendulum migration: individuals remain residents of Estonia, but are working in neighbouring countries. This is especially true in the case of construction and transportation workers. Whether those workers will stay abroad permanently (increase in emigration) or become re-engaged in the local labour market is not yet clear. With the recovery of the domestic construction sector there will come an increased demand for construction workers; these workers might not find the local wage levels attractive enough to return (or this increase in demand might induce another wage-cost push).

In addition, the mismatch of supplied and demanded skills will continue to be one of the major risks for further economic development. The structural unemployment might influence the wage level in certain sectors or groups of occupations that have a more severe

**Labour market indicators**




Source: SE

need for specific skills (e.g., the ICT, electronics manufacturing, and energy sectors), if the immigration policy is not changed and/or the re-education of the unemployed is not encouraged more by the local authorities.

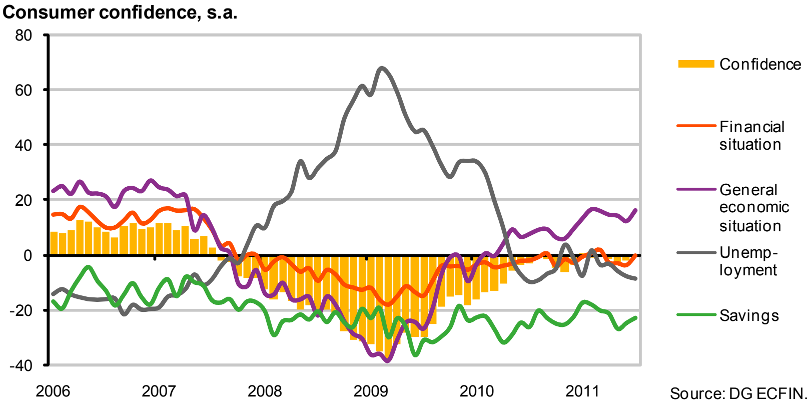
### Consumption is supported by nonresidential spending

The uncertainty that was affecting private consumption in the past few years is gradually fading away – households are less afraid of losing their jobs and more optimistic about future economic developments. The greater confidence has made consumers more willing to spend, which can be observed in the strong growth in private consumption in the first quarter of this year (5.4% annually). More specifically, the main contributor has been the growth of consumption expenditures on durable goods (23.3% annual growth), which might be considered as the indicator of recovering private consumption. We estimate the growth of private consumption for this year to be 4.9% – much higher than we expected in April (3.2%). The main factors driving private consumption are the stronger confidence; the higher income arising from bonuses paid for the year 2010, which boosted consumption at the beginning of the year; and the increasing employment. Similarly, the growing number of tourists visiting Estonia has boosted retail sales. In the next two years, private consumption will continue to grow at strong rates (4.7% in each years), supported by the high confidence level and wage and employment growth, together with the slowing rate of price increases.

At the same time, inflation expectations are still high (even though decreasing a bit during the summer months). This might appear as an obstacle to the further recovery of private consumption. In other words, households' propensity to save is staying high and savings are mainly precautionary – many households are saving to face possible future hardships stemming from higher prices of necessities. Many households are already struggling to make ends meet, and a further increase in food and energy prices will lessen the share of the budget left to spend on other items. We expect prices to increase by 4.8% in 2011, as inflationary pressures from global markets should ease at year's end. Similarly, in 2012 and 2013, prices will grow by between 2% and 3%, as the prices of food products and energy in global markets are expected to decrease.

During the recession, household income decreased due to job losses and/or falling wages. Average real wage growth was already negative by 2009 (-4.5%) and decreased further in 2010 (-2%) – household income accordingly fell considerably. Prices, meanwhile, fell, but for shorter period of time – from May 2009 to February 2010. This short fall in prices was affected by unfavourable developments in global food and energy prices and local tax policy (several taxes were increased in 2009). Recent developments, however, support our estimation of faster wage growth – we expect real wages to grow by 2% this year and by 3.5% and 3.4% in 2012 and 2013. As pointed out in the April forecast, the growth in wages will be uneven across sectors; it will be led by the manufacturing and IT sectors, as well as the construction sector. The latter is mainly influenced by developments in the construction sector in Finland – many Estonian construction workers found jobs there during the recession and are not keen to return home because the wage level in Estonia is considerably lower.

**Consumer confidence, s.a.**




Source: DG ECFIN.

### Government to continue with conservative fiscal policy

In 2010, the general government budget reached surplus (0.1% of GDP); this was mainly due to nontax revenues (mainly from the successful trade in the carbon quota market and the dividends of state-owned companies) and the tight control kept over expenditures. This year, we expect government expenditure to grow because payments into pension funds have been restored, pension outlays are slightly higher, and payments to the Health Insurance Fund have increased. In addition, the government is obligated to invest revenues earned from the $CO_2$ quota sales into environment-related projects.

Currently, no major tax changes are planned for the forecast period, except the lowering of the unemployment insurance tax in 2013; the amount of the decrease, however, has not yet been set. The tobacco excise increased this year by 10% and will be increased by the same amount each year of our forecast period. The tax burden will be further eased through a lowering of labour taxes – the income tax will decline from its current rate of 21% to 20%, in January 2015 or couple of months before the next parliamentary elections.

Government debt will remain very low. The transfers into the European Stability Mechanism are planned to start in 2013, totalling EUR 150 million over the following five years—an amount that will not increase the debt level considerably.

*Annika Paabut*
*Elina Allikalt*

# Latvia: Growth to continue amidst global slowdown

In the second quarter of 2011, the Latvian GDP grew by 5.3% in annual terms. Seasonally adjusted quarterly growth picked up to 2.2% after a somewhat disappointing first quarter (0.5%). The second-quarter results were somewhat better than anticipated. Details are not yet available, but most likely growth was broad based, with exports, investments, and consumption all contributing. The first-quarter growth was impaired by an unusually strong increase in imports, which most likely was boosted by one-off purchases. Import growth thus most likely decelerated in the second quarter, thereby improving the contribution of net exports to GDP growth.

