Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies April 10, 2013

Northern lights – flickering but shining bright

Table of Content:

Global development

- Global growth is recovering but not without exceptions. We maintain a global forecast of 3.1% in 2013 and make a positive revision to 3.7% in 2014. We have become more negative on southern Europe, including France, and more positive on Germany.
- We keep the probability for our main scenario at 65%, the same as in the January report. With structural reforms starting to yield results and pent-up demand is accumulating, the outlook for a continued recovery has improved, despite a recent softening in data.

Sweden

- Real economic growth declined to 1.2% in 2012 from 3.7% the year before. Despite the slowdown, economic activity held up surprisingly well in the last two quarters of the year, and labour market developments were supported by a stronger-than-expected employment growth.
- We expect GDP growth to remain weak in the first half of 2013 before picking up steam. Overall, for 2013 and 2014, we forecast real growth at 1.6% and 2.7%, respectively. In particular, household consumption will drive growth, and economic policy will remain expansionary.

Estonia

- In 2012, economic growth decelerated to 3.2%, primarily due to weakened foreign demand and the contraction of export-oriented manufacturing. Growth was primarily driven by public investments in buildings and infrastructure, financed by EU transfers and CO2 quota sales.
- Boosted mainly by domestic demand, GDP growth is expected to reach 3.3% in 2013 and accelerate to 4.2% next year, with additional support from exports. Investment growth will decelerate as government investments will decrease. Private consumption will contribute the most to economic growth.

Latvia

- The economy expanded by 5.6% in 2012, driven by exports and stronger domestic demand. Inflation has slowed sharply as domestic price pressures are weak and global price dynamics benign. Latvia has applied for euro area membership and is expected to join it on January 1, 2014.
- The GDP growth forecast for 2013 is raised to 4.3% (4.1% before) as lower inflation will support private spending. Inflation is revised down to 1.1% this year but will pick up to 3.5% in 2014. GDP growth will speed up to 5% in 2014, as the global outlook improves and the personal income tax rate is cut.

Lithuania

- Growth remained strong at the end of last year, mainly due to booming exports. Companies postponed some of their investments and slashed inventories, but we do not expect this trend to continue. Last year, for the first time, foreign trade was in surplus.
- We keep our GDP growth forecast at 4.0% for both 2013 and 2014. Real net wages are expected to grow faster this year and the next, due to lower inflation and likely lower labour tax rates. We have cut the inflation forecast for 2013 to 2.5%, but euro accession is far from certain.

Recovery despite continued Eurotroubles

The global economy is picking up pace after the slowdown in many of the advanced economies during the second half of 2012. We see China recovering stronger than we previously expected, and growth will likely once again exceed the target set by the Government. The US economy is regaining strength, based on expanding domestic demand stemming from improving housing and labour markets.

Lower-than-expected growth in southern Europe, although somewhat compensated for by a more positive outlook for Germany, causes us to revise down our forecast for the euro area by 0.3 percentage point in 2013. France is expected to register negative growth due to sluggish internal demand and its persistent weakness in external competitiveness. Recent data on domestic demand in Spain and Italy, reinforced by the political turmoil, confirm that these countries are a long way from recovery. The confused management of the ECB/EU/IMF support package to Cyprus in March is not building confidence.

On the whole, the “muddling–through“ scenario for the advanced economies is very much intact. Monetary policy remains historically expansionary in most large countries, but the strategies have begun to diverge. Japan recently introduced a further easing of measures, which have had strong effects in both the foreign exchange and equity markets. The expansionary policy in Japan is, however, threatening the competitiveness of the trading partners. In the US, on the other hand, the debate has begun within the Federal Reserve about reducing the amount of monthly bond purchases due to the recovering economy. We expect these changes, when they happen, to be well communicated. Given that monetary policy are reaching their maximum potential, we expect the general rhetoric amongst the international policy institutions such as the IMF, EU, OECD, and G20 - to be more “forgiving” when it comes to austerity.

For Swedbank’s home markets, 2012 turned out somewhat stronger than our forecasts in January. Our outlook for 2013 is revised upwards for Sweden, Estonia, Latvia, and Lithuania. From a policy perspective, we think there is a historical opportunity in our part of the world to use structural measures to address issues such as competitiveness, education, wage formation, and tax systems in the coming years.

Taking into account that we have raised our growth forecast over the next two years, we maintain the probability for our baseline scenario at 65%. Our risk assessment is broadly balanced, with downside risks at 20% probability and upside risks at 15%.

Sweden

In Sweden, economic growth fell back last year to 1.2% from 3.7% the year before. The outlook for 2013 and 2014 has improved, but we do not expect a swift return to full employment. Instead, growth will remain weak in the first half of 2013, and, when it increases later in the forecast period, it will be mainly on account of stronger domestic demand.

We foresee that the market growth for Swedish exporters in 2013 will decelerate more than we forecast in January, in particular in the euro area. The growth contribution from foreign trade is expected to be negative in 2013 and zero in 2014. In investments, a rebound is expected at the earliest in 2014, when capacity utilisation in production rises. Against the backdrop of solid household finances, a slowly improving labour market, and pent-up demand, we expect private consumption to rebound in the next two years and provide the foundation for economic growth.

We expect employment to continue to grow relatively strongly, but, due to an expanding labour force, unemployment will continue to rise throughout 2013 before levelling off in 2014.

In monetary policy, we think that a low rate is appropriate given the current state of the Swedish economy. But, based on a domestic recovery in 2014, we expect the Riksbank to begin hiking the rate, to 1.75 % by year-end 2014. Fiscal policy will remain expansionary ahead of elections next year, and the deficit in the public balances will amount to about 1% of GDP for both 2013 and 2014.

Estonia

Estonia’s economic growth decelerated sharply in 2012 to 3.2% from a high of 8.3% the year before. Exports growth decelerated and the trade balance deteriorated considerably, explained by a weakened demand from Estonia’s trading partners. Based mainly on domestic demand, GDP growth is expected to reach 3.3% in 2013 and 4.2% in 2014.

