Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

August 21, 2012

Dancing on the edge of danger

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Global development

- The world economy is cooling, and the euro area is near recession. We have revised downwards global GDP growth to 3% in 2012 and 3.1% in 2013, from 3.1% and 3.4% in our April forecast. Given that our "muddling-through" scenario holds, growth will increase to 3.4% in 2014.
- The main negative forecast risk is a worsening of the crisis in the euro area, but the US's falling off the "fiscal cliff," a hard landing in China, and higher commodity prices could also generate a weaker outcome. On the contrary, faster crisis resolution could lead to higher growth.

Sweden

- Real growth rates picked up significantly in the first half of 2012, driven mainly by net exports. Domestic demand was also robust on the back of a better-than-expected labour market. The external slowdown, however, indicates that the rate of expansion will slow significantly the rest of the year.
- The sharp rise in the krona poses significant challenges for export-oriented companies and for economic policymaking. We expect the repo rate to be kept too high, while fiscal policy will not be able to make up for the slack in demand in the short term. Although growth will pick up to 2.4% in 2014, following the 1.6% gain in 2013, unemployment will remain high, at 7.6%.

Estonia

- Economic growth slowed in the first half of 2012, and growth is increasingly being generated by the domestic economy, while export growth has slowed. Unemployment continued to decrease in the first half of 2012, to 10.8% on average.
- We are raising our GDP forecast for this year from 2.7% to 3.0% due to the better outcome for both foreign and domestic demand, and are revising growth for 2013 downwards from 4.2% to 4.0%. Growth is expected to reach 4.3% in 2014 as global growth accelerates. Inflation will slow from 3.9% in 2012 to 2.7% in 2014. Public finances will remain solid.

Latvia

- The economy expanded by a remarkable 6% in the first half of 2012. Quarterly growth has remained at solid 1% over the last three quarters. Both exports and domestic demand are contributing to growth, owing to robust confidence, gains in competitiveness, and EU fund support.
- We are raising the growth forecast to 4% (2.5% before) in 2012, while keeping it at 3.5% in 2013. Growth is expected to pick up to 5.2% in 2014, as global conditions improve and local labour tax cuts support consumption. Inflation will remain at 2.5% in 2012-2013, but rise to 3.5% in 2014 due to rising global energy prices and strengthening domestic demand.

Lithuania

- In line with expectations, GDP growth has slowed this year and probably bottomed out in the second quarter. Budget revenues continue to exceed the plan, indicating that the goal of cutting the deficit to 3% of GDP this year will be met. Inflation has kept declining but is likely to pick up somewhat next year.
- Although uncertainties remain, we expect growth to reach 4.1% in 2013 (slightly lower than previously forecast) and accelerate to 4.5% in 2014. Unemployment was volatile in the first half of this year, but is expected to decline and reach 9.3% in 2014.

Laudable upswing – but watch out for global tumble

Despite difficulties in the global environment, Sweden and the Baltic economies have so far performed better than expected in our April forecast. Distant from the epicentre of the European crisis, these countries have seen strong growth, but, in the rest of this year, activity is expected to slow as the trade and investment climate is weakening. If developments in the euro area follow our "muddling-through scenario", a pickup in activity is likely during 2013 and 2014. GDP growth is expected to increase from 3-4% 2012 and 2013 to 4.5-5.2% in 2014 in the Baltic countries; growth in Sweden, meanwhile, will fall from 1.8% to 1.6% next year, before reaching 2.4% in 2014.

Compared with our April forecast for these countries, GDP growth with few exceptions has been revised up for 2012, while the reverse applies for 2013. Growth will gradually pick up from 2013 onwards. Sweden and the Baltic countries are highly dependent on the global economy, which, compared with our previous forecast, will grow slower in 2012, at 3.0% (3.1%), and in 2013, at 3.1% (3.4%), before reaching 3.4% in 2014. This means that the global economy will underperform throughout the forecast horizon, increasing the output gap and also unemployment.

The main driving forces for the modest global growth are stimulus policies in the emerging markets through lower policy interest rates and fiscal expansion. In the advanced economies, policy tools are more restricted, since policy interest rates cannot go much further down, the effects of quantitative easing are most likely small and temporary, and the political – and, for some countries, economic – room for fiscal expansion is lacking. We have revised the oil price in dollars per barrel downwards to $110 and $104 for 2012 and 2013, from $119 and $113 in our April forecast. In 2014, the oil price is seen at $111 per barrel. The decline should support consumption in oil-importing economies, and disinflation should push up real purchasing power amongst households. However, increasing food prices is an upward inflation risk. The euro will weaken further, thus supporting the export sector, while making imports more expensive in the euro area.

There are great drags on the advanced economies from credit and fiscal austerity, unclear crisis management in the euro area associated with increased financial market fragmentation, and, in the US, the threat of falling off a "fiscal cliff" if expenditures have to be cut and taxes increased. Business and consumer confidence has already been hurt, and the willingness to invest, recruit, and consume is faltering.

The euro area crisis is the main obstacle to global growth as not only southern Europe, but also the UK are in recession with the risk of spreading to core countries such as France and Germany. In addition, the credibility of the euro as a currency is at stake, thereby putting at risk global financial markets and the real economy. Greece may have to leave the euro area if the country lacks the ability to reform and, subsequently, loses external support to finance its debt and perhaps also to obtain more debt forgiveness. Spain's and Italy's sovereign bond rates are still higher than what is bearable in the medium term, thus increasing the probability of a bailout, in addition to the already existing support for Spanish banks. The permanent bailout fund, the European Stability Mechanism (ESM), is awaiting clearance from the German Constitutional Court, and credit ratings are being slashed in the meantime. Even so, working groups with their task of designing better institutions, composed of both politicians and central bankers in the European Central Bank (ECB), will slowly make progress during the autumn; meanwhile, financial volatility remains high.

As we assign a 60% probability that our main muddling-through-scenario will be realised, there are great risks that could change the outcome substantially. These are biased more towards the negative side (35%), while positive risks are small (5%). Although still coping, the world economy is living dangerously, maintaining imbalances that hold down growth. The euro area crisis could become aggravated if political consensus on how to go forward were not to emerge, Spain and Italy had to seek support simultaneously, and/or Greece had to leave the euro area. On the other hand, confidence could strengthen if the euro crisis management improved, moving towards a banking union, stronger fiscal cooperation with Eurobonds, as well as accepting that the ECB would fully become the lender of last resort. In the US, the political gridlock related to fiscal policy is the greatest risk, since the above-mentioned threat of falling off a fiscal cliff would, if fully realised, reduce GDP growth by 3-4 percentage points in 2013. Growth in emerging markets, not least China, could slow more than

Macro economic indicators, 2011- 2014

	2011	2012f	2013f	2014f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	4.0	1.8	1.6	2.4
Estonia	7.6	3.0	4.0	4.3
Latvia	5.5	4.0	3.5	5.2
Lithuania	5.9	3.3	4.1	4.5
Unemployment rate, % of labour force				
Sweden	7.5	7.5	7.7	7.6
Estonia	12.5	10.5	9.8	8.7
Latvia	16.2	15.5	13.7	11.5
Lithuania	15.4	13.2	11.5	9.3
Consumer price index, annual change in %				
Sweden	3.0	1.2	1.8	1.9
Estonia	5.0	3.9	3.1	2.7
Latvia	4.4	2.5	2.5	3.5
Lithuania	4.1	2.8	3.0	3.4
Current account, % of GDP				
Sweden	7.0	6.9	6.4	6.3
Estonia	2.1	-0.1	0	-0.5
Latvia	-1.2	-1.6	-2.7	-3.8
Lithuania	-1.6	-2.5	-3.0	-3.6

Sources: National statistics authorities and Swedbank.

expected in response to the crisis in advanced economies, thus lowering global growth substantially. Other upside and downside risks include commodity prices, exchange rates, and political developments, including elections.

After contracting at the end of last year, GDP in Sweden expanded by 0.8% and 1.4% in quarterly terms in the first two quarters of this year. Net exports accounted for the largest contribution to growth. Going forward, growth will slow, becoming more dependent on private consumption and investments. GDP is expected to grow by 1.8% this year in calendar-adjusted terms, before slowing to 1.6% next year; however, quarterly growth in 2013 will be higher than in the second half of this year. In 2014, GDP growth will be above potential growth, reaching 2.4%. Unemployment will remain at an elevated level, reaching 7.6% in 2014, which is still high and most troublesome for the long-term unemployed. There is room for economic policy to be more expansionary, e.g., by lowering the repo rate and taxes while increasing expenditures, but both the Riksbank and the government will remain cautious. Thus, the repo rate will bottom out at the current level at 1.5% before rising to 2.5% at the middle of 2014. The Swedish krona will therefore remain strong and constitute a challenge for export companies. Inflation will remain below the target of 2%, and unemployment will be unnecessarily high. With an eye on the election in September 2014, the government will expand fiscal policies, but with the implicit goal of continuing to lower the government debt ratio towards 35%. With 10-year government bonds at 1.4%, an increase of investment spending on infrastructure and education would make economic sense.

Estonia's GDP expanded by 0.4% quarterly and 2.0% annually in the second quarter. Exports has contributed largely to growth, but domestically oriented sectors are now increasingly supporting the expansion. GDP is expected to grow by 3.0% this year, before accelerating to 4.0% in 2013 and 4.3% in 2014. Export growth is slowing this year but will benefit from a weaker euro and relatively dynamic export markets in northern Europe – which are more important to Estonia than the struggling markets of southern Europe. Inflation will decelerate due to a higher base and lower commodity prices, which, together with an improving labour market, are supporting household spending. Public finances remain solid, with a low debt ratio of around 10%, and, after this year's and next year's small budget deficits, the budget again is expected to show a surplus in 2014.

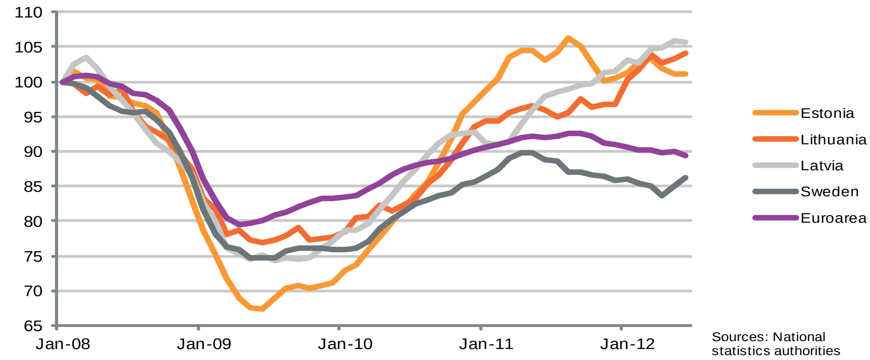
Latvia's economy continued to expand by a brisk 1% in quarterly terms in the second quarter. As, in annual terms, GDP grew by 5.1%, the continuing recovery is also supporting a fall in unemployment and strengthening confidence. Both exports and domestic demand have so far contributed to growth. However, the slowing activity of the main trading partners – and negative calendar effects – will cause growth to decelerate from 4% this year to 3.5% in 2013. Gradually, a better global climate, labour tax cuts, and catching-up effects will drive growth up to 5.2% in 2014. The risks are related to external developments, including foreign demand, commodity prices, and EU funds. Latvia is likely to fulfil the Maastricht criteria and adopt the euro in 2014. The main challenge seems to be government long-term interest rates, while budget deficit and inflation are expected to be in line with the criteria.

After having expanded rapidly in 2011, GDP in Lithuania grew by 0.4% in quarterly terms and by 2.1% in annual terms the second quarter of this year. The outcome, although weaker than expected, can be explained by the closing of the oil refinery for maintenance reasons, which makes up one-fourth of Lithuanian industry output, for five weeks. The uncertainty in the euro area has reduced business inventories and is having temporary negative effects on growth. Growth is therefore expected to pick up. This year's GDP growth of 3.3% will rise to 4.1% next year and to 4.5% in 2014. In line with the deeper recession in the euro area, the downward revision of growth from our April forecast will slow the improvements in the labour market; nevertheless, unemployment is set to decrease to 9.3% in 2014 (from 15.4% last year). Inflation is expected to have an upward trend, as regulated prices are increased. Too-high inflation and long-term interest rates could postpone Lithuania's entry into the Economic and Monetary Union (EMU); another negative factor could be the government's reluctance to make this an official national target. Public finances are strengthening as the budget deficit is declining rapidly and debt will start falling next year.

The external climate has worsened, and the many negative risks point to a fragile world economy, which could have an impact also on Sweden and the Baltic countries. One of the greatest challenges for these four countries is to avoid becoming complacent, and instead to improve the fundamentals for growth – not least since the countries that now struggle in the euro area very well could shape up and become more competitive in a few years' time!

Cecilia Hermansson

Manufacturing growth (index Jan 2008=100, seasonally adjusted and three months moving average)[1/]



1/ Refined petroleum products excluded from manufacturing in Lithuania

Imbalances hold down global growth

Debt deleveraging, credit and fiscal austerity, the difficulties with the institutional setup of the euro area, volatile financial markets, the rebalancing of growth, the implementation of budget consolidation and structural reforms – the challenges the global economy is faced with have become more demanding for policymakers. Compared with our April forecast, the outlook for global growth has become weaker. Notably, GDP growth for 2013 has been revised downwards. The second half of this year – and the beginning of next year – is expected to show recession or very weak growth in most advanced economies. Except for the euro area, the global recovery is continuing, but at a slow speed, and with great risks attached to the outlook.

Global growth will reach 3.0% this year, before increasing to 3.1% next year and 3.4% in 2014. This means that growth rates during our forecast horizon will remain lower than last year's 3.5%, and that growth will stay below its potential, which is around 4%.

In the euro area, the recession will last the rest of this year. High unemployment, austerity and weak demand will continue to contribute to near stagnation for the region as a whole in the coming years, but major differences will remain between a stronger Germany and the crisis-struck southern European countries. In the US, growth prospects will worsen in the second half of this year because of global weakness and the uncertainties surrounding fiscal policy, including the threat of falling off the "fiscal cliff", i.e. the simultaneous tax increases and expenditure cuts that are slated to take place at the end of 2012. With lower inflation, emerging markets have room for more stimulus, and economic growth will thus start to pick up in the next couple of quarters.