The global environment has changed considerably since the April 2011 forecast. The growth of Latvia's main trading partners was stronger than expected in early 2011, thus lifting Latvian exports. Over the last month, however, global uncertainty has risen, and global growth is now expected to slow down more sharply than previously forecast. This will cut into Latvian growth from the third quarter of 2011 onwards, compared with our previous outlook. Global commodity price growth at the beginning of 2011 was higher than anticipated, but food, oil, and metal prices are now expected to back down in 2012-2013, thus reducing pressure on Latvian inflation.

Locally, the referendum and dissolution of the parliament in July, as well as the general elections scheduled for September, on the one hand, raise uncertainty about the 2012 budget (i.e., size and composition of consolidation, timing); on the other, however, they provide an opportunity to speed up growth if the new government accelerates implementation of structural reforms.

We are raising our GDP forecast for 2011 to 4.2% (4% before), due to better growth in the first half of the year and historical data revisions. With the weaker global environment, we now foresee weaker quarterly growth in the second half of 2011 than envisaged in the April forecast. We are also lowering our GDP growth forecast for 2012 to 3.5% (3.9% before), as slower global growth will cut into Latvian exports and investments, while weaker confidence will weigh on consumption. We include a 2014 euro introduction in our base scenario, although accomplishing this is challenging and calls for policy action (see below). We thus forecast somewhat faster growth in 2013 (3.9%), as a confidence boost through the euro accession expectations would promote investments and consumption in the second half of the year.

This is still a muddling-through scenario with subpar economic growth, which does not create enough high-quality new jobs. Although the job-seekers' rate will continue to come down, owing to timid job creation and emigration, it is still expected to be at about 11.8% in 2013. We are revising upwards our average inflation forecast slightly for this year, to 4.5% (4.2% before), but expect it to go down to about 2.5% in 2012-2013. We are revising upwards both exports and imports for 2011 to account for stronger growth in the first half of the year. Consumption and investment growth will spill over to imports, and the goods' and services' trade deficit will widen slowly in 2012-2013.

### Global risks increase

The main set of downside risks to our base forecast comes from the global situation. Financial market volatility has risen, and the probability of a global recession has increased. If such a risk scenario materializes, Latvia's exports, access to financing, and overall economic growth will be hurt substantially. A subsequent fall in tax revenues would worsen the fiscal situation. Domestic demand is still weak, and any problems with export-related activities would directly hit all sectors of the economy. In the worst case (i.e., a global double dip), the Latvian economy would again enter a recession. However, this recession would be significantly smaller than the one in 2008-2009.

It should be emphasised that, since 2008, the capability of Latvia's public and private sectors to resist such turmoil has increased. Latvia is now considerably less vulnerable to a sudden stop of capital inflows – asset bubbles have been deflated and imbalances have by and large been corrected (e.g., the current account is in surplus). Businesses (especially exporters) have accumulated reserves and are more competitive than previously. Capital adequacy and liquidity in the financial sector are high, although a worse scenario would mean that liquidity constraints would appear. The government does not urgently need to

**Key Economic Indicators, 2010 - 2013 1/**

| | 2010 | 2011f | 2012f | 2013f |
|---|---|---|---|---|
| Real GDP | -0.3 | 4.2 | 3.5 | 3.9 |
| Nominal GDP, billion euro | 18.0 | 19.9 | 21.4 | 23.2 |
| Consumer prices (average) | -1.1 | 4.5 | 2.4 | 2.5 |
| Unemployment rate, % 2/ | 18.7 | 15.9 | 13.9 | 11.8 |
| Real net monthly wage | -6.6 | 0.0 | 3.0 | 3.4 |
| Exports of goods and services (nominal) | 19.2 | 22.8 | 9.2 | 9.2 |
| Imports of goods and services (nominal) | 16.9 | 25.0 | 9.9 | 11.9 |
| Balance of goods and services, % of GDP | 0.3 | -1.4 | -1.8 | -3.3 |
| Current account balance, % of GDP | 3.6 | 1.5 | -0.1 | -2.1 |
| Current and capital account balance, % of GDP | 5.5 | 2.5 | 1.2 | -0.9 |
| FDI inflow, % of GDP | 1.5 | 3.7 | 3.0 | 4.0 |
| Gross external debt, % of GDP | 165 | 150 | 140 | 133 |
| General government budget balance, % of GDP 3/ | -7.6 | -4.9 | -2.8 | -2.1 |
| General government debt, % of GDP | 44.7 | 44.4 | 43.0 | 40.8 |

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

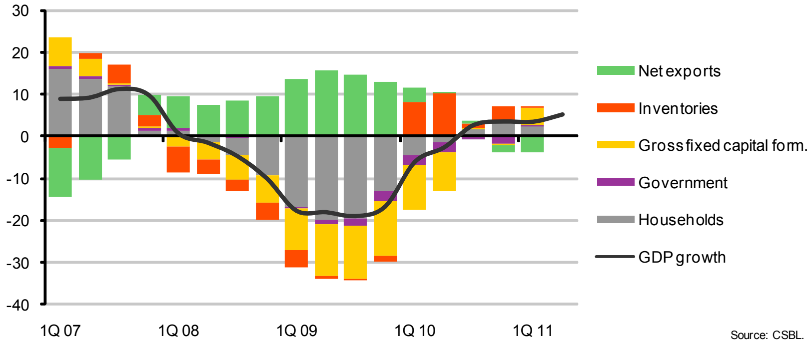
raise financing in international financial markets – it has ample reserves (about 7% of GDP), while large debt rollovers are not due until 2014-2015. In June 2011, the Latvian Treasury successfully issued 10-year bonds of $500 million, with a coupon rate of 5.25%, thereby returning to the international financial markets. The weakest link is households, as their still-low savings and high unemployment would make it impossible for them to weather the crisis without reducing their consumption.