Private consumption will be the main driver of growth. Investments are slowing considerably, in particular in the public sector. Private sector investments are far from sufficient to compensate, since companies in general

Macro economic indicators, 2011- 2014

	2011	2012	2013f	2014f
Real GDP growth, annual change in %				
Sweden (calender adjusted)	3.7	1.2	1.6	2.7
Estonia	8.3	3.2	3.3	4.2
Latvia	5.5	5.6	4.3	5.0
Lithuania	5.9	3.6	4.0	4.0
Unemployment rate, % of labour force				
Sweden	7.8	8.0	8.3	8.2
Estonia	12.5	10.2	9.5	8.9
Latvia	16.2	14.9	13.5	11.5
Lithuania	15.3	13.2	11.5	10.0
Consumer price index, annual change in %				
Sweden	3.0	0.9	0.3	1.8
Estonia	5.0	3.9	3.3	2.9
Latvia	4.4	2.3	1.1	3.5
Lithuania	4.1	3.1	2.5	3.4
Current account, % of GDP				
Sweden	7.3	7.0	6.5	6.1
Estonia	2.1	-1.2	-2.5	-2.7
Latvia	-2.2	-1.7	-2.8	-3.8
Lithuania	-3.7	-0.5	-0.9	-2.3

Sources: National statistics authorities and Swedbank.

have spare capacity and are cautious in their investment plans due to the global uncertainty.

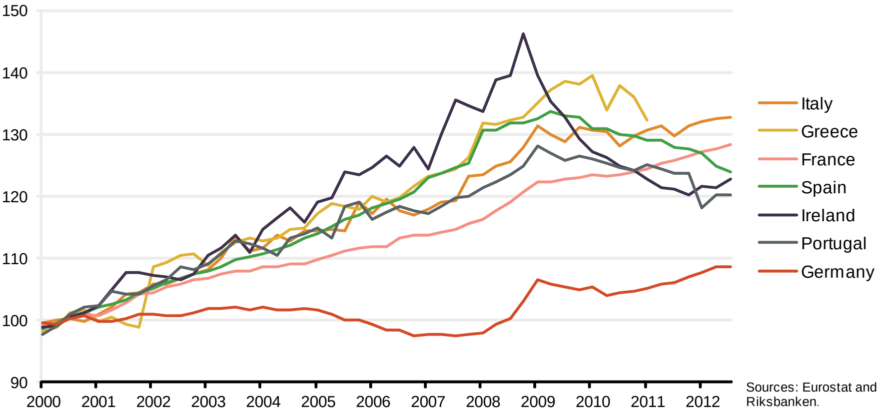
The economy will grow close to its potential during the forecast period. Unemployment fell below 10% last year, but structural and demographical challenges make a further decrease difficult. An increase in labour demand could generate wage pressures. Therefore, an improvement in productivity is important to protect competitiveness among Estonian companies. An important challenge for Estonia is to improve the skills of its labour force, and aim to move towards more high-value-added production. During the forecast period, companies are expected to be able to keep labour costs under control. Inflation is expected to slow.

Latvia

Economic growth has exceeded 5 % for two years now. Export remains the fundamental source of growth, supporting both private consumption and investment. We retain our view that export growth will slow in 2013 due to weak external demand and rising competition in export markets. So will private consumption due to slower job creation. Import growth is anticipated to accelerate, driven by corporate investments to build export capacity. Comparing our January outlook, the surprisingly low inflation early in the year has made us to reduce inflation forecast for 2013; it will raise real income and thus spur household spending. Hence, GDP growth forecast is revised up to 4.3% (from 4.1%). We retain the 5% growth forecast for 2014, due to improving global outlook and rising domestic demand supported by labour tax cuts and improving overall confidence.

Domestic price pressures are weak as the economy is below its potential. We forecast consumer price inflation at 1.1% in 2013, rising to 3.5 % next year, due to rising global prices and somewhat stronger internal pressures, as the gap between the actual and potential GDP is closing. We expect gross wage growth to remain moderate and broadly in line with productivity gains. Yet, challenges are on the rise, as already in 2015 the unemployment is likely to approach its natural rate when wage pressures tend to grow and exceed productivity gains. Enhancing productivity growth and raising participation rates will thus be vital to diminish such pressures. Latvia is on track to join the euro area in 2014. The reform agenda has so far been considerable, but in our view insufficient to support swift and sustainable growth in the medium term.

Unit labour cost (index 2000=100; sa)



Sources: Eurostat and Riksbanken.

Lithuania

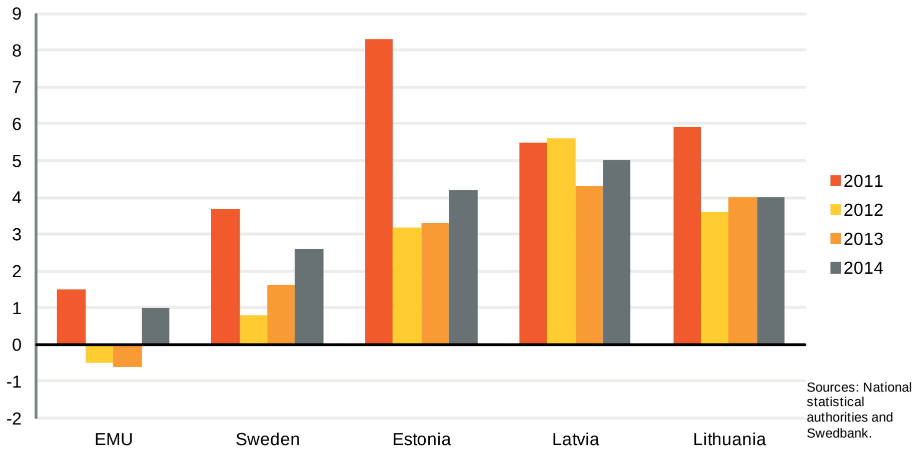
The Lithuanian economy grew somewhat faster last year than we had forecast, mainly due to very strong exports and higher household consumption. Weak investments and contracting inventories lowered the demand for imports, and Lithuania's foreign trade was in surplus for the first time since reinstatement of independence in 1990. This surplus is not expected to last, since it to a large extent was the result of a record grain harvest and laggard imports. Investments are expected to recover after a contraction in 2012. However, in the face of continued uncertainties in the euro area, we have adjusted the forecast for investment growth this year to 8% (10% in our January report). Private consumption is expected to expand at a robust pace, based on higher real wages and improved confidence. This creates the basis for a continued decrease in unemployment.

