Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

April 24, 2012

Continuing on the road to recovery

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Global development

- Global economic data have been mixed since January. We have maintained our forecast of global GDP growth at 3.1% this year, but have revised it upwards to 3.4% from 3.1% for 2013,as the muddling-through scenario in the euro area seems to be more clearly in place.
- Our main scenario has a probability of 60%, while the probabilities for a worse and a better scenario are 30% and 10%, respectively. The main negative risks include a higher oil price, a new crisis in the euro area if Spain and Italy need rescue, a hard landing in China, and a slower recovery in the US.

Sweden

- Economic growth contracted sharply in the last quarter of 2011, pulled down by falling exports but partly offset by resilient household consumption. This led to an annual growth rate of 4.0%. Economic data for the first months of 2012 suggest that the downturn has hit bottom and that growth will resume.
- The economy will start recovering in 2012, but unemployment will remain high. Monetary policy will not provide additional support, and fiscal policy is in a wait-and-see position. With external demand dampened by Europe's crisis, the growth outlook for 2012 and 2013 is 0.5% and 2.2%, respectively.

Estonia

- After three quarters of nearly 9% year-on-year growth, GDP growth slowed in the last quarter and annual growth in 2011 reached 7.6%. Exports grew by a solid 24.9% despite a slowdown at the end of the year. Employment grew by 6.7%, supporting households' confidence and willingness to spend.
- We keep our GDP growth forecast at 2.7% for this year and revise it slightly upwards for 2013, from 4.0% to 4.2%, due to a better outlook for foreign demand growth. Inflation will decelerate from 5% in 2011 to 3.8% in 2012 and further to 3.2% in 2013. Despite the resumption of budget deficits, public finances will remain solid.

Latvia

- The economy expanded by a robust 5.5% in 2011. Investments contributed most to growth, but private consumption supported it as well. Growth, albeit slowing, has remained strong in early 2012, owing to the surprisingly robust confidence and resilience of Latvian exporters in response to the slowdown in external demand.
- We are raising the growth forecast to 2.5% in 2012 and 3.5% in 2013, owing to the stronger economy in recent months and somewhat better outlook for Latvia's main trading partners. Inflation is to retreat from 2.8% this year to 2.5% in 2013. Euro adoption in 2014 is feasible, but has become more challenging.

Lithuania

- The economy grew more slowly at the end of last year, mainly because companies slashed their inventories. Despite falling confidence, growth of household consumption and investments remained strong in the final quarter of 2011. At the end of the year, unemployment dropped below 14%, and real wage growth has accelerated.
- We expect GDP growth to accelerate to 4.3% next year after a more modest 3.3% growth in 2012. Inflation will be somewhat higher than previously forecast and, at 2.8%, is likely to be above the Maastricht inflation criterion. Inflation will ease to 2.5% and unemployment will drop to 11% in 2013.

A shaky surrounding – but a turnaround is near

The economic situation in Sweden and the Baltic countries slowed markedly at the end of last year and has continued its hesitating pace since our forecast in January. Economic data have been mixed, leading us to keep the global forecast in aggregate terms unchanged for this year; meanwhile, the prospects for a pickup in growth in 2013 have improved as the muddling-through scenario in the euro area seems to be more clearly in place.

The outlook for 2012 in Sweden and the Baltic countries is not much changed from the one in January; for 2013, it has been revised upwards slightly. In Sweden, GDP is set to grow by 0.5% in 2012, before reaching 2.1% in 2013. In the Baltic countries, GDP growth will vary between 2.5% and 3.3% this year, and between 3.5% and 4.3% next year, with Latvia at the lower and Lithuania at the higher ends of the interval.

The main risks to the Swedish and Baltic outlook are international, such as new instability in the euro area. This could result if Spain and also Italy needed rescue funding, and if this were followed by a deeper-than-expected recession. Also, a higher (or lower) oil price, a more pronounced slowdown in China and other emerging markets, and a slower (or faster) recovery in the US are other external risks. Internal risks are geared towards private consumption, as the sentiment of households could change if labour markets improved or worsened more than expected. In addition, internal risks deal with statistical uncertainties because revisions of national accounts and employment have blurred the picture both backwards and forwards.

Our main scenario comes with a probability of 60% and has a global growth rate of 3.1% in 2012, with a mild upturn in 2013 to 3.4%. This is still lower than in 2011, when GDP growth reached 3.5%. Stronger manufacturing activity and investments are driving the US economy. Although growth has picked up, the higher oil price and the slower employment creation is counteracting this development, leaving GDP growth with a marginal revision upwards, to 2.1% this year and 2.3% next year.

The recession in the euro area is expected to become deeper in the crisis-struck economies, while it will go away in Germany and France in the second half of this year. The worst of the crisis in terms of management is assumed to be over, as member countries avoid new rescue packages. Liquidity support from the European Central Bank (ECB) could be provided if the situation warrants. The UK and the Nordic countries will grow below potential, especially the UK and Denmark, where the financial crisis is still felt.

Emerging markets are reducing their problems with overheating and can counteract some of the slowdown with stimulus; still, growth will abate somewhat in oil-importing countries and pick up in commodity-based Russia and Brazil. China's growth falls towards 8% this year and next, as its property sector cools and the export sector loses speed. Also, Japan is affected by China's slowdown, but investments are increasing after the tsunami and nuclear plant accident last year, and next year Japan's growth will also benefit from a weaker yen against the US dollar.

Commodity prices will increase during the forecast period, contrary to our assumptions in January. The oil price is assumed to reach US$119 per barrel this year on average, meaning that it will fall back in the second half of this year as concern about a conflict in the Middle East alleviates. The oil price will reach an average of US$113 per barrel next year, and the consumer price pressure from commodity markets will abate, which, will cause inflation to fall during 2012 and 2013. Monetary policy will remain expansionary in advanced economies (interest rates will stay close to zero while quantitative easing will be forthcoming mainly in Japan and the UK). In emerging markets, monetary policy will become less restrictive. Fiscal policy in most of Europe will be restrictive. The effects of monetary policy, and also of a weaker euro against the US dollar, cannot counteract the negative growth effects from less government spending and higher taxation. More budget consolidation could be needed if growth slows. Unemployment is already above 10% and increasing in the euro area, where it has reached its highest level for 15 years, while the opposite is true for Germany, where the rate of 6.7% is the lowest in 20 years.

In our worse scenario, to which we give 30% probability, the crisis in the euro area worsens further, with Spain requesting rescue funding to avoid a collapse, and with risks therefore also increasing for Italy. The recession deepens, and political and social un-

Macro economic indicators, 2010- 2013

	2010	2011	2012f	2013f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	5.8	4.0	0.5	2.2
Estonia	2.3	7.6	2.7	4.2
Latvia	-0.3	5.5	2.5	3.5
Lithuania	1.4	5.9	3.3	4.3
Unemployment rate, % of labour force				
Sweden	8.4	7.5	7.8	7.9
Estonia	16.9	12.5	10.5	8.6
Latvia	18.7	15.4	13.6	11.9
Lithuania	17.8	15.4	13.0	11.0
Consumer price index, annual change in %				
Sweden	1.2	3.0	1.5	1.9
Estonia	3.0	5.0	3.8	3.2
Latvia	-1.1	4.4	2.8	2.5
Lithuania	1.3	4.1	2.8	2.5
Current account, % of GDP				
Sweden	6.8	7.2	6.9	7.1
Estonia (incl. capital account)	7.2	6.7	5.9	5.5
Latvia	3.0	-1.2	-1.8	-2.6
Lithuania	1.5	-1.6	-2.5	-2.7

Sources: National statistics authorities and Swedbank.

rest worsens. Financial market sentiment becomes volatile, with new wealth losses weakening confidence. Also, the oil price could rise higher, and China could land harder, with growth below 6-7% this year and next. In the US, if the Bush tax cuts would not be extended, restrictive fiscal policy would slow growth. As global growth would fall under 2% and trend towards stagnation, the world economy would move into a recession.

A better growth case is also made possible, with a low probability of 10%, if the oil price falls, the euro area recession turns out to be shallow, and the recovery in the US picks up, while growth in emerging markets reaches sustainable high levels.

Sweden's economic data were recently revised. In 2011, GDP grew by 4%, compared with expected 4.5%, while growth in 2010 was revised up to almost 6%. A sharp drop in exports pulled down growth in the last quarter of 2011, but private consumption was resilient. Since then, the purchasing managers' index indicates a marginal improvement only, and the rebound in new orders is still weak. GDP is set to increase by 0.5% this year (with fourth quarter last year markedly negative, and first quarter showing a minor drop before activity picks up in the second half of this year). Unemployment will almost reach 8% early next year before falling back slowly in line with the higher GDP growth in 2013 of 2.1%; as household spending will increase more than we assumed in January. The Riksbank will keep the repo rate at 1.5% this year, before hiking it twice next year. The government budget is cautious, leaving room for expansion next year when the economy will have already started to improve.

Estonia's economy expanded by a strong 7.6% last year; and our GDP forecast for 2012 remains at January's 2.7%. Global demand lost steam contributing to negative quarterly growth at the end of last year. In 2013, GDP is expected to increase by 4.2%, a slight upward revision from January in light of the somewhat stronger global outlook. Inflation will also be higher due to higher global commodity prices, thus reducing real wages, sentiment, and consumer spending. The main domestic risk is the labour market, where the lack of qualified labour in some sectors is increasingly becoming a problem; meanwhile, long-term unemployment remains high. Also, emigration may pose a threat to competitiveness, going forward. While having the lowest government debt ratio in Europe, Estonia's loan payments by the European Financial Stability Facility (EFSF), help to raise the gross debt ratio from 6% to 10% of GDP in 2013. Even so, the overall public finances remain solid, and the budget deficits are temporary.

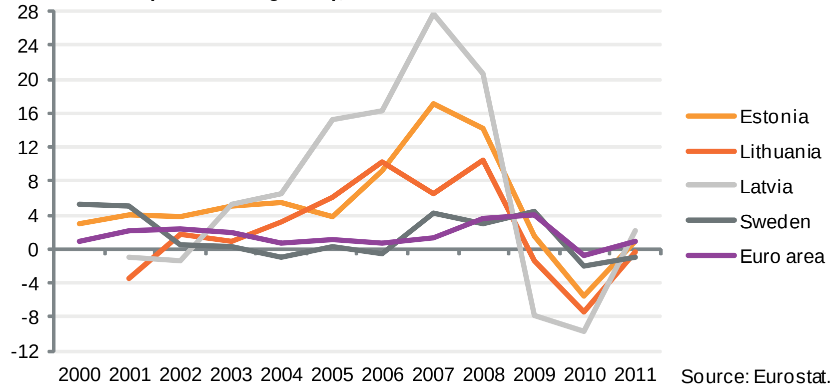
Latvia's GDP grew by 5.5% in 2011, the first full year of growth after the recession. The drivers for the recovery were exports and EU funding, which boosted investments. Better confidence among households also led to higher consumption. In 2012, we forecast GDP to slow to 2.5% as the global climate weakens (up from January's 2.0% on the basis of stronger demand). External competitiveness has improved, leading to a larger market share and export growth in an overall weak export market. In addition, Latvia's main export partners are still rather strong, compared with the crisis-struck countries in southern Europe. In 2013, economic growth will increase to 3.5% as the global outlook improves and the inventories give a positive contribution to growth. Unemployment is set to fall under 12% next year. As the budget deficit shrinks in line with EU rules, the EMU entry is made possible, although the inflation outlook is challenging (2.5 % next year) not least as other euro nations' inflation outcome is uncertain. Also, the euro area's willingness to accept new members still constitute major uncertainties.

Lithuania's GDP growth has slowed markedly, but the rate was still positive in quarterly terms at the end of last year, thus leading to a high but lower-than-expected growth of 5.9% for 2011. The inventory cycle contributed to the weaker outcome, while exports and domestic demand held up relatively well. Going forward, GDP is set to weaken to 3.3% this year, before reaching 4.3% next year as export and investment demand improves. In 2013, unemployment is expected to fall to 11% on average, and the inflation outlook drops to 2.5%. Public finances have become less strained, but risks remain because politicians' propositions could lead to a more expansionary fiscal policy as this year's election approaches. The outlook for membership in the EMU is, therefore, cautiously positive with regard to domestic risks with the inflation outlook especially challenging; and, it is still uncertain with regard to actions by the policymakers of the euro area.

The outlook for Sweden and the Baltic countries has marginally improved for the next year, but the risks are skewed and remain high for a weaker outcome. Therefore, it is still important to manage risks, and to continue the reform process to strengthen competitiveness in all four countries, thereby increasing resilience if worse comes to worst.

Cecilia Hermansson

Unit labour cost (annual change in %), 2000 - 2011



Source: Eurostat.

Lacklustre global growth at best

Since our January forecast, economic developments have been mildly positive although increasingly mixed over time, as the impact on sentiment from central banks' liquidity injections abates. The recovery in the US economy has picked up but is still cautious; the recession in the crisis-struck euro area economies is more evident while core countries have stagnated. For now, the worst is likely to be over in terms of crisis management; the region has returned to the "muddling-through-mode." GDP growth in emerging markets has slowed. Also, with higher energy costs for oil-importing countries, the global economy will grow modestly, just above 3% this year, before returning in 2013 to last year's growth of near 3.5% – a modest upward revision since January.

Since the beginning of the year, the world economy has been characterised by a continuation of the recovery, albeit with some mixed signals. Commodity and share prices have risen, and the purchasing managers' index and confidence indicators have strengthened slightly. GDP growth in the last quarter of 2011 indicates that the recovery has picked up in the US; meanwhile, it has faltered in the euro area, the UK, and Japan, while losing speed in the emerging markets.

In the euro area, the European Central Bank (ECB) has once again injected liquidity (through long-term refinancing operations, or LTROs). In February, the ECB's loans amounted to EUR 530 billion, thus adding to December's amount of EUR 489 billion. Although financial stress is abating, it is still high, as banks are shrinking their balance sheets and credit austerity is weakening growth in the region. The agreement made in March to support Greece with a second loan conditional on reforms, while forcing private banks to write down their claims, has given Greece more time. However, political, economic, and social stress is building up in the country before the election in May, driving expectations of either calls for more support or, but less likely, a decision to leave the euro area and reintroduce the drachma. To strengthen crisis management, the two rescue facilities, the European Financial Stability Fund (EFSF) and the European Stability Mechanism (ESM), now have the possibility of running parallel with increased funding, with the addition with increased funds from the IMF, thus lowering the still-present risks of contagion. Recently, the focus has shifted to Italy and especially Spain, where the risk premium for sovereign bonds again is increasing despite the ECB's measures, and where market actors doubt that the Spanish government's efforts will be sufficient to cut the budget deficit to reach the agreed 5.3% of GDP this year, and 3% next year.