Locally, risks are more balanced. On the downside, not fulfilling the Maastricht criteria and not introducing the euro in 2014 will subtract from growth in 2013 by not boosting confidence. On the upside, if a parliament more amenable to structural reforms is elected on September 17, Latvia may be pulled out of the current muddling-through scenario and enjoy more solid, faster growth.

## Stronger export growth in 2011, but weaker further on

Export growth was stronger than anticipated in the first half of this year. For goods exports, this is partly attributable to faster growth in the main trading partners in early 2011, especially Lithuania and Estonia (nearly one-third of Latvia's goods exports go to these countries),[1] as well as Germany, Sweden, and Russia (which together account for one-fourth of goods exports). The growth forecast for these countries is now revised downwards for 2012-2013, although they are still expected

Contribution to annual GDP growth, pp




to perform better than other European countries. A slowdown in foreign demand in 2012-2013 will hinder Latvia's export growth. We are thus revising upwards our export forecast for 2011 to account for higher growth in the first half of the year, but are reducing our average quarterly growth forecast from the third quarter of 2011 onwards.

Not only foreign demand has contributed to export growth; Latvian exporters are continuing to increase their market shares and search for new markets. However, unit labour costs have started to rise, which may pose a risk to future growth. Capacity utilisation in manufacturing continues to rise; constraints on qualified labour and resources (e.g., logging volumes for wood manufacturing) are also becoming more apparent and thus slowing future growth. Falling commodity prices may undermine growth in some industries, whereas a shift towards higher-value-added products may counteract it.

Growth of services exports is much slower and will continue to be so. Freight transportation via railways, roads, and ports developed better than expected in the first half of the year. However, the railway sector is experiencing physical capacity constraints, and, while changing the product mix and raising efficiency can create growth, investments are necessary to promote it. Tourism is on track to expand, but uncertainty remains with respect to the investment plans of the Riga airport and Airbaltic, the largest airline carrier based in Riga.

The rise in imports at the beginning of this year was surprisingly rapid, even considering the stronger export, consumption, and investment growth. We believe it was partly due to one-off purchases, particularly investment goods, and import growth should slow going forward, aligning more closely with the dynamics of the fundamentals. Nevertheless, with consumption and investments rising, import growth will continue to exceed that of exports. So far, imports have followed exports quite closely, but the trade deficit is expected to widen slowly in 2012-2013.

## Strong investments driven by exporters and EU funds

The pickup in gross fixed capital formation at the beginning of this year was stronger than expected, but, as noted in our forecast, it is very difficult to forecast quarterly investment dynamics, partly because large projects last several years.

Under the base scenario, investments in fixed capital are expected to continue expanding quite rapidly (in total by about 50% by the end of 2013); this will correct for the investment shortfall (predominantly in exporting sectors) of previous years. Activity in the real

1 A part of these exports does not stay in Estonia and Lithuania, but it is hard to find out their final destination.

**Swedbank's GDP Forecast – Latvia**

| Changes in volume, % | 2010 | 2011f | | 2012f[1/] | | 2013f |
|---|---|---|---|---|---|---|
| Household consumption | -0.1 | 4.2 | (2.5) | 2.9 | (3.5) | 3.6 |
| General government consumption | -11.0 | 0.0 | (-3.0) | 0.0 | (-0.1) | 0.5 |
| Gross fixed capital formation | -19.5 | 22.0 | (12.0) | 13.0 | (16.5) | 15.0 |
| Inventories [2/] | 5.8 | -0.5 | (-0.5) | -0.1 | (-0.1) | 0.4 |
| Exports of goods and services | 10.3 | 12.0 | (10.5) | 5.0 | (6.0) | 5.0 |
| Imports of goods and services | 8.6 | 16.0 | (8.5) | 7.0 | (9.0) | 9.0 |
| GDP | -0.3 | 4.2 | (4.0) | 3.5 | (3.9) | 3.9 |
| Domestic demand (excl. inventories) [2/] | -6.7 | 7.2 | (3.6) | 5.0 | (5.8) | 6.3 |
| Net export [2/] | 0.6 | -2.5 | (0.8) | -1.4 | (-1.8) | -2.8 |

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

estate market has increased, not least that of non-EU residents (particularly from Russia), who invest to obtain EU residence permits. The financial situation of businesses has improved, particularly in export-related sectors, and investments in machines and equipment (including in production capacities) have increased notably. EU Funds are more actively being used for infrastructure development. Banks are gradually becoming more active in lending, while interest rates remain low. These factors are also expected to support investments over the forecast horizon. In the second half of 2013, investment activity is expected to be supported by improving confidence due to the introduction of the euro in 2014.

At the same time, uncertainty about the 2012 budget remains. Although the activity of current investors should not diminish for this reason (because they are used to political uncertainty), the uncertainty may delay the entrance of new investors. Current foreign direct investment data show stable inflows of new equity capital, but mostly into real estate, and not so much into manufacturing. Worsening confidence globally is expected to weigh on investment growth in the second half of 2011 and 2012.

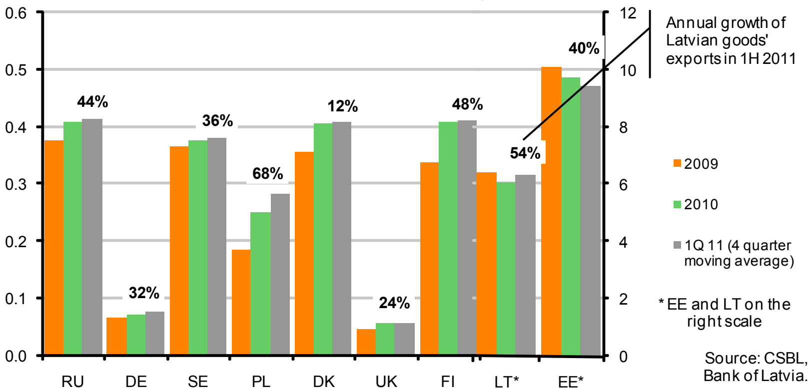
### Productivity growth slowing as efficiency gains get exhausted

The labour market situation continues to improve. In the second quarter of this year, the job-seekers' rate declined to 16.2%, while employment grew by 3.3%. However, such structural/social problems as demographic challenges, skills mismatches, rising income inequality, regional imbalances within the country, and a low participation rate call for policy action.