The inflation outlook, critical for the government meeting its target to adopt the euro in 2015, has become more benign. Current price pressures are lower than expected, and, with favourable global commodity trends, the inflation forecast for 2013 has been lowered to 2.5%. We see the probability of adopting the euro in 2015 as close to 50%.

From a structural perspective, Lithuania faces challenges primarily in labour market legislation and tax system reforms. Implementing structural changes and a long-term energy reform would be most critical to enhance Lithuania's growth potential.

Cecilia Skingsley

Real economic growth rates (annual change in %)



Sources: National statistical authorities and Swedbank.

Recovery on shaky legs

The year 2013 began in a rather positive mood, with gradual improvements in many confidence indicators, as well as benign market movements, including lower funding costs for crisis struck countries in the euro area. However, many challenges are still on the horizon and political decision making in various countries shows signs of becoming dysfunctional: Last-minute fiscal policy deals in the US, an unclear electoral result in Italy, and a controversial support agreement for Cyprus.

However, financial market movements have been fairly calm so far. We see several reasons for this: the deleveraging process is progressing in the most vulnerable economies, and competitiveness is slowly improving. Furthermore, the major central banks maintain an expansionary policy stance. From an activity point of view, manufacturing output is on the mend after the sharp slowdown at the end of last year. This trend is strong in the US but less so in Europe. However, it is hard to tell how much is final demand and how much is inventory build-up.

Overall, we have become more positive about the developments in Germany and in China, but more negative about southern Europe, including France. For 2014, on the other hand, we expect a more broad based but slow recovery for euroland, pulled by Germany.

In **China**, confidence regarding the macro outlook is rising, but companies are still hesitant regarding their own business opportunities, according to the recent published quarterly survey by the People's bank (PBC).

Still, PMI surveys are indicating growth above 8%, as during the last three quarters in 2012.

Coupled with increased demand and supply for credits, this may cause the economy to overshoot the growth target of 7.5% to some extent. Such a result may prompt another—but not too severe-round of policy tightening.

In the **US**, the political conflicts regarding the fiscal policy continue to attract a lot of media attention. However, beneath this surface, the economy is in a clear recovery. Fourth-quarter GDP data were mainly pulled down by the volatile inventory effect and an unusual cut in public spending.

At present and looking forward, the cyclical data are strong, especially manufacturing output. On the demand side, both export and domestic orders are at their strongest levels in many months. Although the international recovery may have lost some steam recently, the US data show resilience.

The housing recovery is continuing, and, with increasing house prices, more households can reset their mortgage rates to lower levels, making room for private spending. Together with recovering employment, the trends in housing and equities can explain why retail sales and total private consumption withstood the rise in payroll taxes in January, which negatively affected disposable incomes. Looking at the private sector balance sheet, it is notable that household debt shows signs of rising, for the first time in five years. Rising house prices, a recovering labour market, and pent-up demand are clearing the ground for a gradual recovery in consumption, going forward.

The **euro area** continues to be vulnerable as GDP fell 0.6 percent from the third to the last quarter of 2012. Compared with our January report, we see a longer adjustment taking place in Southern Europe, but we have, on the other hand, become more optimistic about Germany, which should benefit from the global recovery and the weakening of the euro.

After more than five years of bank- and sovereign-related crisis management, the political management of the most recent troubles, in Cyprus, shows that the collective leadership is still making mistakes. For a couple of days in March, it looked like the politicians in the euro area were on their way to tax depositors' money protected by the deposit insurance scheme in Cyprus. This would have been the third broken promise in the management of the sovereign debt crisis in the euro area, adding to the no-bailout principle that was abandoned in 2010 and the promise that sovereign bond holders would not get hurt that was broken in 2012. A paradigm shift over the past five years of global debt

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

		Outcome		April 2013		January 2013		
		2011	2012	2013	2014	2012	2013	2014
US		1.8	2.2	1.8	2.6	2.2	2.0	2.3
EMU countries		1.5	-0.5	-0.6	1.0	-0.4	-0.3	0.7
Of which:	Germany	3.0	0.7	0.6	1.9	0.9	0.2	1.5
	France	1.7	0.0	-0.7	0.5	0.0	0.1	0.7
	Italy	0.6	-2.2	-1.5	0.5	-2.1	-1.1	0.0
	Spain	0.4	-1.4	-1.8	0.5	-1.5	-1.1	0.1
	Finland	2.8	0.1	0.7	1.8	-0.2	0.5	2.0
UK		0.8	0.0	0.8	1.8	-0.1	1.0	1.7
Denmark		1.1	-0.2	1.0	1.5	-0.5	0.4	1.4
Norway		1.2	3.2	2.1	2.3	3.2	2.0	2.3
Japan		-0.7	1.9	1.3	1.6	1.8	0.7	1.2
China		9.2	7.8	8.3	8.0	7.7	7.9	7.5
India		7.2	5.1	6.4	6.8	5.5	6.0	6.5
Brazil		2.7	0.9	3.5	4.0	1.4	3.5	4.0
Russia		4.3	3.4	3.3	4.0	3.6	3.7	4.1
Global GDP in PPP[2/]		3.9	3.0	3.1	3.7	3.0	3.1	3.4
Global GDP in US$[2/]		2.9	2.4	2.4	3.0	2.3	2.3	2.8

Sources: National statistics and Swedbank.
1/ Countries representing around 70 % of the global economy.
2/ Weights from World bank 2011 have been used.