Developments since our April forecast

As we were publishing our April forecast, sentiments started to turn negative since the optimism from central banks' liquidity injections that had permeated the first quarter of this year began to fade. Japan and Germany, especially, grew stronger than expected in the first quarter, while the recovery in the US continued at a modest pace.

In the second quarter, economic growth weakened. Business and household confidence fell, while purchasing managers noted a decline in industrial activity. In Europe, especially, the signs of a recession became more visible; and euro area crisis management was complicated by the elections in Greece and escalating sovereign bond rates in Spain and Italy. Spanish banking problems increased, and a bailout of banks was agreed upon. In the US, the slowdown intensified in the second quarter, and the labour market remained weak. Emerging markets experienced a slowdown as well, not least China, India and Brazil, as demand from their important export markets fell.

In line with weaker global economic growth, commodity prices decreased, thus alleviating the situation in most advanced economies and worsening the outlook for commodity-exporting countries. More recently, agricultural prices increased due to, e.g., harsh weather conditions in the US and Russia, exerting price pressures, mainly in emerging markets.

The muddling through scenario still prevails

Compared with our April forecast, the global economy will recover at a somewhat slower speed, especially during 2013. Our main scenario, a muddling through scenario, where global GDP growth increases from 3.0% this year to 3.1% in 2013 before reaching 3.4% 2014, is lower in total by 0.4 percentage point than the April forecast. One of the main reasons for the downward revisions is the situation in the euro area, which is more troublesome than earlier expected; this is also contributing to a weakening of activity in other advanced economies, such as the US, UK, and Japan, as well as in most of the emerging markets. Apart from importing European problems, the US economy has slowed more than expected due to the fear of falling off the "fiscal cliff" and the political gridlock in Congress. In India, domestic developments, including inadequate structural reforms, have weakened the economy more than previously thought. In China and Brazil, also, growth has weakened more than expected.

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

		Outcome	August 2012			April 2012	
		2011	2012	2013	2014	2012	2013
US		1.8	2.1	1.7	2.3	2.1	2.3
EMU countries		1.5	-0.4	0.1	0.8	-0.5	0.4
Of which:	Germany	3.1	1.1	1.1	1.6	0.5	1.3
	France	1.7	0.3	0.5	1.1	0.3	0.6
	Italy	0.4	-2.2	-1.0	0.2	-1.8	-0.3
	Spain	0.7	-2.0	-1.2	0.3	-2.0	-0.8
	Finland	2.8	0.7	1.1	1.8	0.8	1.7
UK		0.7	0.2	1.0	1.7	0.5	1.0
Denmark		0.8	0.8	1.2	1.5	0.5	1.0
Norway		1.5	3.3	2.0	2.5	2.0	2.5
Japan		-0.7	2.2	1.3	1.2	1.5	1.2
China		9.2	7.9	7.8	7.6	8.1	8.0
India		7.2	6.2	6.5	6.8	6.7	7.3
Brazil		2.7	2.0	3.9	4.1	3.1	3.5
Russia		4.3	3.8	3.9	4.3	4.1	3.9
Global GDP in PPP		3.5	3.0	3.1	3.4	3.1	3.4
Global GDP in US$		2.6	2.2	2.3	2.7	2.2	2.3

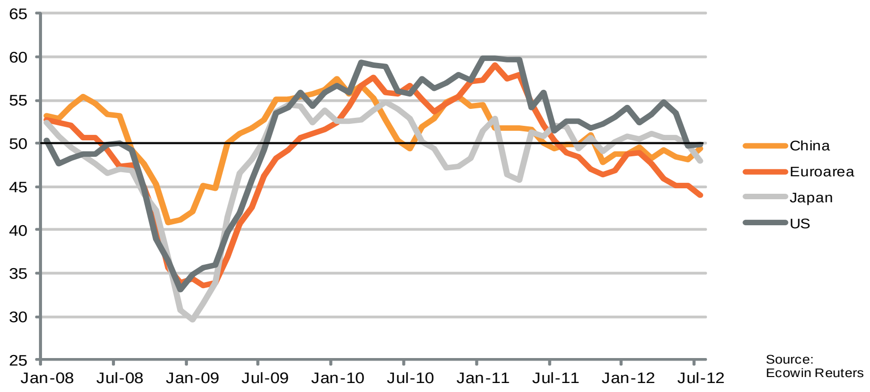
Sources: National statistics and Swedbank.

This main scenario, almost 80% driven by growth in the emerging markets, is given a probability of realisation of 60%. Towards the end of the forecast horizon, the advanced economies' contribution to global growth is expected to have increased only to almost 30%. This means that the world economy will still be running at "two speeds," with a high dependence on emerging markets' maintaining vigorous growth.

One of the driving forces for the recovery in the main scenario is more stimulus from policymakers in the emerging markets. Central banks have started to lower policy interest rates and will continue to do so; however, the room for manoeuvre is limited as disinflation could come to a stop with the increase in food prices, and because of the capacity constraints resulting from the inadequacy of reforms in the past. There is also room for expansive fiscal policy, e.g. in China, but the large amount of stimulus seen in 2008-2009 will not be repeated as the risk for a new inflationary pressures is by no means negligible.

In the advanced economies, driving forces for growth include a lower oil price, as well as lower overall inflation, which will support real growth in consumption. Even if the oil price has again started to rise, the concern about Iran has declined, while the recovery is slowing and, thus, the demand for oil is dampening. Our price assumption has been revised down to $110 and $104 per barrel for 2012 and 2013, from $119 and $113, respectively. In 2014, we see, although with great uncertainty, the price coming back to $111 as demand picks up. Inflation is falling, but

Purchasing Managers' Index (PMI) for manufacturing



the room for economic policy measures is limited, and increasing food (and oil) prices are still a risk. Besides quantitative easing and lower policy rates, structural reforms could increase medium-term growth and in the short run at least strengthen confidence. Reducing the euro area's institutional deficit needs to be at the top of the agenda, in order to create expectations that the euro will remain the region's single currency. In the US, agreeing on fiscal policy is the most important, both from a short- and a longer-term perspective.

The effects of a loose monetary policy in the advanced economies are fading, and the changes to policy interest rates will be marginal going forward. A weaker euro supporting the export sector in the euro area is probable, while the dollar – in line with a stronger recovery – will continue to strengthen. China will be more wary of a too strong appreciation of the renminbi against the dollar, as exports and investments are still seen as the most important driving forces for growth; however, the willingness to consume will play a larger role. In Japan, the yen will weaken, as the current account balance is challenged by large energy import bills and a slowdown in export growth.

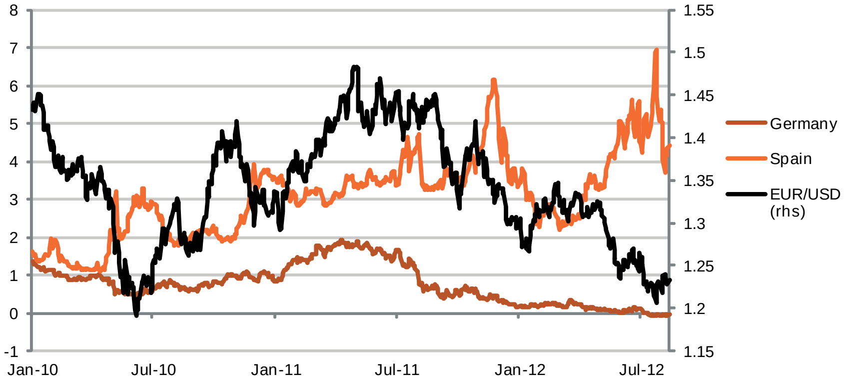
GDP growth in the US slowed from 1% in quarterly terms at the end of last year to 0.5% and 0.4%, respectively, in the first and second quarters of this year. In line with the lacklustre growth seen in the first half of this year, investments, recruiting, and income growth have slowed. Unemployment will remain elevated, and, with inflation falling, the demands on the Federal Reserve to ease monetary policy further by introducing a new round of quantitative easing has risen, and we foresee that such a measure will be taken in early autumn. We do not foresee the US actually falling off the "fiscal cliff", but do foresee some drag on growth, once decisions have been taken after the election has produced a new Congress. GDP growth is expected to fall from 2.1% this year to 1.7% the next, before recovering to a modest 2.3% in 2014.

In the euro area, GDP was unchanged in the first quarter, after contracting by 0.3% in the fourth quarter of last year. In the second quarter, GDP fell by 0.2% and will keep falling during 2012, before growth slowly comes back next year. Inflation, at present at 2.4%, will fall below 2% next year, and the European Central Bank (ECB) will lower the policy rate to 0.5% in the autumn. Other tools are seen as workable only when politicians begin taking their responsibilities seriously, i.e., purchases of Spanish or Italian sovereign bonds will be possible only if and when governments request support bailout funds and fulfil the conditions set up by the bailout funds. Until then, financial market instability and fear will continue, and the prob-

Interest and exchange rate assumptions

	Outcome	Forecast				
	17 aug 2012	31 Dec 2012	30 Jun 2013	31 Dec 2013	30 Jun 2014	31 dec 2014
Policy rates						
Federal Reserve, USA	0.25	0.25	0.25	0.25	0.25	0.50
European Central Bank	0.75	0.50	0.50	0.50	0.50	0.50
Bank of England	0.50	0.50	0.50	0.50	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10
Exchange rates						
EUR/USD	1.23	1.16	1.18	1.20	1.22	1.25
EUR/GBP	0.79	0.77	0.76	0.75	0.75	0.75
RMB/USD	6.36	6.30	6.20	6.08	5.98	5.85
USD/JPY	79	80	83	88	90	90

Two-year government bond yields (in percent) and the euro in relation to the US dollar



Source: Reuters Ecowin

ability that Italy and Spain will have to request support increases as interest rates keep rising – a probability that is higher than 50%. As Germany also is experiencing a slowdown of economic activity, the need for policy measures becomes stronger, and a weaker euro may at least give some relief to export sectors. GDP in the euro area is foreseen to fall by 0.4% this year, before growing by a marginal 0.1% next year and 0.8% in 2014.

In our main scenario, the euro area remains intact, with all 17 countries part of the currency union. Institutions are strengthened as an answer to the unstable financial markets and the crisis. The mechanisms for banking and fiscal cooperation slowly improve, also opening up an enhanced role for the ECB as lender of last resort. In a second scenario, Greece leaves the euro area; the probability of this happening is close to 50%. In a third scenario, all the southern European countries leave the euro, thus strengthening the currency union for the countries that remain. In a fourth and less probable scenario, the euro area is dismantled, as the basis for cooperation disappears; Germany finding the price of bailing out countries that do not sufficiently reform their economies to be too high. The second, third, and fourth scenarios have side-effects that would be very costly, not only for Europe, but for the global economy at large. This – and the goal of further integrating Europe – is the reason why politicians will continue to work to realise the first scenario, although the challenges to keep the currency union together continue to grow.

Japan's quarterly growth reached 1.3% in the first quarter of this year; this was unexpectedly strong and driven by consumer spending. Growth slowed to 0.3% in the second quarter. Despite the need for public reconstruction that will increase GDP going forward, private investment is slowing and exports are struggling because of the strong yen and the decelerating Chinese growth. The Bank of Japan will resume buying assets, but fiscal policy will not be adjusted to fix medium- and long-term threats. GDP will grow by 2.2% this year, before falling to 1.3% next year and 1.2% in 2014. Deflation is coming back, but at least the yen might depreciate while the more negative current account trend continues.

GDP growth in Brazil and India – and, to a lesser extent, in China and Russia – has been revised downwards, taking into account the weakening demand from advanced economies. The question is whether potential growth in these countries will also be lower going forward, as capital inflows for investments are slowing, capacity has not been built, and reforms are lacking. China is the exception; here, investments, at least in the short term, may be too large in relation to demand. The rebalancing is continuing. This means that the outlook for growth below 8% is actually a positive development – if the authorities do not try to boost investments again, increasing the risk for a hard landing at a later stage – and instead focus on consumption, while maintaining exports as much as possible. For an extended discussion on country developments, read the *Swedbank Global Outlook*, published August 21st.

Downward risks are abundant

We have given a probability of 60% to our main scenario, while arguing that downward risks are much larger (35%) than upward risks (5%). Among the risks that would cause the outcome to become more negative, we find the following: 1) increased financial market instability and a spreading crisis in the euro area, with the any of the adverse scenarios for the euro described above materialising; 2) a fall off the fiscal cliff, reducing US GDP growth by some 3-4%, driving the US into recession; 3) much higher commodity prices due to drought and/or geopolitical tensions, limiting the room for manoeuvre for monetary policy makers, especially in the emerging markets; 4) a hard landing in China and a stalling of growth in other emerging markets, which are more affected by the crisis in the advanced economies; and 5) political risks in connection with upcoming elections in the US, Germany, and Italy, and with the transfer of power in China.

Amongst the risks that would improve the outlook, we find the following:1) confidence building and crisis management improving in the euro area, thus shortening the recession and stabilising financial markets; 2) lower commodity prices due to improved supply conditions; 3) a consumption boom in Germany in line with lower unemployment and inflation; 4) more stimulus in the emerging markets, driving up growth; and 5) an improvement in the political process for enacting fiscal measures in the US, creating confidence, and thus strengthening the growth outlook.

The global outlook remains uncertain, not least for 2013 and even more so for 2014, as political and economic developments are likely to change the picture. The challenges facing, especially, the advanced economies are vast, and less probable developments but with large consequences, i.e."fat-tail" outcomes, cannot be excluded. Sweden and the Baltic countries may not be at the centre of these challenges, but, as open and export-dependent economies; they will not be spared should the outcome become more negative.

Cecilia Hermansson

Sweden: External conditions strain growth

Economic growth in Sweden was surprisingly strong in the first half of 2012. Following an annual growth of 1.5% in the first quarter (calendar-day adjusted), the second-quarter rate of expansion was estimated at 2.3%. According to these preliminary numbers, growth in Sweden was broad based, with net exports accounting for the largest contribution to GDP. The positive development was mirrored in other sectors as well. Demand for labour picked up, but, due to a large increase in the labour supply, the unemployment rate increased in line with our expectations. Households benefitted from employment and wage growth, but nevertheless showed some restraint in raising spending. Instead, savings increased and borrowing slowed.

Recent macroeconomic data give a mixed picture. The purchasing managers' index for manufacturing indicates stagnation, while the index for services points to a continued growth in the services sector. The economic tendency indicator, while declining in recent months, has shown an upward trend for consumer confidence. This suggests that the underlying conditions for the Swedish economy are still sound, although vulnerability – in particular, to external shocks – is high.