With the economic recovery widening, productivity growth is inevitably slowing, as new efficiency gains become harder to achieve and less skilled/trained persons become employed. Average labour productivity grew by 2% in the second quarter (4.5% on average in 2010). It will be hard to accelerate this growth in the coming years without making structural changes. Real wage growth is expected to exceed that of productivity as early as 2012. Although in our base scenario the gap will remain small, and we do not foresee a major worsening of competitiveness, there is a risk that wages will grow faster. The productivity level exceeds that of wages in manufacturing, thus giving grounds for wage growth in this sector. However, taking into account skills mismatches and emigration risks, wage growth might spill over to nontradable sectors, where productivity gains have been much smaller.

Consumer price (CPI) inflation accelerated in the first half of this year along with global commodity price increases and local tax hikes. No tax hikes seem to be planned for this or next year, and global commodity prices have stabilised or even decreased during the summer. Therefore, we expect Latvia's annual CPI inflation to stay close to 4.5% this year (due to base effects) and to decelerate next year. We forecast average inflation at 2.4-2.5% in 2012-2013. However, if wage growth significantly exceeds that of productivity, household demand and inflation expectations will exert larger upward price pressures.

Latvian export market shares (% of particular country's imports)




Source: CSBL, Bank of Latvia.

### Consumers to gain from wage growth and retreating inflation

In the first half of 2011, household consumption grew faster than expected. While raising our forecast for this year to account for this, we foresee only marginally stronger consumption growth than previously envisaged for the second half of the year. We are reducing our average quarterly growth forecast for next year due to lower confidence and a possible increase in savings, but expect consumption to pick up somewhat in 2013.

A number of factors are supporting consumption growth. Wage growth in the public sector picked up early this year. In previous years, the remuneration for key positions was sharply cut, bringing it significantly below the level for similar positions in the private sector. There are thus objective reasons to increase wages for these employees; however, taking into account the necessity to continue to reduce the budget deficit, we think it is too early to increase the overall public sector wage bill. Wage growth in the private sector is weak but likely to be understated by the official statistics due to tax evasion. While these incomes cannot be picked up by official income statistics, they do show up in consumption statistics.

Banks are becoming more active in issuing credit. Transfers from emigrants to their families in Latvia also seem to have increased, as shown by the current transfers account in the balance of payments. At the same time, household deposits did not grow in the first half of 2011. It thus seems that, with consumer confidence improving and wages growing slowly, households are tending to spend rather than save. Taking into account the still very low level of household savings (a recent survey by the Swedbank Institute of Private Finances revealed that only 46% of inhabitants have any savings), this is not prudent.

The high unemployment rate, diminishing population, and inflation (particularly of the first necessities) continue to be the main factors undermining consumption. In 2011, CPI inflation is expected to "eat" all the nominal wage growth and thus not improve the purchasing power of households. With inflation decelerating and wage growth strengthening in 2012-2013, purchasing power is expected to get stronger.

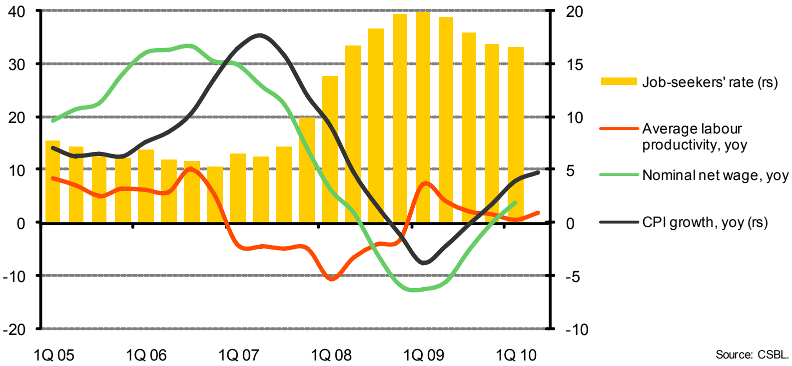
## Fiscal discipline is of utmost importance

Tax revenues exceeded the plan by 7% in the first seven months of this year (9% annual growth). However, overall revenues have by and large stayed on last year's level, and the cumulative general government budget deficit was at 1.7% of our forecast annual GDP in July 2011, nearly the same as a year ago. Overall revenues in the first half of the year were artificially smaller, as a part of the inflows of EU Funds was suspended, while expenditures were made as planned. Inflows of EU Funds will increase in the second half of 2011 and raise budget revenues.

Still, maintaining strict fiscal discipline remains crucial to achieving this year's deficit target, especially taking into account traditionally large end-year spending. The higher spending in December is partly explained by objective reasons (e.g., payment procedures), but also by the willingness of civil servants to spend all the funds planned for this year, as they are not transferrable.

If economic growth continues as forecast, revenues this year will most likely be in line with the plan. Tax evasion problems, although recently addressed more actively, remain – despite tax hikes, the ratio of tax revenues to GDP in the first quarter of this year was still below the level of the first quarter of 2010 and 2009.

**Labour market and inflation, %**




Source: CSBL.

Despite the somewhat better than expected economic development in the first half of the year, one has to remain cautious with respect to the size of the 2012 fiscal consolidation, especially given recent global developments. Bank of Latvia recent estimates suggest that consolidation of about LVL 100-130 million (0.8% of our forecast GDP) will be needed, and we believe it is too early to talk about a smaller consolidation. It is very important that the measures undertaken be sustainable.

