Swedbank

Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

January 16, 2013

The worst is behind us – but challenges remain

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Global development

- The global economy cooled in the second half of 2012, but developments have been mixed. While growth is picking up in the US and China, Japan and the euro area are in recessions. We expect global GDP to grow by 3.1 % in 2013, and by 3.4% in 2014, a slight downward revision.
- Our "muddling-through" scenario is the new normal. The probability of its being realised is up from 60% to 65%. Downside (20%) and upside (15%) risks are now more balanced and relate to the policy agenda. Both in the US and in Europe, politicians are flirting with disaster, but, if managed well, confidence amongst households, companies, and financial markets could rise and support growth.

Sweden

- Following three quarters of relatively strong growth, the Swedish economy appears to have slowed sharply in the closing quarter of 2012, due to a combination of weaker external demand and increasing gloominess amongst households and companies.
- The recovery will be slow in the early part of 2013 and thereafter pick up on the back of more expansionary economic policies, stabilising external markets, and a renewed willingness to spend on behalf of consumers. Growth is forecast at 1.1% in 2013 and 2.6% in 2014. Combatting rising unemployment will be the main policy challenge ahead of elections in 2014.

Estonia

- Economic growth slowed substantially in 2012 but remained the highest in the euro area. Increasing investment activity based on EU-financed infrastructure projects was the main growth driver.
- Due to fragile external demand conditions in Nordic countries, export performance will remain weak over the first half of 2013. In addition, state-financed investments are expected to be somewhat smaller than in 2012. As a result, we are lowering the GDP growth forecast for 2013 to 3.1%. Growth is expected to pick up to 4.5% in 2014.

Latvia

- GDP rose by 5.6% in the first nine months of 2012. Exports and household spending have remained strong, while investment growth has dipped. The improved fiscal stance and better chances to adopt the euro in 2014 have led to higher sovereign ratings and cheaper government borrowing.
- We expect growth to slow from 5.4% last year to 4.1% in 2013 due to weak external demand and tougher competition in export markets. Growth is anticipated to pick up to 5% in 2014, when the personal income tax is cut further, global conditions improve, and Latvia joins the euro area.

Lithuania

- The economy expanded in line with our forecast in 2012, and household consumption and exports surprised on the upside, but investments grew slower than expected. Average annual inflation decreased to 3.1% but was slightly above our forecast. Lithuania did not formally apply to join the EMU.
- We have lowered our GDP growth forecast for 2013 and 2014 to 4.0% in both years, mainly due to a weaker outlook for main export markets and domestic policy uncertainty. The budget deficit is expected to decline further, but inflation will remain the main obstacle to joining the euro area.

Hit by the weak global economy – but set for stronger upturn

Sweden and the Baltic countries on average performed better in 2012 than envisaged in our October forecast. Growth is estimated at around 3% in Estonia and Lithuania, and to have reached almost 5.5% in Latvia and just above 1% in Sweden. Our estimation for the fourth quarter of last year, however, is that growth slowed in the Baltic countries and that the GDP level fell in Sweden.

Except in Latvia, GDP growth has been revised down for 2013. GDP will continue to grow by just above 3% in Estonia and just above 1% in Sweden, while reaching 4% or slightly above in Latvia and Lithuania. We see somewhat lower growth in the global economy as well. Prospects look somewhat better in the US and in China, while recessions still prevail in the euro area and Japan. Towards summer, we expect activity to start to grow slowly also in the euro area, thus strengthening external demand for Swedish and Baltic companies' products.

In 2014, therefore, when the global economy is expected to grow by 3.4% in our main "muddling-through" scenario, growth is foreseen to reach just above 2.5% in Sweden, and 4-5% in the Baltic countries – relatively strong upturn compared with many other European countries.

Global growth will still perform below its potential. Fiscal and credit austerity remains a constraint, especially in Europe, but also to some extent in the US. The negative effects on growth from deleveraging and budget consolidation cannot be compensated for by expansionary monetary policy and structural reforms in the advanced economies. However, the stimulus implemented in emerging markets should support global activity, and the growth momentum in these countries is already stronger. Emerging markets – now representing more than half of the global economy – will make up 80% of global growth in 2013, a share we foresee falling to 72% in 2014 as advanced economies strengthen somewhat.

We see a higher probability for our main scenario at 65%, compared with 60% in October, since the "fat tails" in the euro area began to decrease when institutional reforms gained strength. We are raising upward risks to 15% (from 5%) and lowering downward risks from 35% to 20%. Amongst the upward risks, we see higher confidence, as policy challenges are addressed and stimulus programmes in emerging markets give a more positive impact. Amongst the downward risks, we see increased turbulence in the euro area, as problems in Spain and Italy worsen again with widening interest rate spreads, financial market turbulence, and a negative spiral of deleveraging, depression, and deflation. Moreover, continuing political gridlock in the US would reduce growth more than envisaged, and tensions between China and Japan, as well in the Middle East, could put the global economy at risk.

Sweden showed a quarterly growth of 0.5-0.7% in the first three quarters in 2012, but GDP is now estimated to have shrunk by 0.6% in the fourth quarter; it is expected to stabilise in the beginning of this year. Factors contributing to the Swedish economy's putting on the brakes are faltering external demand and weaker domestic activity. The strong krona and increasing unit labour costs are adding to the challenges. As production levels fall, companies adjust employment, and thus we foresee unemployment increasing until late 2013 before falling only marginally in 2014, to 8.2% on average. Public finances remain relatively robust, but a lower growth forecast for 2013 and additional spending initiatives will raise the deficit to just above 1% of GDP this year and next. We foresee public spending at SEK 5-10 billion, additional to the already budgeted increase of SEK 23 billion, for 2013, and another SEK 25 billion for 2014, which is an election year. This also means a smaller chance of reaching the 1% surplus target over the business cycle. Monetary policy will continue to be expansionary, and the krona will remain at the current strong level. We foresee an additional interest rate cut during the spring of 2013. Despite high unemployment and consumer price pressures being well below the inflation target, the policy interest rate is seen as rising in early 2014. The main reason would be the concerns of the household debt level among the Riksbank's Executive Board members.

Estonia's GDP is estimated to have grown by 3.0% in 2012, slightly higher than our forecast in October. Increasing investment activity was the main growth driver, while exports weakened

Macro economic indicators, 2011- 2014

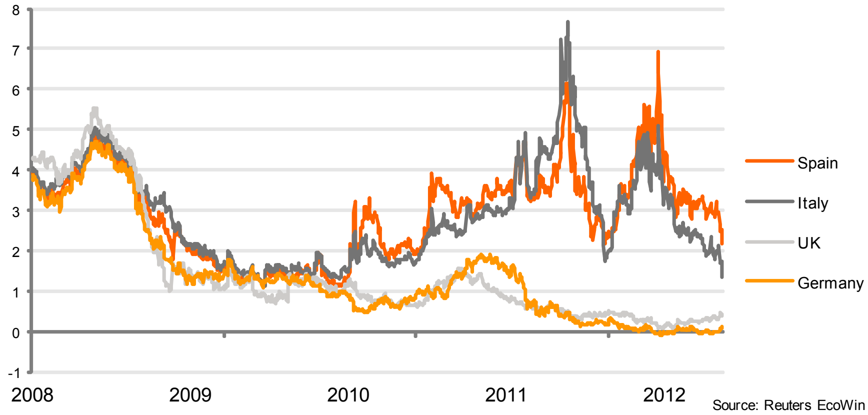
	2011	2012e	2013f	2014f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	3.8	1.1	1.1	2.6
Estonia	8.3	3.0	3.1	4.5
Latvia	5.5	5.4	4.1	5.0
Lithuania	5.9	3.3	4.0	4.0
Unemployment rate, % of labour force				
Sweden	7.5	7.7	8.3	8.2
Estonia	12.5	10.3	10.0	9.4
Latvia	16.2	15.0	13.6	11.6
Lithuania	15.3	13.2	11.5	10.0
Consumer price index, annual change in %				
Sweden	3.0	0.9	0.3	1.9
Estonia	5.0	3.9	3.2	2.7
Latvia	4.4	2.3	1.9	3.5
Lithuania	4.1	3.1	3.3	3.4
Current account, % of GDP				
Sweden	7.3	6.8	6.5	6.3
Estonia	2.1	-2.1	-3.9	-3.2
Latvia	-2.4	-2.0	-2.4	-3.4
Lithuania	-3.7	-1.0	-0.8	-1.4

Sources: National statistics authorities and Swedbank.

markedly; this also had a negative impact on external balances. In 2013, domestic demand will again be the main supporter of growth. Since state-financed investment will cool somewhat and companies remain cautious about investing in the subdued external climate, our GDP forecast for next year has been lowered to 3.1%, from 3.7% in October. In 2014, we project GDP growth to reach 4.5% as external demand improves. In early 2013, private consumption will slow as risk aversion picks up and inflation rises, mainly due to higher electricity prices; however, it will strengthen thereafter in line with lower unemployment and decreasing consumer price pressures. Wage growth has so far been subdued, but, due to labour supply constraints, it could increase faster than productivity growth and thereby hurt competitiveness. Public finances remain solid, and the external debt burden continues to ease.

We estimate that, after growing by 5.5% in 2011, Latvia's GDP increased by 5.4% in 2012. Surprisingly strong exports despite weakening growth of trading partners, and decreased import propensity contributed to higher net exports. Employment has strengthened, and unemployment has continued to decrease; also inflation has come down, supporting a somewhat stronger growth in private consumption than envisaged. We expect GDP growth to cool to 4.1% in 2013, still stronger than expected in October, due to a larger carry over from 2012. Supported by stronger external demand, local labour tax cuts, and higher confidence amongst households and companies, growth is

Interest rates, 2-year government bonds (percent)



Source: Reuters EcoWin

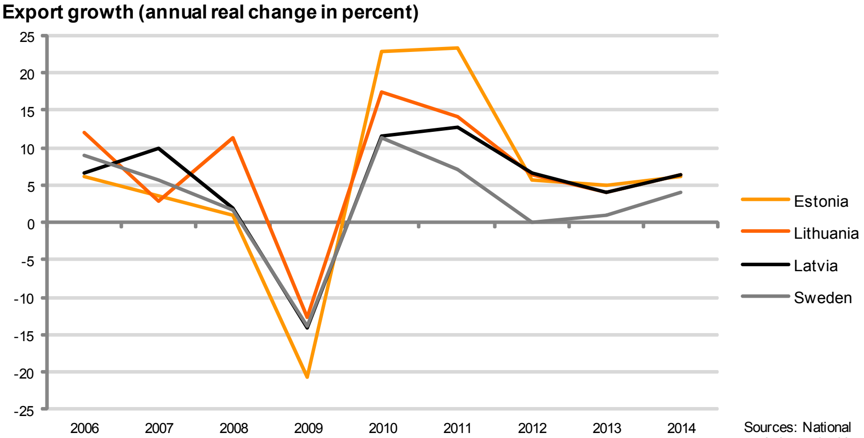
expected to pick up and reach 5.0% in 2014. Improved fiscal balances – and good chances of fulfilling the Maastricht criteria and introducing the euro in 2014 – have led to higher sovereign credit ratings. Government bonds issued in December were thus issued at their historically lowest yield, making possible an early repayment of the full IMF emergency loan. While forecast risks are mainly external, domestic risks can be linked to capacity constraints and a stalling of reforms.

Lithuania's estimated growth rate in 2012, at 3.3%, is unchanged from our October forecast. However, while domestic demand seems to have been weaker than projected, net exports contributed positively to growth as exports surprised on the upside. Investments, especially, – including inventories – were hit by the dampened external climate, while private consumption surprised on the upside. Going forward, we have lowered our GDP forecast for 2013 marginally to 4.0%, but more substantially for 2014, as it is seen to remain at 4.0% (4.5% in October). The main reasons for lower forecast are more cautious investment and recruitment by companies, as external concerns carry over into domestic concerns about stagnating reforms and policy uncertainty. Thus, unemployment will not fall below 10% in 2014, as earlier envisaged. While public finances are improving and the deficit continues to fall towards 2% of GDP – which would support European Monetary Union (EMU) membership – the inflation outlook is more uncertain, as electricity prices as well as the minimum wage will rise. In any event, Lithuania has not formally applied for EMU membership. Unless the Lithuanian government sets a clear accession date and applies measures to guard price stability, membership may have to be postponed until 2017 or later.

Sweden and the Baltic countries will continue to grow despite the weaker global economic climate, but growth will be below potential, and structural effects on the economies will be stronger, especially in the manufacturing sector. In these circumstances, to implement reforms that create better fundamentals for growth is the best our countries can do. Even if the investment climate has cooled, this may be exactly the right time to invest – both in the private and public sectors.

Cecilia Hermansson

Export growth (annual real change in percent)



Sources: National statistics authorities

Wanted! A clear turnaround in 2013!

After more than five years of extraordinarily high financial and economic stress, the global economy has become more diverse. While the American and Chinese economies are strengthening, albeit with hesitation and lingering downward risks, the European and Japanese situations have worsened with new recessions to overcome. Also, in Brazil, India and Russia, challenges are large, and stimulus programmes designed to support growth have to be carefully implemented to avoid new phases of overheating since there are capacity constraints.

We project global growth at 3.1% in 2013, marginally higher than the estimated 3.0% last year. A turnaround in the euro area is expected towards summer, although the deepest fall in activity may already be behind us as indicated by the global purchasing managers' index (PMI). With most regions picking up in the second half, growth in 2014 will strengthen and reach 3.4%. It is difficult to pinpoint the exact time for the turnaround as it is dependent on many political decisions affecting confidence amongst companies and households; it could very well take longer for the euro area to return to the recovery path.

We regard the "muddling-through" scenario to be the most probable, suggesting continued struggles, mainly in Europe and the US, while governments carry out fiscal reforms and consolidation programmes, find the proper regulations and central banks continue to pursue expansionary monetary policy. As in all phases of recuperation after a severe banking crisis, growth will be lower and unemployment higher than in normal recovery periods. Global growth of around 3-3.5% may not be great, but considering the difficult position, especially of mature economies, it is positive that the relatively strong developments in most emerging markets are continuing to support the world economy.

Most of the slowdown may already be behind us

In the second half of 2012, activity dampened markedly, much more so than we had foreseen at the beginning of the year. Europe and Japan entered or came close to recessions, but growth also slowed in China, India, Brazil, Russia, and the Nordic countries, albeit from higher levels. The US was the most important exception as quarterly growth in the third quarter picked up to a better-than-expected 0.7%.