Even so, sentiment among investors, companies, and households has improved, as a response to both the increased liquidity in the euro area and the somewhat stronger recovery in the US economy in terms of growth and lower unemployment. In the US, purchasing managers are signalling higher manufacturing activity. The stock markets have continued to strengthen, although remaining volatile and fragile. However, there are new disappointments, as employment growth again is slowing and the oil price – since the geopolitical stress has raised supply concerns - has returned to the high levels last seen during the Japanese catastrophe a year ago.

The winding down of growth in emerging markets also explains why the world recovery has over the last two quarters been losing speed. After policymakers reduced overheating by removing stimulus, domestic activity is slowing while global demand is growing less briskly. Especially in China, the property market and car consumption have cooled, driving expectations of a hard landing. Manufacturing growth has slowed and export orders' growth is much weaker than a year ago. Inflation has decreased, but, since it is still a concern, the room for new stimulus – although building up – is somewhat limited.

Expectations of modest growth in our main scenario

In our main scenario, to which we give 60% probability, global output growth will be lacklustre at best. The world economy is now expanding at a rate of just below 3% in purchasing power

Swedbank's GDP forecast - Global[1/]
(annual percentage change)

		Outcome	April 2012		January 2012		
		2011	2012	2013	2011	2012	2013
US		1.7	2.1	2.3	1.8	2.0	2.2
EMU countries		1.4	-0.5	0.4	1.6	-0.3	0.2
Of which:	Germany	3.1	0.5	1.3	3.0	0.4	0.9
	France	1.7	0.3	0.6	1.6	0.2	0.5
	Italy	0.4	-1.8	-0.3	0.5	-1.3	-0.8
	Spain	0.7	-2.0	-0.8	0.6	-1.0	-0.5
	Finland	2.9	0.8	1.7	2.9	0.4	1.5
UK		0.7	0.5	1.0	0.9	0.5	0.5
Denmark		1.0	0.5	1.0	1.0	0.7	1.3
Norway		1.7	2.0	2.5	1.7	2.0	2.3
Japan		-0.7	1.5	1.2	-0.5	1.7	0.9
China		9.2	8.1	8.0	9.3	8.2	7.8
India		7.2	6.7	7.3	7.3	6.7	7.0
Brazil		2.7	3.1	3.5	3.0	2.7	2.2
Russia		4.3	4.1	3.9	4.2	3.9	3.7
Global GDP in PPP		3.5	3.1	3.4	3.6	3.1	3.1
Global GDP in US$		2.5	2.2	2.6	2.7	2.3	2.3

Sources: National statistics and Swedbank.

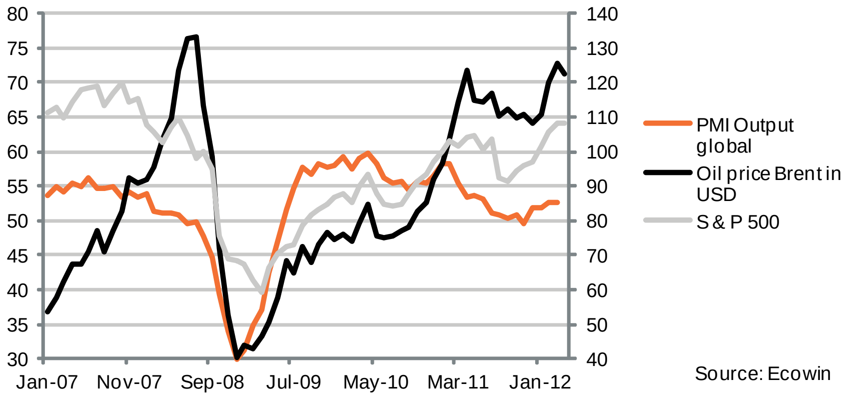
1/ Countries representing around 70 % of the global economy. The World Bank weights from 2010 have been used.

terms; this will increase towards the second half of this year before reaching an average of 3.1% in 2012 and 3.4% in 2013. For more details of the outlook see Swedbank's Global Economic Outlook, published April 24th.

Compared with our January forecast, growth in the US has been revised upwards only slightly, as the stronger momentum will be negatively affected by higher energy prices. Growth in the euro area has been revised downwards for 2012; however, in 2013 we see possibilities for stronger activity in the core countries such as Germany, as export and investment demand picks up in the second half of this year. Germany is expected to have a recession in technical terms, but the underlying strength of the economy is still good. The recession in southern Europe will deepen this year, and we still cannot see growth coming back until after the forecast horizon. Investments are growing in Japan as a response to the tsunami shock, although the strong yen, high energy costs, and slower demand from China will reduce growth expectations somewhat this year before they strengthen in 2013 as the yen weakens.

Our forecast is not much altered in emerging markets, as we maintain our view, expressed in January that growth will slow in 2012 before picking up slightly in 2013. Growth in oil-exporting countries like Russia and Brazil looks stronger than in our January forecast, while India and China will try to limit the larger negative growth effects by using more expansionary economic policies. A hard landing in China will thus be avoided.

Global PMI, S&P 500 (indeces) and Brent oil price, Jan 2007 - Apr 2012



Source: Ecowin

In the advanced part of the world, fiscal austerity is putting on the brakes to growth; meanwhile, households are busy deleveraging, which means increased savings and cautious spending. Monetary policy will stay expansionary, but will not be sufficiently effective in counteracting the adverse effects arising from the restrictive fiscal policy. Still, policy interest rates will remain close to zero in most advanced economies, and we foresee more initiatives from central banks to provide liquidity in various forms, especially in the UK and Japan – and to lesser extent in the US and the euro area, where criticism is arising and calls for exit strategies are growing louder (e.g., from the Bundesbank).

The US dollar will continue appreciating, as the economic recovery there is expected to remain stronger than in the euro area or Japan, which will be relieved to see the yen weakening. The appreciation of the renminbi will be kept at close to 4% per year. Tensions regarding exchange rates are building up, not least as Brazil and other emerging markets try to keep their industries from losing competitiveness.

For oil-importing countries, responsible for some 80% of global output, the high oil price is applying another brake, lowering growth while increasing inflation. However, over the forecast horizon, global inflation in terms of consumer and commodity prices will not be a major problem. Capacity utilisation is still low, and the output gap (assuming potential global growth of some 4%), although shrinking, will close only a few years' from now. Labour costs will stagnate or grow weakly, as the bargaining power of the labour force remains low.

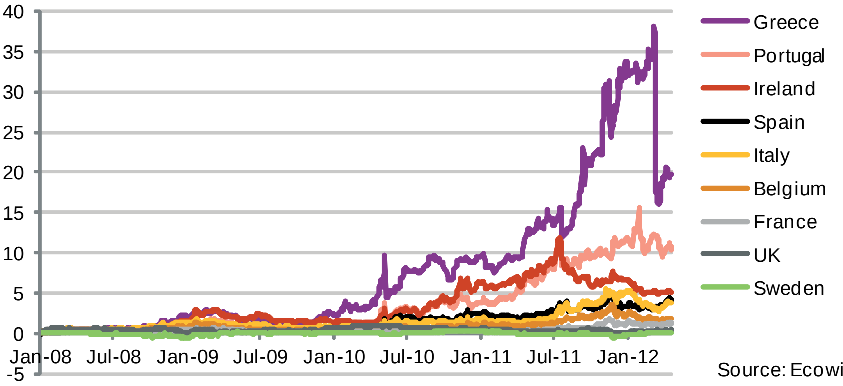
Global growth is also too weak to support a new boom in the commodity markets. Even so, commodity price inflation will stay high for some time, before the oil price falls as expectations of a war between Iran and Israel cool down. Most commodity prices will remain high as they are supported by the global recovery, high liquidity, and low interest rates. Our assumptions for the oil price have been revised upwards to $119 and $113 per barrel for 2012 and 2013, respectively (up from $102 and $96 per barrel in January). Metal and food prices – already high – will continue their slow ascent during 2012 and 2013.

The fundamental driver for commodity prices is the emerging markets, where catching up to richer countries' living standards and improving productivity are increasing the demand for commodities. Emerging markets, although experiencing a slowdown, have less need to deleverage and tighten their fiscal belts. High commodity prices have so far been met by more restrictive economic policies, and, over the forecast horizon, most of the overheating problems will have been overcome.

Interest and exchange rate assumptions

	Outcome	Forecast			
	20 Apr 2012	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
European Central Bank	1.00	1.00	1.00	1.00	1.00
Bank of England	0.50	0.50	0.50	0.50	0.50
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.32	1.28	1.26	1.23	1.20
EUR/GBP	0.82	0.81	0.81	0.81	0.80
RMB/USD	6.30	6.18	6.05	5.94	5.82
USD/JPY	82	85	87	90	95

Interest rate differences to German 10 year government bond, Jan 2008 - Apr 2012 (percentage points)



Source: Ecowin

In January, we limited our discussion on scenarios to the euro area. Then, the main scenario was characterised as one in which small, but important steps were taken to alleviate the crisis. With almost as high a probability, we envisaged a weaker scenario – resembling the crablike movement seen during 2011 – and also a crisis scenario in which a euro area collapse had a small but not negligent probability. In April, we include our main euro area scenario in the overall global main scenario, seeing a continuation of the muddling-through policies. Fiscal cooperation is slowly being strengthened; the rescue funds are being made larger – although perhaps not sufficiently. The policy still includes balancing crisis support and avoidance of moral hazard, thus forcing crisis-struck countries to speed up their reform efforts. Even though sentiments on financial markets improved after the ECB's LTRO support, a credit crunch is in the making; because of this, together with fiscal austerity, the region is in a recession.

In our main scenario, the recession in the euro area levels off towards the second half of this year, driven by stronger growth in the core countries. Some relief will come from a weaker euro, mainly in relation to the US dollar. Over the forecast horizon, and well beyond, unemployment will remain high in the crisis-struck countries in southern Europe, resulting in an inevitable severe social, economic, and political crisis.

Asymmetric risks – a worse scenario is more likely than a better

There are plenty of negative risks to this forecast. The risk view is asymmetric because the probability of a worse scenario, which we put at 30%, is higher than the probability of a better scenario, which we assess to be only 10%.

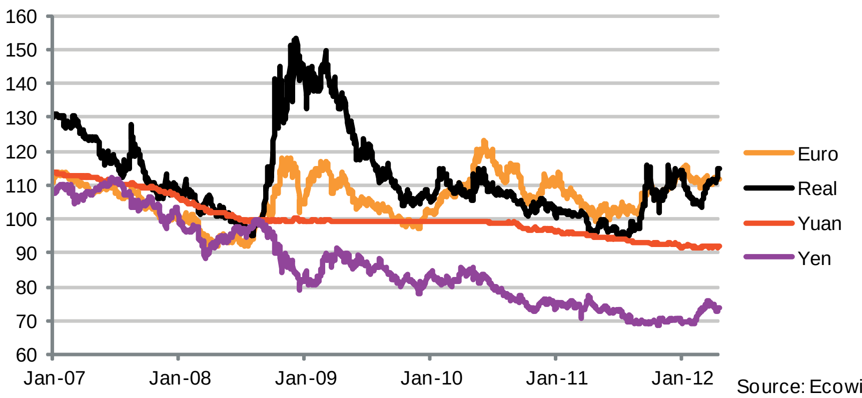
The factors driving the better scenario – towards potential growth of around 4% – are greater-than-expected stimulus in emerging markets, supporting growth; either a lower oil price or less negative effects from the current price level; and stronger confidence arising from the crisis management in the advanced economies, mainly the US and the euro area, which would generate higher consumer and investment spending.

A worse scenario – with global growth of 2% or less – could materialise if the oil price continues to rise along with geopolitical tensions, while the supply of oil is reduced. In the euro area, political and social unrest could pick up, increasing uncertainty before the elections this spring in Greece and France, and next year in Italy and Germany. There could also be backlashes from the crisis management in the euro area, with the risk of one of more countries leaving the currency union. In the US, the main risk, except for that of energy prices eating a big hole in consumers' wallets, is the continuation of a congressional gridlock beyond this fall's presidential election. If tax exemptions are removed, fiscal policy could become restrictive, thus slowing growth. The problems involved in deciding on debt ceilings, tax and expenditure policies, and health reform could escalate during the rest of the forecast period, breaking the momentum of the US recovery and increasing tensions on the global financial markets. Another negative risk is, of course, of a hard landing in China, as falling property prices could reduce local and regional activity and weaken the financial sector.

In the longer term, there are many challenges for the world economy. For those interested in this discussion, see Swedbank's Global Economic Outlook. In this we discuss a number of long-term issues: how to exit an expansionary monetary policy; how to safeguard financial and consumer price stability; how to create growth in Europe despite an environment of austerity; how to avoid global imbalances; how to put the environment back on the global policy agenda; and how to reduce unemployment, which most likely has become more structural in the advanced economies. A modest recovery in the short term is one thing; the build-up of challenges for the world economy in the medium and long term is quite another.

Cecilia Hermansson

The Japanese yen, the Chinese yuan, the euro and Brazilian real against the US dollar, Jan 2007 - Apr 2012 (Aug 2008=100)



Source: Ecowin

Sweden: Recovering after the hit last year

A sharp drop in exports pulled down growth rates in the last quarter of 2011. Following a surprisingly strong performance during the first three quarters of 2011, economic growth contracted by more than 1% (seasonally adjusted), reducing overall annual real growth to 4.0%, compared with our previous estimate of 4.5%. Among the positive signs was a surprising resiliency of private consumption. Households increased their spending at an annual rate of 2.1% and withstood the worsening risk sentiments in the global markets.