## Euro 2014: last call for policy action

While euro introduction is still included in our main scenario, there are considerable risks involved. Euro entry will be particularly challenging, given the trade-off between holding down inflation and cutting the budget deficit (eg. by increasing VAT).

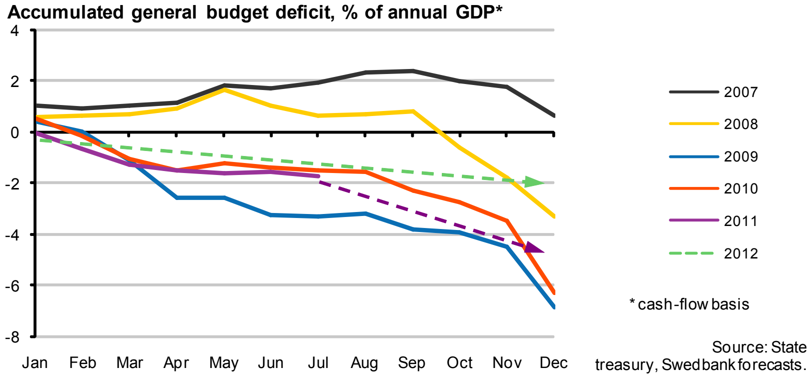
If economic growth continues and consolidation of LVL 110-130 million is implemented, the 2012 budget deficit is likely to be below 3%. However, if the global economy slides into the worse scenario and significantly erodes Latvia's growth, additional fiscal tightening would be needed to achieve the Maastricht criterion. Taking into account the already large consolidation so far (above 15% of GDP in 2009-2011) and increasing reform fatigue, this would be very challenging.

On the other hand, notably slowing global growth would ease pressure on Latvian inflation through lower commodity prices. In our base scenario, global commodity prices fall very modestly in 2012-2013, and Latvia's12-month average annual CPI inflation is still expected to be in the range of 2-2.5% in early 2013, when the Maastricht criteria are assessed. This may be insufficient to fulfil the price stability criterion, especially given that some EU countries struggling with austerity measures may show very low inflation rates (unless they raise their tax rates to reduce their budget deficits).

Consequently, we see the rest of 2011 and early 2012 as the last chance for politicians to act to strengthen the economy structurally and maximise the likelihood of euro entry in 2014. There seems to be a political determination to achieve this goal. Yet, necessary measures take time to bring results (e.g., stronger competition to cut inflation), and the political cycle will make it much harder to push through the needed decisions later on – municipal elections are planned for 2013 and general elections for 2014.

*Lija Strašuna*
*Mārtiņš Kazāks*
*Dainis Stikuts*

**Accumulated general budget deficit, % of annual GDP***




* cash-flow basis

Source: State treasury, Swedbank forecasts.

# Lithuania: A more balanced economy meets headwinds

In the first half of 2011, growth exceeded our expectations – annual GDP grew by 6.5%. This was mainly due to exceptionally strong GDP growth in the first three months of the year, when seasonally adjusted quarterly growth reached 3.5%. In line with our expectations, investments in the first quarter recovered rapidly – a 41% annual increase – and contributed to GDP growth the most. Another important growth factor was household consumption, which increased by 5.5%, compared with the same period in 2010. Second-quarter growth was somewhat disappointing – seasonally adjusted quarterly growth was a meagre 0.2%. However, we expect that this was a temporary slowdown, probably caused by a reduction of inventories.

We are increasing our GDP forecast for this year from 4.2% to 6.3%, due to stronger-than-expected growth in the first half of 2011. Improving consumer confidence and lending conditions are likely to contribute to growth, which will be only slightly slower in the second half of this year. Manufacturing will remain an important source of growth, but, as domestic demand recovers, retail and wholesale trade, financial intermediation, and other services will also become important factors of growth.

We are keeping our economic growth forecast for 2012 at 4.7% – although exports and investment will probably increase slower than we forecast in April, household consumption will increase slightly faster than previously anticipated because of an expansionary government policy, better lending conditions, and lower inflation. Growth will slow further, along with that of the global economy in 2013, when Lithuania's economy is expected to expand by 4.5%. Insufficient structural reforms, dwindling population and labour force, underinvestment in 2009 and 2010, and continued deleveraging across the developed economies will all weigh on growth in 2013.

Higher prices of oil, food, and other commodities have spurred consumer price growth above our forecast in the April outlook. Although prices declined in June and July, average annual inflation is at 3.5%, and we forecast that it will be equal to 4.0% at the end of this year. As average prices of oil and food are expected to drop by 7.6% and 0.3% (in euros) in 2012, external factors will be behind the lower prices of some consumer products. However, we think that demand-side factors will become more important – especially due to upcoming elections, as well as higher pensions and net wages. Thus we leave our forecast for 2012 inflation unchanged, at 2.5%. Higher demand, increasing net wages, and, to some extent, capacity utilisation constraints will drive inflation in 2013, for which we forecast a 3% increase in consumer prices.