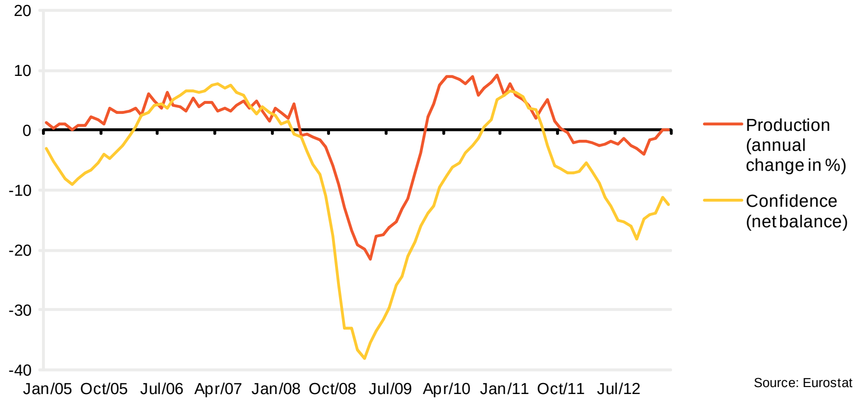
crisis is that politicians and political decision making has become much more intrusive in both household and corporate planning and that decisions have become more erratic. Although many of the public measures have been welcome, and in the initial phases of the banking crisis in 2007-2009 absolutely necessary, parts of the policymaking is now actually hampering the ability of households and companies to adjust and to contribute to growth. Recent research from the IMF[1] shows that especially uncertainty regarding the macro outlook and economic policy hurts business spending and hiring, as well as household spending. The IMF has been very vocal in that the present level of uncertainty in policymaking is dampening the macro outlook.

On the positive side, some vital adjustments are gradually taking place in the debt-challenged part of the euro area. Current account deficits are declining, due not only to collapsing imports, but also to rising exports. Competitiveness is also slowly being restored in the critical countries, with the exception of Italy. The election result in Italy must be interpreted as a symptom of the growing fatigue with the necessary adjustment policies, and that the policies of acting Prime Minister Mario Monti do not go down well with the electorate, despite some structural improvements in the economy and lower funding costs for the eye-watering level of public debt. It is hard to understand what the Italians want and expect from their politicians. With a fiscal primary surplus, the situation in Italy—despite the unclear political leadership-is far from as alarming as that in Greece last year. However, with a weak outlook for growth and little acceptance for further structural improvements, Italy must maintain a tight grip on the fiscal situation. Presently, if sovereign spreads widen quickly, similar as they did in 2011, the parliamentary support for new fiscal and/or structural measures would be uncertain.

With a US and Chinese recovery under way, confidence in German manufacturing industry has recovered, although with a wobbly trend. Improving external

1 IMF World Economic Outlook Oct 2012

EMU industrial sector



Source: Eurostat

demand, high employment, and favourable financing conditions should provide room for capital spending and consumption, boosting the German economy while its neighbours are struggling.

The new government in **Japan** has started by taking a number of bold actions, including revising the monetary policy target and implementing a fiscal stimulus package. Monetary policy is now aimed at meeting an inflation target of 2 percent. Markets have reacted strongly to the new policy, trading the yen to its lowest levels in many years and turning the Nikkei index into one of the strongest-performing stock markets in recent months. Steering the economy onto a sustainable growth path is, however, another matter. We expect Japanese growth to remain at somewhat above 1 percent for the coming two years.

In the **Nordic countries**, the Norwegian economy has begun an overdue slowdown, avoiding wage pressure in the labour market and aided by additional measures to limit credit expansion. Finland had a weak 2012, but we see room for gradual recovery based on the global outlook. A consolidation of the public finance will have a dampening impact on the domestic demand. Denmark is still suffering from real estate and banking troubles but is recovering gradually based on a more favourable composition of exports.

The trend of a weaker currency in Japan, together with an uncertain recovery in external demand from China, makes the outlook for other **emerging economies** in Asia somewhat downbeat. For central and eastern Europe the high export dependence on the euro area dampens the outlook during the forecasting period. Latin America is a mixed bag, where the upbeat story is Mexico, benefitting from the recovery in the US. But also, from a structural perspective, Mexico has improved its potential growth through its recent labour market reforms. Brazil, on the other hand, faces challenges, as it is experiencing a trough in growth while its current expansionary fiscal policy threatens to raise the inflation rate.

Oil prices rose at the beginning of 2013, mainly explained by cold weather and low inventories. Based on higher global consumption but stable production, we have revised our forecast for the average oil price in 2013 to $110 ($107 in our January report). Furthermore, the pickup in global growth in 2014 is expected to raise the average oil price in 2014 to $111 ($109 in our January report.)

Base metals are expected to have a more gradual upward trend in line with global recovery. High metal inventories and subdued demand from end users will have dampening impact on metals. In 2014 however we foresee a stronger recovery in metal prices when the global growth is strengthening and inventories decreases. Agricultural prices are expected to rise less in 2013 than we expected in January due to a improved balance between demand and supply. A stronger global growth and higher production costs will press the food prices upward in 2014.

In the world of monetary policy, we expect the major central banks (the Federal Reserve, the European Central

Bank, the Bank of England, and the Bank of Japan) to maintain present policy rates during our forecasting horizon.

Neither the inflation outlook nor resource utilization call for any rate changes in 2013-2014. However, changes in asset purchasing programs are likely. Here, we expect the Federal Reserve to gradually cut back on their $85 billion-a-month purchases, starting later this year. In the foreign exchange markets, given our growth outlook and the monetary policy stance, we expect the US dollar to appreciate against the euro during the forecast period. The yen will continue to depreciate on the back of the revised economic policy in Japan, and the rouble is expected to strengthen against the euro, based on continued high world market energy prices, stronger growth compared to the the euro are, and progress concerning the macroeconomic policy framework.

Risk scenario

We keep the probability for our main scenario at 65%, the same as in the January report. Some negative carry-over effects from 2012 are affecting 2013, but with structural adjustments and pent-up demand around the corner, the outlook for a continued recovery is unchanged.