Data in the first couple of months of 2012 give a mixed picture. Export growth has recovered somewhat, labour market developments are not as bad as were previously expected, and sentiments have strengthened. However, industrial production plummeted in February – although one month's reading should be interpreted carefully – and the purchasing managers' index (PMI) does not point to a rapid rebound in either manufacturing or services. Furthermore, uncertainty regarding international developments has increased, with weaker data coming in from both Europe and the US late in the first quarter. On an annual basis, we are lowering our growth forecast for 2012 from 0.6% to 0.5%, but underlying these numbers is a stronger recovery in the latter half of the year. Thus, we expect a turnaround of the declining trend in economic growth seen since mid-2011. In 2013, the recovery continues, but at a slower quarterly rate, and annual growth is forecast at 2.2%. Due to the weak external environment, growth is still below trend, and the main growth engine will be domestic demand, in particular private consumption.

The quite substantial data revisions in connection with the 2011 GDP release have altered the path and dynamics of the Swedish economy following the financial crisis in 2008-2009. GDP growth for 2010 was revised upwards, while the rate of expansion in the first three quarters of 2011 was lowered. Thus, the recovery was faster in 2010, but the performance of the economy has since been more modest. In addition, the number of hours worked was significantly higher than previously reported. This implies that productivity growth in the Swedish economy was slower, and together with rising unit labour costs, competitiveness was not as strong.

The risks to the forecast, and to the Swedish economy, mainly derive, as before, from external sources. However, the downside risks have decreased, according to our assessment, while the upside risks have increased somewhat. The actions to resolve the Greek debt crisis, together with increased lending by the European Central Bank (ECB) to banks, have calmed the European economies, but the debt dynamics in Spain and Italy could again pull down European growth rates. Also, emerging markets and the US are facing some headwinds, in particular from rising energy prices. Domestically, risks have receded, in our view, with a lack of housing underpinning real estate markets and unemployment rates increasing at a slower rate.

Key Economic Indicators, 2010 - 2013 1/

	2010	2011	2012f	2013f
Real GDP (calendar adjusted)	5.8	4.0	0.5	2.2
Industrial production	19.8	6.7	-3.5	2.0
CPI index, average	1.2	3.0	1.5	1.9
CPI, end of period	2.3	2.3	1.3	2.0
CPIF, average 2/	2.0	1.4	1.3	1.6
CPIF, end of period	2.3	0.5	1.7	1.6
Labour force (15-74)	1.1	1.2	0.2	0.3
Unemployment rate (15-74), % of labor force	8.4	7.5	7.8	7.9
Employment (15-74)	1.0	2.1	-0.1	0.2
Nominal hourly wage whole economy, average	2.5	2.7	3.2	3.1
Nominal hourly wage industry, average	2.8	2.4	3.1	3.0
Savings ratio (households), %	8.5	9.7	10.1	9,8
Real disposable income (households) 3/	1.2	3.3	2.0	2.1
Current account balance, % of GDP	6.8	7.2	6.9	7.1
General government budget balance, % of GDP 4/	-0.1	0.2	-0.3	0.2
General government debt, % of GDP 5/	39.4	36.5	35.8	33.5

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 to recover after a sharp decline

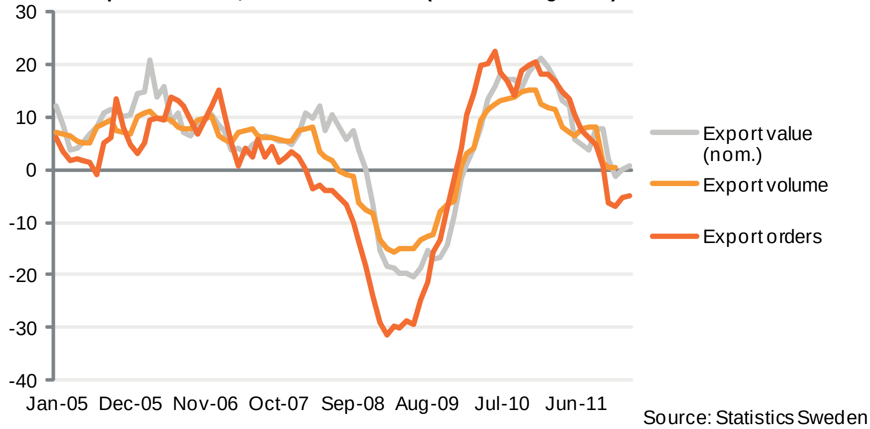
After rebounding strongly in the previous quarters, Swedish export volume fell in the fourth quarter last year by much more than we expected. The decline was driven by weaker global demand and growing uncertainty about the sovereign debt crisis in the euro area and its impact on the global economy. In particular, Swedish exports of intermediate and investment goods were affected when investment plans globally were postponed, not least in Europe, which is the largest export market for Swedish industry. On an annual basis, however, total export volume increased by 6.8% in 2011 due to the strong growth in the first three quarters. Goods exports increased by 8.5%, while services picked up by 2.9%.

The world market growth for Swedish exporters will be below the long-term trend during the forecast period, mainly due to a slow growth rate in the OECD region. Since 2000, the annual growth of world markets for Swedish firms has increased by 6-6.5%. For 2012, we expect these markets to grow by 3.5-4%, which is more or less the same level we forecast in January. The weakest growth performance will be seen in the euro area, while emerging markets' growth will still be relatively high. For next year, we foresee market growth as somewhat stronger but still below the long-term trend. A low utilisation rate in the business sector and budget consolidations in several OECD countries mean that global investment activity is expected to be modest in the coming years.

In the immediate term, there are signs of an improvement in the Swedish export industry after the sharp slowdown at the end of 2011. New orders have started to pick up, although from low levels, and the export value for the first two months shows only a minor decrease from the last months of 2011. Swedbank's PMI for the manufacturing sector also improved marginally in the first quarter of 2012. Although we assume a mild recovery in Swedish exports during the second half of 2012, the average export volume will be 1.3% lower than in 2011.

Weak investment activity in the OECD will limit Swedish export possibilities. The global outlook for e.g. heavy trucks is expected to weaken in 2012, mainly on mature markets; however, demand is also expected to decelerate in emerging markets. In particular, slower export demand from Germany – destination for nearly 10% of total Swedish exports - will have a dampening impact on Swedish export performance. We foresee an export volume growth of 2.5-3% in 2013, when global demand is improving. After two years of market gains, we foresee losses of market shares in 2012-2013 due to a less favourable demand composition and worsening competitiveness. Unit labour costs are expected to increase faster than we expected in January due to lower productivity growth and higher wage increases.

Swedish export and order, Jan 2005 - Feb 2012 (annual change in %)



Source: Statistics Sweden

Investments on hold

Gross fixed investment increased in volume terms by 5.8% in 2011. This was in line with our expectations. Although investment has trended upwards since 2010, with an accumulated investment growth of 16%, total investment volume has not yet reached the pre-crisis level of 2008. Furthermore, the investment trends differ across sectors. The largest shift has been in real estate. Investments in housing fell by 7.3% (seasonally adjusted) between the third and fourth quarters last year, after two years of strong growth. Despite the large drop, real estate volume was 12.8% higher in 2011 than in 2010. In the private sector excluding housing, investments continued to grow even while production growth was decelerating and uncertainty about the business outlook was growing. The strongest investment performance was recorded in the services sector, while the transport industry and energy sector showed the largest slowdown.

Modest global demand and lower capacity utilisation will restrain private investments during 2012. In Swedish industry, the utilisation rate fell to 82.8% in the first quarter of 2012 from 86% in the same period last year, in line with the decreasing production volume. In the Statistics Sweden's investment plan survey of February 2012, the industry reports plans to increase investment volume by 5%, which seems optimistic due to the modest export outlook and low utilisation rate. In the services sector, which accounts for more than one-third of total investment, we foresee a continued increase in investment, particularly in household-related industries. Public investment, which started to decrease at the end of 2011, is expected to continue to shrink in 2012, mainly due to declining infrastructure investments. This is the first time since 2003 that investment in the public sector is expected to fall.

The main downward revision from January concerns real estate investment. The sharp drop in the number of building permits issued at the end of last year will have a negative impact on investment growth this year. Although house improvements will be stimulated by the continuing tax reductions for renovation, the growth rate will decelerate from a high level. Since December 2008, when these tax reductions were introduced, investment in rebuilding has increased by 50%. Overall, we foresee a fall in housing investment of 6% in 2012; this means that investment in real estate as a share of total investment will decrease. Fundamentally, there is still a need for more investment in housing. The growing popula-

Swedbank's GDP Forecast – Sweden

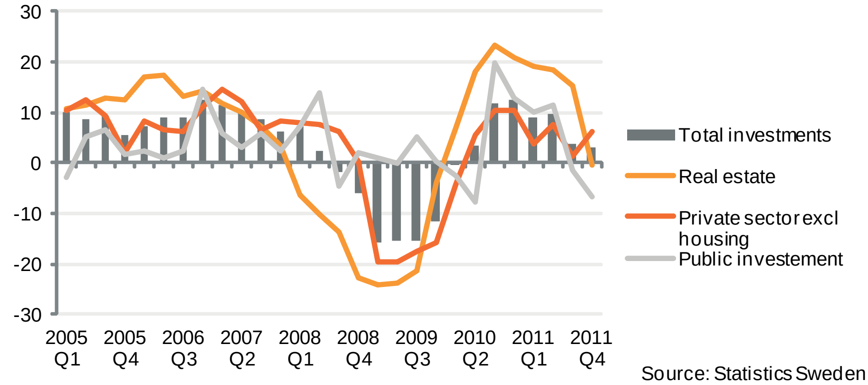
Changes in volume, %	2010	2011[1/]		2012f[1/]		2013f[1/]	
Households' consumption expenditure	3.7	2.1	(1.4)	1.3	(0.2)	2.5	(2.1)
Government consumption expenditure	1.9	1.8	(1.7)	0.6	(0.7)	0.9	(0.9)
Gross fixed capital formation	7.7	5.8	(5.8)	0.1	(1.5)	2.6	(2.5)
private, excl. housing	5.7	5.0	(2.9)	2.6	(2.7)	4.0	(4.3)
public	6.2	1.6	(6.6)	-1.8	(-0.8)	0.4	(0.4)
housing	17.2	12.8	(15.4)	-6.2	(-0.5)	-0.2	(-1.5)
Change in inventories [2/]	2.1	0.7	(0.6)	-0.4	(-0.5)	-0.1	(0.2)
Exports, goods and services	11.7	6.8	(8.4)	-1.3	(-1.1)	2.6	(1.7)
Imports, goods and services	12.7	6.1	(5.9)	-1.1	(-1.7)	2.0	(2.2)
GDP	6.1	3.9	(4.5)	0.2	(0.3)	2.2	(1.8)
GDP, calendar adjusted	5.8	4.0	(4.5)	0.5	(0.6)	2.2	(1.8)
Domestic demand (excl. inventories) [2/]	3.7	2.6	(2.2)	0.8	(0.5)	1.9	(1.7)
Net exports [2/]	0.3	0.7	(1.6)	-0.2	(0.2)	0.4	(-0.1)

Sources: Statistics Sweden and Swedbank.
1/ The figures from our forecast in January 2012 are given in brackets.
2/ Contribution to GDP growth.

tion, particularly in the large cities, and the lack of housing in 60 percent of the Swedish municipalities imply a large underlying demand for new housing. Of the Nordic countries, Sweden has the lowest investment in housing per capita.

We foresee investment growth in 2012 to be weaker than envisaged in the outlook in January, and gross fixed capital formation is expected to grow by only 0.1% this year. In 2013, we expect total investment volume to pick up by 2,6%, driven by stronger investment activity in the private sector and a recovery in the real estate market.

Gross fixed investments in different branches, 2005 Q1 - 2011 Q4 (annual change in %)



Source: Statistics Sweden

Unemployment to increase, competitiveness a challenge

Although the labour market is losing steam, it is holding up somewhat better than we expected earlier in the year. The unemployment rate in February, seasonally adjusted, was 7.5%, which is roughly unchanged from January and December. On average in the first two months of 2012, 390 000 people were registered as unemployed, compared with the 400 000 registered in the same period of 2011. However, labour market participation is trending down, suggesting that more people are discouraged from looking for jobs. Also, the reforms of the sickness benefit system imply that many that were previously registered as unemployed are now leaving the labour force and returning to the health insurance, thereby reducing the unemployment rate.

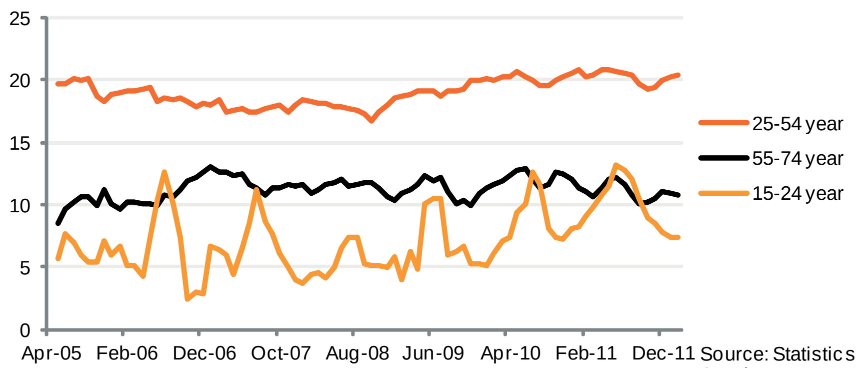
Short-term indicators suggest that the unemployment rate is set to increase in the immediate term. The number of notifications has more than doubled in early 2012 from 2011, and new registrants as job seekers at the public employment service are also up. A positive sign is that the number of open positions is increasing. Partly, this is a result of employers bringing forward summer-season temporary jobs. The "hours worked" statistic is also holding up better than expected, and data do not yet show a decline. This suggests that employers are not seeing an urgent need to reduce labour input.

Against the background of a better-than-expected outturn in the early months of 2012, and a stronger projected economic turnaround, we are revising down our unemployment forecast for 2012 and 2013; however, we still expect the unemployment rate to increase well into next year. The average unemployment rate for 2012 is forecast at 7.8%, unchanged from our January forecast, and at 7.9% in 2013, compared with 8.0% in the January forecast. We do not expect the unemployment rate to exceed 8% in seasonally adjusted terms during the forecast period. In 2013, we expect a pickup in labour demand to raise participation rates and slow the reduction of the unemployment rate. Furthermore, as real growth is expected at 2,1%, below potential, we do not expect a significant dent to unemployment rates.