We expect the main drag on Swedish growth in the near term to be a weaker external demand. We have revised downwards our global outlook from the April forecast, and this slowdown will have a negative impact on economic activity in Sweden for the remainder of 2012. This development will be reinforced by the sharply stronger krona. Thus, we expect the reduction of unemployment to be protracted. Household consumption will take over as the main driver of growth, while investments will fall back after the large increase in the first quarter. Overall, we expect GDP growth of 1.8% for the whole year.

In 2013, as global conditions improve, underlying quarterly growth will pick up (although the annual growth rate, at 1.6%, will be lower than in 2012). The improvement in the labour market will lag, however, and we foresee the unemployment rate in early 2013 gradually increasing to reach 7.8%, before falling to around 7.5% in the end of 2014. Structural unemployment will remain a major concern, although we expect there will be some government initiatives to address this. The monetary policy rate will, in our view, be kept too high, since resource utilisation in Sweden is still low and price increases will fall short of the inflation target over the forecast horizon. This will also cause the krona to remain relatively strong. In the last year of our forecast period, 2014, we expect growth to continue to increase, reaching 2.4%, but the combination of weak external conditions and a continued strong krona will be a challenge to Swedish export companies.

The main risk to our forecast, and to the Swedish economy, is a worsening of the crisis in the euro area. This would entail significantly lower growth rates in the euro area and deepen the mistrust in the ability of southern European countries to stabilise their economies. Such a worsening would have ripple effects on global growth and on Swedish exports. In addition, given the preliminary nature of the second-quarter GDP estimates, there is a nonnegligible risk that the past growth numbers will be revised downwards, thereby altering the growth path of the Swedish economy.

Challenging export conditions going forward

After a sharp fall at the end of last year, export volumes recovered faster during the first six months of 2012 than we expected in our April report. This was mainly driven by exports of services and nondurables, while weak global investment activity led to a decline in the exports of investment goods, such as telecommunications products and vehicles. In total, export volumes increased by nearly 2% at an annual rate in the first six months, with exports of services growing by 3.2%, compared with 1.7% for exports of goods. A limited exposure to the crisis-struck countries in southern Europe – less than 4% of total exports - and relative strong demand from the Nordic countries and Germany explain why Swedish exports have so far avoided a slowdown in 2012. An additional factor is the diversification of exports to emerging markets.

Another important structural change is that services have gradually increased their share of total exports, from 20% at the beginning of the 1990s to nearly one-third last year. Although the services trade is still significantly smaller than the goods trade, its rate of growth has accelerated due to globalization and

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012f	2013f	2014f
Real GDP (calendar adjusted)	4.0	1.8	1.6	2.4
Industrial production	6.7	-3.5	1.8	3.0
CPI index, average	3.0	1.2	1.8	1.9
CPI, end of period	2.3	1.0	2.0	1.8
CPIF, average [2/]	1.4	1.1	1.7	1.6
CPIF, end of period	0.5	1.6	1.6	1.5
Labour force (15-74)	1.2	0.4	0.4	0.4
Unemployment rate (15-74), % of labor force	7.5	7.5	7.7	7.6
Employment (15-74)	2.1	0.4	0.2	0.5
Nominal hourly wage whole economy, average	2.6	3.3	3.0	3.2
Nominal hourly wage industry, average	2.8	3.4	2.8	3.2
Savings ratio (households), %	9.7	10.3	10.0	9.9
Real disposable income (households) [3/]	3.0	2.7	2.3	2.5
Current account balance, % of GDP	7.0	6.9	6.4	6.3
General government budget balance, % of GDP [4/]	0.1	0.2	0.0	0.2
General government debt, % of GDP [5/]	38.4	37.3	36.2	35.5

Sources: Statistics Sweden and Swedbank.

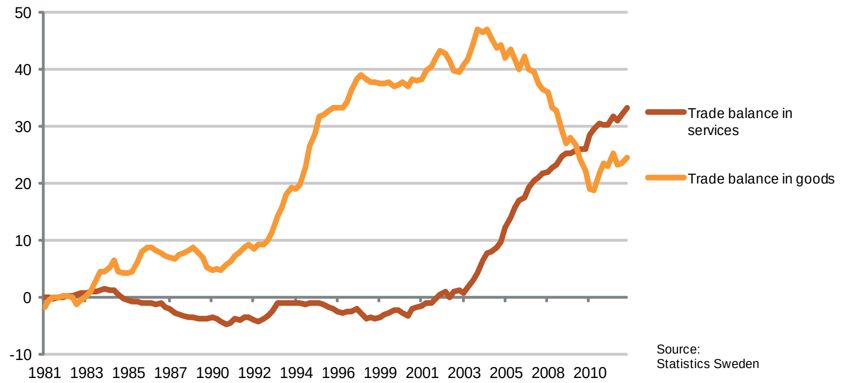
1/ Annual percentage growth, unless otherwise indicated.
2/ CPI with fixed interest rates.
3/ Based on short-term earnings statistics
4/ As measured by general government net lending.
5/ According to the Maastricht criterion.

specialisation. This adds to the diversification of Swedish exports and reduces the vulnerability to changes in the global investment cycle. Furthermore, the increase of services input in industrial production has been important for strengthening the competitiveness of, and raising value added in, exports.

In the second half of 2012, we expect export growth to slow due to the renewed weakness in the global industry and the significantly stronger krona. In addition, the temporary boost from postponed export deliveries and unexpectedly large increases in merchanting[1] is unlikely to be repeated. For 2012, we thus foresee an annual export growth of 1.2%, which, although an upward revision of our April forecast, is largely a result of the stronger outcome in the first half of the year.

In our updated global outlook, world market growth for Swedish exporters is expected to be somewhat faster next year than in 2012 (4.6% compared with 3.9%) but slower than we forecast in the spring. A low utilisation rate in the business sector, a high unemployment rate, and budget consolidations in several OECD countries will dampen global investment activity after the strong rebound in 2010-2011. The weakest performance will be in the euro area, but the emerging markets will also be affected by the slow growth in the OECD region. The global demand for heavy trucks and telecommunications prod-

Trade balances in exports and imports of goods and services, SEK billions



ucts is expected to be modest, both in mature and in emerging markets.

That the krona is appreciating when global demand is worsening is unusual for Swedish exporters and will be a challenge to Swedish competitiveness. Historically, the Swedish krona normally depreciates when external demand weakens. However, due to the extraordinary developments in Europe, we cannot expect the krona to adjust to the weaker demand, and Swedish companies will instead have to raise productivity or adjust costs to maintain competitiveness. Thus, the business sector's competitiveness is expected to come under pressure in 2012. For next year and for 2014, we foresee a decline in unit labour cost growth as productivity in the economy is picking up. The krona will, however, remain relatively strong. This will in particularly affect export of commodity products like wood and metal, but services with main costs in Sweden will also struggle. Export companies with a large import content will be less affected. Overall, we forecast an export growth of 1.5% during 2013. For 2014, we expect Swedish export volumes to grow by 3.3%, mainly driven by a modest pickup in global demand. This export growth is below the long-term trend, which was 4.6% during the latest decade. The surplus in the current account balance is expected to decrease in 2013-2014 due to a strong krona, which, together with robust domestic demand, will stimulate growth in imports.

Rebound in investments was temporary

Gross fixed investments increased by 6.6% annually in the first half of 2012, which was significantly stronger than we expected. In the private sector, excluding residential, the growth rate was even more pronounced, driven by large investments in the energy sector and in private services. Growth in industry investments was modest and in line with the weak growth in goods exports and declining production. A decrease in the number of housing starts during 2011 has led to a sharp drop in real estate investments so far in 2012. Public investments, however, picked up, mainly on account of municipalities. Volatility in gross fixed investments is high, and factors such as a mild winter have boosted investments in buildings. Postponed investments from last year also spilled over to 2012, and we do not believe the growth rate from the first six months is sustainable. Early warnings, such as dampened imports of investment goods, decelerating credit growth in the business sector, and heightened uncertainties about the global economy, signal a slowdown in investment activity. However, due to a significantly stronger investment performance in the

1 The values of production and exports that comprises purchases and sales made by Swedish enterprises of products that have been manufactured and then sold abroad without having been imported to Sweden.

Swedbank's GDP Forecast – Sweden

Changes in volume, %	2011	2012f[1/]		2013f[1/]		2014f[1/]
Households' consumption expenditure	2.0	1.9	(1.3)	2.7	(2.5)	2.8
Government consumption expenditure	1.8	1.1	(0.6)	0.8	(0.9)	1.1
Gross fixed capital formation	6.3	3.6	(0.1)	2.4	(2.6)	3.3
private, excl. housing	5.0	8.2	(2.6)	3.0	(4.0)	3.8
public	1.5	0.4	(-1.8)	1.6	(0.4)	2.4
housing	15.1	-7.5	(-6.2)	1.1	(-0.2)	2.2
Change in inventories [2/]	0.7	-0.7	(-0.4)	0.0	(-0.1)	0.0
Exports, goods and services	6.9	1.2	(-1.3)	1.5	(2.6)	3.3
Imports, goods and services	6.3	0.4	(-1.1)	2.9	(2.0)	3.4
GDP	3.9	1.6	(0.2)	1.6	(2.2)	2.3
GDP, calendar adjusted	4.0	1.8	(0.5)	1.6	(2.2)	2.4
Domestic demand (excl. inventories) [2/]	2.6	1.8	(0.8)	2.0	(1.9)	2.2
Net exports [2/]	0.7	0.4	(-0.2)	-0.5	(0.4)	0.1

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

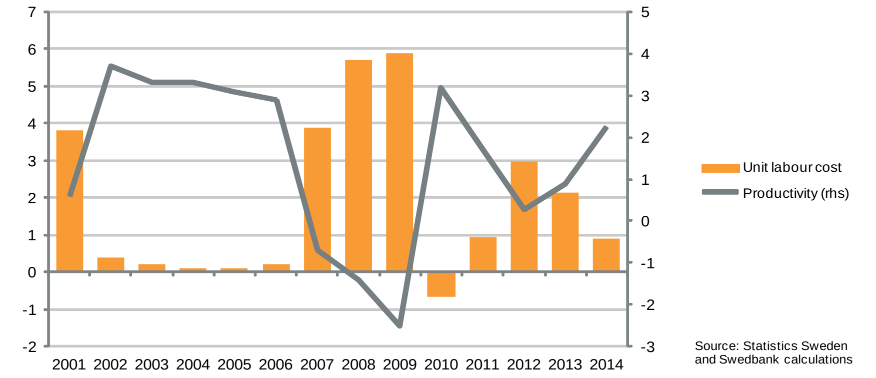
first half of the year, the annual growth rate for the whole year has been revised upwards to 3.6%.

For next year, we foresee a further slowdown in investment growth to 2.4%. The stronger krona and modest global demand will squeeze profit margins and returns on investments. In 2014, when global growth is expected to improve slightly, we forecast Swedish investment growth to pick up. The investments in energy are expected to continue to grow in line with the goal to increase investment by SEK 300 billion over a 10-year period. Investments in housing will also increase during 2013-2014, although from a low level. Fundamentally, there is a need for more investment in housing. A growing population, particularly in the large cities, and a lack of housing in 60 percent of the municipalities mean there is still a large underlying need for new houses. Furthermore, infrastructure investments growth has been amongst the lowest in European countries. The government has indicated that new investment measures will be in the budget for next year, but it is still uncertain how far-reaching they will be.

The private sector lags in job creation

The Swedish labour market performed well during the first half of 2012, and employers have been able to meet the surprisingly strong growth in labour supply. This means that the unemployment rate has developed approximately as expected, and it reached 7.5% in June (seasonally adjusted). However, for the remainder of the year, unemployment rates will remain stubbornly high as employment creation will slow due to a weakening external demand.

Unit labour cost and productivity (annual change in %)



Source: Statistics Sweden and Swedbank calculations

Digging deeper into the numbers, one can see it was primarily the publicly financed sectors that added to the payroll, while manufacturing and retail trade reduced employment. Public administration and education were strong, and it is a worrying sign that employment decreased in business-cycle-dependent sectors. Also, in terms of hours worked, the underlying data do not paint as positive a picture. Overall, hours worked were unchanged in the second quarter, after increasing by 1% in the first. This is a notable slowdown compared with 2011, when hours worked increase by an average of 2.3% in the first half of the year. Again, it was the private sector that reduced its labour demand. Within the private sector, producers of services raised labour input, reinforcing the picture that manufacturing and retail trade are seeing a slowdown in demand and/or a growing need to improve productivity.

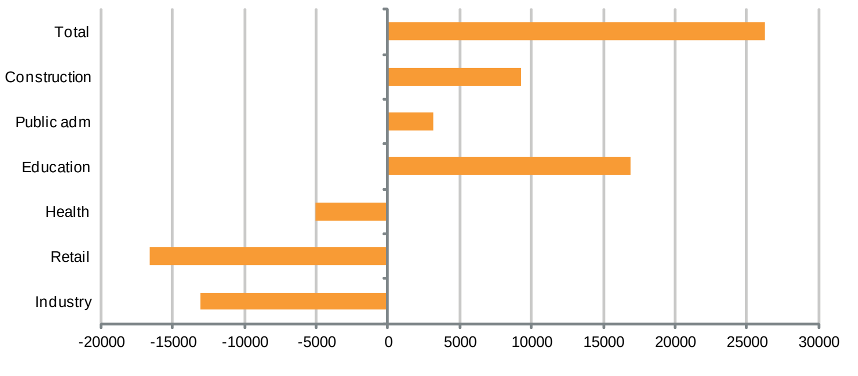
Productivity in the Swedish economy picked up during the first half of 2012. However, the wage increase, in particular in the industry sector, has been faster than expected, and, in combination with a strengthened krona, we anticipate that relative unit labour costs for Swedish companies will grow by 3.0% in 2012 compared with 0.9% in 2011. Swedish competitiveness will remain challenged also in 2013 and 2014 due to the still-strong krona, although growth in unit labour costs will decelerate to 2.1% in 2013 and 0.7% in 2014, when productivity growth strengthens.