**Key Economic Indicators, 2010 - 2013** [1/]

| | 2010 | 2011f | 2012f | 2013f |
|---|---|---|---|---|
| Real GDP | 1.3 | 6.3 | 4.7 | 4.5 |
| Nominal GDP, billion euro | 27.4 | 30.3 | 32.4 | 34.5 |
| Consumer prices (average) | 1.3 | 4.0 | 2.5 | 3.0 |
| Unemployment rate, % [2/] | 17.8 | 15.5 | 13.0 | 10.5 |
| Real net monthly wage | -4.3 | 0.5 | 3.0 | 3.0 |
| Exports of goods and services (nominal) | 30.3 | 27.0 | 12.0 | 8.0 |
| Imports of goods and services (nominal) | 28.9 | 29.0 | 13.0 | 8.0 |
| Balance of goods and services, % of GDP | -0.7 | -2.1 | -3.0 | -3.0 |
| Current account balance, % of GDP | 1.8 | -1.6 | -2.5 | -2.7 |
| Current and capital account balance, % of GDP | 4.5 | 1.4 | 0.5 | -0.7 |
| Net FDI, % of GDP | 1.7 | 3.5 | 4.0 | 4.0 |
| Gross external debt, % of GDP | 86.0 | 80.0 | 77.0 | 74.0 |
| General government budget balance, % of GDP [3/] | -7.1 | -5.2 | -3.0 | -2.0 |
| General government debt, % of GDP | 38.2 | 39.0 | 38.0 | 37.0 |

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

### External and internal risks

Despite improving fundamentals and a better outlook, external risks seem to be more acute than they were in the spring. The global economy may grow much slower or even dip into a new recession. Certainly, this would negatively affect exports and investments, as companies would once again postpone their expansion plans. Global developments could also negatively affect household expectations and their consumption, which would in turn add further pressure on job creation and investments. Nevertheless, the Lithuanian economy is more resilient and balanced than it was in 2008. The private sector has lower financial leverage, companies have significantly reduced their costs and are more efficient, and the financial sector has better capital adequacy ratios and liquidity, even if new liquidity constraints could occur. Even households are better prepared – with lower debt and higher savings they would not need to reduce their consumption as they did in 2009.

As we forecast in the spring, the upcoming parliamentary elections in 2012 may produce proposals that may be growth restricting in the medium term. It is also not clear how problems in the euro area will affect perceptions towards the euro – although we do not predict any changes in the strategic objective of adopting it as soon as possible, general scepticism will probably be higher.

### Export growth ebbs, foreign trade deficit will widen

Exports exceeded pre-crisis highs in

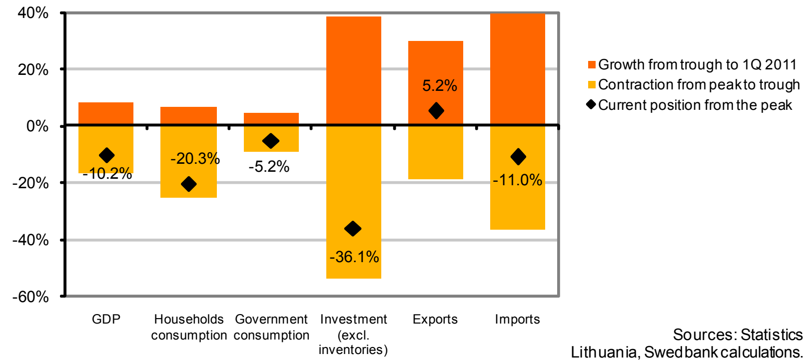
the autumn of 2010, and their strong growth continued into this year. This is a consequence of internal devaluation, improved efficiency, and higher competitiveness. In the first half of this year, the nominal growth of exports of goods was 41.2% higher than in the same period in 2010. Part of this rapid growth was due to strong re-exports of motor vehicles to Commonwealth of Independent States (CIS), which have faced higher import duties since July. Export of goods produced in Lithuania in the same period grew slower, by 31.7%.

Despite the continued strong growth of exports in the first half of 2011, the times of double-digit real growth are likely to be over. We revised upwards our exports forecast for this year – they are expected to increase by 14.0%. However, we forecast that, next year, exports will grow two times slower and will decelerate further in 2013.

Russia's continuing strong economic performance in 2011 is expected to be maintained next year (GDP grows by 4.5% and 4.4%, respectively), but imbalances, which will be even more pronounced as oil prices drop, cause some concern. A possible devaluation of the rouble would definitely hurt Lithuanian companies' competitiveness in the region. Since the beginning of 2010, exports to the CIS have contributed the most to overall export growth.

However, a big part of Lithuania's exports to this region are re-exports (motor vehicles, machinery); thus, even a rapid slowdown would not cause a dramatic shock to the real economy.

**GDP dynamics by expenditures, %**




Sources: Statistics Lithuania, Swedbank calculations.

For example, in the first half of this year, 15.9% of Lithuania's total exports of goods were sold in Russia, but only 4.9% of exports of goods produced in Lithuania were sold there.

The difference between exports including and excluding re-exports is even starker in Belarus, where Lithuania sells, respectively, 7.1% and 1.1% of its exports. In contrast, 12.3% of exports of goods produced in Lithuania are sold in Germany, which is by far the biggest market of these goods. Thus, a recession in EU countries would be more dangerous for the Lithuanian economy than one in CIS countries.

## Greenfield investments are more important than EU funds

Gross fixed capital formation in the first quarter of this year increased by 41% over the same period a year ago, confirming our forecast that investments will be the main force behind GDP growth this year. Both the private and public sectors increased their investments significantly. The private sector was the main contributor to the growth of investment in equipment and machinery – its nominal annual growth exceeded 58%.

Capacity utilisation is at 71%, below previous peaks of around 75%. Thus, it is likely that it was not current capacity constraints (scale), but rather the creation of altogether new capacity (scope) that was the main cause of investments. Due to greater uncertainty in the global economy, some companies might be reconsidering expansion; thus, we are reducing slightly our forecast of investment growth for 2012.

Although foreign direct investments (FDI) will pick up in 2011 and 2012, they will, as a percentage of GDP, remain below the 2008 level. One reason for the slow growth in FDI is structural – the business environment is still not favourable. Another reason is that the majority of foreign investments is concentrated in services, which are less capital intensive.

In line with our expectations, acquisition of EU funds continued at a rapid pace – of the total funds allocated for 2007-2013, which amount to EUR 7.4 billion, 72% have already been allocated and 36% paid out. Through the Operational Programme for Economic Growth more than 37% of the total of EUR 3.3 billion has already been paid out. High bureaucratic hurdles were supposed to ensure the transparency and fairness of fund allocation.