The wage-bargaining process that was initiated last year is expected to increase cost pressures for companies, which could further strain competitiveness in Sweden. Due to quite drastic revisions of data on hours worked in 2010, productivity was developing significantly more slowly in the Swedish economy in 2010 and 2011 than was earlier believed. This also implies that unit labour costs are increasing faster. Thus, we expect companies to struggle harder in the export markets while productivity growth continues to lag behind wage costs over the next two years.

Although the employment rate has been trending downwards since the autumn of 2011, a stronger-than-expected growth recovery in the second half of 2012 will raise employment levels. However, we expect that job growth will be unevenly distributed among different groups in the labour market. A long period of relatively high unemployment has increased structural unemployment, i.e., long-term unemployed who have had little or no job experience in recent years find it increasingly more difficult to find employment. This is particularly the case for young entrants and for foreign-born job seekers. For these groups, employment rates dropped last year, and, with their lack of experience and labour market connections, we believe that redoubled efforts will be needed to reduce the unemployment rates in these groups. For the age cohort of 25-54-year-olds,

Employment rates: difference between Swedish born and foreign born, Apr 2005 - Feb 2012 (percentage points)



Source: Statistics Sweden

there has been a steady increase in the difference between domestic born and foreign born, despite the improvement of the labour market since mid-2009. For 15-24-year-olds, the employment rate varies more by season, suggesting that Swedish-born youth have easier access to temporary seasonal jobs, something that improves their future work prospects.

Households - the backbone of growth

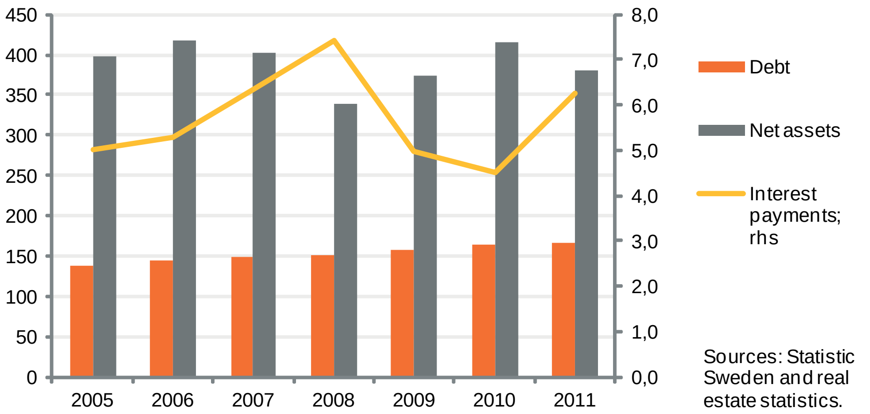
Household consumption picked up rapidly in the fourth quarter of last year after declining sharply in the third quarter. Seen over the whole year, however, consumption grew by 2.1%, compared with 3.6% in 2010. Thus, despite a strong growth in real disposable income, households prioritised savings, which is an indication of the persisting elevated sense of economic uncertainty. The savings ratio increased to 9.7% of disposable income in 2011 from 8.5% in 2010. In addition, credit expansion continued to decline in early 2012, slowing the growth of household indebtedness. Note that the statistics were revised significantly downwards following the exclusion of nonprofit institutions serving households (NPISH). This did not, however, cause a change in the pattern.

Overall consumption continued to develop strongly in the first couple of months in 2012. Both consumer durables and nondurables picked up, while consumer sentiment improved from low levels. Some hesitation remains, however, as registration of cars dropped by almost 4% in the first quarter of 2012 compared with same quarter in 2011. In all, we estimate that private consumption has continued to grow in line with developments at the end of last year.

The financial situation of households has been bolstered by solid earnings, but increasing interest costs and high indebtedness underscore their continuing vulnerability to shifts in asset prices and employment. Real disposable income rose by 3.3% in 2011, more than double compared with 2010. At the same time, consumption grew by 2.1% in real terms. Not only eroding sentiments but also a decrease in household assets can explain the difference. Overall household net financial assets declined as a share of disposable income. In particular, households' holding of equities fell in value by about 10%, while housing assets was roughly unchanged. Using estimates from Statistics Sweden (2006), this would mean a decline in nominal consumption growth of about 1 percentage point, which can partly explain why consumption grew by less than incomes last year. The impact of a housing price decrease of the same magnitude would be about 3 percentage points.

Against the background of a better labour market than in our January forecast, with higher employment and earnings, together with stable asset prices, we revise upwards our consumption growth forecast to 1.3% for 2012 and to 2.5% in 2013. The underlying quarterly growth rate for 2012 is expected to be significantly higher than in our January forecast. The reasons are a better labour market where employment is gradually increasing and a higher real disposable income in combination with stable asset prices and a somewhat better global growth outlook. The improved conditions implies that the savings ratio will not increase to the same extent as in our January forecast, but instead is estimated at around 10% of disposable income. In 2013, the labour market will strengthen further and we expect household sentiments to improve as the European situation stabilizes. Together with fiscal policy supporting household incomes through tax rate reductions, private consumption will continue to increase and the saving ratio will fall to 9,8% of disposable income. Thus, we expect that household spending will provide the largest contribution to growth over the next two years.

Household balance sheet, 2005 - 2011 (% of disposable income)



Sources: Statistic Sweden and real estate statistics.

The monetary easing cycle has ended

The Riksbank kept the repo rate constant on April 17 at 1.50% and gave fairly strong signals that there would be no more reductions, barring a significantly worsening of the economy. Market expectations of a rate cut have declined recently and the new repo will be higher than we forecast in our January report. At the same time, the Riksbank is presenting a slightly worse economic outlook, which leads us to believe that it is putting more weight on financial stability and household indebtedness.

Inflationary pressures have decreased, but with higher oil prices we expect inflation to start picking up. However, according to our current forecast, price increases with fixed mortgage rates (CPIF) will clearly undershoot the target of 2% at the end of the forecast period. At the end of 2013, headline inflation is expected to be 2.0%, while the CPIF is forecast at 1.6%. Thus there is clearly room for a more expansionary monetary policy in the short run.

Despite falling exports at the end of last year, the Swedish krona has strengthened since the beginning of the year, primarily against the euro. The relatively strong performance of the Swedish economy, together with the country's growing status as a safe haven following the demonstration of solid fundamentals in internal and external balances (budget balance and current account), is likely to lead to an appreciation of the krona. Against the US dollar, we do not expect much change, but the euro will lose in value. Together with increasing wage costs and a slowing productivity growth, a stronger krona will put pressure on Swedish competitiveness and increase the challenge of gaining export market shares.

We expect the Riksbank to maintain the repo rate at 1.50% for the remainder of the year, before raising it twice in 2013. However, in our view, the monetary stance will dampen the economic recovery and reduce the rate of decline of unemployment. Thus, we would argue for a continued reduction in the monetary policy rate and would propose dealing with financial stability issues by other means, primarily banking supervision and fiscal policy.

Interest rate and currency outlook

	Outcome 2012 20 Apr	Forecast 2012 30 Jun	2012 31 Dec	2013 30 Jun	2013 31 Dec
Interest rates (%)					
Policy rate	1.50	1.50	1.50	1.75	2.00
10-yr. gvt bond	1.80	2.10	2.60	2.90	3.10
Exchange rates					
EUR/SEK	8.84	8.70	8.65	8.60	8.60
USD/SEK	6.68	6.80	6.87	6.94	6.85
TCW (SEK) [1/]	121.8	120.3	119.8	119.5	119.1

Sources: Reuters Ecowin and Swedbank.

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

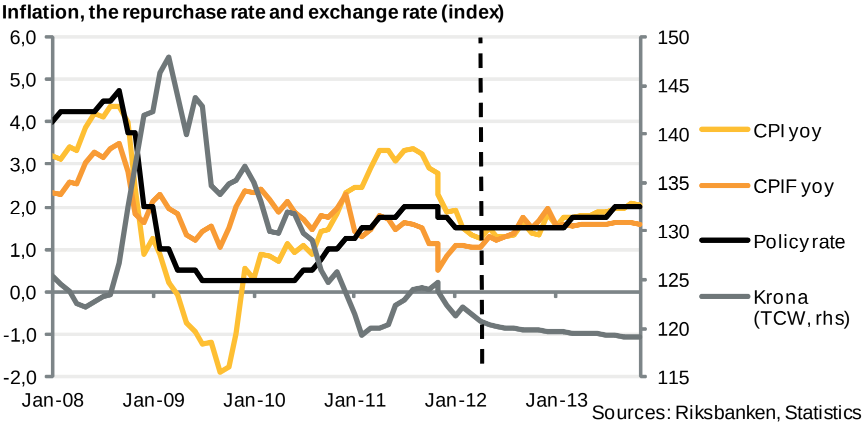
A return to fiscal deficit

The public sector, according to preliminary estimates, ran a surplus corresponding to 0.2% of GDP in 2011, which is an improvement over the previous year by 0.3 percentage point. While the surplus in the pension system (0.5% of GDP) improved the bottom line, the local governments continued to run deficits (0.3% of GDP). Furthermore, government consumption and investments both declined as a share of GDP. The public sector debt decreased by almost 3 percentage points of GDP (according to the Maastricht criterion) as a result of the surplus, positive economic growth, and from revenues of sale of government assets (mainly Nordea shares).

The slowdown in growth, together with unfinanced reforms corresponding to 0.4% of GDP, is expected to move public finances into deficit during 2012. A weaker labour market reduces household tax payments, but increased consumer spending will underpin revenues from value-added taxes. Furthermore, as labour taxation will remain under pressure, we expect local governments to increase their deficits in 2012. In the complementary budget for 2012, the government presented reforms aimed at improving housing market flexibility. This will have a small budgetary impact in 2012, and only a limited one over the coming years (SEK 1.6 billion).

The public sector balance for 2013 is expected to improve as growth picks up and unemployment starts to decrease. Labour market-related taxes and profit taxes are expected to increase, and we forecast the public sector to have a small surplus corresponding to 0.2% of GDP. Included in the budget is an additional fiscal stimulus amounting to SEK 15 billion, the bulk of which will be on the expenditure side. The government has already signalled that it will increase its efforts to bring down unemployment, and we expect targeted measures addressing the situation of youth and foreign born. Additional spending is also expected on infrastructure. However, the impact on the economy will be offset by local governments' striving to consolidate their balances through spending restraint and tax hikes.

Inflation, the repurchase rate and exchange rate (index)



Sources: Riksbanken, Statistics Sweden and Swedbank's forecasts.

The room for expansionary fiscal policy is declining, but the biggest obstacle to the implementation of the government's policy is the weak parliamentary situation that it faces. The downward revision of productivity growth lowers potential GDP. Together with the fairly rapid GDP growth seen in the last two years, this will reduce the amount of business cycle-adjusted savings. Also, the seven-year rolling budget deficit indicator points toward reduced space for increased deficits, and the expenditure ceilings will restrict the expansion of permanent spending to about SEK 18 billion (0.5 % of 2011 GDP). However, we still believe that fiscal stimulus would be appropriate, in particular during the current year of slowing growth. For next year, we would endorse not only a targeted spending initiative to reduce unemployment, but also tax reforms that support growth. The challenge for the government is to develop reforms that can be supported by a majority in the parliament.

However, with the possibility of tax cuts in 2013 and 2014, there is a risk that a procyclical fiscal stance will force the Riksbank to raise policy rates faster than planned.

Magnus Alvesson
Jörgen Kennemar

Estonia: Growth prospects improve

During 2011, the Estonian economy showed strong 7.6% growth in real terms (during the first three quarters, the average growth was approximately 9% but slowed considerably during the last quarter). Strong export growth, together with recovering domestic demand, brought along employment growth, which, in turn, increased households' willingness to spend. In addition, solid foreign demand, despite hazy outlooks for many of Estonia's export partners, encouraged investment growth. This growth, however, slowed in the last quarter of 2011 as uncertainties, already elevated for a long time, forced entrepreneurs to use a wait-and-see strategy in making investments.

Growth in 2011 was a bit slower than we expected in January, as export growth in the fourth quarter was weaker than envisaged and GDP fell in quarterly terms. Nevertheless, domestic demand, especially private consumption, showed solid growth rates. Slowing export growth was mainly caused by the slowing of export sales in the machinery and equipment sector..

For a small and very open economy, the main risks continue to be external – the slowdown of the main export partners' economies will affect the further growth of the Estonian economy. Nevertheless, as economic developments have so far been more balanced than during the boom years, a recession – should it occur – would be considerably smaller than the one seen during 2009-2010. All in all, a global recession or stagnation would affect the Estonian economy through foreign demand, which, in turn, would reduce the need for investments and lowers job creation. This lowering would have its impact on private consumption as well. At the same time, the risks in the global markets are also upside, which might indicate that our forecast is too conservative – the better-than-expected growth in the export markets might raise foreign demand, which, together with stronger confidence, would induce the growth of investments (the inflow of foreign as well as locally available funds).

In addition, Estonia's economic development is affected by the perception of market participants about not only the global outlook but that for the Baltic states. If the global slowdown is not followed by a rapid increase in investors' perception of uncertainty and nervousness, the overall negative effect might be even smaller than described above.

Adverse developments in the global commodity markets pose a risk for the Estonian economy as well. Higher-than-forecast inflation would harm the purchasing power of households, increasing the number of budget-constrained households; hence, private consumption growth might be considerably lower.

Internally, the biggest risk continues to be structural unemployment and the lack of qualified labour – many sectors are facing difficulties in hiring new employees as not enough qualified labour is available. This means that, in the near future, another wage rally might develop for certain occupational groups (e.g., ICT sector specialists, engineers, health care workers, etc.), as was seen in the mid-2000s. In addition to the skills mismatch, emigration continues to pose a threat to competitiveness, as during the crisis years the trend of pendulum migration was on the increase. Those residents who continue to work abroad might eventually emigrate, which, in a country with a decreasing and ageing population, will pose a long-term risk in the form of labour shortages. This, in turn, might affect investment decisions of foreign investors (e.g., regarding small-scale production).

Better outlook for trade partners supports export growth

In 2011, exports of goods and services grew by 24.9%, which were by and large in line with our expectations. For 2012, we revised export growth marginally up to 3.1% (from 2.7%) as we forecast a slightly better outlook for the main export markets. The year 2013 will be even better for exporting companies, as economic activity will increase even more, especially in Europe. In addition, in our previous outlook, we projected the economies of Estonia's main export partners to slow this year, but, in our current view, the slowdown will be smaller. According to our main scenario, the economy will slow only moderately during the first half of this year.