When the economy gradually improves in 2013, we expect the unemployment rate to decline, even if the average annual rate still increases to 7.7% from 7.5% in 2012. The improvement in the labour market will continue, but we expect unemployment to remain above 7% (seasonally adjusted) by the end of 2014. External conditions are expected to improve and domestic demand is supported by stable public finances. As 2014 is an election year, we should see intensifying efforts to bring down unemployment, and, together with a more stable environment, this should support employment growth. The main challenge in the medium term will be to reduce structural unemployment. The long-term unemployment rate remains high, at 30% of all unemployed, which is almost 20% higher than during 2006-2008.

Still some hesitation among households

Household consumption continued to recover in the first half of 2012, but there are signs of hesitation in consumers' sentiments and willingness to spend. In the first quarter, the rebound in consumption continued, with 2.1% annual growth, but slowed again in the second quarter to 0.8%. In particular, households drew down on purchases of durables, such as cars, but retail trade

Employment change Q2 2012 - Q2 2011 [1/]



1/ Not all sectors are inlcluded in the chart

Source: Statistics Sweden

was also affected. Instead, expenditures on housing, something that cannot easily be affected by households in the short run, provided the biggest boost to overall spending. This suggests that consumers were somewhat more cautious than the headline growth numbers indicated.

Household income has developed solidly on the back of robust employment growth and increasing wages. We expect, however, that unemployment, although lower than we previously forecast, and the slow growth in hours worked will limit income developments in the remainder of 2012. On the other side, pension payments are set to increase in real terms in both 2012 and 2013, which will boost spending power, before contracting in 2014. Thus, a dampening in hours worked and wage increases in 2013 will reduce overall real disposable income growth to 2.3% from 2.7% in 2012, before increasing again in 2014 to 2.5%.

Household savings, according to the financial accounts, showed a strong increase in the first quarter of 2012, and, together with a deceleration in credit growth, the decrease in households' net wealth slowed. Approximately 80% of the increase in savings was due to valuation changes, stemming mainly from the stock market recovery, but growth in bank deposits was also high. At the same time, credit expansion to households slowed, especially mortgage borrowing. This suggests that the households' financial situation was recovering in the early half of the year and it provides grounds for robust growth in consumption going forward.

Recent confidence indicators confirm an improved sentiment among households. In July, the consumer confidence indicator (NIER) rose and is now above the historical average. In particular, households' view of their own economy is improving, while the outlook on the Swedish economy is less upbeat. However, the perceived risk for unemployment did not show much of an improvement during the first half of the year, which could hold back households' willingness to spend.

Given the stronger-than-expected consumer spending so far in 2012, we are revising upwards the annual growth rate to 1.9%. This is still quite modest by historical standards, but the uncertainty that characterises, in particular, economic developments in Europe, in addition to many households' still-vulnerable financial position, is likely to dampen spending. Together with the strong income growth, this is causing the savings ratio to increase from 9.7% of disposable income in 2011 to 10.3% in 2012. As the underlying growth momentum strengthens in 2013, an improved labour market will boost household consumption. We therefore expect a real growth in private consumption of 2.7% in 2013, to be followed by an expansion of 2.8% in 2014. The main limiting factor will be households' indebtedness, but, given the improvement of the economy, we expect the savings ratio to continue to decline.

A stronger krona complicates monetary policy

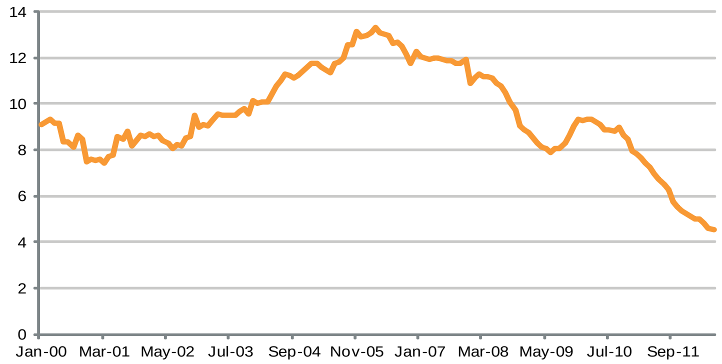
The Riksbank kept the repo rate unchanged at 1.50% on July 4th and, at the same time, the majority of the Executive Board reinforced the message that, barring a deepening of the euro crisis, no easing was in the cards. However, the repo rate path was lowered marginally, reflecting increased worries concerning euro area developments. For the majority in the Board, the debt buildup amongst households was still a major concern, and, as the Swedish economy was performing surprisingly well, they saw no immediate reason to let up. A minority of two Board members continued to argue for a cut in the repo rate of 50 basis points and for a lower repo rate path since inflation will fall short of the inflation target and resource utilisation was still weak.

The recent sharp appreciation of the Swedish krona increases the challenges for monetary policy. The krona has been at its strongest against the euro since the beginning of the last decade. As worries grow concerning the increased turmoil in the euro area, many investors are looking for alternative currencies to spread risks; this includes other central banks that are trying to offset appreciation pressures. In trade-weighted terms, the krona is also stronger, but to a lesser extent. Nonetheless, the index value of 117.7 recorded at the end of July implies the strongest krona in more than 10 years.

The main short-term impact from the krona appreciation on inflation is lower prices for imported goods. Thus, we expect inflationary pressures to be lower than previously anticipated. However, the stronger-than-anticipated growth and improved labour market we witnessed in the spring should counteract this, and we are reducing our average inflation forecast (with fixed mortgage rates—CPIF) only marginally down, to 1.6%, in 2012. As the euro area economies stabilise next year, we expect the Swedish krona to weaken somewhat but to remain strong in historical terms. This will have a negative impact on the competitiveness of Swedish companies. Thus, we expect export growth to dampen and its contribution to economic growth to decline. It would also reduce inflationary pressures further out in the forecast period. For 2014, we forecast the CPIF to increase by 1.5%, which is significantly below the Riksbank's inflation target.

Seen in isolation, the strengthening of the Swedish krona would argue for a looser monetary policy to offset dis-

Credit to households (annual growth in %)



Source: Statistics Sweden

inflationary pressures and the loss of competitiveness. Furthermore, the Swedish economy, despite its recent strong growth rates and rising employment levels, is still operating below potential. Thus, in our view, the Riksbank should lower the repo rate during the autumn to support a reduction in unemployment and raise growth rates. The weak demand situation, especially from external markets, suggests that the inflation risks will undershoot the target, rather than being too high. However, we expect the Riksbank to maintain the current level of the repo rate until the second half of next year, when the rate would be raised to reach 2.00% at the end of 2013 and 2.50% at the end of 2014. The Riksbank itself forecast a repo rate at the end of 2014 of 2.75%, but in our view the combined impact from the krona appreciation and lower growth will bring about a reduction. However, with this rather tight monetary policy, compared with other central banks, we foresee that the Swedish krona will remain strong over the forecast period, and this will have a negative impact on growth and employment.

Interest rate and currency outlook

	Outcome	Forecast				
	2012 17 Aug	2012 31 Dec	2013 30 Jun	2013 31 Dec	2014 30 Jun	2014 31 Dec
Interest rates (%)						
Policy rate	1.50	1.50	1.50	2.00	2.25	2.50
10-yr. gvt bond	1.51	2.00	2.40	3.00	3.40	3.50
Exchange rates						
EUR/SEK	8.22	8.40	8.50	8.60	8.70	8.70
USD/SEK	6.67	7.30	7.20	6.88	6.96	6.96
TCW (SEK) 1/	116.2	119.8	120.0	120.4	121.4	121.4

Sources: Reuters Ecowin and Swedbank.

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

Room and reason for fiscal expansion

Stronger-than-expected real economic growth, together with faster employment growth and associated higher tax revenues, will improve the public sector balances in 2012. In April, we forecast a deficit corresponding to 0.3 % of GDP, but increased revenues and limited spending pressures will in our estimation produce a surplus of around 0.2 % of GDP. This includes the additional spending announced in the spring budget proposal. In addition, local government taxes are expected to increase this year, which, together with a one-off transfer, will yield a small surplus in this sector. We expect the public sector debt (according to the Maastricht criteria) to fall to 37.3% of GDP this year; due to a revision of local government debt statistics. This is higher than in our April forecast.

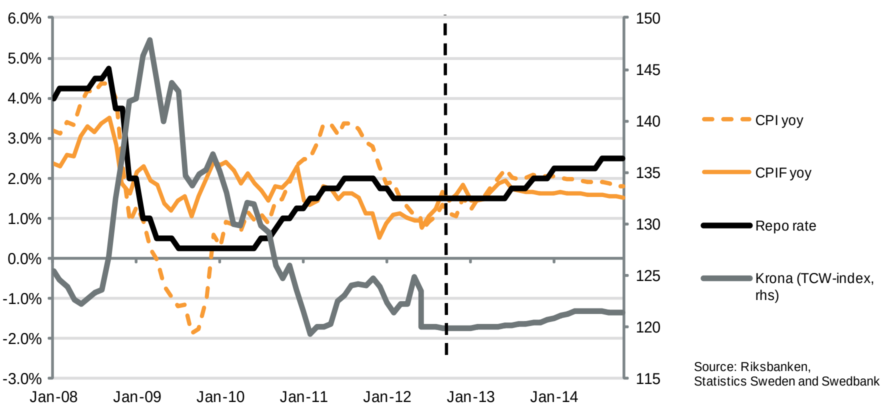
As the general economic conditions are improving, we expect the public sector finances to continue to be solid in 2013. This, together with the fact that the economy is still operating below potential, will provide room for additional spending initiatives in the fiscal budget for 2013 – according to our estimates, around SEK 20 billion. There are, in particular, reasons for the government to increase infrastructure investment, which will raise future growth potential; however, we would also support more spending on research and education – something that has already been suggested by government officials. In all, we expect additional spending amounting to SEK 15 billion in 2013, with the bulk ending up on the expenditure side. In the same year, pension payments will also increase, and we expect the budget surplus to be eliminated. A zero balance is, however, only mildly countercyclical, and fiscal policy could provide more support to domestic demand and growth.

In 2014, government finances are expected to generate a surplus corresponding to 0.2% of GDP, including our expectation of additional spending initiatives of about SEK 20 billion. As 2014 is an election year, we expect the ruling coalition government to expand fiscal policy. There will be a continued need to increase spending on research and education, as well as on infrastructure. Furthermore, as pension payments are projected to decline, it is not unlikely that the government will corral a majority for a reduction of tax rates on pensions, as well as on other tax rate reductions.

The high economic growth rate in the first half of 2012, might suggest that the need for additional stimulus is declining. However, as we expect a weakening of the global business cycle, and a persistently high unemployment rate we would still argue that fiscal policy should remain expansive during the forecast period. Although the margins in the fiscal framework are declining; both according to the business cycle-adjusted budget balance and the expenditure ceiling, these should be used. In particular, we would argue for targeted reforms aimed at reducing structural unemployment, in particular amongst foreign born and youths. These would also be growth enhancing in the medium term and would reduce future spending needs.

Magnus Alvesson
Jörgen Kennemar

Inflation, the repo rate and the exchange rate



Estonia: Domestic economy safeguards growth

GDP growth slowed in the last quarter of 2011, and, in the first quarter of 2012, growth reached 3.6%; this was explained by the base effect (annual growth in the first quarter of 2011 was more than 9%), as well as by slowing foreign demand. The growth slowed further in the second quarter, to 2%. Growth in the first half of 2012 was mainly driven by domestic demand. During the first half of 2011, the main contributor was manufacturing, while at the end of the year domestically oriented sectors (e.g., construction, retail sales, and services) started to contribute more. In the beginning of this year, the domestic economy continued to show strong growth rates – households are more confident and eager to spend, and investment growth is supported by government investments.

Growth in the first quarter of 2012 was a bit faster than we expected in our April forecast. This points to stronger economic activity than the confidence indicators show, and, all in all, the larger uncertainties in the euro area seem not to be affecting domestic spending – private consumption and investments were showing strong growth rates despite slowing export growth and weak confidence indices. Judging from the preliminary estimates of the second quarter GDP[1] it cannot be excluded that the impact from increased uncertainties is lagging.

GDP growth to be slow this year but accelerate in coming years

GDP growth this year is expected to reach 3%   a bit faster than we expected in April. The main reason behind the upward revision is the better-than-expected performance of domestic demand. According to our global outlook, the overall economic development in the EU will be contradictory – Nordic countries are doing better than in our April forecast, and southern Europe will face a more severe recession. This by and large means better outcomes for export growth, too, as Estonia's main trading partners are its neighbouring countries, including the Nordics. The year 2013 will be characterised by a modest recovery in the world; this will affect the Estonian economy through economic sentiments and thus, also, the demand for Estonian services and products. We foresee export growth accelerating in the second half of 2013 as, according to our main scenario, the global environment starts to improve. In addition, the Nordic countries' outlook has strengthened somewhat due to the better-than-expected developments so far. All in all, we expect Estonian GDP growth to reach 4% in 2013 and to accelerate even more, to 4.3%, in 2014.

As before, the main risks for the Estonian economy continue to be external – the overall development of EU countries, together with the outcomes of the current crisis in the euro area countries. According to our alternative scenario, there is a probability of a partial breakup of the Economic and Monetary Union (EMU) – this kind of outcome depends highly on the chronology of events, as well as the magnitude of the losses in the financial sector. The latter will have its effects on the sentiments and decision making of investors throughout Europe. All in all, the effect of these kinds of developments will not appear in the Estonian economy directly as a direct trade relationship with southern European countries is very limited or even absent. This, however, does not mean that there will not be any effects, as indirect impacts such as a liquidity freeze, higher capital prices, etc., will harm the economy through the financial markets and trade affecting the recovery of the domestic economy as well.

At the same time, there is also a probability, albeit small, that the external environment will be more favourable for the Estonian economy, boosting export volumes already by the end of 2012 or the beginning of 2013, and fostering growth even more than we predict in this report.

Another set of risks is related to energy and commodity prices – a faster-than-expected increase in oil prices will raise the domestic price level and, in turn, private consumption, and the higher inflation will harm purchasing power.

Internal risks are, as stated already in several earlier Swedbank Economic Outlooks, related to the labour market as long-term unemployment continues to pose a risk to the social system, as well as to the well-being of those households whose members are having trouble finding jobs (the poverty trap). In addition, unemployment might not decrease as much, especially when parts of the adverse global scenario are realised (especially for the euro area).

[1] This estimate is based on the revised national accounts which are not directly comparable to the first quarter figures.