However, the very rigid requirements imposed may have discouraged some innovative companies from tapping into these resources, whereas often doubtful projects have been initiated, as companies have not been able to resist the temptation to take "free mon-

**Swedbank's GDP Forecast – Lithuania**

| Changes in volume, % | 2010 | 2011f | | 2012f[1/] | | 2013f |
|---|---|---|---|---|---|---|
| Household consumption | -4.1 | 5.5 | (2.5) | 5.2 | (4.5) | 5.0 |
| General government consumption | -3.0 | 1.7 | (1.0) | 2.0 | (1.0) | 2.0 |
| Gross fixed capital formation | 0.0 | 25.0 | (16.0) | 11.0 | (13.0) | 10.0 |
| Inventories [2/] | 7.8 | -0.1 | (-0.2) | -0.3 | (-0.7) | -0.3 |
| Exports of goods and services | 16.3 | 14.0 | (12.5) | 7.2 | (9.4) | 5.6 |
| Imports of goods and services | 17.6 | 15.2 | (11.8) | 7.8 | (9.1) | 6.2 |
| GDP | 1.3 | 6.3 | (4.2) | 4.7 | (4.7) | 4.5 |
| Domestic demand (excl. inventories) [2/] | -4.7 | 8.2 | (4.2) | 6.1 | (5.8) | 5.8 |
| Net export [2/] | -1.8 | -1.8 | (-0.4) | -1.1 | (-0.4) | -1.0 |

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

ey." The Ministry of the Economy has proposed changing the way the government distributes EU funds in 2014-2020 – instead of giving subsidies, the government would provide equity capital. Although this might slow the acquisition of funds and raise questions about the state's role as a shareholder, it would also sift out the less justifiable projects or at least increase their economic efficiency.

### Signs of lower unemployment and higher salaries

This year, Statistics Lithuania conducted a population and housing census; preliminary estimates somewhat unexpectedly revealed that Lithuania has only 3.05 million inhabitants. This is well below the estimate of 3.25 million inhabitants at the beginning of this year and the 3.5 million estimated during the previous census at the beginning of the last decade. Both emigration and negative natural change have contributed to the shrinkage of the population. The total fertility rate increased from 1.39 in 2000 to 1.55 in 2010 but remains below 2.1, the fertility rate needed to keep the population stable. This has major negative implications for the labour force, and potential GDP output, in the long term.

In the short and medium term, the serious issue of structural unemployment persists. Unemployment in the first quarter was still at 17.2% and declined to 15.6% in the second. And, at the same time the manufacturers are indicating that they cannot find skilled engineers and the transport sector does not have enough long-distance drivers, service centres of international companies are generating a very strong demand for IT specialists.

Recent data from the Labour Exchange suggests, however, that unemployment will decline more rapidly in the near future. Average registered unemployment was around 14.5% in 2010 and only slightly lower (14.1%) in the first quarter of this year. However, it has decelerated very rapidly in the past few months, reaching 11.1% at the end of July. Admittedly, this could have been the consequence of more active efforts by the Labour Exchange to weed out "fake" unemployed, the ones who are more interested in social benefits than actual jobs. Second-quarter employment data, too, suggest positive developments going forward - employment increased by 3.3% compared with the first quarter.

The increase in net real wages will be negligible this year but will become more tangible in 2012 and 2013, when nominal net wages will increase by 5.5% and 6%, respectively. First significant increase since 2008 will be good news for households from a consumption perspective; at the same time, it causes some concern – net real wages will grow a bit faster than productivity.

### Household demand picks up

Household consumption increased by 5.5% in the first quarter of this year over the same period a year ago and is likely to maintain a similar pace throughout the rest of 2011. As real wage growth was negative in the first quarter and social benefits were more or less flat, it is likely that households reduced their savings rate, which peaked at 7.9% in 2009 and probably declined a little in 2010. As we predicted in our April outlook, the fastest increase was in consumption of durables, whereas the growth in consumption of necessities was negligible.

For the first time since the second quarter of 2007, household deposits exceeded household loans in the second quarter of this year. Outstanding household loans have contracted by 10.2% since their peak at the end of 2008. As banking balance sheets improve, and as interest rates are well below 2009 levels, it is likely that lending will increase.

Household consumption poses the biggest upside risk to our GDP forecasts for 2012 and 2013. Lithuanian households are the least indebted in the EU (when measured by debt as a percent of disposable income). New consumer loans started growing somewhat in recent months; in the first half of 2011, they were 5.4% higher than in the same period a year ago.

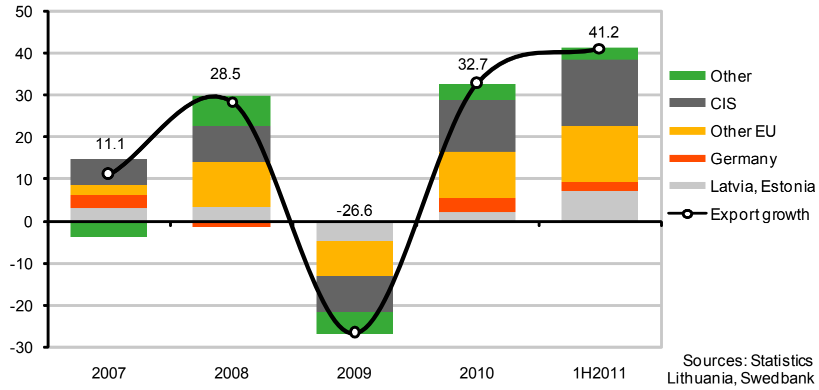
A more impressive growth was enjoyed by "fast credit" companies – loans newly issued by these companies grew by almost 40% during the same period. The amount of these loans is no longer negligible. However, due to the very high annual interest rates, ranging from 100% to 250%, these loans are boosting current purchasing power at the expense of a much lower purchasing power later.