In 2011, the main contributor to export growth was the electronics sector, viz., machinery and equipment. Growth in this sector will slow (growth rates might even turn negative in some quarters), but other sectors – e.g., the manufacture of wood and wood products, the food industry and the metal industry – will contribute more this year and the next.

Key Economic Indicators, 2010 - 2013 1/

	2010	2011	2012f	2013f
Real GDP	2.3	7.6	2.7	4.2
Nominal GDP, billion euro	14.3	16,0	16.9	18.1
Consumer prices (average)	3.0	5.0	3.8	3.2
Unemployment rate, % 2/	16.9	12.5	10.5	8.6
Real gross monthly wage	-2.0	0.5	1.6	2.0
Exports of goods and services (nominal)	25.5	27.4	9.2	10.3
Imports of goods and services (nominal)	24.8	34.0	9.2	11.1
Balance of goods and services, % of GDP	7.4	3.8	4.0	3.4
Current account balance, % of GDP	7.2	6.7	5.9	5.5
FDI inflow, % of GDP	8.1	8.0	9.9	10.8
Gross external debt, % of GDP	115.2	98,0	91.4	90.8
General government budget balance, % of GDP 3/	0.3	1.0	-1.8	-0.6
General government debt, % of GDP	6.7	6.0	7.7	10.0

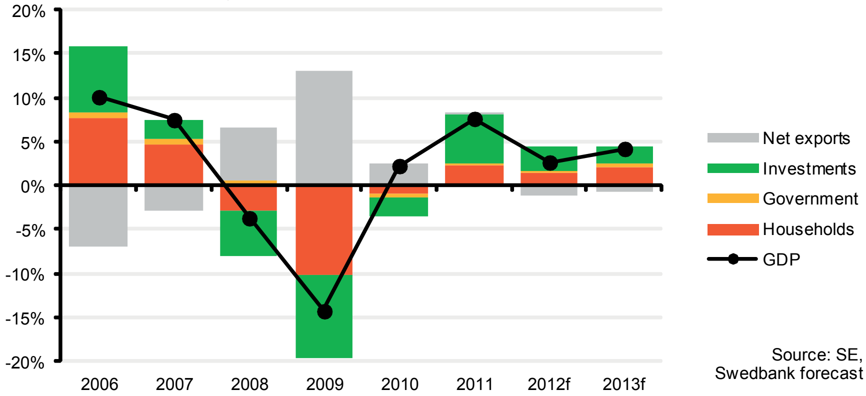
Sources: Statistics Estonia, Bank of Estonia and Swedbank projections.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

Exports of goods and services will be highly dependent on developments in the neighbouring countries of Sweden, Finland, Russia, Latvia, and Lithuania. As 2011 showed, Estonian companies' sales seemed to have been quite resilient to the global slowdown, which might indicate that their price competitiveness allowed them to increase their market share in the destination markets, as well as to find new markets and thus avoid too high a level of concentration. Exchange rate developments have also favoured Estonian companies' competitiveness.

The share of machinery and equipment will be smaller in 2012 and going forward – overall manufacturing in the machinery and electronics sector will be growing at a modest rate. Other sectors' contributions will increase. The beginning of 2012 has already witnessed a strong development in the chemicals and metal industry, as well as the food industry. Therefore, we expect exports to grow by 3.1% this year and 7.1% the next. In exports of wood and wood products, the change in selection in products is also present – higher-value-added products are being sold abroad (i.e., the share of unprocessed wood is decreasing).

The growth in services exports will be supported by the growth in travel and other business services. Transport services (the most important branch in services exports), on the other hand, will grow more slowly, as the need to ensure trade flows is somewhat smaller. The share of IT-related services in services exports is quite small, but increasing rapidly.

Contributions to GDP growth



Import growth will be supported by rising domestic demand, especially private consumption, as well as by exports, because many production inputs are imported. Therefore, the import growth rate will decelerate as well, but at a slower rate than exports, as the share of consumer goods in imports will increase. At the same time, we expect private consumption to grow less than expected in January due to the more rapid price increase; this, in turn, means that the increase in imports of consumer goods might be smaller. We expect imports to grow 4.6% this year and 8.4% the next (in real terms). All in all, this means that the trade balance will worsen.

The government spurs investment growth

In 2011, investment grew by 26.8%, supported by investments in machinery and equipment. This rapid growth rate was also supported by growing demand, causing many enterprises to face their limits in capacity utilisation. Many firms have been facing elevated demand already since 2010 and have incurred the need for investments in order to improve and/or enlarge their production processes. In addition, large investment projects were observed in the energy sector (renewable energy-related projects).

Compared with the January forecast, we revised the expectation of investment growth upwards due to a more favourable market, supported by strengthening confidence as well as by the abolishment of local governments' lending limits. We expect investment to grow 11.5% this year and 7.4% the next. As mentioned in the previous outlook, the main contributor to the increasing investment activity is the government sector – there is an obligation to invest revenues from the CO2 quota trade, as well as to use structural funds as the programming period ends next year. In addition to the central government, local authorities are expected to increase their investments, as there is a need to renovate publicly owned houses like kindergartens, schools etc; the government abolished the temporary limitations for local governments' on-lending this year – if their debt level is less than 60% of their annual budget, they are not obliged to ask permission for additional lending from the Ministry of Finance.

The contribution of the private sector will increase in 2013 – we believe that, throughout most of this year, entrepreneurs will tend to be more cautious and not resume their investment activity until the end of 2012. Corporate sector investments will increase considerably during the next year when the uncertainties will have substantially lessened. Public sector investments will be more modest next year.

Swedbank's GDP Forecast – Estonia

Changes in volume, %	2010	2011 1/		2012f 1/		2013f	
Household consumption	-1.7	4.2	(4.3)	2.7	(3.0)	4.2	(5.6)
General government consumption	-1.1	1.6	(2.6)	1.8	(3.0)	1.7	(2.0)
Gross fixed capital formation	-9.1	26.8	(20.2)	11.5	(7.1)	7.4	(9.8)
Inventories 2/	4.2	-0.7	(0.0)	-0.8	(-1.0)	0.6	(-0.1)
Exports of goods and services	22.5	24.9	(25..8)	3.1	(2.7)	7.1	(6.7)
Imports of goods and services	20.6	27.0	(27.0)	4.6	(2.9)	8.4	(8.9)
GDP	2.3	7.6	(8.0)	2.7	(2.7)	4.2	(4.0)
Domestic demand (excl. inventories) 2/	-3.4	8.1	(7.0)	4.5	(3.7)	4.4	(5.6)
Net export 2/	2.5	0.3	(1.0)	-1.1	(0.0)	-0.8	(-1.6)

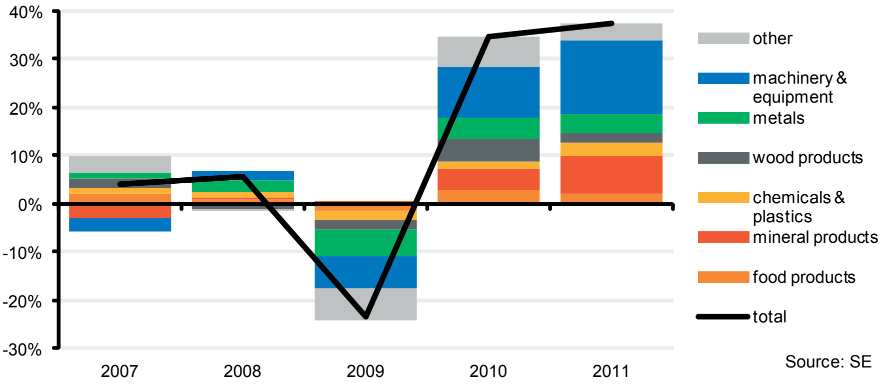
Sources: Statistics Estonia and Swedbank.
1/ The figures from our forecast in January are given in brackets.
2/ Contribution to GDP growth

We expect activity in the residential housing market to increase this year – activity in the housing market started to grow already at the end of 2011. At the same time, despite the rising number of building permits, we are of the opinion that the number of new construction works in 2012 will be modest as construction prices are, according to real estate developers, too high due to the elevated investment activity in the public sector. Nevertheless, we expect residential construction works to increase more next year.

Residential investment activity during this year will be mainly directed towards increasing the energy efficiency of dwellings – energy prices have increased considerably and, according to our main global scenario, we expect oil prices to remain elevated, which, in turn, will affect heating and electricity prices. The latter will also be affected by the opening of the electricity market in Estonia. The initiative to increase the energy efficiency of apartment houses is also supported by a state-owned institution (KredEx).

In addition, the number of purchase-sales contracts has been increasing; this, however, depends on the location and quality of the real estate. All in all, buyers are more demanding: real estate that is still in the market but has poor infrastructure, together with a less-in-demand location, will not find buyers so easily and will remain on the market for a while. On the other hand, there are cases in which apartment houses have found buyers even before construction has started. It is worth noting, however, that many of these purchases have been financed by households' own funds; loan demand will be modest, especially this year, as many households prefer to pay back their old loans and avoid taking on new ones because they still remember the hardships of the past crisis. Next year, loan demand will grow modestly as overall economic development will encourage households to improve their living conditions; average square meter per household member in Estonia is still below average in Europe (30.1 in Estonia compared with 45.2 in Germany and Austria).

Contributions to export growth by product groups



Source: SE

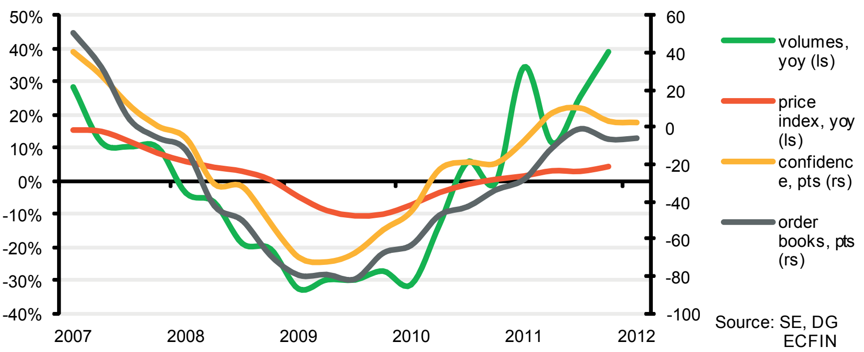
Unemployment will continue to decline

Employment growth was remarkable in 2011 – on average, 6.7% more people were working in 2011 than in 2010 (more than 38,000 people). On one hand, this rapid employment growth was supported by increasing foreign demand, which induced an increase in both investments and the number of employees. On the other, the large inflow of tourists was feeding the services sector and, therefore, created the need for additional workers in the retail, housing and accommodation, and recreation sectors, as well as restaurants and cafes. The latter jobs tended to be more seasonal by nature – at the end of the year, employment decreased a bit. In addition to the above-mentioned sectors, one of the largest increases in the number of employees was observed in the construction sector, where the number of workers increased more than 20% on average.

The unemployment rate fell to 12.5% in 2011 and is expected to fall further and reached 10.5% this year. Due to the rise of job creation and somewhat declining participation rate (see the reasoning in previous Outlook), the unemployment rate will fall even farther next year, to 8.6%. Nevertheless, even though developments in the labour market continue to be encouraging, the problem of structural unemployment remains: if the young people (aged 15-24) remain in the labour market instead of studying, the skills mismatch will worsen in the medium to long run. It is already a problem in certain sectors – e.g., health care, ICT related, electronics, and energy. If immigration policies do not change, shortages of qualified labour may be the main obstacle to the sustainable growth of the Estonian economy.

The trend of pendulum migration continues to pose a risk to the Estonian economy, as there is a chance that those residents employed abroad might emigrate; in a country with an ageing and decreasing population and a lack of qualified workers, this might be the main obstacle to further growth, together with the additional pressure this migration puts on the social system. This is especially true in the case of transportation and construction sector work-

Construction sector



Source: SE, DG ECFIN

ers, as well as of medical staff (both health care and veterinary). In addition, the labour shortage might in the medium run spark another wage rally similar to that seen in 2006-2007; this, in turn, would jeopardise the competitiveness of local producers/service providers.

Real wage growth in 2011 turned positive only in the third quarter (we expected an increase in purchasing power already by the second quarter) after almost three years of decrease; on average, real wages grew by 0.5% compared with the previous year. We expect wages to grow by 1.6% this year and 2% the next. Compared with the previous forecast, we downgraded this year's wage expectations as the price increase will not slow as much as was expected in January. Real wage growth will be supported by an increase in labour shortages. This is especially true in the case of the construction sector – real estate developers and construction firms have to compete with firms in Finland for construction workers, and, to attract them, might have to raise wages quite rapidly.

Oil prices to lower households' willingness to spend

Household spending showed strong growth rates already at the end of 2010, and, in 2011, consumer spending grew by 4.2%. Strong employment growth, together with favourable developments in the labour market, increased households' disposable income which, in turn, gave them more assurance about future developments. This increase in confidence resulted in an increase in spending on durables and semi-durables – purchases that had been postponed during the crisis years, when uncertainty about maintaining jobs and income ran high. For this year, we expect consumer spending to increase by 2.7% – a bit lower rate than was projected in January. The main reason behind such a downgrade is our expectation of faster inflation, due to oil price developments in the world markets: the average consumer basket will be 3.8% more expensive in 2012 than in 2011. Inflation will slow somewhat next year, reaching a growth rate of 3.2%. This faster inflation in 2012 will induce households to spend less as budgets will be even tighter and fixed costs will be higher. Households might even increase their savings on a rational basis – expecting higher housing costs during the winter months, they might not spend as freely during the spring and summer months.

In 2013, households will remain cautious – we expect household spending to increase by 4.2%. In addition to the accelerating inflation, the other factor affecting consumer spending is wage growth – as mentioned above, real wage growth will be rather modest during the forecast period, and not all workers will be able to enjoy the increase in wages – wage growth will be uneven among sectors and will be led by the occupations where the lack of labour is more pronounced (e.g., ICT-related sectors, energy sector, and construction).