Key Economic Indicators, 2011 - 2014 1/

	2011	2012f	2013f	2014f
Real GDP	7.6	3.0	4.0	4.3
Nominal GDP, billion euro	16,0	16.8	18.3	19.9
Consumer prices (average)	5.0	3.9	3.1	2.7
Unemployment rate, % 2/	12.5	10.5	9.8	8.7
Real gross monthly wage	0.5	2.3	1.9	3.5
Exports of goods and services (nominal)	30.7	7.7	8.1	9.0
Imports of goods and services (nominal)	34.1	11.6	7.3	7.8
Balance of goods and services, % of GDP	6.4	3.1	3.8	4.8
Current account balance, % of GDP	2.1	-0.1	0.0	-0.5
FDI inflow, % of GDP	1.2	1.9	5.1	5.9
Gross external debt, % of GDP	97.1	95.5	91.4	85.2
General government budget balance, % of GDP 3/	1.0	-1.2	-0.6	1.0
General government debt, % of GDP	6.0	10.1	11.5	10.5

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.

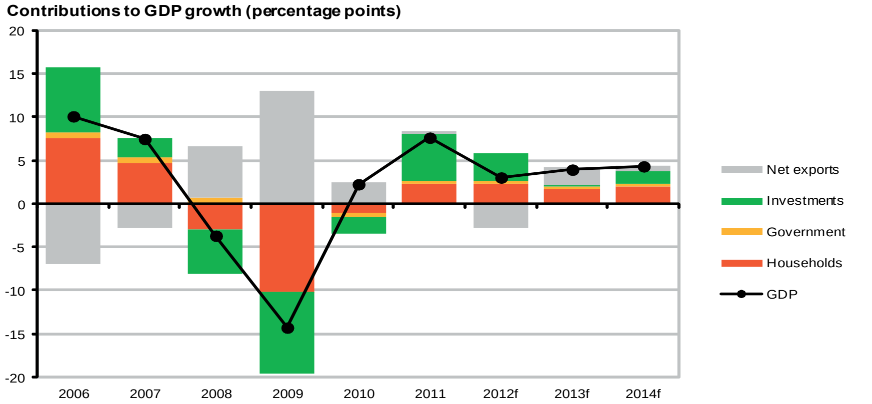
Better outlook for trading partners improves export growth expectations

Exports showed strong growth rates in 2010 and 2011. The growth was driven mainly by one sector – electronics – whose export sales began to soar in 2010. In 2011, contributions by other manufacturing sectors started to grow as well. During the first five months of 2012, however, goods exports suffered from a drop in mineral products sales, which are by nature transitory. The overall annual growth in goods and services exports (real terms) in the first quarter of 2012 reached 6.5%, which induced us to revise upwards our outlook for this year. For 2012, we expect exports of goods and services to grow by 3.4%. For 2013, we have revised the growth number downwards to 5.9% from 7.1%, as we expect uncertainties to grow during the first half of 2013, causing a moderate slowdown in trade. In 2014, export growth will accelerate to 6.8% in real terms.

Estonian goods exports are highly dependent on overall developments in neighbouring countries[2] (approximately 60% of total goods exports). The second half of 2011 and the first months of 2012 showed that Estonian firms (other sectors than electronics) have been doing rather well in selling their goods and services despite the overall slowdown in the EU economies. Unit labour costs have been increasing in almost all subsectors in manufacturing and this could have a negative impact on competetiveness. However, the weaker euro could improve the outlook for sales of Estonian exports.

2 Sweden, Finland, Norway, Denmark, Lithuania, Latvia, and Russia.

Contributions to GDP growth (percentage points)



Source: SE, Swedbank forecast

Import growth, supported by rising private consumption, is expected to reach 6.7% in 2012. Growth will be somewhat lower in 2013, reaching 4%. In 2014, the growth rate will accelerate, along with economic activity in foreign markets (imports are very much connected with exports as many production inputs are imported rather than produced locally) and household spending. Higher import demand will drive the current account balance into deficit, but the effect will gradually disappear as in 2013 trade will improve somewhat. The current account will be affected by inflows of current transfers; these inflows will gradually decrease because the current transfers consist mainly of EU funds.

Investment growth to decelerate

Investments last year grew at a high rate (volume increased by more than 25%) and continued to increase in the first quarter of 2012. This year, the overall volume of investments will be higher because of the government's obligation to use revenues from CO2 quota sales to make energy-efficiency-related investments. Public sector investments are planned to exceed by about 30% (in nominal terms) the total for 2011. Public sector investments are also affected by local authorities' willingness to lend – the restriction on local municipalities lending was eased, which might make municipalities more willing to lend to finance their investments in public housing, renovation of kindergartens, schools, etc. In 2012, overall investments are expected to increase by 12.6% – a bit more than we expected in April.

The main reason behind the upward revision is the higher-than-expected growth in corporate investments in the first quarter of 2012, which indicates that private sector investors are less cautious than, was envisaged in April. For 2013 and 2014, the growth of investments is expected to reach approximately 7%. In 2013, private sector contributions will start to revive and continue to grow throughout the forecast period. At the same time, we expect government sector investments to begin falling next year. In 2014, total public investment will start to diminish because the programming period of EU funds ends in 2013 (see also the government subsection of this report); according to the "State Budget Strategy 2013-2016,"[3] the next wave of funds starts flowing in 2015, as the new programming period is planned to begin in 2014. As a result, public investments planned for 2014 are about 40% less than those planned for 2012. Private sector investment will start to revive, according to our estimate, at the end of this year. The largest contributions will

3 Available at the Ministry of Finance webpage www.fin.ee

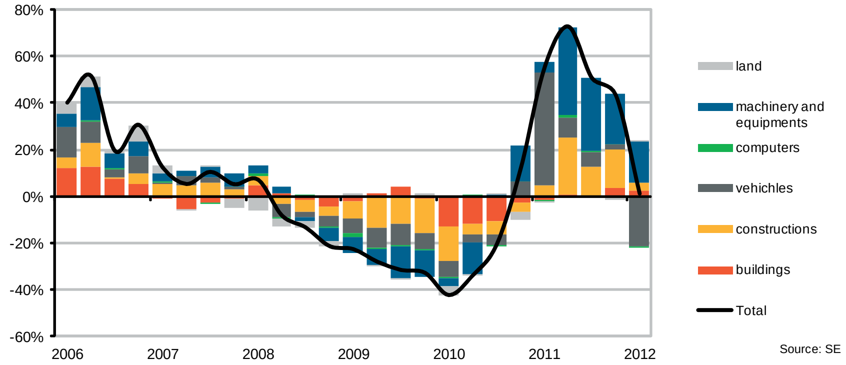
Swedbank's GDP Forecast – Estonia

Changes in volume, %	2011[1/]	2012f[1/]		2013f		2014f
Household consumption	4.2	4.3	(2.7)	3.3	(4.2)	3.9
General government consumption	1.6	2.3	(1.8)	1.6	(1.7)	1.8
Gross fixed capital formation	26.8	12.6	(11.5)	7.0	(7.4)	7.3
Inventories [2/]	-0.7	0.2	(-0.8)	-2.0	(0.6)	-0.6
Exports of goods and services	24.9	3.4	(3.1)	5.9	(7.1)	6.8
Imports of goods and services	27.0	6.7	(4.6)	4.0	(8.4)	6.6
GDP	7.6	3.0	(2.7)	4.0	(4.2)	4.3
Domestic demand (excl. inventories) [2/]	8.1	5.7	(4.5)	3.9	(4.4)	4.3
Net export [2/]	0.3	-2.8	(-1.1)	2.1	(-0.8)	0.6

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

be made by the manufacturing, construction, and energy sectors.[4]

Contributions to annual growth in enterprise investments (percentage points)



Residential investments are also expected to grow, but at a slower rate than seen last year. Households' investments in dwellings have not affected much the overall loan stock – even though new loans are increasing at a modest rate, the overall loan stock is still decreasing, as many households prefer to pay back their loans (there is still some housing with negative equity). We expect residential investments in housing to increase this year, and the growth rate to accelerate in coming years. In addition, we expect an increase in energy-efficiency-related investments in apartment houses, supported by government programmes.

Favourable trends in the labour market continue, but downward risks increase

In 2011, the recovery of employment was remarkable – more than 38,000 people found jobs (annual growth of 6.7%). In the first half of 2011, the jobs were mainly created in the manufacturing sector, which had started to create jobs already by the end of 2010. The services sector gained from the rapidly increasing number of tourists and the gradually recovering purchasing power of residents. The unemployment rate dropped to 12.5% in 2011. During the first months of 2012, employment continued to grow. We expect employment to grow by 1.8% in 2012, supported mainly by the services sector's needs, as well as by the continuing labour shortage in sectors such as energy, electronics, and ICT related. In 2013, the number of employed will be roughly the same – employment growth will reach a modest 0.3% as the problem of skills mismatch becomes more pronounced. In 2014, we expect job creation to accelerate again due to favourable developments in the economy; employment growth should reach 1%. Activity on the labour market will continue to be high, and unemployment will decrease from 10.5% in 2012 to 8.7% in 2014.

The shortage of skilled labour is more pronounced in the electronics, ITC-related, energy, and health care sectors. The latter is affected by the age structure of workers in this sector and by the increase in pendulum migration of young doctors. In addition, employment growth will be affected by the low inland mobility of the labour force. In this connection – entrepreneurs have stated that it is hard to find workers, e.g., in eastern Estonia; at the same time, there are people in other counties unemployed with relevant skills and knowledge. This means that there is a need for some support to increase inland labour mobility.

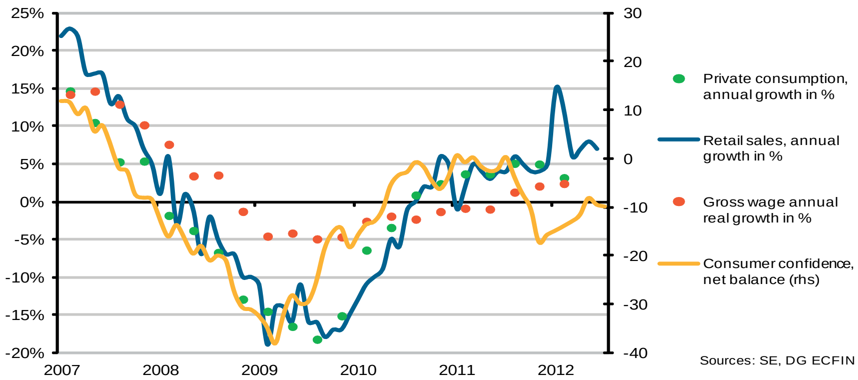
We expect the overall wage bill to increase by 8.6% in 2012 (in nominal terms) and to continue at a similar rate throughout the forecast period. Real wages, which started to grow in the third quarter of 2011 after 11 quarters of decrease, are expected to grow by 2.3% this year. This growth will decelerate somewhat in 2013 and accelerate again in 2014. Overall productivity showed negative growth rates at the end of last year, but this might be explained by the inertia on the labour market – employment is by nature more stable than output. Productivity growth is expected to accelerate throughout this year and continue outpacing wage growth during the forecast period.

Private consumption recovery strong despite the euro area crisis

Household spending increased in 2011 by 4.2%, supported by the strong recovery of employment and gradually rising wages. Even the deterioration in household confidence at the end of 2011 and the beginning of 2012 did not seem to have had an effect on overall spending behaviour. In the first quarter of 2012, private consumption grew by 3.2% in annual terms (the first quarter is usually characterised by lower growth rates). We expect private consumption to grow by 4.3% in 2012; this is considerably faster than we expected in April. The main reason behind such an upward revision is the more favourable developments on the labour market (employment and wage growth), as well as the households' positive perceptions of their own financial well-being, seemingly unattached to perceptions of the developments in

[4] See also the monthly letter, The Estonian Economy, published in August.

Consumer confidence, consumption, retail sales and wages



the euro area. Despite higher expectations for spending growth rates, we expect savings to continue to increase further this year – household deposits have shown stable (albeit lower than last year) growth rates throughout this year as well. In 2013 and 2014, the savings rate will fall as the memory of the crisis gradually vanishes and the precautionary motive becomes less pronounced. Private consumption growth is expected to slow somewhat in 2013, to 3.3% and to accelerate in 2014 to 3.9%. Even though one might say that private consumption has recovered strongly, the growth rates are well below those seen in the pre-boom years; this points to the households' remaining cautiousness, as well as to the increasing number of budget-constrained households. The latter phenomenon has been influenced by the rising prices of necessities and the uneven increase in wages across sectors. During the forecast period, household spending will depend on the growth of disposable income (i.e., of both employment and wage growth), as well as the prices of necessities.

Inflation about to slow

Inflation accelerated in 2011 to 5% (annual terms). The main factors affecting the overall price level were external – the rapid increase in both energy and food prices in the global markets. In the first quarter of 2012, the price increase reached 4.4% in annual terms, fuelled by rising housing costs (an increase in administratively controlled prices) and the unexpectedly high oil price in the global market. The latter affected transportation costs, as well as other prices, as many goods and services prices include costs of transportation. In 2012, we expect price growth to slow; the average price increase is estimated to slow to 3.9%. In 2013 and 2014, overall inflation will decelerate even further. In 2013, the main factor affecting the overall price level will be the opening of the electricity market, which most probably will affect all other prices in the consumer basket. During the second half of the year, the effect will gradually vanish, and the overall inflation rate will slow to 3.1%. In 2014, inflation will decelerate to 2.7%. The main determinant of this rate will be the shortages appearing in the labour market – the increase in economic activity will create another wage-push effect as the labour shortage becomes even more pronounced.

Public sector deficit falling, but debt increasing

Strong private consumption growth and the favourable labour market developments in the first half of this year have stimulated tax collection, which has been about 10% higher than in the corresponding period of 2011; this rate will slow at the end of the year as economic growth decelerates. Nontax revenues, which have constituted a large share of revenue in recent years, will start to decline during the forecast period, affected by smaller proprietary income revenues, the end of CO2 quota sales period, and the change in the EU budgetary period (between 2013 and 2014); this change will temporarily lower revenues from foreign financing.