The probability of a worse outcome is, at 20%, the same as in our January report. The main negative risks are that financial markets, although following benign trends in the first quarter of the year, may find it difficult to stay on this path. Voters and policymakers are exhausted in many countries in the euro area. This raises the possibilities of mistakes, such as the proposed, but later abandoned, levy on insurance-protected deposits in Cyprus, or of opportunistic political leaders gaining popularity, which could suspend necessary but unpopular structural reforms.

Geopolitical risks are on the whole unchanged. Little progress has been made in the energy rich Middle East and the recent verbal exchanges between North and South Korea are, as yet, unlikely to have any immediate economic consequences.

Our upside risks, still at 15%, are based on a situation in which financial market pricing continues to support a recovery and the current political turmoil calms down. This would indeed be a best case scenario where companies would find the confidence to extend their planning horizons and invest, and households would find the confidence to increase consumption.

Cecilia Skingsley

Interest and exchange rate assumptions

	Outcome	**Forecast**			
	08 apr 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	0.50	0.50
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Exchange rates					
EUR/USD	1.30	1.27	1.24	1.20	1.25
EUR/GBP	0.66	0.86	0.85	0.83	0.80
USD/CNY	6.2	6.1	6.0	5.8	5.7
USD/JPY	99	100	102	105	105

Source:Reuters Ecowin and Swedbank

Sweden: The households grab the baton

Economic growth fell back in 2012 to 1.2% from 3.7% the year before, but, despite the slowdown, the outcome was better than we had expected. It was in particular the developments in the second half of the year that surprised on the upside, as exports defied the strong krona and weak external demand, and household spending held up despite weakening confidence. Nevertheless, labour market developments deteriorated, with increasing unemployment, and housing indebtedness remains a concern, albeit somewhat less than before.

The economic outlook for 2013 and 2014 has improved, but we do not expect a swift return to full employment and sound balances. Instead, growth will remain weak in the first half of 2013, and, when it increases later in the forecast period, it will be mainly on account of stronger domestic demand. Overall, we are revising up our growth projection for 2013 to 1.6% from 1.1% in our January forecast. Most of the improvement comes from the better-than-expected outcome in late 2012, but we also see a stronger pickup in economic activity than we previously foresaw. In 2014, GDP is set to rise by another 2.6%, which, although not bad, still leaves the Swedish economy below its potential. We expect employment to be relatively strong, but, due to an expanding labour force, the unemployment rate will continue to rise somewhat throughout 2013 before levelling off in 2014.

The economic policy discussion will be dominated by the upcoming elections in 2014 and will likely be centred on the high and rising unemployment rate. We believe that the government will face pressures to increase spending and lower tax rates, which, together with the still-weak economy, will result in budget deficits exceeding 1% of GDP. Monetary policy is less uncertain. Because the authorities refrained from lowering the policy rate in February, the main question now is when it will be raised. We think that a low rate is appropriate given the current state of the Swedish economy, and thus forecast that the Riksbank will wait until early 2014 before starting to raise the rate. At the end of that year, we expect the rate to be 1.75%.

Export sector decrease in significance

Swedish exporters are negatively affected by the weak global demand and the strong krona. In volume terms, the growth in exports fell from 7.1% in 2011 to 0.7% last year. The deceleration in exports was, however, lower than we had expected. In the fourth quarter, the export volume dropped, largely driven by a fall in goods. Export deliveries of vehicles showed the biggest decline, followed by telecom products. Although the export value in nominal terms fell sharply, the surplus in the current account balance was still large in 2012, above 6% of GDP. Since the exports sector is highly dependent on imports, the fall in export and industrial production also negatively affected import growth. In all, net exports contributed positively to GDP by 0.4% last year.

The increase in the purchasing managers' index (PMI) for manufacturing during the first quarter of 2013 and the slight uptick in export orders suggest that Swedish exports are recovering. The basis is, however, still fragile and the risk for a backlash is still significant, particularly if the recovery in the European markets falter. Another challenge is the appreciation of the krona. In trade weighted terms, the krona has reached its strongest level since the beginning of the 1990s.

The weak global demand and the relatively strong krona have affected companies' pricing strategies. As external demand has worsened, export prices in foreign currency have not been raised by exporters, which means export prices in Swedish currency have decreased. Prices on exported goods fell by 5% at an annual rate in February, and we foresee continued price pressures. This means that the profit margins in the manufacturing sector are squeezed and that productivity gains will be necessary to maintain profit levels. The alternative is to raise export prices in foreign currency, but this would instead lower market shares and reduce export volumes.

We expect that the world market growth for Swedish exporters in 2013 will be weaker than we forecast in January. In particular in the euro area, which accounts for nearly 40% of total Swedish export sales, market growth will continue to decrease. When the global economy recovers in 2014, Swedish exporters will see increasing demand. Overall, growth in Swedish export markets is expected to be close to 6% next year, compared with 4% in 2013. The

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012	2013f	2014f
Real GDP (calendar adjusted)	3.7	1.2	1.6	2.7
Industrial production	6.7	-3.2	-1.8	3.7
CPI index, average	3.0	0.9	0.3	1.8
CPI, end of period	2.3	-0.1	0.9	2.3
CPIF, average [2/]	1.4	1.0	1.2	1.5
CPIF, end of period	0.5	1.0	1.2	1.5
Labour force (15-74)	1.4	0.8	0.7	0.4
Unemployment rate (15-74), % of labor force	7.8	8.0	8.3	8.2
Employment (15-74)	2.3	0.6	0.4	0.4
Nominal hourly wage whole economy, average	2.4	2.9	2.9	3.0
Nominal hourly wage industry, average	2.5	3.9	2.8	2.9
Savings ratio (households), %	10.2	11.4	11.1	10.1
Real disposable income (households) [3/]	3.5	2.5	2.6	1.8
Current account balance, % of GDP	7.3	7.0	6.5	6.1
General government budget balance, % of GDP [4/]	0.0	-0.7	-1.1	-1.0
General government debt, % of GDP [5/]	38.4	38.2	38.7	38.0