Public debt will increase from a low level

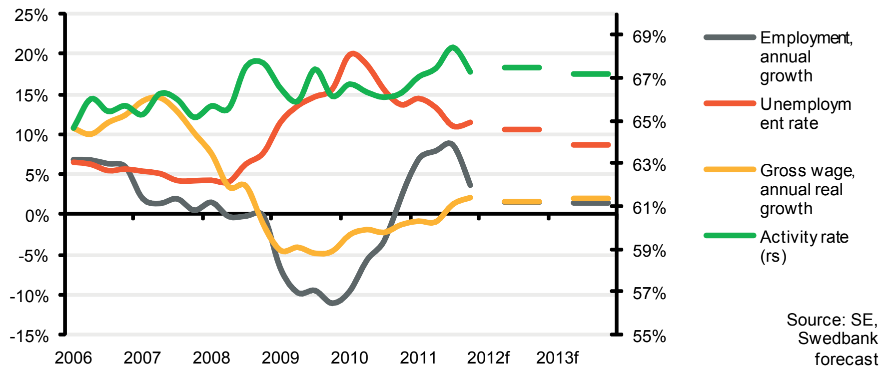
The general government budget reached a surplus for the second year in a row in 2011, at 1% of GDP. This was mainly supported by revenues from CO2 quota sales (the total impact reached 1.2% of GDP), but also by a 7% increase in tax revenues as economic growth and the labour market recovered strongly. This year and the next, however, budget deficits will resume. In 2012, we forecast the deficit to reach 1.8% of GDP due to several temporary factors – e.g., mandatory investments from the quota sales (total impact 1.5% of GDP) and full restoration of the pension pillar payment system. The temporary factors' disappearance will lessen the deficit to 0.6% of GDP in 2013.

Major tax changes that will affect the budget position, besides regular tobacco and alcohol excise increases, include lowering the unemployment insurance tax from 4.2% to 3% in 2013 (which decreases the Social Security Fund's surplus) and reducing the highest allowable deduction from taxable income by 40% (which increases total tax collection).

General government debt was measured at a very low level – 6% of GDP – in 2011; this will increase to 10% of GDP by 2013. The main factor increasing the debt level during our forecast period are the loan payments by the European Financial Stability Facility (EFSF) (3% of GDP), which are reflected as an increase in the debt level; other factors include down payments to the European Stability Mechanism (ESM), investments to raise Eesti Energia's equity capital, the abolishment of temporary debt ceilings for the local governments, and partial coverage of current budget deficits. These factors will weigh on the public finances and might require additional liquidity purchases, as net public debt is set to turn negative during the forecast period. Nevertheless, the situation of the overall public finances is solid, the budget deficits are considered temporary (as the government is fully committed to restoring surpluses as soon as possible), and the growth of the debt is sustainable.

Annika Paabut
Elina Allikalt

Labour market indicators



Source: SE, Swedbank forecast

Latvia: Better outlook, but caution still necessary

The Latvian economy expanded by 5.5% in 2011, with developments in the fourth quarter a bit better than expected. The underlying drivers last year remained exports and EU funds, which boosted investments (both in fixed assets and inventories) and confidence, thereby also promoting consumption. At the same time, since exports and investments are import intensive, rapid import growth resulted in a negative net exports' contribution to GDP growth. The first months of 2012 have brought an anticipated slowdown in industry and export growth, but retail trade has been still surprisingly strong with positive sentiments.

Rising business and consumer confidence in the first quarter of this year and, thus, a somewhat better external environment improve the growth prospects for Latvia. Exporters have so far been more resilient to the global slowdown then we presumed in our January outlook. Furthermore, we have slightly revised upward the outlook for Latvia's main trading partners. Overall, we now see somewhat better opportunities for Latvian exports and a friendlier investment environment. Still, global growth is expected to be slower this year than in 2011 before picking up again next year.

As a result, we are revising our GDP growth forecast to 2.5% in 2012 (2% before) and 3.5% in 2013 (3.2% before). We are also raising the forecast for average consumer price growth from 2.4% to 2.8% in 2012, in order to account for higher-than-expected global oil prices in the beginning of the year. The inflation outlook for 2013 stays unchanged for now, at 2.5%.

The target of introducing the euro in 2014 remains on the agenda, and we believe that it is still feasible. Still, fulfilling the inflation criterion has become more challenging.

The outlook for the labour market is a tad brighter. The unemployment rate is forecast to continue retreating and the participation rate to rise slowly. Employment growth will be slower than last year, though. The unemployment rate based on the current Labour Force Survey data (to be revised according to 2011 population census results) is expected to fall to under 12% in 2013 from 15.4% in 2011.

The current account deficit is anticipated to widen gradually, but will remain under 3% of GDP and to be fully covered with EU funds and foreign direct investment (FDI) inflows.

This is our base scenario. There are both positive and negative risks to it. The main uncertainties come from abroad. One is the global oil price, which may rise further if conflict in the Middle East intensifies. In such a case, inflation in Latvia is likely to be higher in both 2012 and 2013. At the same time, if higher oil prices slow global growth, Latvia's economic development will be more sluggish. A backlash in the euro area is possible, especially if the situation worsen in Spain and Italy worsen. This would hinder Latvian exports and investments, and spill over to slower consumption growth. Lastly, while the current EU sanctions against Belarus will have only a marginal negative effect on Latvian trade, political risks remain. On the positive side, better-than-expected global growth would provide better opportunities for Latvian exports.

Local risks stem mainly from the labour market, where overheating pressures in certain market segments may start to appear already in 2013 if policy action is not taken to reduce structural unemployment and increase the participation rate. Skills and regional mismatches, as well as emigration, could push wages up more than productivity and fuel inflation pressures.

Better export outlook, but growth to continue slowing

We are revising the export outlook upwards for 2012 and 2013, owing to somewhat better growth in Latvia's main trading partners (e.g., Germany and Russia) and the increased flexibility of Latvian exporters (e.g., in finding new markets). The export market shares of Latvian manufacturers continue to rise – e.g., publishing companies are outcompeting publishers in the Nordics. External competitiveness remains sound, even though wages are rising – unit labour costs have risen marginally in manufacturing and continued to decline in transport and tourism in 2011. Research by the Bank of Latvia shows that, accounting also for nonprice factors (e.g., quality and complexity of products), Latvia's external competitiveness is stronger than the unit labour costs suggest.

Food exporters are continuing to penetrate the Russian market, benefitting also from the new Russian investors in Latvia's industry. The political risks

Key Economic Indicators, 2010 - 2013 1/

	2010	2011	2012f	2013f
Real GDP	-0.3	5.5	2.5	3.5
Nominal GDP, billion euro	18.0	20.0	21.3	22.8
Consumer prices (average)	-1.1	4.4	2.8	2.5
Unemployment rate, % 2/	18.7	15.4	13.6	11.9
Real net monthly wage	-6.3	0.1	1.2	2.9
Exports of goods and services (nominal)	20.3	22.5	9.5	10.9
Imports of goods and services (nominal)	19.4	27.2	9.6	11.8
Balance of goods and services, % of GDP	-1.0	-3.4	-3.5	-4.2
Current account balance, % of GDP	3.0	-1.2	-1.8	-2.6
Current and capital account balance, % of GDP	4.9	0.9	-0.4	-1.1
FDI inflow, % of GDP	1.6	5.5	3.5	3.9
Gross external debt, % of GDP	165	146	140	135
General government budget balance, % of GDP 3/	-8.1	-3.5	-2.2	-1.0
General government debt, % of GDP	44.7	42.6	41.3	38.9

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

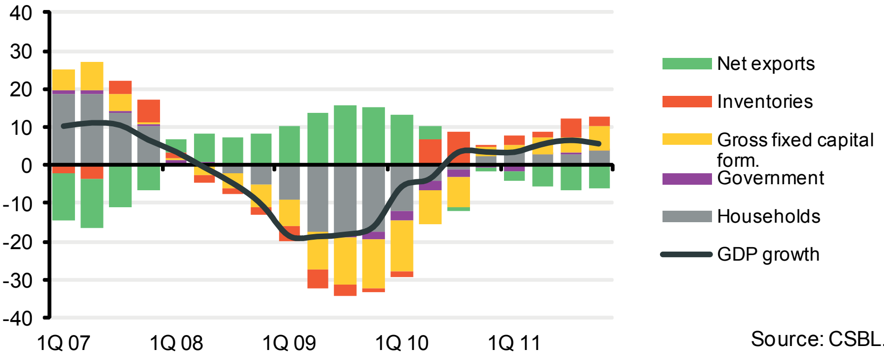
remain high, and the economic environment in Russia is unpredictable (e.g., the ban it imposed on pigs' imports from the EU as of March 2012). Still, Latvian food manufacturers and farmers are taking advantage of this rapidly growing market. Metal and machinery processing-related companies are also expanding in the CIS. Investments made in this industry last year are slowly starting to be transformed into higher output.

At the same time, capacity constraints are acute in some sectors. For instance, capacity utilisation in wood manufacturing, the manufacturing of leather products, and base metals is already higher than in the pre-crisis years. The railway sector is experiencing bottlenecks of freight transit in the east-west direction. Exporters are continuing to invest in production facilities (see the next section for more details), but the effect on output will not be immediate. The EU sanctions against Belarus will have a marginal negative effect on Latvian trade. However, risks for the future export outlook remain, especially for transportation by railway, which is highly dependent on freight transit coming to or from Belarus.

Overall, external demand will rise slower in 2012 than in 2011, hindering Latvian export growth. A quarter with negative quarterly growth of export volumes is possible this year, although overall export volumes are anticipated to rise by about 4.7% in the whole year. Demand is expected to pick up in 2013, and, together with improved production capacity locally, this will boost exports by 5.6%.

Investments, exports, and, to a smaller extent, consumption will continue to drive imports. One of the large investment projects boosting imports is the purchase of passenger trains (41 trains costing LVL 144 million during next three years, which is 1% of 2012 GDP), most of which will be imports. In 2012, imports for this project are still likely to be low, as the bulk of imports will be new machinery and equipment for Rīgas Vagonu Rūpnīca (RVR), the local subcontractor of the Spanish supplier, CAF. It is planned that the first trains fully made in Spain (6 in total) will start arriving in the middle of 2013; in 2014-2015, parts of the trains and materials will be imported, since the production will be gradually taken over by the RVR locally. The largest boost to imports will thus be in 2013-2014.

Contribution to annual GDP growth, pp



Source: CSBL.

The goods and services trade deficit in 2012 is to remain close to that of 2011 (about 3.5% of GDP) and rise somewhat next year. The deficits will be fully covered with EU funds and FDI inflows. The current and capital account deficit is forecast to stay close to zero in 2012 and rise to 1.1% in 2013.

Better confidence supports investments

The investment outlook has been revised upwards somewhat. Pessimism in Europe has abated somewhat and stress in financial markets is declining, with interbank interest rates diminishing. This could support foreign investments. The prospects of a better situation in Germany and other important export markets have improved the confidence of Latvian exporters, who plan to continue boosting their investments in production facilities, taking advantage of EU funds.

Contracts are still not signed for LVL 430 million of EU funds (13% of the total for the planning period 2007-2013), of which LVL 100 million is likely to be allocated for the train purchase project mentioned above. Only 45% of total EU funds have been paid out so far. The profit margins of companies were quite good in 2011, and, despite a strong investment rebound in 2011, deposits of nonfinancial institutions have continued to rise, while liabilities have diminished notably. Businesses can actually start increasing leverage to finance their investments, although they are still cautious about doing so.

Among large public projects, the purchase of new passenger trains (see the previous section) would add on average 1.5 percentage points to the growth of gross fixed capital formation each year in 2012-2014. There will be fewer investments in 2012 – mostly new machinery and equipment for the RVR (under LVL 12 million) – but this will pick up in 2013 when the first trains start arriving.

Still, investment growth in the coming years will be slower than during the 2011 rebound. Investments in residen-

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2010	2011		2012f[1/]		2013f	
Household consumption	0.4	4.4	(4.4)	2.5	(1.7)	3.0	(2.7)
General government consumption	-9.7	1.3	(-0.9))	2.0	(0.5)	2.3	(2.4)
Gross fixed capital formation	-12.2	24.6	(25.7)	7.8	(7.0)	8.0	(3.5)
Inventories [2/]	4.5	2.1	(0.9)	-0.9	(-0.3)	0.8	(0.3)
Exports of goods and services	11.5	12.6	(12.9)	4.7	(3.3)	5.6	(4.6)
Imports of goods and services	11.5	20.7	(18.9)	4.9	(4.0)	7.5	(4.2)
GDP	-0.3	5.5	(5.4)	2.5	(2.0)	3.5	(3.2)
Domestic demand (excl. inventories) [2/]	-4.4	8.6	(8.5)	4.0	(3.0)	4.5	(3.1)
Net export [2/]	-0.5	-5.2	(-4.0)	-0.5	(-0.7)	-1.8	(-0.2)

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

tial real estate will remain weak, as the existing stock is large and local demand feeble. FDI inflows into real estate will also diminish (19% of total FDI inflows in 2011), as the repossession of real estate through banks' daughter asset-management companies will shrink. We forecast about an 8% growth of gross fixed capital formation in 2012-2013. The share of gross fixed capital formation will reach 25-26% of GDP in 2013, the same as in 2003-2004 (before the real estate boom started).

Labour market pressures may intensify already in 2013

The rebound in employment will slow in 2012. Manufacturers are continuing to optimise their production processes, and some of them are also shedding labour. Not much new hiring is expected for the public sector. On the other hand, expanding production facilities requires more labour, as does a pickup in services' activities.

Employment expectations in industry and services have grown in the beginning of this year. Our labour market outlook is a bit brighter now, with slightly more new job creation expected for 2012-2013, but it is still slower than last year. Using the current Labour Force Survey data (still to be revised according to the 2011 population census results), the unemployment rate is expected to fall gradually to under 12% in 2013.

Businesses are cautious about raising wages since they are still focusing on costs. Although wage pressures in the public sector are starting to mount, they are expected to result in actual increases at the earliest in the second half of this year (and only for part of the employees). In the private sector, companies are trying to balance wage and productivity growth by motivating employees with bonus systems and other benefits and are raising base wages only for selected employees.