Although the euro area made progress in the institutional area, growth faltered – not least in southern Europe, where unemployment rose to historical highs. The opposite was true for the US where growth picked up and institutional weaknesses became more visible as the country proceeded towards the fiscal cliff. A temporary relief was given right after New Year as tax hikes for 98% of the population were voted against by Congress, but many challenges remain. Moreover, the agreement reached will reduce growth this year by about one percentage point. In the euro area, politicians took a step towards a banking union, agreeing on supranational supervision of banks. Two earlier steps taken towards better crisis management had already strengthened financial market confidence: interest spreads fell after the establishment of the European Stability Mechanism (ESM) allowed for the transfer of funds to crisis-struck countries; and the European Central Bank's (ECB's) outright monetary transactions (OMT) made possible purchases of government bonds on the secondary market. However, these achievements in reducing financial fragmentation may not last if confidence is hit again.

Many policy challenges remain

Even if there have been institutional improvements and some countries' business cycles have been strengthened, many challenges remain in 2013. In Europe, Spanish and Italian interest rate spreads may start rising again, raising the likelihood that these countries will apply for support programmes with the ECB, the EU Commission, and the International Monetary Fund (IMF), the condition for receiving support through the ESM as well as the OMT. A complicating factor is the parliamentary elections in Italy in February and in Germany in September, as politicians may put more emphasis on short-term votes than on long-term, viable solutions. There are still important actions needed, such as establishing common rules and management of a banking resolution and deposit guarantees. In addition, uncertainties surround the outlook for a

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

		Outcome	January 2013			October 2012		
		2011	2012	2013	2014	2012	2013	2014
US		1.8	2.2	2.0	2.3	2.1	1.8	2.4
EMU countries		1.4	-0.4	-0.3	0.7	-0.5	0.1	0.8
Of which:	Germany	3.0	0.9	0.2	1.5	0.9	1.0	1.6
	France	1.7	0.0	0.1	0.7	0.2	0.5	1.1
	Italy	0.6	-2.1	-1.1	0.0	-2.2	-1.0	0.2
	Spain	0.4	-1.5	-1.1	0.1	-2.0	-1.2	0.3
	Finland	2.8	-0.2	0.5	2.0	0.5	1.2	2.0
UK		0.8	-0.1	1.0	1.7	0.0	1.0	1.7
Denmark		1.1	-0.5	0.4	1.3	0.2	1.1	1.3
Norway		1.3	3.2	2.0	2.3	3.8	2.0	2.5
Japan		-0.7	1.8	0.7	1.2	2.2	1.3	1.2
China		9.2	7.7	7.9	7.5	7.9	7.8	7.6
India		7.2	5.5	6.0	6.5	6.2	6.5	6.8
Brazil		2.7	1.4	3.5	4.0	2.0	3.9	4.1
Russia		4.3	3.6	3.7	4.1	3.8	3.9	4.3
Global GDP in PPP		3.6	3.0	3.1	3.4	3.0	3.1	3.5
Global GDP in US$		2.7	2.3	2.3	2.8	2.2	2.3	2.7

Sources: National statistics and Swedbank.

1/ Countries representing around 70 % of the global economy.

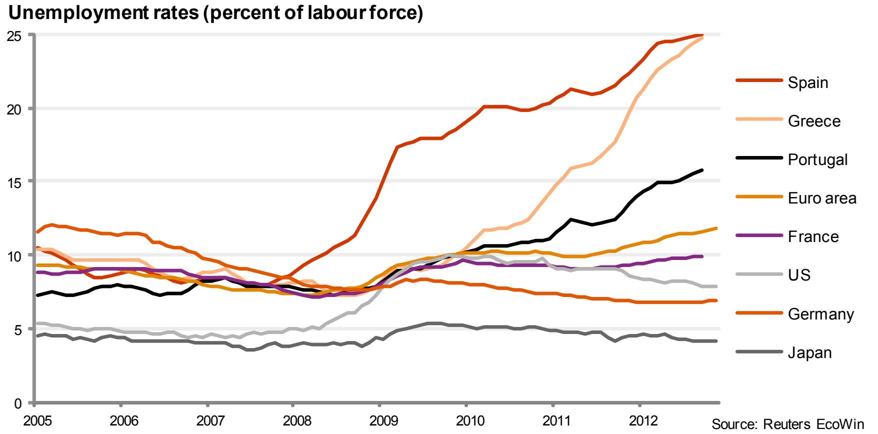
2/ Weights from World bank 2011 have been used. If the same weights had been used in October, global GDP growth had been 3.1%, 3.2% and 3.5% for 2012, 2013 and 2014, respectively.

stronger political union, not least the shortage of democracy within the euro area and the opaque decision-making practices amongst politicians. Overall, the biggest challenge is to continue to find a balance between budget austerity and growth, and there are risks of increased social and political unrest in southern Europe. In the euro area, the alternatives to budget consolidation are less obvious than in the US or the UK, where financial markets have so far remained relatively confident. Even so, the speed and depth of consolidation could be altered somewhat to avoid a negative spiral of deleveraging, depression, and deflation, and thus limit the unemployment.

In the US, the first step to avoid the fiscal cliff has been taken, but many steps remain since it did not tackle long-term fiscal sustainability at all. In late February/early March, the debt ceiling will be breached unless Congress decides to raise it from the current $16.4 trillion. Again, as in the summer of 2011, creditworthiness may be downgraded, and turbulence on financial markets may escalate. The trigger date for sequestration is March 1; this would mean $600 billion a year in automatic spending cuts across 1,000 government programmes. Republicans are demanding spending cuts to add to the initial tax package already agreed, while democrats see more room for revenue increases, and there is a risk of continued political gridlock. By March 27, lawmakers must have renewed the continuing resolutions that substitute for a fully fledged budget; otherwise, the federal government will be shut down. Additional issues to be included in the congressional negotiations are gun control, immigration, and climate change; this will make it more difficult reach an agreement, not least on the medium-term budget needed to be consolidated to avoid large deficits and an unsustainably high federal debt. Other challenges include higher structural unemployment and a lower participation rate, which if not addressed, will make it harder to sustain high growth and fiscal robustness in the years to come.

In China, the new leadership will have to balance the need for stimulus with

Unemployment rates (percent of labour force)



Source: Reuters EcoWin

the risk of again building up too much capacity and thereby, increasing the prospects of a hard landing. Chinese economic policy is entering a phase of fine-tuning, as growth is targeted at around 7%, at the same time, it should not fall much below 7% as this may affect social and political stability. Financial stress is another problem, hidden, but occurring not least in the growing shadow-banking system. Corruption is another concern; it makes it harder to take sound political decisions since they can upset vested interests.

Japan has new political leadership as the Liberal Democratic Party (LDP) and Prime Minister Shinzo Abe have regained power. The challenges can be identified as weak growth, deflation, demographics, aggravated relations with China affecting the business community, divided views on nuclear power, and the need to build up the crisis-struck areas after the tsunami. As Japan has had six prime ministers in six years, the chance of establishing a more stable political situation is not evident.

Emerging markets in general, and India and Brazil in particular, will have to balance new stimulus programmes with the risk of overheating, as inflation tends to rise quickly when growth strengthens. Efforts to build capacity in infrastructure and labour markets are, therefore, much needed.

The policy challenges will be handled – albeit at the last minute

As fiscal policy tightening will reduce growth in most mature economies, it will be necessary to find growth impetus elsewhere. In our main muddling-through scenario, the recovery is expected to start towards the second half of this year in the euro area, and thus add to the strengthening of growth already occurring in other parts of the world, mainly in the US and in emerging markets. The recovery will remain slow due to the combination of fiscal and credit austerity, and the large uncertainties surrounding political decisions. In our main scenario we assume that most challenges with regard to institutional reforms and fiscal policies will be dealt with, albeit at the last minute and with compromises that cause subpar outcomes for the global economy.

The main driving forces for growth will be 1) moderately sized stimulus programmes in emerging markets, such as investments in infrastructure and increased credit availability; 2) policy interest rates near zero and greater quantitative easing in the US, UK, Japan, and a "loaded bazooka" in the ECB strengthening confidence; 3) fewer uncertainties in the US, as the fiscal cliff is assumed to have been taken care of towards the second quarter of this year, thus making the recovery more robust; and 4) a weaker euro, at least in the next few quarters, supporting exports from the euro area, and major unit labour cost cuts, making crisis-struck economies more competitive.

Commodity prices in terms of oil are still expected to fall during 2013, but the level will be higher than in our October forecast since it rose towards the end of 2012. In line with increased production in the US and Saudi Arabia, large stocks, and weaker growth in the first half of this year, the oil price is expected to fall, reaching $106.5 per barrel in

2013, before increasing to an average of $109 in 2014, when demand picks up. Metal prices are also assumed to increase in line with a more robust recovery going into 2014. Food prices fell in 2012 but are expected to rise in 2013 since food stocks have come down; they will level off in 2014 when production increases. Inflation pressures will remain subdued in the global economy, except in emerging markets, where spare capacity is low and/or the increase in food and energy prices strongly affects consumer prices.

The main scenario is more than 80% driven by growth in emerging markets during 2013. This share is expected to fall to 72% in 2014, when growth returns in Europe, picks up in Japan, and increases in the US from 2.0% this year to 2.3%. Housing, credit, and labour markets in the US are expected to continue to improve, but spending cuts will hold back growth somewhat. The euro area will see GDP fall two years in a row (2012-2013), but growth rates will become slightly positive in the second half of 2013, and more so in 2014. Southern Europe will lag, as GDP will continue to fall in 2013 and unemployment rates remain high. Germany should do somewhat better as the relatively strong labour market is supporting the domestic economy and the main downturn is assumed to have occurred in the last quarter in 2012; before the economy stabilises in the beginning of this year, and show growth already in the second quarter. The low growth rate of 0.2% in 2013 is thus mainly due to the fall at the end of last year, which was caused by lower external and domestic demand.

In Asia, Japan plans to stimulate the economy with a new fiscal package, but the most important step it could take would be to improve relations with China, thus strengthening exports. A higher inflation target will mean more monetary stimulus, and the yen is weakening on these expectations. Growth will increase from 0.7% this year to 1.2% next year. GDP growth in China is also expected to increase, from 7.7% in 2012 to 7.9% this year, as the recovery has become more robust lately. In line with development plans, a stronger yuan, and the continued efforts to rebalance the economy towards consumption, growth rates will reach only 7.5% next year. In other emerging markets like Brazil and India, this year will be better than 2012, and, with structural reforms and stimulus impetus – as well as a better outlook for more advanced economies – growth is set to strengthen even further during 2014.

Main risks and alternative scenarios

Compared with the previous forecast, the probability of the main scenario has increased somewhat, from 60% to 65%. Fewer political uncertainties are seen than in 2012, as the euro area has taken a step forward and the US is about to sort out its budget problems. The muddling-through scenario has been fairly accurate, and the likelihood it will continue to do so also in 2013 and 2014 has risen as very negative “tail-risks” have decreased in the euro area. Our forecast has also become more balanced, as downward risks are more comparable in probability to upward risks (20% and 15%, respectively).

Amongst the risks that would cause the outcome to become more negative, we find the following: 1) increased financial market instability, with wider interest rate spreads due to aggravated problems in Spain and Italy (including the election in the latter), prompting a request for support through the ESM and OMT, and new turbulence also as a consequence of increased skepticism in UK leading to a referendum and/or increased social unrest in southern Europe; 2) political gridlock continuing in the US, causing the automatic spending cuts to go through and thereby reducing growth more than envisaged; 3) higher commodity prices than assumed, not least if bad harvests raise food prices, and geopolitical tensions, as well as quantitative easing, raise oil prices; and 4) tensions between Japan and China breaking out in military conflict, and other geopolitical risks such as the Middle East and North Korea. After our forecast period, risks related to exit strategies from excess liquidity appear.

Amongst the risks that would improve the outlook, we find the following: 1) much higher confidence after US and euro area political uncertainties have been overcome thereby increasing the will to invest, recruit, and consume; 2) stronger positive effects from quantitative easing, not only on financial markets, but also in the real economy; 3) more stimulus in emerging markets and larger effects from these stimulus programmes than envisaged; and 4) lower commodity prices than expected.

Mature economies have fewer possibilities to combat a recession, since fiscal and monetary policy tools are less usable than in 2008-2009. As a negative scenario would constitute a large risk to the world economy, politicians have a great responsibility to avoid such a scenario. In addition, it is time to focus more on structural reforms – which already are a reality in parts of Europe – to improve product and labour markets, as well as fiscal/public sector management. These reforms need to become more important also in Japan, the US and emerging markets – if they do not, the negative risks for the global economy would increase in the longer term.

Cecilia Hermansson

Interest and exchange rate assumptions

	Outcome	**Forecast**			
	14 jan 2013	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
European Central Bank	0.75	0.75	0.75	0.75	0.75
Bank of England	0.50	0.50	0.50	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.34	1.27	1.20	1.25	1.25
EUR/GBP	0.62	0.82	0.80	0.78	0.76
USD/CNY	6.22	6.07	5.93	5.78	5.63
USD/JPY	89	92	95	95	97

Source:Reuters Ecowin and Swedbank

Sweden: Decent recovery after blow to growth

A significant number of short-term indicators now suggest that economic growth turned negative in the last quarter of 2012, after being resilient in the previous three quarters. Although this slowdown came later than we predicted in our October forecast, the growth contraction in the fourth quarter is sufficiently large as to leave the overall forecast for 2012 unchanged, at 1.1%.

We do not expect a rapid rebound, primarily due to a sharp increase in uncertainty amongst households and companies, which is eroding confidence and delaying consumption and investment decisions. Last year's worsening of the labour market and deterioration in global demand will have a lasting impact in 2013. Although policy uncertainty has decreased, particularly in Europe, the long-term challenges in most developed economies will constrain export market growth for Swedish companies. In addition, competitiveness will be challenged by a relatively strong krona and by cost-cutting measures taken abroad. Thus, the frailty of external demand, combined with the increased weakness in domestic demand, cause us to revise down our growth forecast for 2013 to 1.1% from 1.7% in our October forecast. Growth is expected to pick up in the latter half of 2013 and reach an annual rate of 2.6% in 2014. Unemployment is forecast to rise and will decline only modestly after peaking in the second half of 2013. This will be the main policy challenge in the short and medium term.