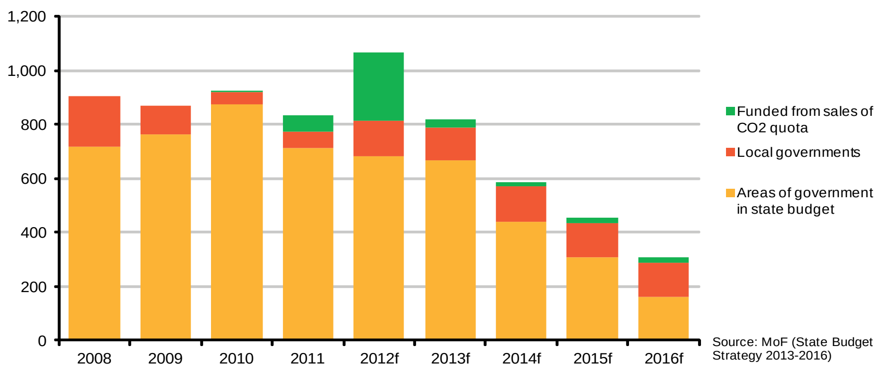
The high level of expenditures this year is affected by one-off factors (e.g., the record-high investments on account of the previous CO2 quota sales revenues and the full recovery of the pension pillar payments). During the next few years, the one-off effects will diminish or disappear, lowering expenditure growth considerably. However, there might be a risk of a faster rise in current expenditure due to pressures for wage and/or employment increases, especially before the parliamentary elections, scheduled for early 2015. All in all, the budget deficit will start to decrease gradually, before turning into a surplus in 2014.

The government has committed itself to easing the tax burden[5], while increasing the share of consumption taxes on account of the decreasing labour taxes. The former includes periodical excise hikes, and the latter a fall in the unemployment insurance tax (from 4.2% to 3% in 2013) as well as in the income tax (from 21% to 20% in 2015).

Although the public debt level is very low in Estonia, it will grow noticeably this year and peak next year (11-12% of GDP), after which it will stabilise and start to fall again. The major part of the increase comes from loan payments made by European Financial Stability Fund (EFSF), which are reflected as an increase in the participating member countries' debt. Payments to increase the energy company Eesti Energia's stock capital will have an impact as well. Membership in the European Stability Mechanism (ESM), which was contested as unconstitutional in April by the Chancellor of Justice, got the green light from the Supreme Court in July. The parliament is ratifying the treaty; our forecast includes down payments to the ESM during the forecast period.

Annika Paabut
Elina Allikalt

General government investments, EUR millions



Source: MoF (State Budget Strategy 2013-2016)

5 Estimated at 33% of GDP in 2012

Latvia: Decent growth despite the global headwinds

In the first half of 2012, Latvia's growth figures were outstanding – the economy expanded by 6% compared to the same period last year. Annual growth slowed (from 6.9% in the first quarter to 5.1% in the second) but remained the most rapid in the EU. Quarterly growth stayed at about 1% for the third quarter in a row, reflecting the fundamental economic strength. The export engine has so far kept up the good work, supporting the growth of investments and household spending. Both retail trade and manufacturing growth slowed in the second quarter but were about 8% above last year's level. The registered unemployment rate continued to retreat to 11.9% in July (7.7% in Riga).

Economic growth early this year surprised on the upside, partly because we had underestimated the calendar effects (actual first-half GDP growth was 1.2 percentage points higher than the seasonally and working-day-adjusted), and partly because of the better-than-expected growth in Europe. Better growth has brought higher tax revenues, opening up room for tax policy changes. As of July 1, 2012, the base rate for the value-added tax (VAT) was cut to 21% from 22% reversing some of the austerity-induced tax increase during the recession. More important, the personal income tax (PIT) rate will be cut to 24% on January 1, 2013 from the current 25% and by a further 2 percentage points (pp) each year until reaching 20% in 2015. This is expected to encourage employment growth and support cost competitiveness (in 2012, the comparable tax rates are 23% in Estonia and 25% in Lithuania). This action may be too little to radically cut tax evasion, although a small effect is still expected; yet, it will give a positive signal to potential foreign investors.

GDP growth is expected to slow in the second half of the year, reflecting more sluggish global growth. The calendar effects will play the opposite role for Latvia in the second half of 2012, and annual GDP growth is thus anticipated to slow quite sharply, sliding below 2% in the last quarter. However, due to unexpectedly strong developments in the first quarter and the improving competitiveness of Latvian exporters, we have revised our GDP growth forecast to 4% in 2012 (2.5% before). Growth is expected to pick up towards the second half of 2013 and 2014, owing to an improvement in the global situation, local tax cuts, and rising confidence. We are keeping our 3.5% growth forecast for 2013, as slower export growth due to downward revisions in the global outlook will be outweighed by stronger investments and private consumption. In 2014, growth is anticipated to speed up to 5.2% as the global background improves and a further PIT cut promotes domestic demand.

We are cutting the forecast for average consumer price growth from 2.8% to 2.5% in 2012 to account for lower global oil prices and the VAT cut. The inflation outlook for 2013 stays unchanged at 2.5%. We expect consumer prices to grow by 3.5% in 2014, as (i) PIT cuts support private consumption, making it easier for businesses to lift prices, and (ii) increasing global energy prices will raise fuel, gas, and heating prices. The target of introducing the euro in 2014 remains on the agenda, and we believe it is feasible. The major challenge seems to be fulfilling the Maastricht criterion on long-term interest rates, while government finances and inflation are expected to be in line with the criteria (for details, see Swedbank Analysis, August 2012).

The unemployment rate is to continue falling (11.5% in 2014), although the levels are now somewhat higher than in our previous Outlook due to historical data revisions. Assuming that businesses will take advantage of PIT cuts and will thus raise gross wages more slowly, we hold to our forecast of a rise in average net wages of 4% in 2012 and 5.5% in 2013. In 2014, we expect net wages to pick up by 6.5%.

The current account deficit is anticipated to widen, mostly due to larger trade deficits. As it will remain fully covered by EU funds and foreign direct investment (FDI) inflows, the deficit so far poses no sustainability risks. Yet, it may be a risk over the medium term if EU fund inflows are reduced in the next planning period (2014-2020) and/or foreign investors become more risk averse in times of excessive financial market volatility.

The risks to the forecast are biased to the negative side. The main negative risks come from abroad (see the global section of this Outlook) – higher-than-expected commodity prices and worsening crisis management in the euro area. Locally, labour market tightening still poses a risk for higher inflation and a possible deterioration in competitiveness; however, the planned tax de-

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012f	2013f	2014f
Real GDP	5.5	4.0	3.5	5.2
Nominal GDP, billion euro	20.0	21.7	23.6	26.0
Consumer prices (average)	4.4	2.5	2.5	3.5
Unemployment rate, % [2/]	16.2	15.5	13.7	11.5
Real net monthly wage	0.1	1.5	2.9	2.9
Exports of goods and services (nominal)	22.5	11.9	9.2	12.4
Imports of goods and services (nominal)	27.2	12.0	10.3	13.4
Balance of goods and services, % of GDP	-3.4	-3.6	-4.2	-4.9
Current account balance, % of GDP	-1.2	-1.6	-2.7	-3.8
Current and capital account balance, % of GDP	0.9	-0.2	-1.3	-3.1
FDI inflow, % of GDP	5.5	3.3	3.6	3.2
Gross external debt, % of GDP	146	137	130	123
General government budget balance, % of GDP [3/]	-3.5	-1.9	-1.2	-0.7
General government debt, % of GDP	42.6	40.2	37.6	34.1

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.

clines will somewhat withhold demand for higher wages. Although there is a small chance of better global developments, positive risks to the outlook are mainly local. If current policy discussions on industrial policy, social benefit system, and educational and regional policy turn into an active implementation phase, growth potential will be boosted. However, this would begin to significantly support GDP growth in 2014 at the earliest.

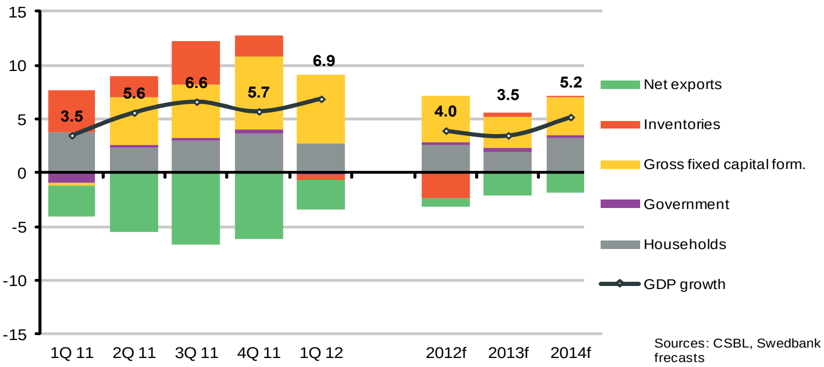
Exporters gain from improving competitiveness

Although export growth has been slowing, it remains strong – volumes were up by nearly 10% in annual terms in the first quarter of 2012. Some of the main trading partners have so far performed better than our April Outlook expected (e.g., Germany and the Nordics); however, developments in others have been weaker (e.g., Russia and the UK). Overall, Latvian exports are growing more rapidly than foreign demand, and we expect this trend to continue over the forecast period.

The main reason is the ongoing improvements in competitiveness that have allowed Latvian manufacturers to raise their market shares (especially to Poland and the Nordics). In the first quarter of 2012, unit labour costs in manufacturing were 5% lower than a year ago. The quality-price relation of Latvian products (and small volumes on a global scale) seems to be what clients currently want.

Furthermore, during the last three quarters, the growth of services' exports exceeded that of goods, accounting for nearly half of total export volume growth. The main driver of services' export growth was freight transportation, followed by tourism and other services.

Contribution to annual GDP growth (percentage points)



Taking into account the global uncertainty, the focus of manufacturers remains primarily on lowering costs rather than expanding production. Overall capacity utilisation in manufacturing has reached the pre-crisis level. There are capacity and resource constraints in the exporting services sectors (for details, see our Latvian monthly newsletter, May 2012). We maintain our view that export growth will continue to slow, yet we have raised our export forecast for 2012 to account for the stronger-than-expected beginning of the year. With global developments improving slowly, average quarterly export growth will pick up again in 2013 and 2014.

The weakening euro exchange rate will support exports to Commonwealth of Independent States, Sweden, and Norway. Rising prices globally and a change in product mix towards higher-value-added products and services will also help to raise export revenues. For instance, a recent hike in global grain prices is favourable for Latvian exporters, particularly as this year's harvests are expected to be good.

Stronger exports require more imports; yet, as domestic demand, especially investments, is picking up, import growth continues to exceed that of exports. The trade deficits in the balance of payments will grow to just below 5% of GDP in 2014. So far there are no threats to current account financing; it is covered through FDI inflows and EU funds (see the next section for details). However, this is a risk in the medium term – expanded output capacity and new higher-value-added products and services are needed to raise exports and finance imports.

Robust investment activity

Investment growth in the first quarter of 2012 was very strong – the annual growth of gross fixed capital formation accelerated to 39%. Economic sentiment in Latvia continues to be surprisingly robust and support growth; meanwhile, in Europe confidence is falling again after a temporary boost caused by the European Central Bank's operations. Latvian manufacturers remain cautious in their investments – to retain flexibility, they are implementing investment projects piecemeal even if this costs more. Facing slowing demand growth, exporters keep focus on cost cutting to preserve their profit margins – major investments are in machines and equipment to improve efficiency and reduce labour

There are new entrants expanding production capacities, e.g., new FDI in metal industry from Russia, attracted by availability of EU funds. Construction activity in residential real estate is to remain poor over the coming years; yet, such activity in office and retail spaces will continue growing slowly.

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2011	2012f[1/]		2013f[1/]		2014f[1/]
Household consumption	4.4	3.9	(2.5)	3.0	(3.0)	4.8
General government consumption	1.1	2.0	(2.0)	2.3	(2.3)	2.4
Gross fixed capital formation	27.9	17.0	(7.8)	10.5	(8.0)	11.5
Inventories [2/]	1.8	-2.3	(-0.9)	0.3	(0.8)	0.1
Exports of goods and services	12.6	6.8	(4.7)	4.8	(5.6)	7.0
Imports of goods and services	20.7	7.2	(4.9)	7.2	(7.5)	8.5
GDP	5.5	4.0	(2.5)	3.5	(3.5)	5.2
Domestic demand (excl. inventories) [2/]	8.8	7.1	(4.0)	5.3	(4.5)	7.0
Net export [2/]	-5.2	-0.9	(-0.5)	-2.1	(-1.8)	-1.8

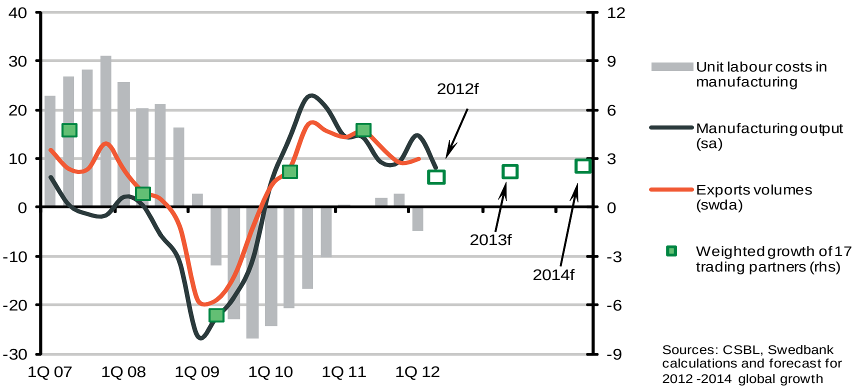
Sources: CSBL and Swedbank.
1/ The figures from our forecast in April are given in brackets.
2/ Contribution to GDP growth

The investment activity will remain driven by underinvestment in productive capacity and infrastructure in the run up to the crisis and during the crisis. In 2012-2013, EU funds will remain a major source of investment financing, both in industry and the public sector. In 2014, a new EU fund-planning period begins, and fewer new projects are expected since extensive administrative work is required from the state and companies, to set the rules and apply for the projects before actual investments are made. It is also likely that less EU funds will be allocated to Latvia in the 2014-2020 (negotiations on this continue), as the focus in EU is placed on fiscal austerity. Already-commenced investments and regular capital expenditure will still be in place, but the average quarterly growth of gross fixed capital formation is expected to decelerate.

The corporate sector is mostly investing own resources with the support of EU funds. The financial situation of businesses remains good – despite growing investments, deposits of non-financial corporations largely remain stable. Bank lending is growing – in the first quarter of 2012, new loans made up 19% of total gross capital formation (up from 13% a year ago). Lending is expected to become more active in 2013-2014 as the global situation and confidence improve.