We forecast net average nominal wages to rise by 4% this year and 5.5% next year, but there are upward risks to this forecast. Labour market pressures are mounting and could heat up already in 2013. The registered unemployment rate in Riga is already below 8% and is approaching the level where wage pressure could arise. Unless policy action is undertaken to reduce structural unemployment and push discouraged persons back into the labour market (especially in the regions), skills and regional mismatches will expand. This might again result in wage growth exceeding productivity growth in the nearest future.

During the recession, labour taxes have been increased; the labour tax wedge (the share of taxes in employers' labour costs) in Latvia is wider than in neighbouring countries and in the EU on average. Labour tax cuts are being discussed. These would increase the purchasing power of households, allowing businesses to contain increases in gross remuneration. However, taking into account that these cuts could worsen the budget situation and increase inflation pressures, they are unlikely to occur in the forecast period – the earliest possible opportunity is the second half of 2013, but 2014 is more likely. The size of the cuts is still uncertain as well.

Inflation recedes, but upward risks exist

Following the unexpected sharp rise in global oil prices in the beginning of this year, we are revising our inflation outlook upwards for 2012. We expect consumer prices to rise by 2.8% on average (2.4% before). Elevated oil prices and a weaker euro have not only resulted in higher gasoline prices, but will also feed into gas and heating tariffs and later into the prices of other goods and services.

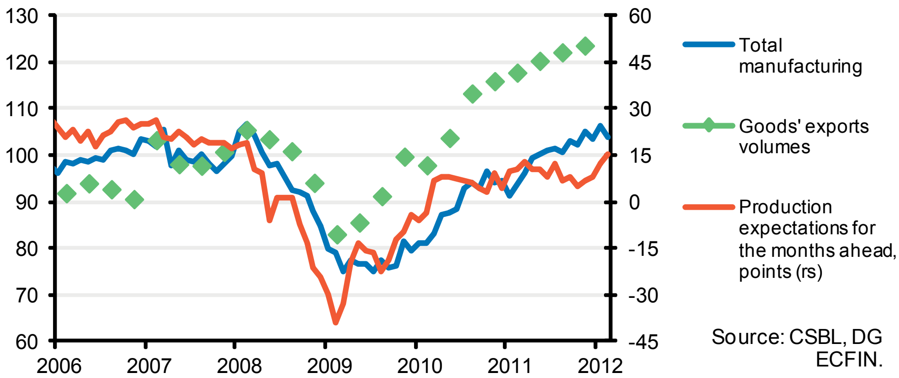
Still, if global oil prices do not rise higher and start retreating slowly in the second half of the year (which is assumed in our outlook), price pressures will recede in the second half of 2012. Global food prices are anticipated to remain largely stable this year. The average inflation forecast for 2013 remains unchanged, at 2.5%.

Risks to the forecast come mainly from abroad, i.e., oil prices. However, from 2013 onwards, there are also local risks, as the strengthening labour market may make it easier for companies to raise prices for their products.

We consider fulfilling the Maastricht inflation criterion in early 2013 to be feasible, but more challenging than it appeared before. First, Latvia's inflation outlook has worsened mainly due to higher global commodity prices, and possibly more so than in three countries with the lowest inflation; thus making it more difficult to fulfil the Maastricht inflation criterion. Second, due to the recession and the debt crisis in the euro area, the ability and willingness to accept new members in the currency union is unclear.

Irrespective of whether Latvia joins the euro area, price stability must be maintained to safeguard consumer purchasing power and external competitiveness. Such structural measures as strengthening competition and improving energy efficiency to lessen the influence of rising global oil prices are fundamental for sustainable growth.

Manufacturing and exports (s.a.), 2007=100



Source: CSBL, DG ECFIN.

Higher confidence fuels private consumption

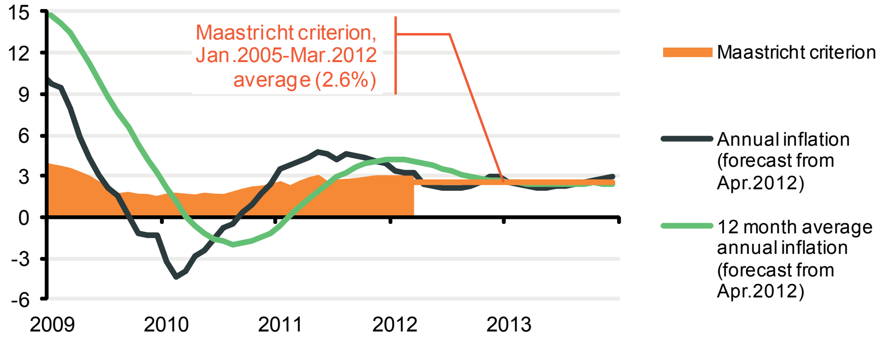
We are raising the private consumption forecast a bit for 2012-2013. This year, the increase is largely due to the surprisingly strong consumer optimism and retail trade growth early in the year. Next year, stronger exports are anticipated to spill over into higher confidence and, thus, consumption.

Household consumption in 2011 rose swifter than the total wage and pension bill, and the same is expected for 2012. Wealthier households, which contribute significantly to overall private consumption growth, often earn capital income. The good business profitability last year encouraged wealthier consumers to spend more. Net transfers by private persons to Latvia (including also emigrant remittances) amounted to about 4% of GDP in 2010-2011 (about 6% of private consumption). Another factor that might have supported consumption is tax evasion.

Household savings rates declined in 2011, but there are indications that lower- and medium-income households started increasing their savings in early 2012. This behaviour is appreciated for reasons of prudence. Total household deposits remain largely stable, though, since wealthier households are shrinking their deposits, most likely shifting to more profitable asset classes (given the current historically low deposit interest rates).

Households have reduced their debt burden (credit stock has declined and interest rates have fallen), and new lending is growing slowly. Still, the deleveraging of households will continue over the forecast horizon, as new loans will not be able to compensate for the amortisation of the boom-years' credit stock.

Latvian HICP inflation and Maastricht criterion, %



Source: Eurostat,

Be careful with budget spending!

The government budget situation is better than anticipated. Tax revenues exceeded the plan by about 10% in the first quarter; they were 17% higher than a year ago, since economic activity in the beginning of the year was still quite strong. In the first quarter, the central government budget deficit was about 0.9% of annual forecast GDP (1.6% a year ago).

Spending pressures are increasing, but the government should be very careful with increasing expenditures, especially taking into account the wide range of risks to the economic outlook. We believe that this year it will still be possible to contain spending pressures, and the budget deficit will be marginally above 2%. We revised the government consumption forecast for 2012 upwards, though, because of the higher-than-expected outcome for 2011.

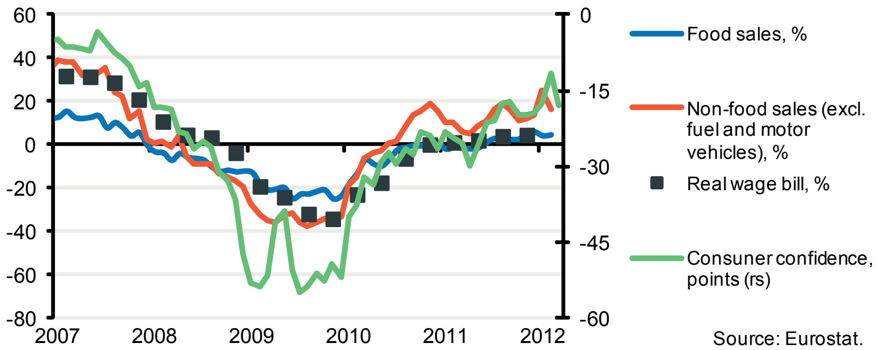
We anticipate government spending to pick up next year, when the budget situation allows for it. The budget deficit is forecast to continue declining in line with the new fiscal rules adopted in the EU. We thus expect the authorities to comfortably meet the Maastricht budget deficit criterion.

Although active discussions on reforms in education, health care, the social security system, tax policy, and regional policy are continuing, so far little has been done. It is vital to keep going and increase the speed of reform implementation to exploit the current window of opportunities (municipalities' elections are scheduled for the summer of 2013 and parliamentary elections for the autumn of 2014).

We urge the authorities to look at these reforms through the prism of the labour market – to reduce overheating pressures, structural unemployment should be lowered, the participation rate raised, and regional imbalances addressed.

Lija Strašuna
Mārtiņš Kazāks
Dainis Stikuts

Annual growth of retail trade and wage bill, consumer confidence



Source: Eurostat.

Lithuania: Rosy developments stained with oil

The tension and concerns at the end of 2011 have taken their toll on the economy, which expanded by 5.9%, slightly less than we forecast. Annual growth in the final quarter of last year slowed sharply to 4.4%. However, the only reason for this slowdown was a severe contraction in inventories – gross capital formation in the final quarter was 13.5% lower than a year ago, although growth in gross fixed capital formation accelerated to 10.4%. At current prices, inventories in the final quarter contracted by almost LTL 1.2 billion, or 4.2% of GDP in that quarter. Similar trends were observed at the onset of the global financial crisis and deep recession at the end of 2008 – companies, wary of a possible contraction in domestic and foreign demand, cut the production and stocks of final and intermediate goods.

Households, however, shrugged off the negative sentiment, and, in the fourth quarter of 2011, annual consumption growth was 8.1%, almost two times faster than in the previous quarter. Consumer resilience was supported by rapidly declining unemployment, which dropped to 13.9%, and by healthy growth in real net wages, which were 2.1% higher than in the previous quarter. Furthermore, emigrant remittances last year reached a record LTL 4.8 billion (4.6% of GDP) and made up almost one-fifth of household disposable income.

Developments at the beginning of this year were in line with our January forecasts; thus, we keep our growth forecast for this year unchanged. However, the economy is expected to grow faster in 2013 – at 4.3%. As the global economy and main Lithuanian export markets are expected to grow faster next year, so will Lithuanian exports. However, the main drivers of growth will remain household consumption and investments, which are expected to increase somewhat faster than previous forecast, by 3.7% and 10.0%, respectively. We also raise our forecast for inflation this year to 2.8%, up from 2.5%. This is mainly due to frothy oil markets, but some domestic factors play a role as well.

Internal and external risks

The external risk related to the euro area debt crisis has subsided. Although Europe, especially the periphery, remains in the grips of recession, the probability of chaotic defaults and break-up is lower. Admittedly, the risk related to worse developments in Italy and, especially, Spain can further worsen European woes and, in turn, Lithuanian prospects for export-driven growth. A more immediate risk is related to tensions in the Middle East and the dangerously high oil price. If supply from Iran and other countries in the region were to be disrupted and cause a further increase in the oil price, this would have painful direct and indirect effects on the Lithuanian economy.

The Lithuanian government nearly collapsed (or so it seemed) at the beginning of this year, and there were calls for early elections. However, despite the real tensions between members of the coalition, we believe that this government will continue working until parliamentary elections in October. The number of politicians' propositions related to tax cuts and spending is increasing and will probably continue to do so. However, the biggest risk is related not to the decisions taken before the October elections, but to the composition of the incoming government and its willingness to continue fiscal austerity and long-term economic policy, especially related to energy projects (the nuclear power plant and liquefied natural gas terminal).

Admittedly, there are tangible positive risks to our forecasts this year – consumers can become less cautious and lower their savings rate, whereas companies may emerge from a three-year-long lethargy and increase their investments at a faster pace (as they have the means to do so).

Exports are likely to shift eastwards somewhat

Lithuanian export volumes of goods and services increased by 13.7% last year and exceeded their previous peak by 13%. As imports started growing much slower than exports in the second half of last year, the foreign trade deficit was only 1.3% of GDP in 2011, below our forecast of 3.0%. This, at least partially, was caused by the above-mentioned decision to cut inventories.

Although the recession in the euro area is worsening Lithuanian export perspectives in that region, the weaker euro has pushed the Lithuanian real effective exchange rate downwards in recent months. Both the Polish zloty and the Russian rouble have appreciated some 8 percent versus the euro since the beginning of this year. As this

Key Economic Indicators, 2010 - 2013 [1/]

	2010	2011	2012f	2013f
Real GDP	1.4	5.9	3.3	4.3
Nominal GDP, billion euro	27.5	30.7	32.2	34.6
Consumer prices (average)	1.3	4.1	2.8	2.5
Unemployment rate, % [2/]	17.8	15.4	13.0	11.0
Real net monthly wage	-4.3	-2.0	1.4	2.0
Exports of goods and services (nominal)	29.8	27.5	10.0	8.0
Imports of goods and services (nominal)	28.9	27.6	10.8	8.0
Balance of goods and services, % of GDP	-1.1	-1.3	-2.0	-2.0
Current account balance, % of GDP	1.5	-1.6	-2.5	-2.7
Current and capital account balance, % of GDP	4.2	0.9	0.5	-0.7
Net FDI, % of GDP	2.1	2.8	4.0	4.0
Gross external debt, % of GDP	87.4	80.8	79.5	76.5
General government budget balance, % of GDP [3/]	-7.2	-5.5	-3.0	-2.0
General government debt, % of GDP	38.0	38.5	40.0	39.0

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

improves Lithuanian manufacturers' competitiveness in these countries, it is likely that exports will grow, mainly to neighbouring and CIS countries.

The Belarusian rouble lost around two-thirds of its value last year, but only around 1% of exports of Lithuanian origin are sold in this country. Despite massive devaluations, exports of goods of Lithuanian origin to Belarus were stable throughout last year and trended downwards only during the first two months of this year. If the EU decided to impose stricter sanctions on Belarus, the transport sector would sustain a severe blow – last year, out of 36.6 million tonnes transported through the Klaipeda port, 11.5 million tonnes, or 31.4%, were Belarus transit goods. The Lithuanian Confederation of Industrialists calculate that the shutdown of all trade with Belarus would cause LTL 2.5 billion (2.3% of GDP) in losses to the transport and storage sectors. However, we do not think that such a scenario is very likely.