Short-term risks to the Swedish economy are principally a further worsening of external demand and entrenchment of negative sentiments amongst households and companies. In the medium term, there is also a risk that the credibility of the rules-based economic policy framework in Sweden will weaken. Although the drawn-out period of low growth has strained policymaking far more in the rest of Europe and the US, it is also taking a toll on the Swedish policy framework.

In Sweden, the fiscal framework, which is anchored by a surplus target over the business cycle, is being loosened to avoid contributing to the oncoming economic slowdown.

The Swedish public finances can sustain this, in contrast to those in many other European economies, due primarily to the low public debt. Also, the possibility of expanding the monetary policy framework to explicitly encompass macroprudential aspects, such as household debt ratios, has been discussed. While these changes to the macroeconomic policy framework are in our view a reasonable response to the changing realities brought about by the financial crisis, the lack of an explicit formulation of new rules could create unnecessary uncertainties. This, in itself, could prolong a full recovery from the crisis.

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012e	2013f	2014f
Real GDP (calendar adjusted)	3.8	1.1	1.1	2.6
Industrial production	6.7	-3.2	0.5	3.5
CPI index, average	3.0	0.9	0.3	1.9
CPI, end of period	2.3	-0.1	1.0	2.4
CPIF, average [2/]	1.4	1.0	1.2	1.6
CPIF, end of period	0.5	1.0	1.5	1.6
Labour force (15-74)	1.2	0.7	0.4	0.6
Unemployment rate (15-74), % of labor force	7.5	7.7	8.3	8.2
Employment (15-74)	2.1	0.5	-0.2	0.6
Nominal hourly wage whole economy, average	2.4	3.2	2.9	3.0
Nominal hourly wage industry, average	2.5	3.1	2.7	2.9
Savings ratio (households), %	10.1	10.4	10.5	10.0
Real disposable income (households) [3/]	3.5	2.6	2.4	2.3
Current account balance, % of GDP	7.3	6.8	6.5	6.3
General government budget balance, % of GDP [4/]	0.2	-0.4	-1.1	-1.2
General government debt, % of GDP [5/]	38.3	37.9	38.6	38.3

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.

Sluggish export performance

The global economic slowdown increasingly impaired the Swedish export industry in the second half of 2012. The purchasing managers' index (PMI) for manufacturing fell to its lowest level since 2009, and the numbers of new orders continued to contract. The Swedish exports fell significantly, particularly to the EU but also to the emerging markets in Asia. Exports of vehicles, telecom products, and intermediate goods accounted for the largest decline. The total export volume dropped by 2.3% annually in the third quarter of 2012, but on average the outcome for the three quarters was marginally higher (0.2%) than in the corresponding period of 2011.

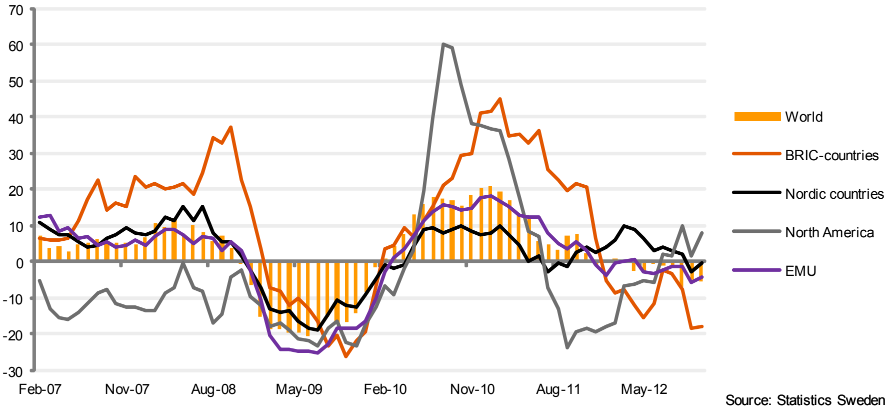
Weak global demand, together with a relatively strong krona, is an unusual combination and a challenge for Swedish exporters. This has affected companies' pricing strategies. Although the krona has strengthened, export prices in foreign currency have not been raised by the exporters, which means that prices in Swedish currency have fallen. Prices on exported goods fell by 4.3% at an annual rate in the third quarter, while export prices for services decreased by 0.2%. Thus, profit margins in the manufacturing sector will be squeezed, and additional productivity measures will be needed to maintain profitability. The alternative, to increase export prices in foreign currency, would instead lead to smaller export volumes and losses of market shares.

In our updated global outlook, world market growth for Swedish exporters is expected to be slower during 2013 than we expected in October. This is mainly because of a deeper contraction of demand in the EU that weakens Swedish export performance, particularly as this region accounts for more than 55% of Swedish exports. Demand from the emerging markets will also be negatively affected by the slow growth in the OECD countries. Uncertainties about the global outlook, high unemployment rates, and low utilisation rates will dampen investment activity, both in mature and in emerging markets. We expect a recovery in world market growth in the second half of 2013

The competitiveness of the Swedish industry worsened during 2012 due to higher growth in unit labour costs and a stronger krona. The unit labour cost is estimated to have grown by 2.5% in 2012, but it is expected to gradually decelerate during 2013 and 2014, to 1.7% and 1.2%, as wage increases will be lower and productivity growth higher. The krona is assumed to remain relatively strong throughout the forecast period and this will continue to be a challenge Swedish export companies.

An expected decrease in the fourth quarter last year implies that export growth will be close to zero for all of 2012. For 2013, we revise down total export growth to 1.0% from 2.8% in October on account of weaker world market growth and negative carry-over from 2012. Although we foresee export growth of 4% in 2014, this is a sluggish recovery and below the long-term trend. Import growth is expected to pick up due to inventory restocking and a recovery of domestic demand. The growth contribution to GDP from foreign trade will therefore be slightly negative in 2013-2014.

Swedish export developments by destination (annual percentage change)



Source: Statistics Sweden

Limited willingness to invest

Gross fixed investment has started to decelerate after a strong rebound since 2009. In the third quarter of 2012, the investment volume increased by merely 0.7% annually, compared with 3.1% and 10.5% in the second and first quarters. The largest drop was recorded in residential investments, which declined by 12.8% in the third quarter. Within the business sector, excluding housing, the trends were divergent. Investments in the private services sector decreased significantly in 2012 while in the manufacturing industries investments continued to rise, driven primarily by expanding production capacities in mining and energy. Public investments picked up mainly on account of municipalities. Overall, gross fixed investment increased by 4.8% at an annual rate during the first three quarters of 2012.

Uncertainty about the global outlook, a low utilisation rate, and declining production will have a larger negative impact on investments than we expected in October, particularly in the manufacturing sector. Credit expansion to the nonfinancial sector has gradually fallen during the latest 12 months, and in November 2012 the annual growth rate (2%) was the lowest since the beginning of 2011. We foresee a slowdown in investment growth to 1% in 2013 from 2.2 % in our October forecast. Although Statistics Sweden's Investment Plan Survey indicated an increase in investments in 2013, we believe these plans will be revised down.

The historically low numbers of new housing permits in 2012 will weigh down on housing investments during 2013. The number of permits fell on average by more than 40% during the first three quarters of last year. Fundamentally, however, there is an increasing need for more investments in housing, particularly in regions with strong population growth. Aside from supporting house prices, housing shortages will be a structural barrier to these regions' development and growth potential.

The investment cycle will be more favourable in 2014, when activity in the business sector is expected to pick up. We also foresee that investment in housing will recover when sentiments improve and additional government measures are implemented. Total investment is expected to grow by 4.2% next year.

Uphill battle against unemployment

The unemployment rate ticked up in late 2012 as strong growth in labour supply continued, while demand fell back markedly. In November, the un-

Swedbank's GDP Forecast – Sweden

Changes in volume, %	2011	2012e1/	2013f1/	2014f1/
Households' consumption expenditure	2.1	1.4 (1.5)	2.1 (2.5)	3.0 (2.6)
Government consumption expenditure	1.1	0.5 (0.8)	0.8 (0.6)	1.1 (0.9)
Gross fixed capital formation	6.4	3.1 (3.2)	1.0 (2.2)	4.2 (3.7)
private, excl. housing	6.2	6.8 (6.9)	1.7 (3.1)	5.1 (4.4)
public	-1.4	2.9 (0.9)	3.1 (0.4)	2.9 (2.6)
housing	14.7	-8.1 (-6.1)	-3.5 (0.7)	2.2 (2.4)
Change in inventories 2/	0.5	-0.8 (-0.9)	-0.2 (0.0)	0.0 (0.0)
Exports, goods and services	7.0	0.0 (0.2)	1.0 (2.8)	4.0 (3.5)
Imports, goods and services	6.3	-0.6 (-0.1)	1.5 (3.5)	4.7 (3.6)
GDP	3.7	0.8 (0.8)	1.1 (1.7)	2.5 (2.4)
GDP, calendar adjusted	3.8	1.1 (1.1)	1.1 (1.7)	2.6 (2.5)
Domestic demand (excl. inventories) 2/	2.5	1.4 (1.5)	1.4 (1.8)	2.5 (2.2)
Net exports 2/	0.7	0.3 (0.1)	-0.1 (-0.1)	0.0 (0.2)

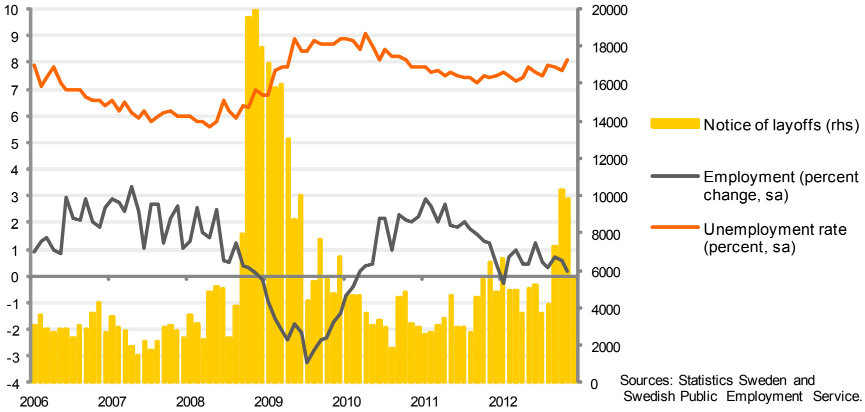
Sources: Statistics Sweden and Swedbank.
1/ The figures from our forecast in October 2012 are given in brackets.
2/ Contribution to GDP growth.

employment rate reached 8.1% (seasonally adjusted), compared with 7.6% in the beginning of the year. The relatively modest increase in unemployment during the first three quarters of the year was the result of surprisingly strong employment growth, which matched a growing number of job seekers with jobs. However, the increase in layoff notices in late autumn, although it fell back in December, as well as the decreasing number of new openings, strongly suggests that the labour market is losing steam.

The weakening of job market prospects complicates wage negotiations, and the slowdown in demand for labour in the private sector will put pressure on the wage demands. There have already been some crisis-related agreements that stipulate a shortening of working hours in exchange for lower wage payments. Thus, in comparison with our October forecast, we expect wage increases to be slower in the next two years. At the same time, real wages will be supported by lower inflation, which will preserve real income developments and household purchasing power.

Insufficient demand will push up unemployment rates this year. Companies are reporting weaker sales and lower profitability, to which they will respond by cutting personnel. PMIs for both manufacturing and the services sector are suggesting that the job cuts continued through December, and the latest business cycle survey by the NIER indicates that hiring intentions are at the lowest level since the 2008-2009 crisis. This, together with weaker growth, leads us to raise our unemployment forecast for 2013 to an average of 8.3% from 7.9% in our October forecast. However, we expect the increase to peak in late 2013 at 8.6 % as labour supply dampens and demand rebounds. Nevertheless, the lowering of unemployment will be protracted, and the rate will fall only to 8.2% during 2014.

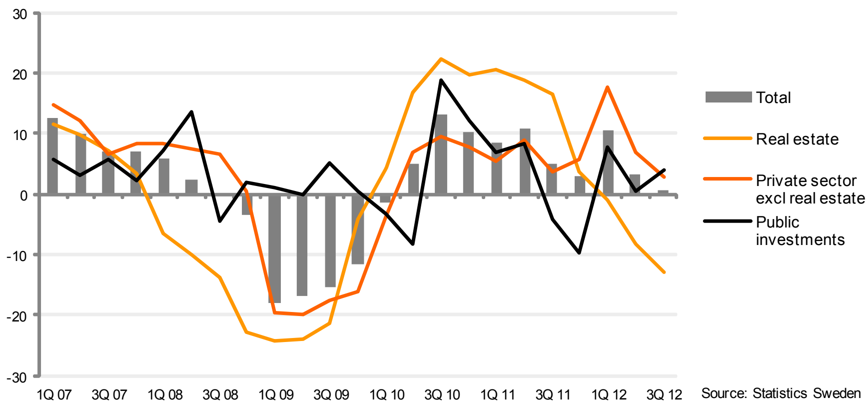
Labour market developments



Sources: Statistics Sweden and Swedish Public Employment Service.

The services sector, more labour intensive than the manufacturing sector, is expected to mitigate the slack in labour demand as private consumption will continue to increase. Also, services are less affected by the relatively strong krona. A sizable part of the downsizing in manufacturing is, however, structural, i.e., many of the jobs that are now disappearing will not come back, and the need for retraining will grow. In addition to increasing the number of long-term unemployed, this situation could also raise the equilibrium rate of unemployment. The social costs will be significant as longer-term unemployed will face lower employability, productivity, and lifetime income prospects. Hence, there are plenty of reasons for policy-makers to mitigate the effects of structural change by facilitating a swift return to work for those who are affected.

Gross fixed investment (annual change in percent)



Source: Statistics Sweden

Households key to recovery

Household incomes held up well during the autumn. Throughout 2012, most segments of the population saw their real earnings grow on the back of strong employment and low inflation. Not only those households that remained in employment, but also retirees, saw their real income levels rise. However, unemployment benefits and sick leave pay have not grown in line with overall nominal wage growth. This is eroding the purchasing power of those most vulnerable to the economic downturn. It also risks dampening overall household consumption as the negative economic consequences of a job loss are growing, thereby raising the need for precautionary savings amongst broader groups in the economy.