### Inflation will be lower; there is a chance for the euro

In the first half of 2011, consumer prices increased more rapidly than we had predicted in April, mainly due to higher prices for oil and other commodities. Annual inflation peaked already in May (at 5%), and prices declined in both June and July. We forecast that average annual inflation will equal 4% at the end of this year and will decelerate rapidly to 2.5% in 2012.

As prices of most commodities are expected to be lower in 2012, this leaves little external pressure on consumer price inflation in Lithuania.

**Export partners' contributions to export growth, %**




Sources: Statistics Lithuania, Swedbank

Domestic factors, however, will start playing a more important role – a more expansive government economic policy (increasing minimum wages and pensions) will create more possibilities for manufacturers and retailers to raise prices of goods and services.

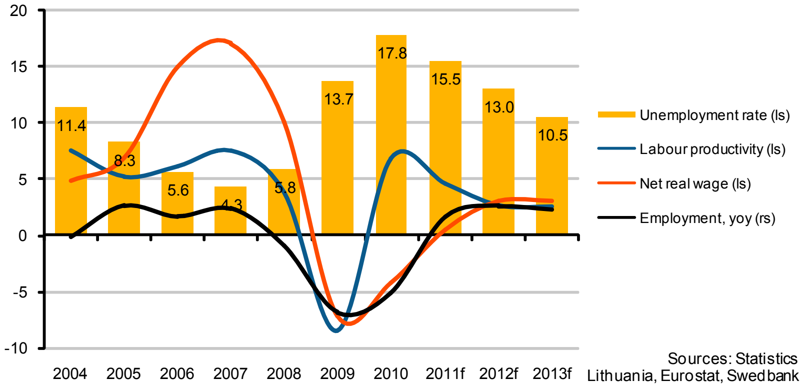
Since the beginning of the recovery, producer prices for manufacturing goods sold outside Lithuania have been increasing much more rapidly than prices of goods sold in local markets. July was the first month when this trend changed, as annual producer price inflation was higher for goods sold locally. The same domestic factors will be behind inflation in 2013, for which we forecast price increases of 3%.

## Budget consolidation should not end prematurely

End-2012 parliamentary elections are approaching and will be preceded by popular, but sometimes counterproductive and inadequate, promises and proposals. It has already been made clear by the government that pensions will be restored to their 2009 level (they were reduced in 2010 and 2011, as a consolidation measure), which means the average annual pension will increase by around 5.5%, costing the government around EUR 170 million.

It is very likely that, next year, the minimum monthly salary, currently at LTL 800 (EUR 232), will be increased to LTL 900. The Ministry of Finance calculates that this will cost the government budget an additional EUR 29 million and has resisted this increase so far, despite a strong push from trade unions. But additional expenses would be offset by additional tax income – currently only 5.7% of full-time employees in the public sector earn the minimum wage, whereas in the private sector 11.7% earn the  minimum salary. Small businesses keep resisting this increase (naturally, given the high structural unemployment), but the government is likely to play this card in an election year.

**Labour market, %**




Sources: Statistics Lithuania, Eurostat, Swedbank

State budget revenues have been supported by strong nominal GDP growth and are close to meeting the very ambitious plans set for this year. In the first half of 2011, state budget revenues were 10.9% higher than in the same period a year ago, and only 2.7% below the plan. Value-added tax (VAT) and personal income tax revenues were above the plan, but excise duties missed the target by 6.7%. This situation might improve somewhat in the second half of this year if the various anti-smuggling measures taken have some effect and Belarus keeps limiting sales of fuel close to the Lithuanian border. Considering this, we project this year's deficit to be 5.2% of GDP, and to decline further to 3% in 2012 and 2% in 2013.

## Euro adoption 2014 still possible

It seems that international circumstances are favourable for Lithuania's meeting the Maastricht criteria in 2012 and adopting the euro at the beginning of 2014. As the global economy slows and commodity prices recede, so does inflation in Lithuania. It is likely, however, that, as there will be at least three countries in the EU with average annual inflation below 1%, the Maastricht criterion for  price stability will be at around 2%. This means that additional (or simply continued) austerity in Lithuania could push inflation below this threshold.

Politicians have been lulled too much by the good GDP numbers and double-digit increase in tax revenues. Unfortunately, the phrase "further consolidation" recently has been absent from their minds and mouths. However, a further deterioration in global conditions could dent GDP growth and tax revenues in 2012. In this case, even if Lithuania meets the price stability convergence criterion, it will not reach the threshold of a general government budget deficit of 3% of GDP.  For the second time in a row, parliamentary elections are coming at the worst possible time.

The policymakers can and should agree that the strategic objective of adopting the euro is essential and abstain from increasing government spending before the election.

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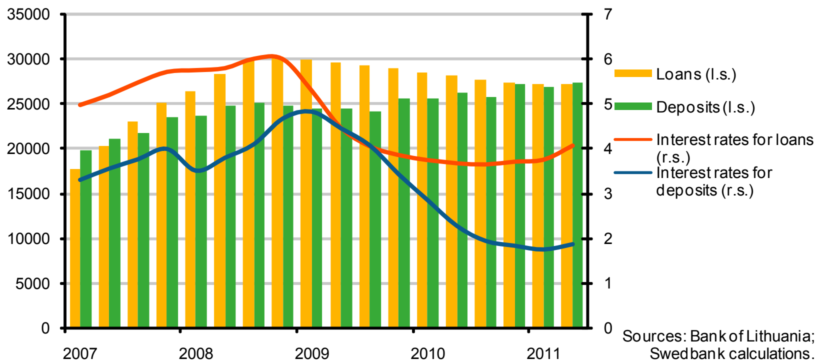
*Lina Vrubliauskienė*
*Vaiva Šečkutė*

**Household credit and deposits: outstanding amounts (m LTL) and interest rates for them (weighted, %)**




Sources: Bank of Lithuania; Swedbank calculations.

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