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

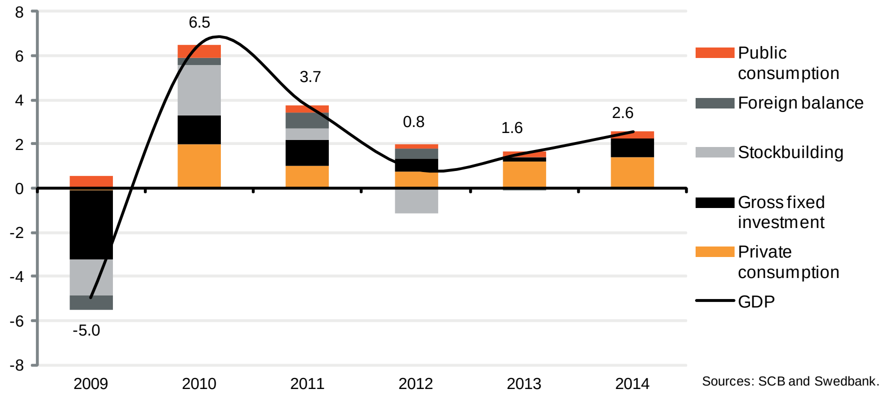
rebound in Swedish exports will, however, be limited due to the modest recovery in global investments. Since actual GDP is still far below potential in several OECD countries, investments will remain subdued. Swedish exports of investment goods, such as vehicles and machinery, have not yet rebounded to their export values of 2008. In emerging market economies, however, export possibilities are better.

Although the increase in unit labour costs is expected to decelerate due to a stronger productivity growth, a relative strong krona will have a dampening impact on the Swedish export performance. Overall, we expect a growth in total export volume of 0.9% in 2013 and 4.2% the next year. The growth contribution from foreign trade is expected to be negative in 2013 and zero in 2014 due to solid domestic demand and a restocking of inventories as production in industry gradually recovers. A longer period with a strong krona would also lead to changes in the purchasing pattern towards imports both within manufacturing and for private services.

Low capacity utilisation holds back investment

Total gross fixed investment volume increased by 3.4% last year. After two consecutive quarters of falling investment, the volume started to pick up at the end of last year. However, the development varies between sectors. In mining and energy, investment increased sharply and contributed to a higher overall investment growth

Contribution to growth (percentage points)



Sources: SCB and Swedbank.

in 2012 (7.3%) compared with 2011 (6.2%). In other parts of the private sector, investment activity was significantly weaker. In manufacturing, the investment volume fell at the end of last year due to a low utilisation rate and growing uncertainty about the economic outlook. A sharp decline in the number of housing starts led to a further decrease in real estate investment. Higher housing prices, lower nominal interest rates, and a resilient labour market have so far not had a significant effect on Swedish housing construction. Public investment picked up by 3.9% in 2012, driven primarily infrastructure investments.

Confidence in the business sector has improved since our forecast in January, but we still expect a weak investment performance during 2013. Overall, gross fixed investment is forecast to grow by a modest 1.8%. A low utilisation rate, shrinking profit margins due to unfavourable unit labour cost developments, and uncertainty about the strength of the global economy will have a dampening impact on business investments. The investment plans for manufacturing were revised downwards in the latest survey from Statistics Sweden. Although production capacity in mining and energy is expected to continue expand, the growth rate is expected to be significantly lower than last year.

A rebound in gross fixed investment is expected at the earliest in 2014, when the capacity utilisation in the Swedish economy will rise and global growth improves. There are several fundamental factors behind the expected increase in real estate activity next year. A lack of housing, improved purchasing power for Swedish households, and growing population will drive higher investment in housing in 2014. We also foresee additional initiatives by the government to stimulate investments in real estate.

A strong labour market cannot prevent rising unemployment

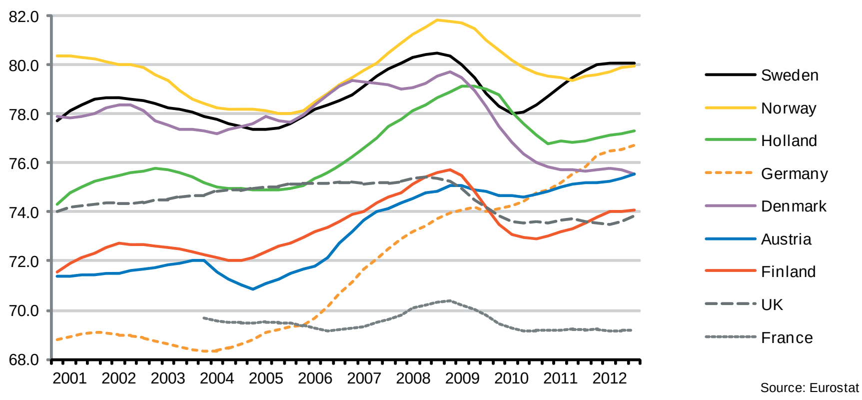
The labour market developed markedly better than expected in 2012, but the unemployment rate nevertheless inched up. Employment actually increased, but the labour force increased even more and unemployment therefore rose somewhat. The slowdown in employment growth towards the end of last year, together with the rise in the number of layoff notifications, point to a continued deterioration on the labour market. However, recent labour market data have been surprisingly resilient. Furthermore, forward-looking labour market indicators have improved, suggesting firms see less need to reduce staffs. Thus, we expect the deterioration in the labour market to be relatively modest. Unemployment is expected to increase to 8.3% on average this year