Recently, household confidence has deteriorated sharply. Correspondingly, consumption growth has been muted, with a flat quarterly growth rate in the second quarter and 0.2% growth in the third quarter (seasonally adjusted). It was primarily consumption of durables that struggled as households increasingly were postponing large non-necessary purchases (an exception was purchases of cars at the end of the year because environmental standards were revised). The savings ratio subsequently increased to 10.4% in the third quarter, which is significantly higher than the third-quarter average since 2009 (7.2%). Equity market gains were strong, 11.9% over 2012, but savings were also boosted by growth in household deposits, which rose by 10.2% in the first three quarters. This signals a growing precautionary sentiment amongst households. Together with the solid income growth last year, however, this rise in deposits also increases the potential for a reversal of spending behaviour should sentiments turn.

Household borrowing continued to slow during the autumn, and annual growth reached only 4.6 % in November, compared with 5.4% in the same month last year. Although lending to households ticked up slightly from October to November, mainly due to increased mortgage lending, the trend in 2012 was clearly heading downwards. Despite decreasing house prices during the year, household net assets (including real estate) rose, while the increase in household debt levelled off. We expect that household debt reached 166.2% of disposable income at end-2012, compared with 165.2% at end-2011. Even if lending increases moderately in the next two years, the debt level will still remain a significant risk to the household economy and, thus, overall growth. This risk stems in particular from the unequal distribution of debt amongst households. Many younger families in the larger cities are exposed to both the volatility of the labour market and changes in house prices and lending conditions. A sharp fall in house prices and larger-than-expected job losses, would lower sentiments further amongst households and reduce consumption and growth.

On the back of eroding sentiments and a worse economic outlook, we are revising down our forecast of household consumption to 2.1% from our October forecast of 2.5%. However, private consumption will still provide the main input to growth, and, particularly in the latter half of 2013, we expect private consumption to pick up the pace. In 2014, we forecast a further increase in private consumption, driven by an improving labour market, stronger sentiments, pent-up demand, and greater support from the fiscal budget. A modest growth in consumption, along with a solid increase in real incomes, will cause the savings-to-disposable income ratio to rise to 10.5% in 2013 before falling back to 10.0% in 2014, compared with an estimated 10.4% in 2012. Hence, a precautionary sentiment will characterise private consumption over the forecast period. However, given the solid finances underlying most households, better-than-expected general economic development could cause consumption to rise faster. Private consumption, thereby, makes up both the main upside and downside risk to growth over the next two years.

Further monetary easing ahead

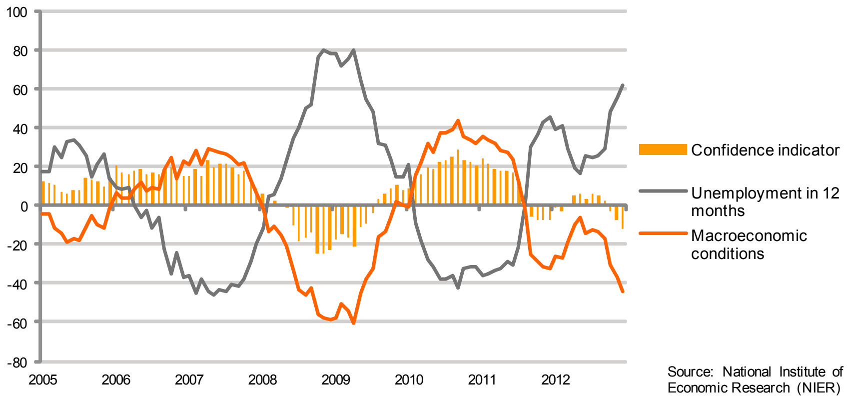
As was widely expected, the Riksbank lowered its policy rate in December from 1.25% to 1.0%. Despite continuing to publicly stress the risk of household debt as a significant threat to the financial sector and the economy, the growing number of negative economic indicators convinced the majority of the Riksbank board to restart the easing process. Furthermore, the Riksbank lowered both the growth projections and the inflation forecast for 2013, while the repo rate path implied only a small probability (15%) of further easing in early 2013.

Besides the repo rate decision, the issue of broadening the monetary policy framework to also cover macroprudential aspects has received much attention recently. Although inflation has consistently been below the target of 2% and unemployment has been high, the Riksbank has been reluctant to lower the repo rate. The main argument for this has been the high household debt levels and the risk that this creates for the financial sector. The discussions in Sweden also reflect the international debate, where it is increasingly recognised that monetary policy needs to take into account the broader risks to the financial sector. In this context, we would also argue that it is important to speed up the efforts to formalise a new monetary framework in a transparent way.

The monetary policy framework is also challenged by rising structural unemployment. Resource utilisation currently is low, which supports the expansive policy stance, but the long period of high unemployment has likely raised the rate at which wage developments would be inflationary (the so-called NAIRU). Although inflation-driving wage increases currently look distant and will not affect policymaking in the short run, monetary policy will nevertheless be tightened earlier if structural reforms are not used to address the issue.

In the short term, we expect that the Riksbank will cut the repo rate by another 25 basis points to 0.75% this spring. This is based on our view that the Swedish economy will continue to be weak in the early part of the year and that unemployment will keep on rising. Another important argument for a lower repo rate is the forecast of a significant downward revision of "underlying" inflation (CPIF-CPI keeping interest rates constant) this year to an average of 1.2%, compared with 1.5% in our October forecast. While the CPIF will remain below the 2% target at end-2014, the three repo rate hikes that are expected as economic growth picks up will push headline inflation up to 2.5%. We would argue for a more expansive monetary policy, mainly due to the improbability of the underlying inflation's reaching the target of 2% in the medium term, and as unemployment will remain high. The krona is expected to remain relatively strong during the forecast period.

Household sentiments (net balance)



Source: National Institute of Economic Research (NIER)

No time to wait for fiscal action

The budget is heading for increasing deficits as the economy slows. The previously expected shortfall of 0.1% of GDP for 2012 is now estimated at 0.4% of GDP. The worse-than-expected developments are mainly explained by lower revenues from capital taxes. Company tax payments have been falling in line with profitability; also, households have seen their capital incomes declining. Looking forward, it is mainly labour-related taxes that will put downward pressure on the public balances.

We also expect that fiscal policy will become more expansionary following the Ministry of Finance's drastic downward revision of the growth outlook in December of last year. The budget for 2013 was based on expected growth of 2.7%, and this high growth rate allowed for additional stimulus proposals of SEK 23 billion without a substantial increase in the projected deficit. The lower growth forecast will, in itself, raise the deficit. Furthermore, although the Minister of Finance was not specific, it is likely that the reduction of the growth forecast to 1% in 2013, and higher expected unemployment, will lead to additional spending initiatives this year. In particular, we expect that the spring budget will contain measures aimed at mitigating the growing joblessness.

Although we would support a more active fiscal policy, the lack of clear communication as to how the 1% surplus target will be met undermines the fiscal framework. The Ministry of Finance argues that, as the current economic downturn is exceptionally protracted, "normal rules" do not apply. We agree that, given the solid public finances, "blind" adherence to preset rules is not desirable in the current circumstances. However, it falls on the policymakers to be transparent when the rules are breached and to be specific in formulating explicit guidance for future fiscal policy rules. It is important for households and companies to have a clear picture of whether, when, and how the surplus target will be met. Uncertainty in this regard could unnecessarily lead to hesitation in consumption and investment decisions.

We expect the fiscal deficit to increase throughout the forecast period. In 2013, in addition to the already budgeted SEK 23 billion in unfinanced stimulus, we expect extra spending of SEK 5-10 billion in the spring budget, adding to the effects of the automatic stabilisers. The stabilisers will mainly work through lower revenues from labour taxes and through larger expenditures relating to the rising unemployment

Fiscal policy has been moderately supportive of the economy in recent years, and, due to the relatively large increase in the budget deficit to 1.1% of GDP in 2013, the fiscal stimulus will continue. Measured through the business cycle-adjusted deficit, fiscal policy is expected to contribute about ½ percentage point to growth in 2013, mainly through a lower corporate income tax rate and reduced tax rate on pensions. However, unless further initiatives are taken in 2014, fiscal policy will turn contractionary, and we therefore expect that the government will propose measures amounting to about SEK 25 billion to maintain support to economic growth through the election year. These measures could include higher public investments, and actions to stimulate house construction, as well as increased child support, raised benefit levels, and reductions in the tax rate on pensions. We do not expect that the current minority coalition government will find parliamentary support for additional in-work tax credits. The expected deficit for 2014 is 1.2% of GDP. The steady decrease in public debt has come to an end, mainly due to increased deficits and lower growth. By the end of 2014, Sweden's Maastricht debt is expected to have risen to 38.3% of GDP.

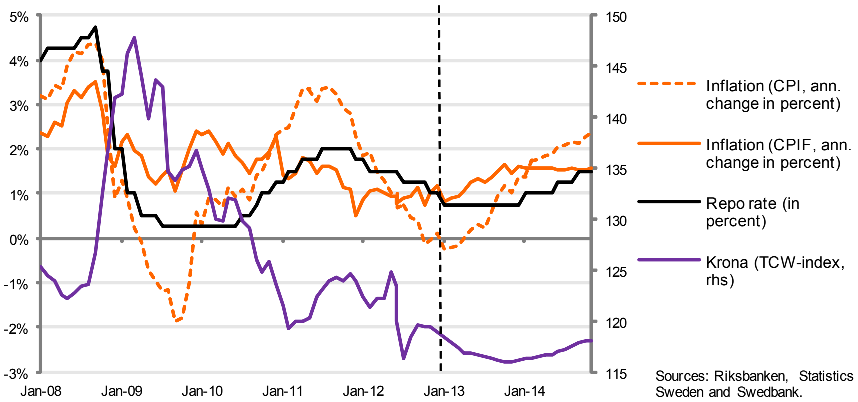
Magnus Alvesson
Jörgen Kennemar

Interest rate and currency outlook

	Outcome 2013 14 Jan	Forecast 2013 30 Jun	2013 31 Dec	2014 30 Jun	2014 31 Dec
Interest rates (%)					
Policy rate	1.00	0.75	0.75	1.00	1.50
10-yr. gvt bond	1.78	2.00	2.50	3.15	3.30
Exchange rates					
EUR/SEK	8.62	8.35	8.30	8.40	8.50
USD/SEK	6.44	6.57	6.92	6.72	6.80
TCW (SEK) [1/]	118.0	116.8	116.0	116.7	118.1

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

Inflation, the repo rate and the exchange rate



Sources: Riksbanken, Statistics Sweden and Swedbank.

Estonia: Domestic economy safeguards growth

In 2012, Estonia's GDP growth fell back substantially, from 8.3% in 2011 to 3%. Despite this, Estonia remained the fastest-growing economy in the euro area. The slowdown was mainly associated with the vanishing of the strong base effect from the recovery from the last crisis, but also with the gradual weakening of external demand conditions. The export-oriented manufacturing industry remained almost stagnant, and growth was mainly based on domestic demand.

Increasing investment activity was the main driver behind GDP growth in 2012. Over the first three quarters, fixed investments were up by 27% from a year ago. The main contribution came from EU-financed infrastructure projects and from the usage of CO2 quota sales revenues. Corporate investments remained surprisingly subdued despite very favourable lending conditions and higher capacity utilisation rates.

Uncertainty regarding future export performance was probably the main factor holding back investment activity in the corporate sector. Towards the end of 2012, there were increasing signs that the global business cycle slowdown was also affecting Estonia's major trading partners in the Nordic countries. Production volumes in the Finnish and Swedish manufacturing industries were sharply lower. The Estonian manufacturing sector's strong dependence on subcontracting to the Nordic countries was reflected in decreasing export orders for its industry. Export orders fell to levels last seen in 2010.

The fragile external demand conditions will persist through the first half of 2013. Export performance will remain weak and corporate sector investment activity subdued. There will be fewer state-financed fixed investment projects than in 2012. As a result, we have lowered the 2013 GDP growth estimate to 3.1%. We now foresee a gradual business cycle pickup towards the end of 2013, when the euro area is also expected to get out of the shadow of recession.

Private consumption grew in line with a wage bill above 4% in 2012. Wages posted the highest growth since the end of the 2008-2009 crisis, but employment gains moderated. There were some signs that, due to greater uncertainty in the export markets, corporate sector hiring plans were reduced somewhat towards the year's end – job vacancies registered at the Unemployment Insurance Fund decreased in annual terms, and industry's employment expectations stagnated. Going forward, we expect only a marginal increase in employment as structural rigidities become increasingly binding – due to the adverse demographic situation, the labour supply is decreasing. As a result, an increase in labour demand could exacerbate wage pressures, especially towards 2014, when the business cycle is expected to pick up.

Key Economic Indicators, 2011 - 2014 1/

	2011	2012e	2013f	2014f
Real GDP	8.3	3.0	3.1	4.5
Nominal GDP, billion euro	16.0	17.0	18.2	19.7
Consumer prices (average)	5.0	3.9	3.2	2.7
Unemployment rate, % 2/	12.5	10.3	10.0	9.4
Real gross monthly wage	0.5	2.0	2.8	3.9
Exports of goods and services (nominal)	28,3	8.3	7.2	9.6
Imports of goods and services (nominal)	34,1	12.8	6.7	8.4
Balance of goods and services, % of GDP	6,4	2.3	0.8	1.8
Current account balance, % of GDP	2.1	-2.1	-3.9	-3.2
FDI inflow, % of GDP	7,7	4.3	4.1	3.8
Gross external debt, % of GDP	97.2	95.1	92.7	89.0
General government budget balance, % of GDP 3/	1.1	-0.7	-0.5	-0.2
General government debt, % of GDP	6.1	10.1	12.0	11.6

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.

Through 2012, households' purchasing power was negatively affected by rising food and oil prices. Driven by external price pressures, consumer prices were up by 3.9% over the year. However, domestically driven core inflation remained subdued. Going into 2013, we foresee that domestic price pressures will become a main source of inflation. Electricity market liberalisation for households and small and medium-sized enterprises (SMEs) will raise higher electricity prices, while excise taxes will be lifted for alcohol and tobacco. For employees, the resulting decrease in purchasing power is, however, compensated for by a reduction in the unemployment insurance contributions. Inflation pressures are likely to moderate towards the middle of 2013, when lower global oil prices are expected to pass through to the consumer level.