FDI inflows are stable and anticipated to remain over 3% of GDP. PIT cuts and an improvement in the business environment (e.g., in the World Bank's "ease-of-doing-business" index, Latvia ranked 21st in 2011, up from 31st a year ago) give positive signals to foreign investors, though competition with the neighbouring countries for FDI remains fierce.

Annual growth of Latvian manufacturing and exports, %



Labour market will continue to improve

Employment grew by 2.2% in the second quarter of 2012 in annual terms. Net of active labour market programmes (ALMPs), it expanded by an outstanding 4.6% or about 38 thousand new jobs since the second quarter of 2011. Meanwhile, the number of persons in the ALMPs declined by 19 thousand. Economic growth has lured people back to the labour market, and the participation rate rose to 66.5% from 64.9% a year ago. Due to the exceptional rise in supply, the unemployment rate only declined from 16.3% in the first to 16.1% in the second quarter (down from 17.1% a year ago). The registered unemployment rate diminished more rapidly and was 11.9% in July.

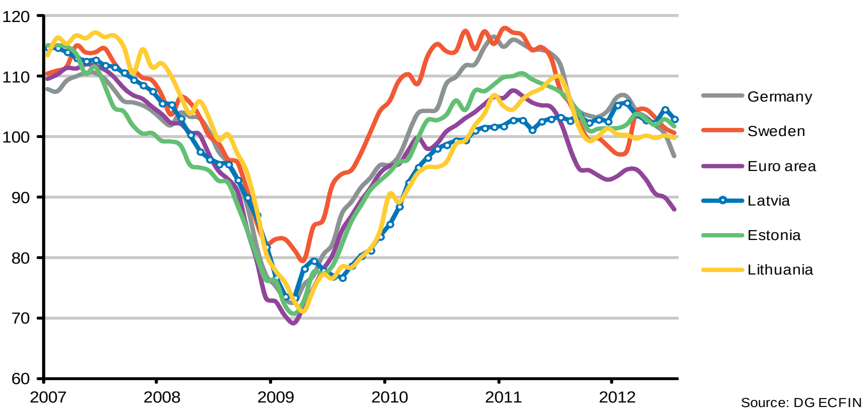
These labour market data have now been adjusted by the 2011 population census results, which raised the unemployment rate by 0.8 percentage points and lowered the participation rate by 0.9 percentage points for 2011. Therefore, we are revising our forecast and now expect the average unemployment rate to be about 15.5% this year and to drop to 11.5% in 2014, assuming the emigration flows diminish slowly. The unemployment rate will then be quite close to its 2003 level. This might create a buildup of upward wage pressures since nearly a half of the currently unemployed are long-term (most of them for structural reasons). So far, these pressures have been muted, and with rising employment, the vacancy rate has been stable for more than a year.

The participation rate is set to rise slowly. From 2014 onwards, this rise will be supported by the increasing retirement age (moving to 65 years in 2025 from the current 62). We expect employment growth to slow somewhat towards the end of this year before returning to over 2% in 2013-2014.

Real wages continue to grow almost as fast as productivity. In manufacturing, where the largest positive gap exists between productivity and wage levels, wage pressures remain subdued since businesses are continuing to replace labour with capital thus undermining employees' bargaining power. Services sectors, especially exporting ones, are more labour dependent – with turnover growing, they will need to give in to wage demands (especially in Riga). Wage pressures in the public sector are rising, although so far they have been withstood by the government – the only across-the-board wage increases this year are planned for school teachers.

We expect wage demands to strengthen in 2013-2014, but actual gross wage growth will be partly held back by PIT

Economic sentiment (index)



cuts. We forecast real average net wages to rise by 1.5% in 2012 and to pick up to nearly 3% annually in 2013-2014.

Inflation recedes

Consumer price inflation has slid below 2% for two consecutive months, supported by favourable developments in global commodity prices and muted domestic price pressures (core inflation, excluding energy and unprocessed food, is growing slower than the headline inflation). After an unexpected pickup early in the year, oil prices have retreated. Yet, the pickup is still having a delayed effect on administratively regulated prices – as of July, gas and heating tariffs have risen. At the same time, a fall in the VAT has held down price growth a bit.

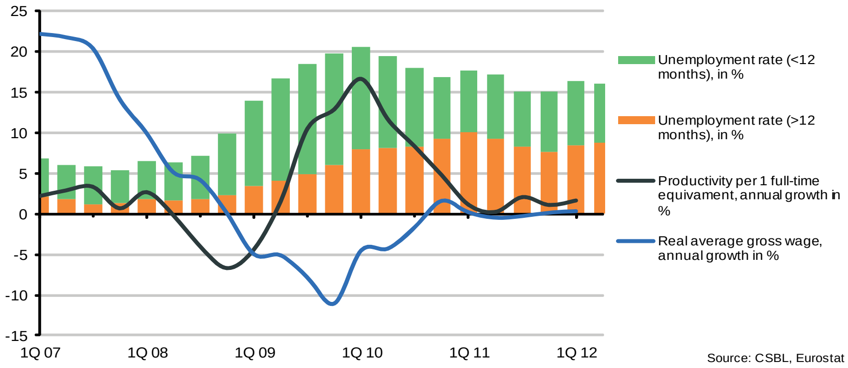
Due to the recent hike in global grain prices, we now expect somewhat swifter food price growth in the second half of the year; however, lower oil prices will suppress fuel, gas, and heating prices, compared with the previous Outlook. We are thus lowering the forecast for average consumer price index (CPI) growth for 2012 to 2.5% from 2.8%. We still expect consumer prices to grow by the same 2.5% in 2013. Because income growth is boosting confidence and domestic demand, and because global energy prices are rising, the Latvian CPI is anticipated to grow by 3.5% in 2014.

Private spending to slow before picking up in 2013-2014

Household spending in the first quarter of 2012 was somewhat stronger than expected (up by 5.4% in annual terms). In the second quarter annual growth of retail sales slowed to still solid 7.9% (11.7% in the first quarter). The rebound in sales of durable goods is starting to fade away.

Retreating inflation, the strengthening labour market, and the diminishing debt burden are supporting household purchasing power and, thus, spending. Transfers from emigrants and other incomes besides wages (including those from the "grey" economy) continue to support consumption. New bank lending remains weak, just 0.7% of total household spending in the first quarter (including mortgages), which is similar to a year ago. The current very low interest rates do not encourage savings, and deposits remain by and large stable.

Labour market indicators (adjusted after census as of 2011 onwards)



Source: CSBL, Eurostat

We are revising upwards our household consumption growth forecast for 2012 to account for strong first-quarter results (including swifter-than-expected growth in the number of working hours); however, we expect this to weaken in the second half of the year in line with an overall slowdown in the economy. In 2013-2014, the average quarterly growth of private spending is anticipated to pick up due to strengthening purchasing power, rising optimism, and more active bank lending.

Fiscal situation continues to improve

The government's fiscal position has continued to improve. Tax revenues in the first 7 months of this year grew by 13% over the same period last year and are 8% above the plan. We see three explanations for this good revenue growth. First, strong economic growth has yielded better tax revenues. Second, tax administration may have improved. Third, there has been a post-recession rebound – IMF studies show that during recessions revenues contract more sharply than the tax base, whereas the opposite is the case during recoveries.

It is impossible to single out the individual contribution of these three effects. Yet, unless tax administration is unusually successful in squeezing the grey economy – given that economic growth will slow and the post-recession rebound will run out – revenue growth will soon slow down. Thus, expenditures must remain under control, and additional spending should be directed to sectors implementing social- and growth-boosting structural reforms, rather than to an across-the-board increase in the entire set of expenditures. On the basis of good revenues, budget expenditures will be raised (the government has just submitted supplementary budget to the parliament), but the 2012 budget deficit will be contained at about 2% of GDP

Besides the already-discussed tax cuts, further discussions have been held on other reforms. The most progress seems to have been made in education. There are discussions on changes in industrial policy, on linking access to health care to tax contributions in order to squeeze tax evasion, on relocation benefits to cut emigration and boost physical and administrative capacity of regional centres, to mention just few of the reform areas. If correctly drafted and implemented, such reforms would significantly boost growth potential. Yet, unless the existing financing mechanisms are changed, reforms will not yield tangible results. It still remains to be seen how much of this will be part of the 2013 budget.

Lija Strašuna
Mārtiņš Kazāks

Lithuania: Stronger growth after a stutter step

In line with our expectations, the Lithuanian economy expanded at a slower pace in the first half of this year. Annual growth eased to 2.1% in the second quarter, down from 3.9% in the first quarter. Most of the slowdown was caused by the five weeks maintenance work on the oil refinery, which makes up one-fourth of total industry output. As expected, growth was driven by investments and household consumption. We expect that annual growth has bottomed out and will pick up slightly in the second half of this year; thus we are keeping our annual forecast unchanged at 3.3%.

We have lowered our forecast for 2013 by 0.2 percentage point to 4.1%, mainly due to the bleaker outlook in the euro area, which will be a drag on Lithuanian exports. Unemployment will also decline slightly slower than we envisaged in our April Swedbank Economic Outlook, causing slightly weaker growth in household consumption. Overall sentiments will remain depressed by external and domestic uncertainties – particularly, further developments in the euro area, as well as the upcoming parliamentary elections and possible shifts in economic policy. We expect the economy to return to close to potential only in 2014, when GDP will expand by 4.5%. Nevertheless, a return to the natural level of unemployment is not expected by the end of our forecasting period. Like this year and the last, the biggest contribution to growth in the coming years will be from household consumption and investments.

Inflation has also been easing in line with our expectations – in July, average annual inflation was down to 3.5%. It will remain on a downtrend and is expected to fall to 2.8% at the end of this year. This trend will continue into the beginning of 2013, but we forecast slightly higher inflation next year, mainly due to an increase in regulated prices. Inflation will accelerate further in 2014, when we expect it to reach 3.4%.

Abundant external and internal risks

Since the publication of our last Outlook in April, tension in the euro area and the accompanying risks have become more acute (see the global section in this Outlook). Although Europe is moving towards the creation of institutions needed to ensure the successful functioning of the monetary union, these will not be quick or easy steps. Even though so far the direct impact of the euro area crisis has been muted, the uncertainty related to the euro area debt crisis has sparked heated debate about whether “the second wave of crisis will hit Lithuania”. This has somewhat damaged consumer and business confidence, which dropped in July after increasing during most of the first half of this year. The risk that Greece and perhaps some other countries will leave the euro area has increased. Should this materialise, the economic recession in the euro area would worsen, and Lithuanian growth would be further dented or even turn into a recession.

Longer-term risks that could damage confidence and potential output are related to the October 14 parliamentary elections. As during elections in other European countries, surveys show that the Lithuanian voters are likely to oust the incumbent government. As no political party is likely to win more than 20% of total votes, the government will be a coalition of three-four parties. The main domestic risk is related to the economic policy path that will be chosen by the new government. We expect that the reforms initiated in higher education and the management of state-owned enterprises, the numerous measures taken against the shadow economy, the energy projects, and overall fiscal discipline will be continued, but this is far from certain.

The upside risks are slim and could materialise only next year, especially if the euro area manages to accelerate the pace of reforms and institution building. However, most previous breakthroughs provided only false hope, and the pick-up in confidence was short-lived.

Exports remain resilient, the direction has shifted

Export growth remained strong in the first half of this year, when it expanded by 7.3% (at current prices) over the same period a year ago. The noticeable contraction of exports in May was caused by the aforementioned maintenance work on the oil refinery, and growth picked up to 5.2% in June (exports except for oil products grew by 16.6%). As expected, the euro area countries contributed less to Lithuanian export growth during the first half of this year – exports to Germany and France contracted by 2.9% and 0.7%, respectively. The baton was picked up by rapidly expanding Latvia and Esto-

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012f	2013f	2014f
Real GDP	5.9	3.3	4.1	4.5
Nominal GDP, billion euro	30.7	32.2	34.5	37.2
Consumer prices (average)	4.1	2.8	3.0	3.4
Unemployment rate, % [2/]	15.4	13.2	11.5	9.3
Real net monthly wage	-1,3	1.4	1.8	2.0
Exports of goods and services (nominal)	27.5	10.0	7.0	13.0
Imports of goods and services (nominal)	27.6	10.8	7.5	13.5
Balance of goods and services, % of GDP	-1.3	-2.0	-2.3	-2.8
Current account balance, % of GDP	-1.6	-2.5	-3.0	-3.6
Current and capital account balance, % of GDP	0.9	0.5	-1.0	-1.4
Net FDI, % of GDP	2.8	4.0	4.0	4.5
Gross external debt, % of GDP	80.8	79.5	76.6	73.2
General government budget balance, % of GDP [3/]	-5.5	-3.0	-2.0	-1.0
General government debt, % of GDP	38.6	40.0	39.3	37.4

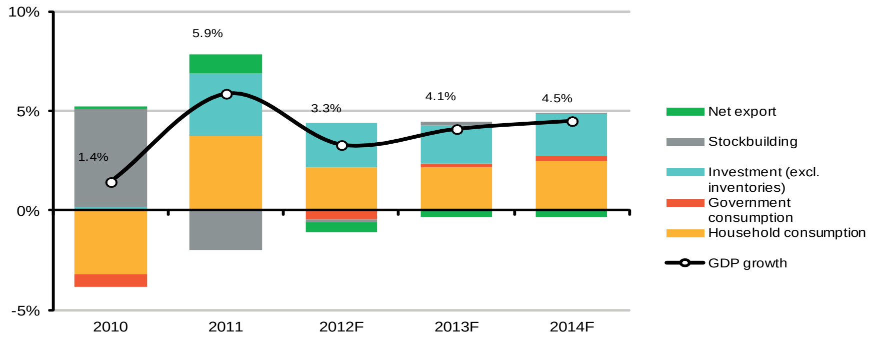
Sources: LCD, Bank of Lithuania and Swedbank.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

nia, as well as by Sweden and Russia. A 62.3% surge in exports to the UK (in line with a contraction of exports to Poland) is related only to the redistribution of product flows from the Orlen oil refinery in Lithuania.