Swedbank's GDP Forecast – Sweden

Changes in volume, %	2011	2012[1/]		2013f[1/]		2014f[1/]	
Households' consumption expenditure	2.1	1.5	(1.4)	2.5	(2.1)	2.9	(3.0)
Government consumption expenditure	1.1	0.8	(0.5)	1.0	(0.8)	1.2	(1.1)
Gross fixed capital formation	6.4	3.4	(3.1)	1.1	(1.0)	4.2	(4.2)
private, excl. housing	6.2	7.3	(6.8)	2.8	(1.7)	4.8	(5.1)
public	-1.4	3.9	(2.9)	2.3	(3.1)	3.8	(2.9)
housing	14.7	-9.1	(-8.1)	-6.4	(-3.5)	2.3	(2.2)
Change in inventories [2/]	0.5	-1.1	(-0.8)	0.0	(-0.2)	0.0	(0.0)
Exports, goods and services	7.0	0.7	(0.0)	0.9	(1.0)	4.2	(4.0)
Imports, goods and services	6.3	-0.1	(-0.6)	1.2	(1.5)	4.7	(4.7)
GDP	3.7	0.8	(0.8)	1.6	(1.1)	2.6	(2.5)
GDP, calendar adjusted	3.7	1.2	(1.1)	1.6	(1.1)	2.7	(2.6)
Domestic demand (excl. inventories) [2/]	2.5	1.6	(1.4)	1.6	(1.4)	2.5	(2.5)
Net exports [2/]	0.7	0.4	(0.3)	-0.1	(-0.1)	0.0	(0.0)

Sources: Statistics Sweden and Swedbank.
1/ The figures from our forecast in January 2013 are given in brackets.
2/ Contribution to GDP growth.

Employment rate (% of population, 20 to 64 years, 4q ma)



from 8.0% in 2012, and we expect the rate to peak in late 2013 or early 2014. The reduction of unemployment in 2014 will, however, be protracted, and the rate will fall only to 8.2% on average in the year. Employment will continue to grow during the forecast period at a decent pace at 0.4% each year.

Household real disposable incomes will be supported by the relatively robust employment growth, positive wage developments, and low inflation. In 2013, higher pension payments will also boost disposable income. Recent wage agreements and a somewhat better labour market outlook imply a slight upward revision of nominal wages for 2014. Together with the strong krona, this will pressure Swedish companies' cost competitiveness abroad. This will be partially alleviated by a pickup in productivity growth in 2013 and 2014, following the decline in 2012. We expect unit labour costs to increase at a slower rate in the next two years.

The structural change that was intensified by the financial crisis in 2008-09 is expected to continue and have a profound impact on the Swedish labour market. Employment in the manufacturing sector is expected to continue to decrease, and many of the jobs that are now disappearing will not come back. Employment in the services sector has surprised positively and is expected to partially mitigate the loss of jobs in the manufacturing sector. In particular, we have seen steady increases in employment in the education and health sectors. Furthermore, services will be less affected by the strong krona. However, this means that the need for retraining and re-education will grow and be crucial for a smooth transition.

Growth in the labour force continues to be affected not only by the trend of people remaining in the labour market at increasing ages but also by the growing participation of foreign-born people in the labour market. The government's labour market reforms and tax reductions for wage income have had positive effects on the labour market. For instance, the number of persons affected by sickness benefits and early retirement decreased from more than 550 000 persons in 2007 to around 375 000 persons at the end of 2012. The overall participation rate has increased from 70.6% in 2009 to 71.1% in 2012 (from 66.2% to 68.1% for foreign born), while the employment rate in Sweden is among the highest in Europe.

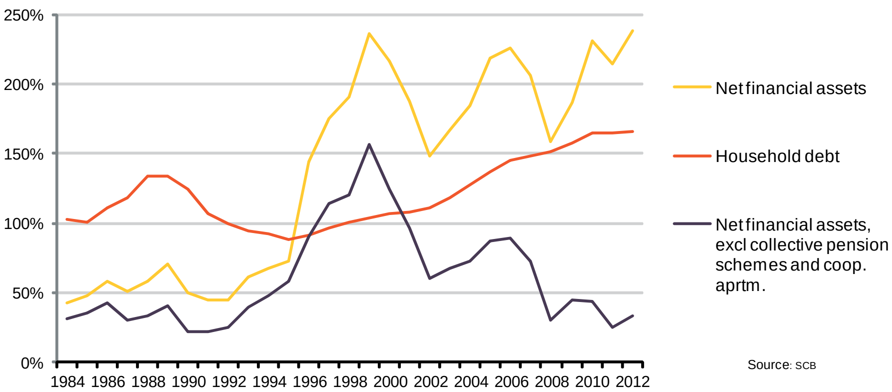
Many challenges remain however. The increasing number of long-term unemployed together with the structural changes in the labour market has likely raised the equilibrium rate of unemployment. It will require continued labour market reforms and targeted measures to bring this rate down. The social costs are also significant as longer-term unemployed will face diminished prospects for employability, productivity, and lifetime income. Hence, there are plenty of reasons for policymakers to mitigate the effects of structural change and facilitate the return to work for of those who are affected.

Private consumption kicks in

Household spending growth slowed during the winter months, but provided nonetheless the biggest contribution to growth in the fourth quarter. The main boost came from rising housing expenses, which to a large extent was involuntary as cold weather raised heating consumption. The relatively harsh winter, together with the strong krona, also increased spending abroad; meanwhile, transport expenses fell back, owing partly to new environmental regulations on vehicles and to higher petrol prices. Overall during 2012, private consumption grew in real terms by 1.5%, which is significantly lower than the 2.1% recorded in 2011; this suggests that households were cautious.

This cautiousness can be partly explained by the weakening last year of the labour market, which dampened household income growth. Lower inflation and falling interest rates, however, mitigated the slowdown. In real terms, disposable income grew by 2.5% in 2012, compared with 3.5% in 2011. Part of the decrease can be explained by the reduced disbursement of collectively agreed pensions. These are expected to return to normal levels this year, which, together with solid increases in real wages, raises disposable incomes in 2013 despite a soft labour market. Next year, an increase in interest rates will reduce real wages,

Households' balance sheet (% of disposable income)



and despite growing employment and election-related fiscal expansion, real disposable income is expected to grow at 1.8%. Thus, although the household economy has been a stabilising factor in recent years, we do not expect a rapid reversal of its purchasing power over the forecast period.