Following the increased investment activity and a small terms-of-trade worsening due to higher commodity prices, the external balances of the Estonian economy deteriorated in 2012. The current account turned out a small deficit, which was fully covered by nondebt capital account financing and by foreign direct investment (FDI) inflows. As a result, external debt continued to decrease, and net external debt turned positive towards the end of the year. The external balance is set to weaken over 2013, however, as exports will remain subdued and investment activity in some larger infrastructure projects has reached a phase where it will become more import intensive. The current account will nevertheless remain fully covered by non-debt-creating inflows.

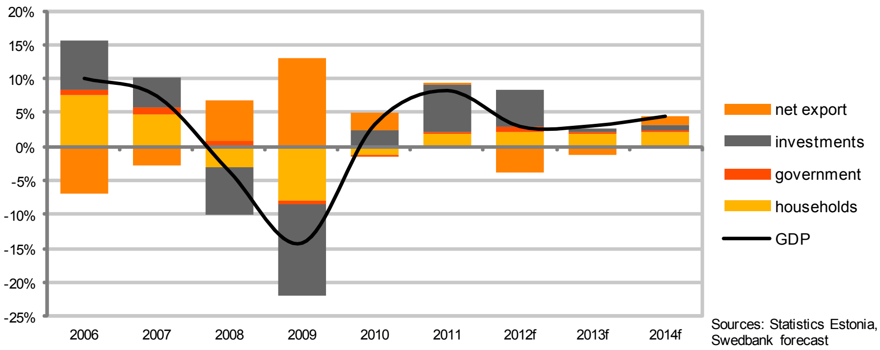
Since independence the Estonian government has aimed for a balanced budget over a business cycle. In practice, fiscal policy has often been procyclical – expenditure controls have been relaxed at times of a business cycle upturn and tightened when the economy weakened. The coming years will be no exception. Better-than-expected revenue collection in 2012 resulted in higher expenditure targets for 2013. The largest increase will take place in public sector wages. The government is targeting a balanced budget for 2014, but we expect that the approaching general elections will generate a small fiscal deficit. Still, Estonian public finances are set to remain amongst the strongest in the euro area. The small increase in government debt reflects the guarantees given to the European Financial Stability Fund and is not directly related to deficit financing. By the end of 2012, Estonia held guarantees amounting to about 2.5% of GDP.

External demand to improve only towards the end of 2013

Until the middle of 2012, Estonia's major trading partners around the Baltic Sea region were little affected by the renewed euro financial crisis and global business cycle slowdown. The Latvian and Lithuanian economies posted growth rates that were amongst the highest in the EU, while business confidence in the Nordic countries remained high. Things started to change towards the second half of the year, when lower global demand for investment and capital goods had a negative impact on Swedish and Finnish manufacturing sectors.

Softer demand in the major trading partners has already been reflected in fewer export orders for the manufacturing sector in Estonia. Nevertheless, the exporting sector has so far managed the slowdown relatively well. Strong exports to Russia and the Baltic countries have partly compensated for softer demand in the Nordic countries. Nordic producers have also shifted part of their production to Estonia. Furthermore,

Contributions to GDP growth



Sources: Statistics Estonia, Swedbank forecast

exporters have found new markets in more distant regions outside Europe – e.g., smaller developing Asian countries and countries in the Middle East and North Africa (MENA) region. As a result, the share of non-euro area countries in Estonia's goods exports has increased to over 70% − the highest in over a decade.

We expect that Estonia's exporting sector will continue to face soft demand conditions during the first half of 2013. Nordic and German industries are reducing their inventory levels, and as a result there are risks that foreign orders for Estonian subcontractors will fall further. However, unlike in late 2008, Estonia's manufacturing sector inventory levels are lean. Accordingly, major layoffs are unlikely, as are longer-term production cuts when the global business cycle slows.

Exports are expected to pick up towards the second half of 2013 and further in 2014. Institutional reforms and gradually improving investor sentiment will help the euro area to get out of the recession. However, growth in the highly indebted economies will remain low for years to come as deleveraging will take time. Growth in the Baltics and Russia will remain solid through the forecast horizon, and it is likely that the share of these markets in Estonia's export structure will increase further.

Strong investment activity increases external imbalances

Investment growth was very strong in 2012, exceeding most expectations. Annual growth of gross fixed capital formation accelerated to 34% in the third quarter, and the share of investments in GDP increased to 28%. This was the highest level since the boom years.

Fixed investments were mainly driven by externally financed infrastructure projects. The usage of EU transfers and CO_2 quota sales revenues were unusually high. The biggest projects were aimed at increasing the efficiency of energy usage and production – the insulation of large residential block houses and construction of a new power plant. The timing of these projects has been relatively good as electricity prices for households will increase in January 2013. The improved insulation of residential buildings will partly mitigate the increase in costs from higher electricity prices. Furthermore, Estonia's energy efficiency is still amongst the lowest in the EU. According to Eurostat, only Bulgaria consumed more electricity per one unit of GDP in 2010. As a result, this continues to be a field where Estonia has ample room for improvement.

Infrastructure investments are expected to moderate over the coming years. The CO_2 quota projects are gradually being phased out, and it is likely that fewer EU funds will be allocated to Es-

Swedbank's GDP Forecast – Estonia

Changes in volume, %	2011	2012e1/		2013f1/		2014f1/	
Household consumption	3.5	4.5	(4.3)	3.5	(3.3)	4.1	(3.9)
General government consumption	1.4	3.0	(2.3)	1.3	(1.6)	2.0	(1.8)
Gross fixed capital formation	25.9	22.9	(12.6)	1.7	(7.0)	2.7	(7.3)
Inventories 2/	2.1	-0.2	(0.2)	-1.5	(-2.0)	0.1	(-0.6)
Exports of goods and services	23.4	5.8	(3.4)	4.9	(5.9)	6.2	(6.8)
Imports of goods and services	25.0	10.4	(6.7)	6.2	(4.0)	4.9	(6.6)
GDP	8.3	3.0	(2.6)	3.1	(3.7)	4.5	(4.3)
Domestic demand (excl. inventories) 2/	9.8	6.6	(5.7)	2.8	(3.9)	3.3	(4.3)
Net export 2/	0.1	-3.8	(-2.8)	-1.2	(2.1)	1.3	(0.6)

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

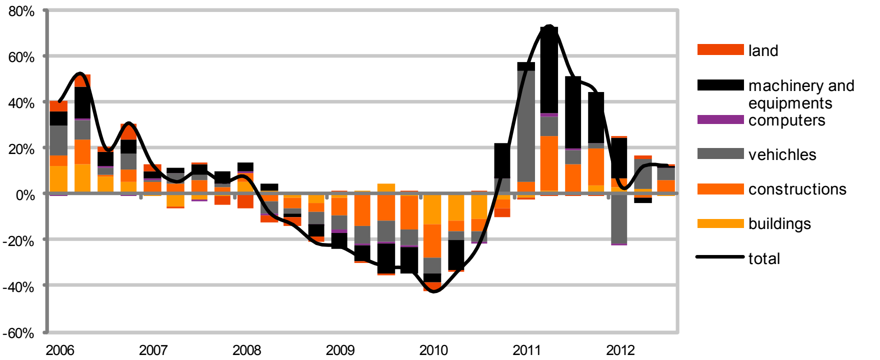
tonia over the first years of the next budgeting period of 2014-2020.

Despite increased capacity utilisation and very favourable lending conditions, corporate investments in machinery and equipment increased only marginally over 2012. Growth even decelerated towards the end of the year as increased uncertainty in major export markets made the corporate sector reluctant to increase production capacity. This trend is likely to continue over the first half of 2013 as external demand conditions will remain fragile.

However, we expect the corporate sector to become more active in investment activity towards 2014. With more export orders, capacity constraints are likely to become more binding. This will lead to higher investments in machinery and technology. Due to strong corporate balance sheets, most investments will still be financed from retained earnings, and corporate loan demand is expected to increase only gradually.

The increase in transactions in the housing market had a positive effect on residential real estate investments. A number of semi-finished property developments that had been returned to banks following the 2008-2009 crisis were finalised. However, residential real estate investments are still only half the size of the boom years. Despite all-time-low mortgage rates, households are still very cautious and price sensitive – banks' mortgage portfolios continued to decrease in 2012. In addition, there are signs that the concentration of CO_2 quota sales projects has significantly raised construction prices and, as a result, lowered the expected return on new developments. Therefore, we do not see that residential property investments will increase significantly over the coming years.

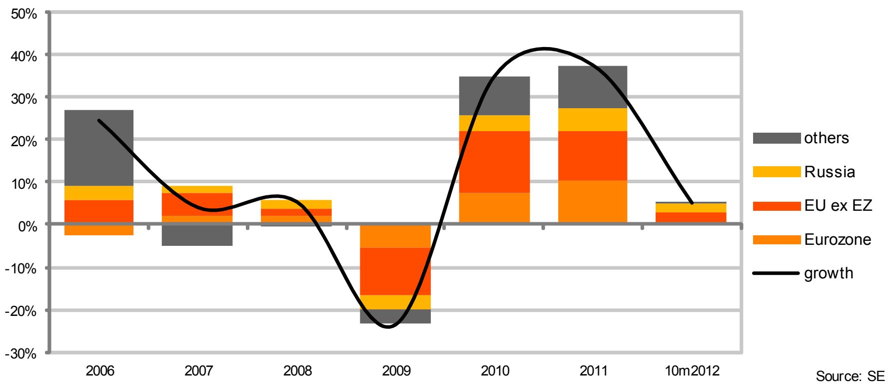
Contributions to annual growth in enterprise investments



Source: SE

The increased investment activity has had a moderate impact on the external balances. Large infrastructure investments have been construction intensive and required little import content. This is likely to change over the coming years. There were already signs in the last months of 2012 that imported investment goods for larger projects related to energy production were starting to increase. In addition to strong investment activity, weak export demand, especially over the first half of 2013, will have a negative effect on Estonia's external balances. As a result, we have revised down the current account forecast and foresee a deficit throughout the forecast period. This deficit will decrease slightly in 2014 as exports are expected to pick up in line with the stronger global business cycle. Since the current account is expected to be fully covered by non-debt-creating inflows, the external debt burden will continues to ease, but more slowly than in our previous forecast.

Contributions to goods export growth



Source: SE

Labour supply constraints and domestic inflation pressures are increasing

The labour market continued to improve during 2012. For the first time since the crisis, the unemployment rate fell below 10% in the third quarter. Labour demand has been the strongest in IT-related activities, where employment increased by over 25% in the third quarter of 2012, compared with the same period in 2011. This sector is becoming more competitive in external markets – over the first nine months of 2012, IT services exports were up by nearly 40% in current prices. As a sign of Estonia's high IT-related competence, the EU's IT agency will be relocated to Estonia in the near future.

There are signs that employment growth is moderating and the unemployment rate is unlikely to decrease significantly further. On the demand side, corporate hiring plans in the manufacturing industry stagnated towards the end of 2012 as export orders fell sharply. The corporate sector's more cautious hiring plans were reflected in a small decrease in registered job vacancies. In addition, some infrastructure investment projects will during 2013 reach a phase when they become less construction and labour intensive. On the supply side, the lack of qualified labour is becoming increasingly binding. Demographic developments will only exacerbate the supply-side bottlenecks as the generation from the low-fertility period of the mid-1990s enters the labour market.

Despite the tightening of the labour market, wage pressures have been subdued. Wages rose by about 6% in nominal terms over 2012 and 2% in real terms (deflated by consumer prices). This was only slightly above the productivity gains, and unit labour costs increased marginally. Also, there are currently no signs that the exporting industries will face tough competition from the domestic demand-oriented services sectors in retaining and attracting labor, unlike in the boom years.

Looking forward, some moderate increase in wage cost pressures cannot be ruled out. Public sector wage negotiations have already resulted in wage increases for public sector employees. As the business cycle will continue to be domestic demand driven in 2013, it is likely that productivity growth will be somewhat lower. It is thus important to monitor potential wage pressures to ensure they do not rise too fast. It is particularly important for SMEs to control their production costs as they, along with households, will face higher electricity prices.

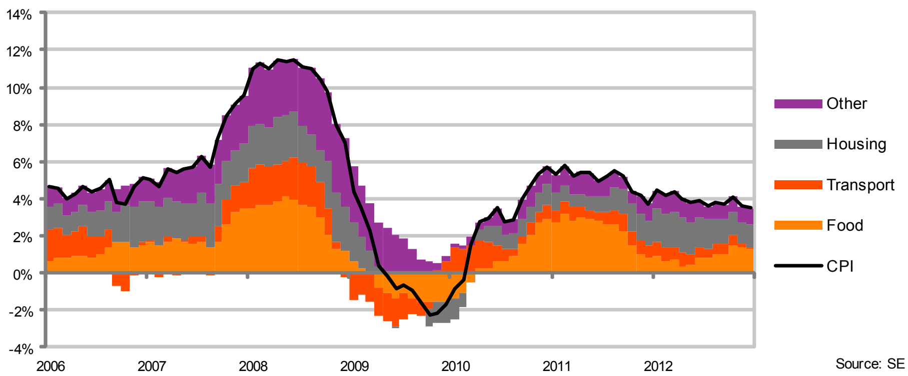
The electricity market liberalisation and excise tax increase on alcohol and tobacco will raise domestic price pressures in early 2013. Households and SMEs will stop receiving electricity at partially subsidised prices, which is expected to raise electricity bills by 20-25%. This, in turn, will increase consumer prices by around 1%. However, we foresee that consumer price inflation will moderate thereafter as external pressures will remain subdued. A well-supplied global oil market and a weak global business cycle are expected to result in somewhat lower global oil prices at the start of 2013. Food prices were sharply higher in the summer of 2012. Due to low global inventory levels, there is still a risk that food prices could also drive inflation in coming years.

Private spending remains stable

Households continued to spend as the labour market improved. Over the first three quarters of 2012, private consumption expenditures increased by 4.1%. The savings rate remained at about 5% of disposable income, and household deposits increased to an all-time high. However, the euro area financial crisis and a possible business cycle downturn held consumer confidence below the levels seen in 2011. As a result, households continued to deleverage.