Low investments to recover strongly

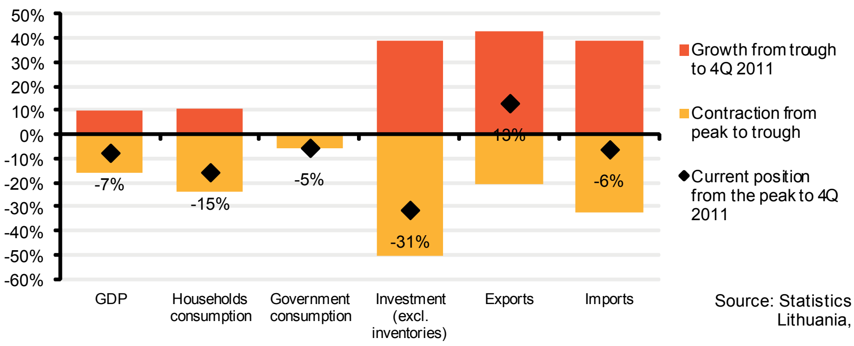
Annual growth of gross fixed capital formation slowed to 9.2% in the second half of last year, but we expect it to accelerate somewhat and grow by 11.0% this year. Although capacity utilisation has been hovering around 70% for the past year and remains below its optimal level and pre-crisis average of 75%, a more rapid growth in investments is overdue.

Investments in fixed assets picked up from the bottom last year, when they increased by 21.6%. However, as a percentage of GDP (13.2%) they are still below the 1997 level of 13.5% and almost two times below the pre-crisis peak of 23.5% in 2007. Admittedly, investments in pre-crisis years were driven by the real estate sector, but the acquisition of equipment, machinery, and transport vehicles also stagnated during the past three years and made up on average only 4.0% of GDP. This is an all-time low and more than two times lower than the 8.5% recorded in 2007.

We expect gross fixed capital formation to continue growing rapidly in 2013 and increase by 10.0%, slightly faster than in our January forecast. The slowdown in investments must have been temporary and caused by jitters in the euro area. As we have argued before, companies have multiple funding sources of investments. Last year, corporate profits before tax reached LTL 12.7 billion, 20.2% above the 2010 level, although they remain below the pre-crisis highs. Outstanding loans to nonfinancial corporations stopped contracting and are expected to start increasing again this year.

Currently, already-signed contracts for funding from EU structural funds amount to EUR 6.0 billion, of which only EUR 3.4 billion has been paid out. The total allocated amount for the period from 2007 until 2013 amounts to EUR 7.4 billion. This means that the majority of the funds will be paid out this year and the next, and will remain important source of investments. Furthermore, until the end of 2013, companies can still benefit from investments in technological renewal, which can lower taxable profit by up to 50%.

GDP dynamics by expenditures, %



Source: Statistics Lithuania,

Improvements in the labour market to continue

Unemployment declined slightly faster than anticipated and, at the end of last year, was below 14% for the first time since mid-2009. However, this is still well above the comfort zone. Unemployment is expected to decline to 12.5% at the end of this year and 10.1% at the end of 2013, slightly lower than we forecast before.

Registered unemployment has edged up at the beginning of this year – there were 244,000 unemployed registered at the Labour Exchange at the end of March. However, employers recently became more active and registered 19,300 new vacant jobs during March, 44.3% more than in February.

A return to the natural level of unemployment of around 6% is still beyond our forecasting period. Before the crisis, 30% of all the jobs were in the manufacturing and construction sectors; at the end of last year, there were 142,600 fewer jobs in these two sectors. If manufacturing and construction recovered all lost jobs, unemployment would drop to some 5%. However, we forecast that only 29,000 jobs will be created in all the sectors this year.

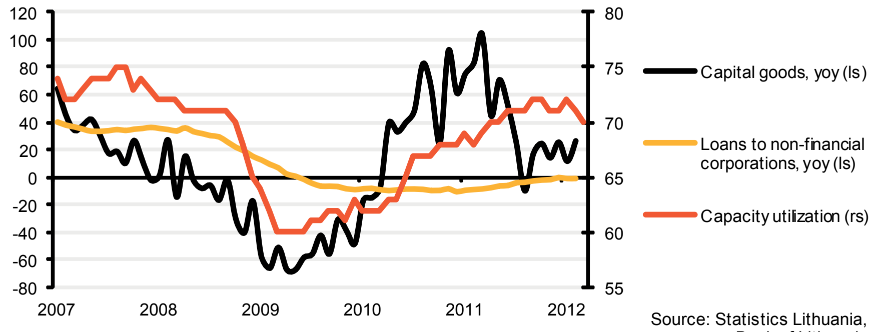
Swedbank's GDP Forecast – Lithuania

Changes in volume, %	2010	2011		2012f[1/]		2013f	
Household consumption	-4.9	6.1	(5.5)	3.5	(3.0)	3.7	(3.5)
General government consumption	-3.3	0.4	(1.7)	-3.0	(-3.0)	1.0	(1.0)
Gross fixed capital formation	1.0	17.1	(20.0)	11.0	(11.0)	10.0	(8.0)
Inventories [2/]	4.9	-1.9	(0.4)	0.0	(-0.2)	0.0	(0.0)
Exports of goods and services	17.4	13.7	(14.0)	4.0	(4.0)	5.0	(4.8)
Imports of goods and services	17.3	12.7	(15.2)	4.8	(4.2)	5.5	(5.0)
GDP	1.4	5.9	(6.3)	3.3	(3.3)	4.3	(4.0)
Domestic demand (excl. inventories) [2/]	-3.7	8.5	(6.6)	3.4	(3.6)	4.5	(4.2)
Net export [2/]	0.2	-0.7	(-0.7)	-0.1	(-0.1)	-0.2	(-0.2)

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

Nominal wages will increase by 4.3% this year, considerably faster than last year's 2.6% rate. Since nominal wage growth will outpace inflation this year and the next, real net wage growth will be positive for the first time since 2008 and will increase by 1.4% and 2.0% this year and the next, respectively. Competitiveness will not be lost, as labour productivity during the same period is expected to increase by 1.2% and 2.5%.

Growth of capital goods import, production capacity utilization level and loans to non-financial corporations



Source: Statistics Lithuania, Bank of Lithuania

Household consumption will grow at a sustainable rate

Retail trade has been relatively unscathed by the falling consumer confidence – annual growth increased throughout last year and eased only in February this year, when it was 7.3% higher than a year ago. Although consumer confidence has recovered somewhat, we expect annual retail trade growth to trend down towards 5%.

Brighter developments in the labour market and ebbing concerns about the euro area breakup will have a positive impact on consumer confidence and domestic demand; thus, we increased our household consumption growth forecast this year and in 2013 to 3.5% and 3.7%, respectively. Consumption will grow in line with the real wage bill, which is expected to increase by 3.6% and 3.7%, respectively. The household consumption growth is markedly lower than that in 2011, when it expanded by 6.1%, despite the stagnating wage bill, which increased only by 0.5% (in real terms). But households were relatively happy last year and put aside a much smaller fraction of their income for savings. We do not expect the savings rate, which is already well below the EU average, to decline further, let alone turn negative, like it did in 2007 and 2008.

As the real growth of wages and decline in unemployment are expected to remain modest, there are few other sources of household consumption growth. During the past three years, households have undergone a deleveraging process and reduced their debt from LTL 30 billion at the end of 2008 to LTL 26 billion. At 23.4% of GDP, Lithuanian household debt is among the lowest in the EU, and there is room to stimulate growth with credit. However, as consumers remain wary and banks are embracing a more sustainable model of growth, one should not expect that household credit will grow by 80% a year, as it did, on average, between 2004 and 2008.

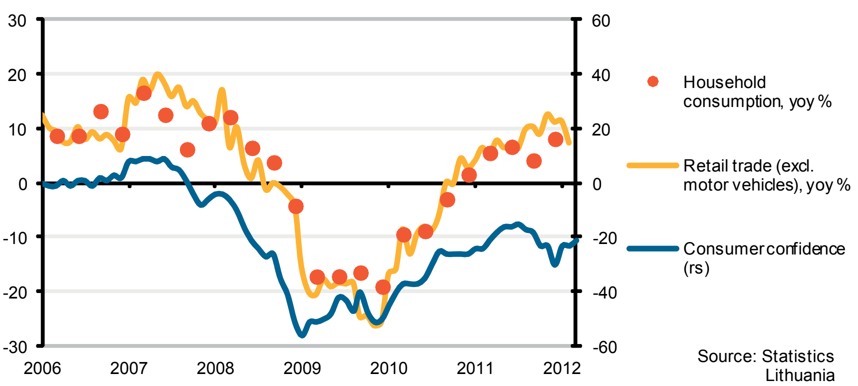
Oil dampens the prospects of euro adoption

The higher-than-anticipated price of oil, more expensive electricity and heating, and larger excise duties on tobacco all have contributed significantly towards higher inflation at the beginning of this year. In January, we were forecasting the oil price to ease and average US$102 per barrel in 2012. However, continued tensions and supply disruptions in the Middle East have pushed the oil price towards US$125 early this year. We now forecast that the average annual price of Brent oil will be US$119.5 this year and US$113.5 in 2013. Furthermore, we forecast a slower decline in global food prices – they are expected to fall by 8.4% this year, compared with our previous forecast of a 12.2% decline. The weakening euro is creating additional inflationary pressure.

We are increasing our forecast of inflation this year to 2.8%, up from our January forecast of 2.5%. Price growth is still lower than last year's 4.1%, but this may not be enough to meet the Maastricht criterion of the three lowest inflation rates in the EU plus 1.5 percentage points. Currently, the threshold is at 3.1% but is likely to decline during the year.

As the oil price is expected to ease somewhat in 2013, so is inflation in Lithuania – we have lowered our forecast of consumer price growth to 2.5% next year. This means that Lithuania is a lot less likely to meet the Maastricht inflation criterion this year; however it seems that, considering the lower inflation and smaller budget deficit, the odds are good of meeting the criteria next year and adopting the euro at the beginning of 2015. However, uncertainty related to price developments and Europe's readiness remains.

Consumer confidence index and consumption



Source: Statistics Lithuania

Public finances are less strained, but risks remain

This year's government budget is based on an assumption of GDP growth of 2.5% and average annual inflation of 2.7% – below our forecast of, respectively, 3.3% and 2.8%. Thus, although fears were expressed during confirmation of the budget, it is very likely that there will be no need to revise the budget in the middle of this year. This is also confirmed by state budget revenues during the first quarter, which were well above the revenues during the same period last year and 3.6% above the plan.

However, we still forecast that the government budget deficit will be close to 3% of GDP this year, not lower as suggested by the currently positive trends in government revenues. The reason being is that, as parliamentary elections approach, more and more propositions related to tax cuts and additional government spending will emerge. For example, as oil and fuel prices at gas stations reached all-time highs, some parliament members proposed to cut the excise duty on fuel to the minimum level allowed by the EU (the duty is currently some 20% above that level).

Other politicians are proposing to apply a reduced value-added tax (VAT) to food products. However, although we think that lower taxes might stimulate domestic demand and possibly reduce smuggling, we do not believe that such propositions are timely, since the above-mentioned tax cuts would undermine government revenues and significantly worsen public finances. A cut in the excise duty would lower government revenues by LTL 100 million (about 0.1% GDP), whereas a reduction in the VAT on all food products could amount to government losses of up to LTL 1 billion (about 0.9% of GDP).

We think that this government will survive until the elections in October of this year and will be, despite its huge unpopularity, the longest-serving government since Lithuania regained independence in 1990. As we forecast in our January Swedbank Economic Outlook, it is likely that the government will decide to increase the minimum monthly wage this summer by 12.5%, to LTL 900 (EUR 261) and perhaps make other popular and demand-stimulating decisions. Thus, we think the economy will grow somewhat faster in the second half of this year. However, the government retains a strong determination to meet the Maastricht criteria this year and have a budget deficit at or below 3% of GDP.

Public finances are set to improve next year, when the budget deficit is expected to decline to 2% of GDP. Overall, current economic trends are favourable and will enable the government to balance the budget in 2014. However, we think that the pre-election promises will prevent this dream from coming true.

There is another risk that could significantly spoil public finances in the coming years. After the bankruptcy of the Snoras bank, the government gave a six-year loan of LTL 3.3 billion (EUR 0.96 billion, or 3% of this year's GDP) to the Deposit and Investment Insurance Fund to help meet its obligations to the depositors (some of the debt was already repaid, current outstanding Fund's debt amounts to LTL 2.4 billion). In theory, this sum should be recovered after Snoras' assets are liquidated; however, creditors of Snoras are seeking to dispute the fund's priority rights at the constitutional court. If the court rules in their favour, Lithuania may have to count this loan as an expenditure and face a one-off spike in public deficit.

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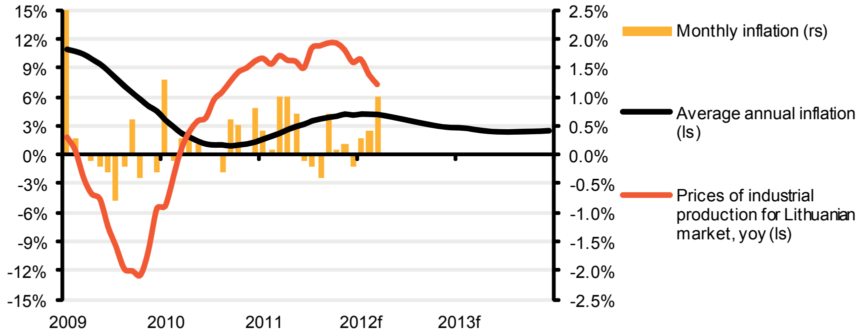
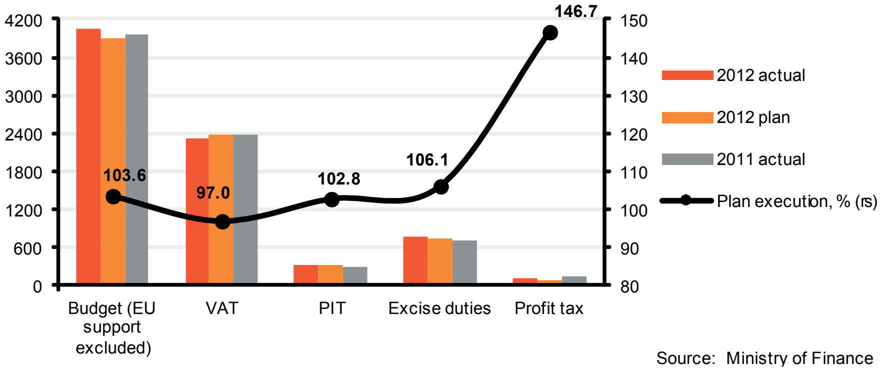
Consumer and Producer Prices



Source: Statistics Lithuania

State budget revenues in 1Q 2012, m LTL



Source: Ministry of Finance

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