Since the beginning of the summer, the Polish zloty, Swedish krona, and Russian rouble have appreciated versus the euro by more than 7 percent. As the weakness of the euro is not likely to be temporary, this development will further strengthen Lithuanian exporters' competitiveness. Unit labour costs have been dropping for four years now – average labour productivity is increasing faster than the wage bill. During the first half of this year, Lithuanian industry production (except for refined oil products) already exceeded its pre-crisis peak, reached in the first half of 2008. However, the industry employs some 20% fewer employees than it did before the crisis.

Despite Lithuania's increasing competitiveness, it will be hard to sustain the rapid growth of exports. The recovery in the euro area will be weaker (we expect it to stagnate next year), and Russia and Germany will also grow slower than we projected in our April Outlook. Thus we have lowered the Lithuanian real export growth forecast to 4.5% in 2013. As Europe emerges from the crisis and growth accelerates in neighbouring countries, we also expect Lithuanian export growth to climb to 7.0% in 2014. Import growth will be slightly faster than that of exports, but the trade and current account deficit will remain sustainable.

Contributions to GDP growth, percentage points



Sources: Statistics Lithuania and Swedbank.

Despite uncertainty, investment growth to remain strong

Investments have been growing in line with our expectations – in the first quarter of this year, gross fixed capital formation was 8.4% higher than a year ago. However, gross capital formation (including inventories) contracted by 5.9%. The reduction of inventories started in the last quarter of 2011 and seems to have continued throughout the first half of this year. Continued problems in the euro area, slower growth in exports, and the perceived threat of a "second crisis" were behind this trend. Although the problems in the euro area will not abate, we do not expect inventories to contract much further during the second half of this year.

The foreign direct investment (FDI) flow accelerated in the first quarter of this year, but mainly due to reinvested earnings. There was relatively little new equity, especially in greenfield investments. We expect the FDI flow to remain similar this year and the next, and to accelerate slightly in 2014, especially if the new government sends appropriate, clear signals: a stable and business-friendly tax policy, fewer unnecessary regulations, more liberal labour laws, and a clear target date for euro accession.

A similar pace of growth in investments is expected for both 2013 and 2014, and we project gross fixed capital formation to reach 23.8% of GDP by the end of our forecasting period, up from 18.3% in 2010. Although capacity utilisation was stuck at 72% during the first half of this year, it will likely trend higher and help meet the demand for investments. As we mentioned in our April Outlook, retained earnings, credit, and EU funds will remain abundant and will not constrict the growth of investments. Until the end of 2013, companies can still benefit from investments in technological renewal; this can lower taxable profits by up to 50%. We expect that this tax exemption will be extended and will further stimulate investments.

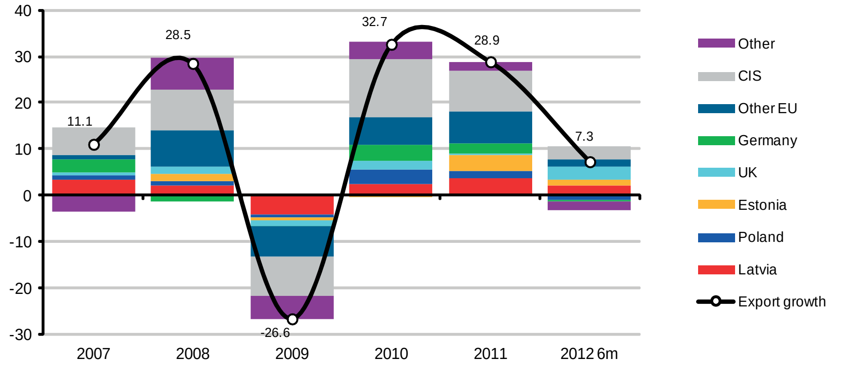
Currently, 62.5% of the total EU structural funds allocated for the period from 2007 until 2013 (which amounts to EUR 7.4 billion) have been allotted, but only 50.3% of the total has been paid out. It seems that not all operational programmes will be able to use all allocated funds by the end of 2013. The growth of investments could be stimulated by a more effective acquisition of the structural funds allocated for the renovation of energy-inefficient buildings. Some breakthrough in this area could be expected next year, but an altogether different model for financing these projects is needed.

Swedbank's GDP Forecast – Lithuania

Changes in volume, %	2011	2012f[1/]		2013f		2014f
Household consumption	6.1	3.5	(3.5)	3.5	(3.7)	4.0
General government consumption	0.2	-2.8	(-3.0)	1.0	(1.0)	2.0
Gross fixed capital formation	17.1	11.0	(11.0)	9.0	(10.0)	9.0
Inventories [2/]	-2.0	-0.1	(-0.1)	0.2	(0.0)	0.0
Exports of goods and services	14.1	4.0	(4.0)	4.5	(5.0)	7.0
Imports of goods and services	12.9	4.8	(4.8)	5.0	(5.5)	7.5
GDP	5.9	3.3	(3.3)	4.1	(4.3)	4.5
Domestic demand (excl. inventories) [2/]	6.9	3.9	(3.4)	4.3	(4.5)	4.8
Net export [2/]	1.0	-0.5	(-0.1)	-0.3	(-0.2)	-0.3

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

Nominal export growth contribution by countries, %



Sources: SL and Swedbank.

Unemployment will decline slower

Unemployment was slightly higher in the first quarter of this year. This was caused partially by seasonality and partially by much weaker business confidence at the end of last year, which slowed the creation of new jobs. Confidence has recovered since, and 31,600 new jobs were created during the first five months of this year (a 2.3% increase in the number of employed). In line with better confidence, unemployment dropped in the second quarter to 13.3% Similar trend is seen in registered unemployment – after increasing to 11.7% in the first quarter, it dropped back to 10.6% in the second.

As the labour market reforms stalled and the first-quarter data were worse than expected, average unemployment (labour survey data) is not likely to drop to 13%, as we envisaged in our April Outlook. Thus, we have raised our unemployment forecast to 13.2% for 2012 and 11.5% for 2013. In 2014, we expect growth in employment to accelerate and average unemployment to drop to 9.3%.

Our gloomier outlook for employment this year is partially related to the government's inability to find common ground with trade unions and to change some rigid regulations of the labour code. The possibility of setting working hours and vacation days more freely, renegotiating wages, and terminating contracts (in some cases) would help employers to feel more confident in the face of huge uncertainty and create more new jobs. We do not expect more progress before the parliamentary elections, but it is to be hoped some agreements can be reached next year.

Growth in consumption to slow

Household consumption grew slightly faster than we expected in the first quarter of this year; it was 7.8% higher than a year ago. Household consumption probably grew much slower in the second quarter, and total annual growth will be a more modest 3.5%.

Retail trade annual growth in the second quarter, at 4.0%, was already two times slower than in the first quarter and is expected to grow at a similar pace in the second half of this year. Growth in retail trade has been supported by a record inflow of tourists, including Byelorussians who come for weekend shopping.

Despite the lower unemployment and higher real wage growth next year, we do not expect household consumption to grow faster. Domestic demand has been supported by non-labour income – pensions were increased by 9.3% this year – and this effect will ebb next year. Furthermore, the savings rate dropped sharply at the beginning of this year (against our expectations); we expect it to be somewhat higher next year barring quick, confidence-lifting breakthroughs in Europe.

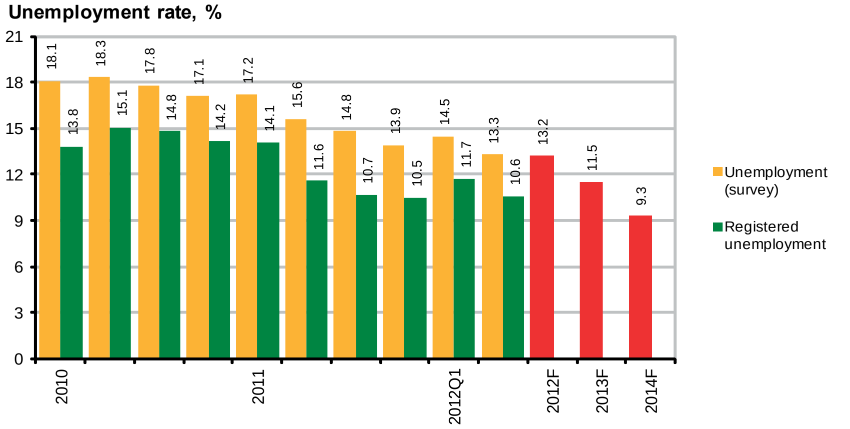
Household consumption growth will accelerate to 4.0% in 2014 but will remain below wage bill growth. There are upside risks, especially if consumer confidence picks up and household debt starts rising again – the loan stock to households was still declining in the first half of this year, although there were the first signs of an increase in newly issued loans.

Inflation will remain low, but euro prospects are dim

The main drivers of inflation in Lithuania remain developments in global goods and commodities markets; however, some increases in regulated prices will also have a tangible effect. The monopoly Lithuanian Gas has decided (and the regulator has agreed) to increase gas prices for households by about 22% as of July 1. This decision was due to higher oil prices (the import price of gas is directly indexed to the price of oil); however, this increase now seems excessive, considering the steep decline of oil prices during the past few months. Our estimates show that this will add about 0.35 percentage point to annual inflation. The price of heating in some major cities will go up in the second half of 2012, and public transport will become more expensive in Vilnius as of August 15.

The biggest impact, however, on inflation will be from developments in commodities markets, which have so far been favourable for Lithuania. Thus we

Unemployment rate, %



Sources: SL, Lithuanian Labour Exchange and Swedbank.

keep our inflation forecast unchanged for this year. Next year, however we expect slightly higher inflation – 3.0%. Although the average oil price will decline by 5.5% – slightly more than we previously forecast – the effect will be partially offset by a weaker euro. Furthermore, droughts in the US and floods in Russia are causing shortages of corn, soybean, and wheat; thus we forecast the global food price index to be 7.0% higher next year. In 2014, because commodity prices and faster wage growth in some sectors will create more upward price pressures, we forecast a further increase of inflation to 3.4%.

The government has increased the minimum monthly wage by LTL 50 (EUR 14.48), or 6.25%, starting August 1. This is below the anticipated LTL 100 (or 12.5%) hike, which we considered in our April forecast. This increase and labour costs in general will have limited (if any) impact on inflation – high unemployment will keep employees' negotiation power low and productivity growth will be in line with wage growth during our forecasting period.

Although it is still possible that Lithuania will meet the price stability and budget deficit Maastricht criteria in the spring of 2013, the prospects of adopting the euro in 2014 are dim because the government has not yet designated this as an official national target.[1]

Government revenues up despite large shadow economy

During the first seven months of this year, national budget revenues were 6.1% higher than during the same time a year ago and exceeded the plan by 1.4%. The above-the-plan revenues raise the likelihood that neither tax increases nor spending cuts are necessary to meet the 3.0% of GDP deficit target this year.

We forecast that the budget deficit will decline further in 2013 and 2014, to 2% and 1% of GDP, respectively. Beginning January 1, 2013, lower VAT taxes for the printed media, technical assistance means for the disabled and their repair, and public transport tickets will go into effect. Spending is likely to increase in coming years, but departures from fiscal discipline will be guarded against by the European Fiscal Compact, ratified by the Lithuanian parliament in June. Thus, general government debt will peak this year at 40.0% and decline to 37.4% by the end of our forecasting period.

Tax revenues as a share of domestic demand (and GDP) have disappointed somewhat and remain close to 15%, well below the pre-crisis average of 18.3%. The government has implemented a number or reforms aimed at reducing tax evasion and the size of the shadow economy, but so far these have brought limited success. The Nielsen "empty-pack" survey shows that in the second quarter the share of smuggled cigarettes dropped to 29.3%, down from 34.6% a year ago and a stunning 43.0% from the end of 2010. The measures taken thus far – the rotation of customs officers, taxation of goods once a person has crossed the eastern border more than five times, implementation of cashiers in covered markets – all these represent a positive progress towards a more transparent economy but have not solved the large-scale corruption and smuggling problem. The continuation of these reforms should remain the priority of the new government.

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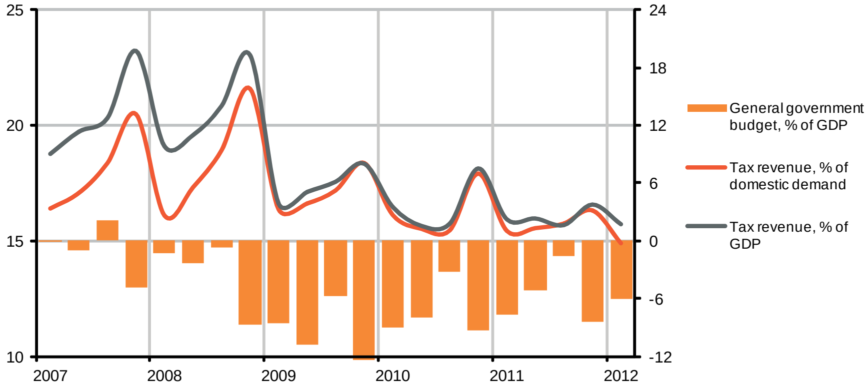
Vaiva Šečkutė

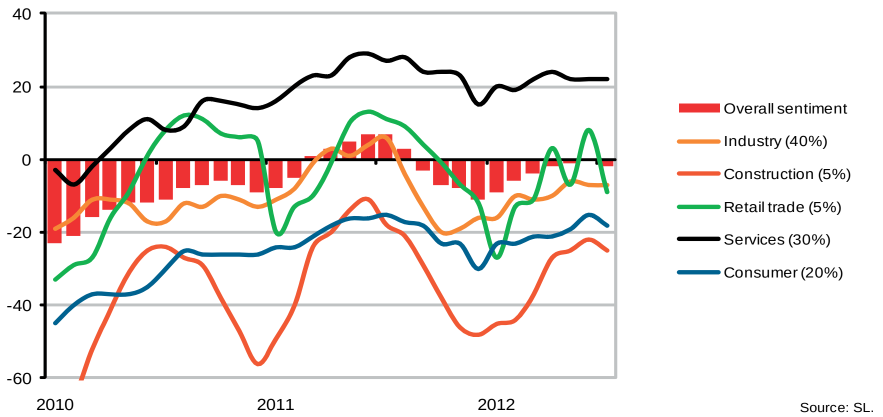
General government budget and its balance, %



Source: Ministry of Finance and Swedbank.

[1] For a more detailed analysis of Lithuania's and Latvia's prospects, see our recent Swedbank analysis, 2012 08 01

Confidence Indicators (net balance)



Source: SL.

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