We expect a small deceleration in private consumption growth over the first half of 2013. Increase in electricity prices and lower labour demand in exporting industries are likely to make consumers temporarily more risk averse. However, compared with the last downturn in 2008-2009, households have considerably increased their savings buffers. This allows them to smooth consumption over a short period, should the demand in major exporting markets deteriorate further. However, should external demand remain weak for a longer period of time, the relatively heavy private sector debt burden (130% of GDP in 2011) will still pose a significant risk for consumption and the banking sector balance sheet. In line with subsiding inflation pressures and improving external demand conditions, we expect consumer confidence to start rising again towards the end of 2013. This will also help accelerate the growth of private expenditures.

Contributions to CPI annual growth



Source: SE

Fiscal balances remain among the strongest in Europe

Strong domestic demand and an improving labour market have generated a better-than-expected tax revenue collection. Tax revenues increased by about 10% in 2012 over the previous year. As a result, the budget deficit is likely to be below the target set at the start of the year. Going forward, Estonia's tax burden is expected to remain almost unchanged, at around 33% of GDP, but its structure will move towards higher indirect taxes – alcohol and tobacco excise tax rates will increase while unemployment insurance contributions will decrease.

In the past, stronger revenue collection has often led to more relaxed cost controls. This seems destined to be repeated also in coming years as the government has not changed the deficit target for 2013. Budget expenditures will grow by 1.1% in 2013, but most of this is attributable to higher consumption (through an increase in public sector wages of 4.5%) and social transfers. Government investments are set to fall by over 10% as projects financed from CO2 quota sales revenues and EU transfers are decreasing. The latter have become a major source for public investments, covering almost half of the fixed investment expenditures. This poses some future risks if the EU member states agree to reduce radically the size of the EU budget for the 2014-2020 period.

Estonia continues to enjoy one of the strongest public finances in Europe, although the government debt burden has increased lately due to guarantees given to the European Financial Stability Fund. By the end of 2012, Estonia held guarantees amounting to about 2.5% of GDP. These are expected to increase to 4% of GDP by the end of 2013. The budget deficit will, however, remain very low, and the government has an ample liquidity reserve position of about 9% of GDP. This implies that public sector net debt is close to zero.

Kristjan Tamla
Teele Reivik

Latvia: Resilient exports build base for growth

The year 2012 was another good one for the Latvian economy – in the first nine months, it expanded by 5.6% in annual terms, and leading indicators suggest that growth was solid also in the last quarter. The growth was broad based, with annual rates similar to those a year ago. However, domestic demand growth (especially investments) slowed quite sharply in the second half of the year, while export growth was supported by temporary factors like the best grain crop ever. GDP growth in the third quarter also benefitted from a surprising fall in imports.

Strong economic activity sped up job creation, accompanied by falling unemployment, rising activity, and moderate wage growth. Yet, the labour market improvement is uneven across sectors and qualifications. Economic growth per se does not solve the problems of inequality, poverty, and regional imbalances – unless an adequate economic policy is employed to improve motivation and support mechanisms, these problems will intensify. At the same time, the improved fiscal stance and better chances to meet Maastricht criteria and introduce the euro in 2014 have led to improved sovereign credit ratings. This helped the government to issue bonds in December at an historically low yield and to make an early repayment of the full IMF emergency loan, thus refinancing public debt at a lower cost.

We have revised upwards our GDP growth estimate to 5.4% in 2012 (4% before), as strong growth held on longer than expected. We anticipate growth to slow in 2013, reflecting global uncertainty, weak external demand, and tougher competition in export markets. We forecast lower average quarterly growth in 2013 than in our October forecast, but, due to a larger carryover from 2012, GDP is set to grow by 4.1% (3.5% before). Economic growth is anticipated to pick up again towards the end of 2013 and to reach 5% in 2014, owing to stronger external demand, local labour tax cuts, and stronger confidence in the domestic economy.

Because of lower-than-expected consumer price inflation in the second half of 2012, as well as the largely stagnating global commodity prices expected in 2013, we are cutting the forecast for average consumer price growth for 2013 from 2.5% to 1.9%. We keep our 3.5% forecast for 2014 – price growth is anticipated to accelerate due to both domestic pressures (higher wage and thus spending growth and the pass-through of the one-off expenses of euro introduction) and the external environment (e.g., increasing global energy prices).

The government is already taking measures to be ready to introduce the euro in 2014 − if permitted to enter the monetary union − including legislative changes, public communication, etc. The major uncertainty vis-à-vis fulfilling the Maastricht criteria is about long-term interest rates, as the reference value will depend on which countries are used to calculate the criterion. Our base scenario assumes that Latvia will join the euro area in 2014, which will support confidence and thus promote growth somewhat.

Employment growth is expected to slow in the coming years, but the unemployment rate will continue to fall (to 11.6% in 2014) and the activity rate rise. Given lower inflation and the global uncertainty, we expect average net wages to rise less in 2013, by 4.7% (5.5% before). We retain our 2014 forecast of 6.5%, though (partly due to a planned personal income tax cut of 2 percentage points). We see the current account deficit to continue widening gradually with no major risks to sustainability, as the shortfall will remain in the low single digits and be fully covered by EU funds and foreign direct investment (FDI) inflows.

The base scenario outlined in this report remains a "muddling-through" scenario and is prone to a number of risks. Globally, higher commodity prices may push up inflation, while lower external demand growth would weigh on Latvian exports and, thus, economic growth. Domestically, the forthcoming municipality elections in June 2013 and general elections in autumn 2014 may stall the reform process and thus diminish medium-term growth.

Export growth to slow as competition toughens

The past year was successful for Latvian exporters – although export volumes grew significantly slower than in 2011, they rose faster than external demand. Exporters have increased their market shares and expanded in markets less penetrated so far, both in EU countries, like Denmark and Poland, and in countries farther away, like Turkey, Algeria, Egypt, and Kazakhstan (for details, see

Key Economic Indicators, 2011 - 2014 1/

	2011	2012e	2013f	2014f
Real GDP	5.5	5.4	4.1	5.0
Nominal GDP, billion euro	20.3	22.0	23.8	26.1
Consumer prices (average)	4.4	2.3	1.9	3.5
Unemployment rate, % 2/	16.2	15.0	13.6	11.6
Real net monthly wage	0.1	1.4	2.7	2.9
Exports of goods and services (nominal)	22.4	13.0	8.2	11.7
Imports of goods and services (nominal)	29.4	11.0	9.1	12.9
Balance of goods and services, % of GDP	-4.3	-3.4	-3.9	-4.7
Current account balance, % of GDP	-2.4	-2.0	-2.4	-3.4
Current and capital account balance, % of GDP	-0.3	0.6	-0.5	-2.0
FDI inflow, % of GDP	5.1	3.3	3.3	3.7
Gross external debt, % of GDP	145	137	130	123
General government budget balance, % of GDP 3/	-3.5	-1.2	-0.7	-0.2
General government debt, % of GDP	42.2	42.0	38.8	34.9

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

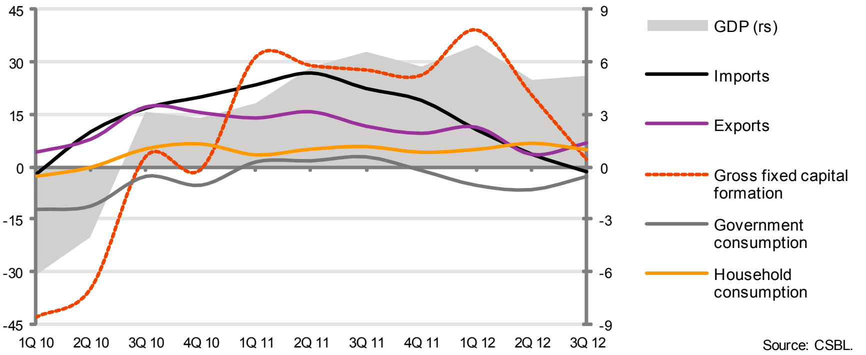
the November 2012 Latvian monthly newsletter)[1].

We foresee export volume growth to continue slowing, from 6.6% in 2012 to 4% in 2013, as external demand remains weak and competition toughens. Subpar growth in Europe will force companies to improve their competitiveness. For instance, southern European countries in deep recessions are reducing their labour costs, also via wage cuts. Wage cuts were widely used also in Latvia a few years back, but are now largely impossible unless a very negative global scenario is considered. Hence, unless Latvian exporters invest in their productive facilities and in new products, other countries are likely to catch up, and Latvia's current competitiveness gains will dissipate. A major current advantage of Latvian companies is their relatively low leverage levels and good financial stance, and, hence, their ability to borrow and invest – something that their competitors in southern Europe lack. This is a temporary window of opportunity and should not be wasted.

These threats to competitiveness put pressure on the costs and markups of Latvian exporters. So far, the competitiveness gains from previous years have been sustained, but exporters need to continue monitoring their costs and quality of production very closely. With the global situation improving in 2014, we forecast a pickup in Latvian export volume growth to 6.4%.

1 http://www.swedbank-research.com/english/latvian_economy/2012/november/index.csp

GDP annual growth by expenditure, %



Source: CSBL.

We anticipate goods exports to be the largest contributor to export growth – after a very strong development in late 2011 and early 2012, services export growth has slowed substantially. Capacity constraints in freight transportation and intense competition amongst the Baltic Sea region ports will continue to be a drag on services export growth, although several investment projects have been initiated to ease bottlenecks in the railway network and enhance the capacity of the main ports.

Import growth surprised on the downside in 2012 but was partly explained by lower investment growth in the second and third quarters. Due to an annual fall in imports (-1.3%) in the third quarter of 2012, the net export contribution to GDP growth turned positive for the first time since early 2010. Also, the investment structure has changed towards infrastructure, which has a smaller import component than machinery and equipment, and companies have reduced their inventories and thus require smaller imports. Yet, as domestic demand and export growth continues, imports are forecast to rebound as well. We forecast import volumes to grow by 3.8% in 2012, 5.9% in 2013, and 8% in 2014.

While import prices grew faster than export prices in 2012 (due to oil price hikes early in the year and more expensive machinery, equipment, and transport vehicles), we expect this situation to reverse in the coming two years, as exporters change their product mix towards higher-value-added products and global commodity prices rise only moderately. Still, nominal imports are forecast to grow a bit faster than exports and the trade balance to deteriorate slowly, reaching a deficit of nearly 5% of GDP in 2014. These deficits will be fully covered with current and capital transfers (including EU funds) and FDI inflows, and will not pose major sustainability risks.

Volatile but growing investments

Investment growth in 2012, albeit very volatile, was largely in line with expectations. The exceptional annual growth early in the year stalled towards the third quarter. Although volatility is likely to persist, we expect moderate investment growth to continue in the coming years, at 9-11% per annum. The share of gross fixed capital formation is estimated to reach nearly 27% of GDP in 2014 in nominal terms (up from about 24% last year), which will still be lower than in pre-crisis years (close to 30% in 2003-2006). In the boom and, especially, the bust years, there was a heavy underinvestment in productive facilities and public infrastructure.

Global uncertainty hurts the risk appetite of investors. We saw Latvian manufacturers becoming more cautious about their investment plans in the second half of 2012. Some of them have

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2011	2012e[1/]		2013f[1/]		2014f[1/]	
Household consumption	4.8	5.2	(4.5)	3.8	(3.3)	4.5	(4.5)
General government consumption	1.1	-4.0	(0.5)	1.1	(1.3)	0.9	(2.4)
Gross fixed capital formation	27.9	12.1	(12.0)	9.0	(10.0)	11.0	(11.0)
Inventories [2/]	2.6	-1.8	(-1.5)	0.5	(0.1)	0.4	(0.4)
Exports of goods and services	12.7	6.6	(5.8)	4.0	(4.5)	6.4	(7.0)
Imports of goods and services	22.7	3.8	(5.9)	5.9	(6.5)	8.0	(8.4)
GDP	5.5	5.4	(4.0)	4.1	(3.5)	5.0	(5.2)
Domestic demand (excl. inventories) [2/]	9.2	6.0	(6.2)	5.2	(5.2)	6.3	(6.6)
Net export [2/]	-6.3	1.2	(-0.7)	-1.6	(-1.8)	-1.7	(-1.8)

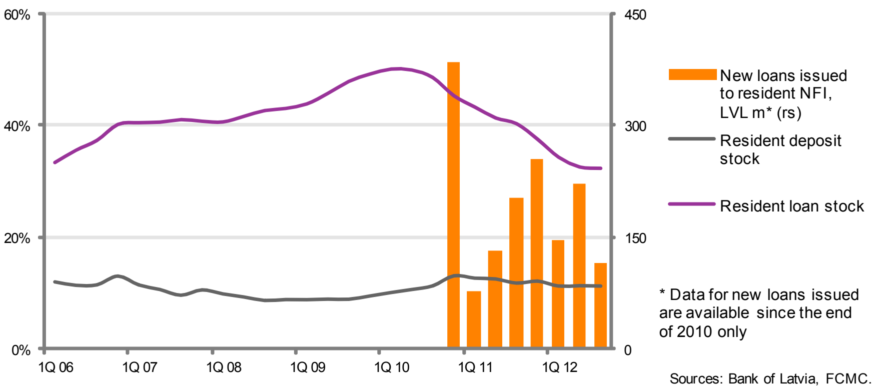
Sources: CSBL and Swedbank.
1/ The figures from our forecast in October are given in brackets.
2/ Contribution to GDP growth

over the past few years made sizable investments and would like to generate positive cash flows before engaging in further major investment projects. Investment projects in heating and electricity supply, which were supporting the growth of nonfinancial investments in 2011 and early 2012, are ending – e.g., the expansion of the cogeneration power plant TEC2 is almost done. However, capacity utilisation in manufacturing is now at pre-crisis levels, and investments are needed to continue expanding the export base.

At the same time, the financial situation of corporates is good – deposit levels are increasing at a similar pace as output, and leverage is back to the 2005 level. Interest rates are at historically low levels. New lending picked up in the first half of the year, although it has weakened since then − new loans for resident nonfinancial institutions in the first nine months of 2012 were 11% higher than a year ago; this accounts for about 18% of gross fixed capital formation (20% a year ago).

EU funds remain a significant driver of investments and will continue to be so in the coming two years (as of November 2012, agreements had been signed on 92% of the financing available from the European Regional Development Fund and the Cohesion Fund, but only 49% had been paid out to final beneficiaries). As the year 2014 will be the first of the new EU planning period, there will be a dip in activity as it takes time to set up new programmes; however, there will most likely still be quite a number of earlier-initiated projects running. This applies also to public infrastructure projects.

Loans and deposits of nonfinancial institutions (NFI), % of GDP



Sources: Bank of Latvia, FCMC.

The smaller inventories in 2012 may be explained by two factors. First, companies must have increased efficiency and learned to live with leaner inventories. Second, companies are cautious about the future and are thus keeping their inventory levels low. Still, we expect inventory rebuilding in 2013-2014 in line with growing economic activity and improving confidence. However, this is the most uncertain part of our forecast, since inventory data include errors and omissions and are often substantially revised later on.

Labour market improving but faces structural problems

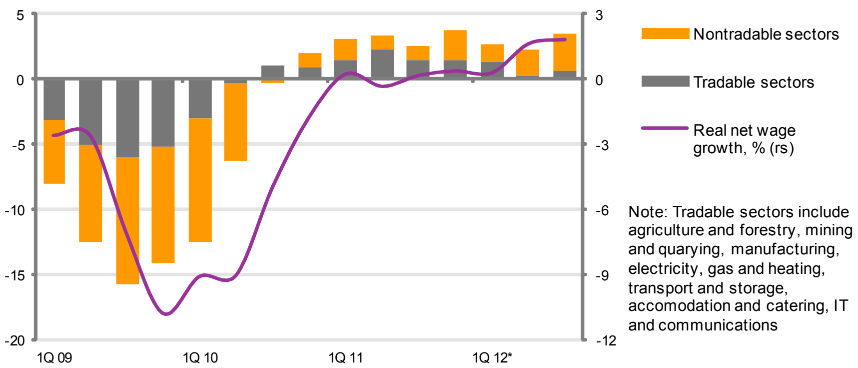
Economic growth has rapidly improved the labour market. We estimate employment growth net of active labour market programmes at 4.5% in 2012, implying the creation of 38,000 new jobs. Job creation has been accompanied by both an increase in the activity rate and a decline in unemployment. Employment growth is increasingly driven by the domestically oriented sectors, while exporters have become more cautious. Job creation is expected to slow in 2013, but, as the global outlook improves in 2014, exporting sectors are likely to become more willing to hire.

Both employment and wage growth remain uneven across sectors; thus, labour market improvement does not benefit all employed. However, wage growth is expected to become broader as more employees get moderate wage increases. Cost pressures on companies and slower consumer price growth are expected to weigh on the bargaining power of employees, while emigration risks and skills mismatches will support it. Wage demands in the public sector are growing, and a raise in the wage bill is planned in the central government budget for 2013. This is expected to materialise mostly through wage growth in the state sector (not new hiring) and spill over to the rest of the public sector.

Overall, we expect 4.7% average net wage growth in 2013 and 6.5% in 2014; parts of the increases are due to personal income tax cuts (1 percentage point in 2013 and 2 percentage points in 2014). Real net wage growth is seen to pick up by 2.7-2.9% in 2013-2014 from 1.4% in 2012. Wage growth is anticipated to remain largely in line with productivity growth.

While labour market improvements will continue, they are likely to remain quite uneven − not only across sectors, but also across qualification levels (and, thus, income groups). Therefore, the impact on inequality and poverty, as well as on regional imbalances, should not be ignored. Latvia has one of the largest income inequality and at-risk-of-poverty rates in the EU. It also has one of the largest unemployment traps

Contribution to annual employment growth, percentage points



Note: Tradable sectors include agriculture and forestry, mining and quarying, manufacturing, electricity, gas and heating, transport and storage, accomodation and catering, IT and communications

* As of 2012, data are adjusted according to 2011 Population Census

Source: CSBL.

and low-wage traps. Economic growth will not per se cure these problems, and adequate policy action is crucial to address them (see below for more details).

Stronger purchasing power and confidence boost spending

Consumer price growth slowed substantially in the second half of 2012, due to both lower global oil prices and very feeble domestic price pressures (core annual inflation was close to zero). Annual average inflation amounted to 2.3% in 2012. As a result, we now anticipate lower inflation also in 2013, 1.9% on average. Both domestic and external pressures are expected to remain subdued, although there is likely to be a one-off increase in household electricity prices in the autumn due to market liberalisation. Currently, tariffs are differentiated according to consumption level, and the smallest tariff is below market cost. In 2014, a pickup in inflation (to 3.5%) is forecast, reflecting stronger domestic pressures, a moderate rise in global commodity prices, and a pass-through to consumers of one-off expenses due to the euro introduction.

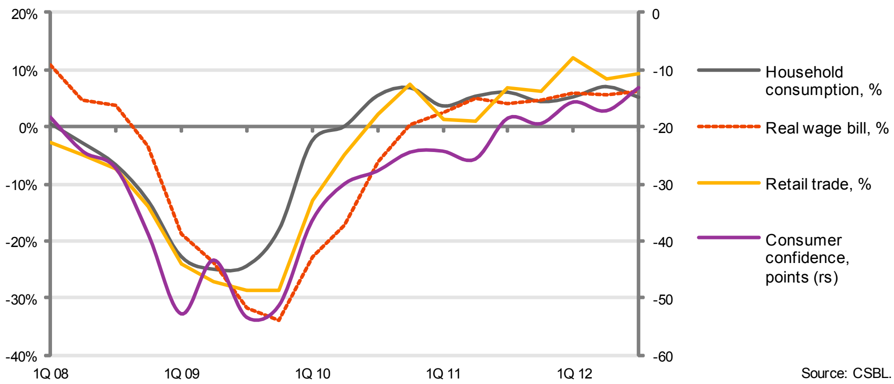
The anticipated increase in purchasing power will promote household consumption growth. With exports growing and the labour market improving, consumer optimism is unlikely to deteriorate − the savings rate is thus likely to remain close to zero or negative, and consumers will keep spending their income increases. Still, as employment growth is expected to slow in 2013, so will household consumption – from above 5% in 2012 to less than 4% – before picking up again in 2014 (to 4.5%).

Risk of reform momentum stalling

The government's fiscal position continued to strengthen throughout 2012. Despite the value-added tax base rate cut from 22% to 21% as of July, tax revenues continued to exceed plans, and expenditures increased only moderately. The year 2012 is likely to have ended with a deficit of about 1.2% of GDP, which is significantly less than planned.

Robust economic growth, a good fiscal stance, and conservative fiscal

Annual growth of retail trade turnover, wage bill and consumption, %



Source: CSBL.

policy have led to rating improvements. Standard and Poor's has moved Latvia's sovereign rating up two notches over the past year to BBB (a positive outlook), i.e., two notches above investment grade. As a result, in December the government was able to issue USD 1.25 billion (equivalent to about 4% of GDP) in seven-year bonds at the historically low yield of 2.89%; this was used for an early and full repayment of the more expensive IMF bailout loan. The low yield corresponds to a higher credit rating, thus making possible further rating improvements early in 2013. This borrowing has reduced refinancing needs for 2013 to about LVL 280 million (1.7% of GDP). The Treasury is likely to issue new debt during the coming year to prepare for the sizable rollover in 2014 (about LVL 1 billion, or 5.5% of GDP).

The 2013 budget is based on a cautious macroeconomic forecast, and the balanced budget strategy has been strengthened by the introduction of a medium-term budget framework that sets expenditure ceilings over a three-year span. This is a significant improvement. Yet, the overall scope of the reforms in the 2013 budget is modest, and their impact is likely to be limited. While intensive discussions on various structural reforms continue (e.g., on tertiary education, welfare, and health care), it seems that the momentum is stalling. On the part of the government, reform activity seems to be more on the agenda of certain ministers, and support from the whole cabinet is patchy or lacking. In mid January, the Minister of Transport expressed the will to leave his post, which may result in the government reshuffle and create additional uncertainty about the reform process.

The reforms in tertiary education have met strong opposition in the sector itself and also within the ruling coalition. Health care financing reform has been postponed to 2014. Another area that is gaining attention is income and regional development inequality. We believe that addressing this issue should be at the top of the policy agenda in order to attain inclusive and sustainable growth − for instance, by making the population more employable via physical mobility, skills training, and changing the social safety net to improve incentives to work and reduce poverty traps, etc. (For a more detailed analysis, see our discussion paper, October 2012, on demographic challenges.[2]) Reforms surely must be well designed before they are implemented; yet one must also recognise that continued procrastination means postponement of any possible gains. Some of the decisions made are often contradictory. For instance, the guaranteed minimum income benefit to the poorest has recently been cut to LVL 35 from LVL 45 a month − a move that, in fact, increases poverty risk.

This stalling of the reform momentum likely reflects the approaching municipality elections in June 2013. But unless the momentum picks up shortly after the elections, valuable time to gain a competitive advantage over other countries will be lost.

Lija Strašuna
Mārtiņš Kazāks

2 http://www.swedbank-research.com/english/discussion_paper/2012/12-10-08/index.csp

Lithuania: Investments will drive growth, but economic policy is key

As forecast in our previous Swedbank Economic Outlook, Lithuanian growth bottomed out in the second quarter of last year and rebounded strongly in the third, when it expanded by 4.4% compared with the same period a year ago. The growth spiked due to one-off effects, such as record grain crops, which were 25.5% higher than the previous year. Overall growth was broad based, and manufacturing and exports continued expanding at an accelerated pace in the final quarter of last year, demonstrating the economy's resilience to the European woes.

Nevertheless, the euro area debt crisis affected business expectations – investments in fixed tangible assets grew less than we had forecast. Gross fixed capital formation (which includes household investments in housing) was even weaker; it contracted by 0.4% during the first three quarters of 2012 compared with the same period a year ago. Household consumption increased slightly more than expected, but its growth continued decelerating and will continue to do so in 2013.

We have lowered the GDP growth forecast for 2013 marginally to 4%, mainly due to the weaker outlook for household consumption and slightly slower export growth. Investments, however, are expected to grow faster than previously expected and catch up after the underinvestment in previous years. We have revised our GDP growth forecasts for 2014 more sharply – down to 4.0% from 4.5% before. Growth is likely to be dampened by a still weak external demand, slower increase in employment and more cautious growth of investments, due to already now stagnating reforms and domestic policy uncertainty.

Inflation declined to 3.1% but was slightly higher than we had expected. Although global developments are favourable and the oil price is expected to be somewhat lower this year, inflation will be driven by domestic factors – more expensive electricity and diesel fuel, and a rising minimum monthly wage. Thus we have increased our inflation forecast for this year to 3.3% but are keeping the forecast for 2014 unchanged.

External risks are smaller, but domestic uncertainty remains

Since our last forecast, the external risk has become more balanced, with negative and positive scenarios having a similar probability of 20% and 15% respectively (our base "muddling-through" scenario probability is 65%). The European Central Bank's (ECB's) decision to (under some circumstances) take the role of lender of last resort and some political progress made towards a more integrated euro area has lowered tail risks. Developments in the euro area could still take a turn for the worse, as euro scepticism is high and households and politicians in southern European countries are weary of austerity. However, the light at the end of the tunnel also creates a positive risk – households and companies may stop deleveraging and start consuming and investing after a prolonged period of abstinence.

The parliamentary elections in October were followed by a prolonged spell of uncertainty, as the new ruling coalition struggled to form a government. Tension in this coalition remains, as the parliament abolished the immunity of three Labour Party members who face allegations due to fraudulent accounting of party finances. Probably partially because of this tension in the political environment, the industrial confidence indicator in November dropped to its lowest level in three years. Upcoming tax system reform and uncertainty regarding other reforms, especially in energy sector, could lower business confidence and dampen investments. On the other hand, there are positive risks too – lower tax wedge on labour could improve growth potential.

More signs of investment recovery

One of the main priorities of the new government is to accelerate the renovation of energy-inefficient Soviet-era residential houses. If successful, this could also significantly boost overall investments and employment. The investments in the infrastructure of the liquefied natural gas (LNG) terminal will amount to LTL 260 million this year and the next. Overall, public investments are budgeted to increase by 10.3% this year, and business is likely to keep pace.

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012e	2013f	2014f
Real GDP	5.9	3.3	4.0	4.0
Nominal GDP, billion euro	30.8	32.6	34.9	37.5
Consumer prices (average)	4.1	3.1	3.3	3.4
Unemployment rate, % [2/]	15.3	13.2	11.5	10.0
Real net monthly wage	-1,3	-0.2	1.6	2.0
Exports of goods and services (nominal)	27.4	12.0	6.7	10.5
Imports of goods and services (nominal)	28.2	9.0	6.0	11.0
Balance of goods and services, % of GDP	-2.6	-0.5	0.0	-0.4
Current account balance, % of GDP	-3.7	-1.0	-0.8	-1.4
Current and capital account balance, % of GDP	-1.3	2.0	1.2	0.8
Net FDI, % of GDP	3.4	3.0	3.5	4.0
Gross external debt, % of GDP	77.8	75.9	73.3	70.3
General government budget balance, % of GDP [3/]	-5.5	-3.0	-2.5	-2.0
General government debt, % of GDP	38.5	40.9	38.4	36.7

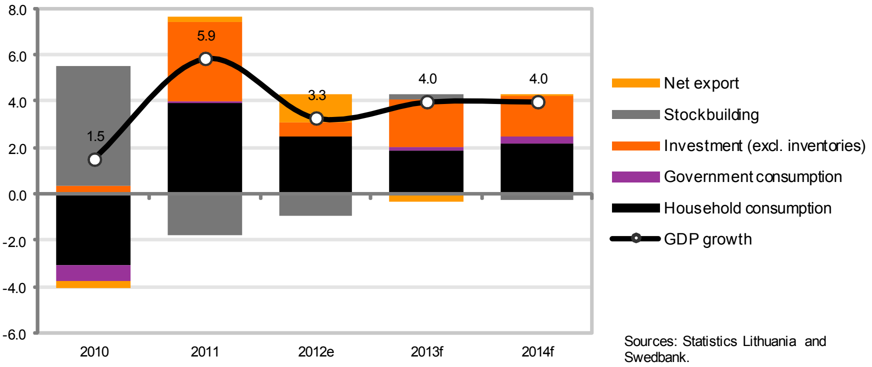
Sources: Statistics Lithuania and Swedbank.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

Retained earnings, remaining EU structural funds, low interest rates, and abundant bank liquidity suggest that the only ingredient that was missing for faster business investment growth was confidence. Despite the slow recovery in domestic demand, exports and manufacturing are well above pre-crisis highs, and capacity utilisation keeps increasing; thus, the need for business investments is self evident.

Statistics Lithuania has recently surveyed 800 companies that earn 80% of total revenues in industry. The survey shows that 42% of the companies are planning to increase investments this year, and only 10% will invest less. The balance of this investment trends indicator (32) is at the highest level since 2006. Of course, plans may still change if one or a few risks derail the global economy, but under our base scenario, companies are ripe for investments.

By the end of last year, out of LTL 25.6 billion of EU structural funds allocated for the period 2007-2013, LTL 23.1 billion was contracted but only LTL 15 billion was paid out. A big fraction of allocated funds will reach companies this year and the next. Interest rates of new loans for companies have dropped to an all-time low of only 2.56% (for loans in euros) and are likely to stay low, at least until end-2014. Increasing bank liquidity, rapidly declining loan-to-deposit ratios, and net interest income will make banks more inclined to expand their loan portfolios. Most important, the profit tax exemption for investments, which currently enables companies to lower their tax rates by 50%, expires at the end of this year. If indications are given that this exemption will not be extended, companies might rush to take advantage of it.

Contributions to GDP growth



Sources: Statistics Lithuania and Swedbank.

Export growth surprised last year

Foreign trade continued thriving in 2012 – exports of goods and services during the first three quarters increased by 7.1% in real terms, compared with the same period a year ago. This growth rate was achieved partly because of the improved competitiveness of Lithuanian manufacturers, who managed to expand their export markets while some European countries contracted. Farmers, too, produced a record harvest, 25.5% larger than a year ago (in real terms). In 2012 exports were also supported by weaker euro, but it will probably have smaller positive effect this year and the next.

Total exports of goods were increasing faster than exports of goods produced in Lithuania, indicating that re-exports were also strong, especially to CIS countries. The nominal growth of exports through November 2012, compared with the same period a year ago, was fastest to Russia (30.8%), Ukraine (25.0%), Estonia (31.5%), and Latvia (22.4%). A 73% growth in exports to the UK was probably caused by an accounting measure – although the oil refinery probably sold its production to the same company, it was registered to a subsidiary in a different country (thus, the contraction of exports to Poland).

The real growth of imports during the first three quarters of last year was much slower than the growth of exports. Thus, the trade deficit narrowed significantly, and the net exports were one of the most important factors of growth last year. However, we do not expect exports to continue outpacing imports; this was probably a temporary trend caused by stagnating investments and a rapid contraction of inventories. We have lowered the export growth forecast for 2013 and 2014 to reflect the prolonged recession in the euro area and weakening growth in Poland, Russia, and other key markets.

Decline in unemployment will be slower, but wage growth faster

In line with our expectations, unemployment declined rapidly to 12.3% in the third quarter of last year. Employment increased by 1.7% and was the most important factor behind the drop in unemployment; however, emigration remained at uncomfortably high levels. Last year, 43,000 people left the country (2.9% of the labour force); meanwhile, however, 21,400 people immigrated (mainly previous emigrants). We forecast that emigration will ebb further, and we project immigration to exceed emigration in the second half of this decade. Of course, government policy could support this trend – a better investment climate and smaller tax wedge on labour could hasten wage convergence and weaken economic

Swedbank's GDP Forecast – Lithuania

Changes in volume, %	2011	2012e[1/]		2013f[1/]		2014f[1/]	
Household consumption	6.4	4.0	(3.5)	3.0	(3.5)	3.5	(4.0)
General government consumption	0.5	0.0	(-2.8)	1.0	(1.0)	2.0	(2.0)
Gross fixed capital formation	18.3	3.0	(11.0)	10.0	(9.0)	8.0	(9.0)
Inventories [2/]	-1.8	-1.0	(-0.1)	0.3	(0.2)	-0.3	(0.0)
Exports of goods and services	14.1	6.5	(4.0)	4.0	(4.5)	6.5	(7.0)
Imports of goods and services	13.7	5.0	(4.8)	4.5	(5.0)	6.5	(7.5)
GDP	5.9	3.3	(3.3)	4.0	(4.1)	4.0	(4.5)
Domestic demand (excl. inventories) [2/]	7.4	3.1	(3.9)	4.1	(4.3)	4.2	(4.8)
Net export [2/]	0.3	1.2	(-0.5)	-0.3	(-0.3)	0.1	(-0.3)

Sources: Statistics Lithuania and Swedbank.

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

2/ Contribution to GDP growth. Domestic demand is in net of inventories.

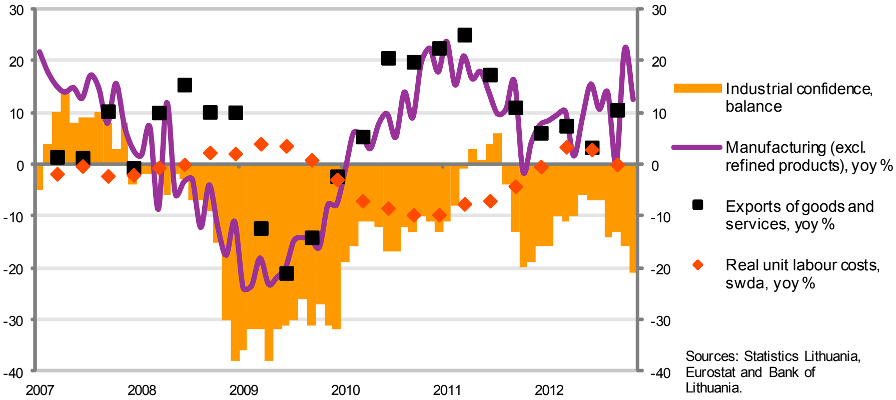
factors behind the emigration trend. At the same time, a more liberal immigration policy could help to balance skills mismatches in the labour market.

Unemployment will continue declining this year and the next, but the pace will be slower. We still think that average annual unemployment will drop to 11.5% in 2013, but we have raised our forecast for 2014 to 10.0%, up from 9.3%. Job creation will be slower because the majority of the remaining unemployed are less qualified or lack the skills demanded in the market. A rather fast increase in the minimum monthly wage (17.6%) may prove to be a double-edged sword – it will increase purchasing power of households, but it will also cut into the creation of new jobs. We think that finding ways to raise the nontaxable income threshold would have been a better tool to increase the disposable income of low earners without distorting the labour market.

Real wage growth was still negative last year, as wages increased by about 2.8% but were outpaced by inflation. This process has lasted for four years now and has been an important source of competitiveness and export growth; however, it will most likely end this year – real wages are expected to increase by 1.6% in 2013 and 2.0% in 2014.

An increase in the minimum monthly wage alone will have an influence of 1.7 percentage points on the average wage, but it is also likely to have spillover effects and trigger wage increases all along the chain. Those who were earning slightly above the minimum wage are probably already negotiating how much their wages will rise this year. Thus, we have increased our nominal net wage growth forecast to 5.0% in 2013; this will probably accelerate further in 2014, when we expect it to grow by 5.4%.

Manufacturing, exports and unit labour costs



Sources: Statistics Lithuania, Eurostat and Bank of Lithuania.

Consumers consumed more because they saved less

Household consumption growth eased to 5.2% during the first three quarters of last year, but was higher than expected and much faster than the growth of the wage bill, which increased by only 1.5%. Higher retirement pensions boosted disposable income, but the main factor behind consumption growth probably was the lower savings rate, which already started declining in 2011.

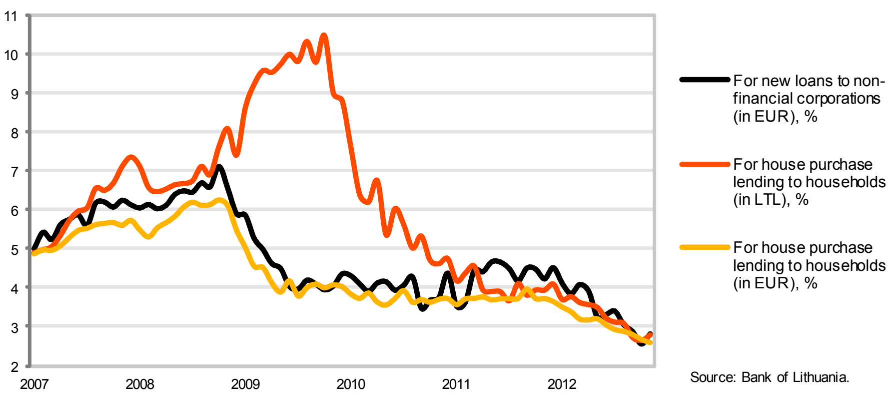
Consumer confidence improved in the post-election period and was close to its highest level since the beginning of 2008. At the same time, however, industrial confidence has dropped to the lowest level since the end of 2009. These diverging sentiments probably reflect different expectations of the economic policy to be implemented by the new government.

Despite stronger household confidence, we have lowered our household consumption growth forecast by half a percentage point for both 2013 and 2014, to 3.0% and 3.5%, respectively. There will no longer be a positive carry over effect, and despite growing real wages, confidence probably will not improve significantly (due to more expensive necessities) and savings rate is not likely to become sharply negative. An end to the contraction in real wages, however, may provide consumers incentives to increase financial leverage and encourage them to benefit from the historically low interest rates. The very high liquidity and lending capacity of Lithuanian banks are shown not only by the very low interest rates, but also by the interest rates for mortgages in litas, which for the first time in history were lower than for those in euros.

Inflation is bottoming out

Since 2009, productivity growth has outpaced wage growth, and companies have had overcapacity; thus, the main driver of inflation has been global commodity prices. This, however, is changing. Not only is the price of electricity for households increasing by 8.9% as of January this year, households will also bear the burden of higher excise duties on tobacco and diesel fuel. Companies will also see their costs rising due to both more expensive electricity and an increase in the minimum monthly wage. More expensive electricity is a one-off event, but future unsustainable increases in the minimum monthly wage could create a competitiveness-threatening wage-inflation spiral.

Interest rates for new loans to non-financial corporations and households



Source: Bank of Lithuania.

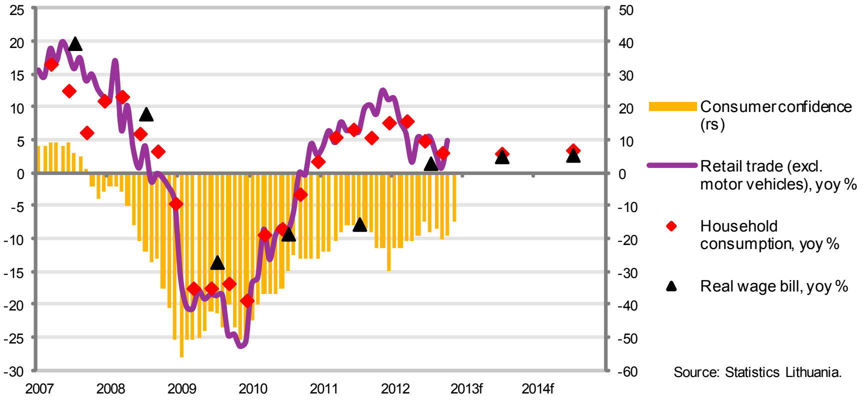
As peripheral European countries undergo internal devaluation, competition is likely to remain fierce, and Lithuania's domestic demand is still weak. Thus we do not think that companies will transfer most of their increase in costs to consumers, but will probably accept lower profitability. Global developments will have mixed impact on local prices – we forecast the average price of oil this year will be 5.2% lower than in 2012, but the food is expected to be 4.8% more expensive. Considering this, we increase our inflation forecast for this year to 3.3% from 3.0%. Prices are expected to grow at a similar pace in 2014 – we keep our forecast unchanged at 3.4%.

This means that average annual inflation will be fluctuating very close to the Maastricht price stability criterion. It is highly unlikely that Lithuania will meet the price stability criterion this spring, but this is not too relevant, as Lithuania has not formally applied for full Economic and Monetary Union (EMU) membership. Lithuania's ability to meet this criterion in 2014 and 2015 will largely depend on prevailing trends in commodities markets, and its chances are best described as 50-50. We forecast that the budget deficit will remain below the 3% of GDP threshold; thus Lithuania's prospects of becoming a full EMU member will depend only on inflation. The government should set a clear accession date and start applying specific measures to guard price stability; otherwise, EMU membership could be postponed to 2017 or later.

Government economic policy: make it or break it

Budget consolidation will be somewhat slower than previously envisaged. We increased the budget deficit forecast to 2.5% of GDP this year and 2.0% in 2014 (2.0% and 1.0% before). The budget deficit will decline more slowly because of the government's plans to introduce more value-added tax (VAT) concessions (which we do not support due to their dubious positive impact on the final consumer), and there are discussions to increase public spending (e.g., public servant wages). However, additional spending will be limited by the Fiscal Discipline Law; thus the stability of overall public finances will not be compromised. Due to the relatively fast GDP growth, the general government debt-to-GDP ratio will start declining this year and will drop to 36.7% next year.

Consumer confidence index and consumption



The change in government does not necessarily indicate a shift in policies or economic prospects; however, the new government has won the election on the back of a fierce critique of the previous government and is promising to reverse at least some of its unpopular reforms. This would be a mistake that could weaken Lithuanian competitiveness, undermine investors' trust, and hamper growth.

Tax reform could both improve and worsen Lithuania's prospects, thus it should be considered one of the most important reforms of this government. Cutting taxes on low earners--and not increasing the already-high taxes on higher earners--should be the priority that could lower inequality and boost growth. Statistics Lithuania calculates that only 10.3% of all employees earn LTL 3,500 (EUR 1,014) or more (before taxes). Only 2.8% earn LTL 5,500 (EUR 1,593) or more. This means that the sources for additional income from taxing labour are slim. Horizontal fairness is as important as vertical fairness, thus a more effective way to increase redistribution through the government budget (assuming that this is an appropriate objective) would be to eliminate the abundant income tax exemptions, which are enjoyed by households earning very high income, and broaden the base of the personal property tax. Social exclusion and poverty are problems, but the government should focus on improving the quality of education, reducing the unemployment trap, and increasing activity rates.

An increase in the minimum monthly wage not only increases the purchasing power of low earners – it is also an additional burden on business. To compensate for this, the new government should find ways to improve the functioning of labour markets – the initiative started by the previous government but abandoned before the elections. Whether the right structural reforms are implemented during the next few years will determine not only foreign and domestic investment growth, but could also strengthen or weaken the growth of productivity and competitiveness.

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