However, households' balance sheets have become stronger as borrowing has slowed and savings have increased. Average monthly credit growth dropped in 2012 to 4.7% from 6.5% in 2011, and the savings ratio picked up from 10.2% of disposable income in 2011 to 11.4% in 2012. The increase in savings was particularly large in the first half of last year, reflecting the uncertainties surrounding euro area developments. This means that debt as a share of disposable income, although still high at around 165%, has levelled off in recent years, and that net wealth has increased. Household indebtedness remains high in Sweden and, as such, is a vulnerability; at the same time, however, households' balance sheets have strengthened, which should support solid consumption growth in the coming years.

Against the backdrop of solid household finances, a slowly improving labour market, and pent-up demand, we expect private consumption to rebound in the next two years and provide the foundation for overall economic expansion. Following a recovery of consumption to 2.5% in 2013, compared with 1.5% in 2012, the consumption growth rate is forecast to reach almost 3% in 2014. Improved consumer confidence early in the year and a pickup in spending on both durables and nondurables in the first two months already suggest an improved momentum. Correspondingly, the savings ratio is expected to decrease to 11.1% of disposable income – still high by historical standards. While we expect the savings ratio to continue to decline in the medium term, changes to the social welfare system (to unemployment benefit replacement levels and in the pension system) in Sweden in recent years are likely to keep equilibrium saving higher than in the early 2000s.

We expect household consumption to be the main driver of growth in the next two years, but renewed external turmoil, in particular in the euro area, could cause precautionary savings to pick up again, with a negative impact on overall domestic demand. In addition, household finances have become more vulnerable to interest rate movements, and larger-than-expected increases, due either to heightened risk perceptions or a stronger economic recovery, would cut into consumers' purchasing power.

Monetary easing has come to an end

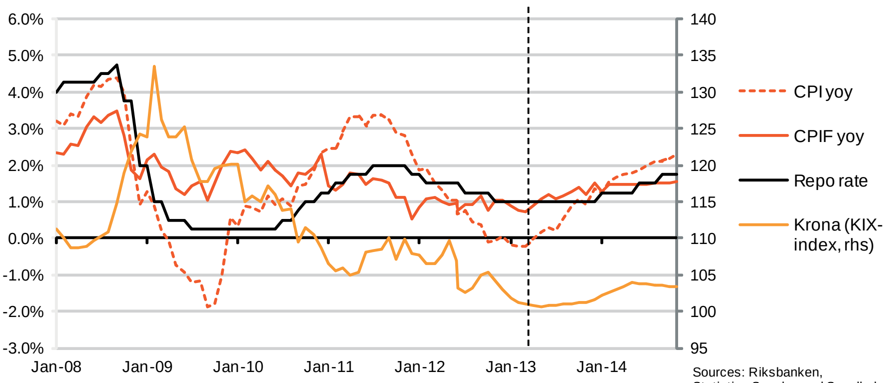
Contrary to our expectations, the Riksbank did not continue to lower the repo rate early this year, and the likelihood for further easing has diminished. Although we believe that the rate cut in December should have been followed by one more in February, not least because of the still-high unemployment level, low inflation, and large interest rate differentials vis-à-vis the main trading partners, the main question now is when the repo rate will be raised. There will also be much discussion about the macroprudential framework, and possible actions, given the continued concerns expressed about housing prices and household debt levels by the majority of the Riksbank's board.

From the point of view of fundamental macroeconomic developments, monetary policy in Sweden remains too tight. Underlying price developments (the CPIF) are still far from the target of 2%, and we have revised down our forecast to 1.1% at the end of this year and to 1.5% at the end of 2014. Unemployment is increasing, albeit not by as much as feared in our January forecast. Thus, the risk of wage pressures is still moderate, despite a possible increase in structural unemployment due to the prolonged of high unemployment levels. In addition, the relatively high repo rate adds to the appreciation pressure on the krona. Besides Sweden's status as a safe haven, on account of its relative strong economic performance, the interest rate differential attracts additional flows. The stronger krona, in turn, pushes down price pressures in Sweden, providing another reason for a looser monetary policy. Over the next two years, we do not expect any significant changes in the value of the krona, only a moderate depreciation; therefore, maintaining the competitiveness of Swedish production will remain a challenge.

We furthermore believe that the repo rate is too blunt a tool to use to reduce the risks of housing prices and household indebtedness levels. Instead, the development and application of more targeted macroprudential instruments would be welcome. The financial supervisor authorities have already announced that minimum risk weights of 15% for mortgages will be introduced, which will add to the effects of the loan-to-value cap of 85% on housing credits. This cap has been effective. Further increases in the risk weights for mortgages are a possibility. More generally, increased short-term liquidity buffers for financial institutions and enlarged international reserves will also lower the risks emanating from the financial sector.

We do not expect tightened macroprudential regulations will have an immediate effect on the monetary policy

Inflation, the repo rate and the exchange rate



Sources: Riksbanken, Statistics Sweden and Swedbak.

stance. Instead, we forecast that the repo rate will remain at 1% until the first quarter of 2014, and then be raised stepwise to 1.75% by the end of the year. These actions, although roughly in line with the Riksbank's own policy rate path, would underpin the low inflation rate and the strong currency. Consequently, a looser monetary policy would more effectively combat unemployment and raise economic growth, although at the same time raising the risks on the housing market. Specific macroprudential measures would make it possible to more directly address the risks related to the housing credit market.

Fiscal stimulus still in the cards

The estimated budget deficit for 2012 turned out worse than we had expected in our January forecast. Revenues underperformed, mainly on account of lower revenues from profit taxes from enterprises, while spending increased predominantly in the areas of transfers to households. On the revenue side, taxes on labour income and consumption increased, although not to the same extent. On the expenditure side, higher pension payments accounted for the main part of the increase; these followed the large upward revisions of income pensions. Overall, public finances recorded a deficit of 0.7% of GDP in 2012, compared with a zero balance in 2011 (and compared with our estimate of -0.4%).

For the next two years, we expect the government balance to continue to worsen, although the better growth outlook will limit the deterioration. The government has already announced additional measures in the Spring budget on education. However, the better-than-expected developments in the labour market, with lower unemployment numbers than feared, reduce the pressures for extraordinary initiatives. Instead, we expect that the spring budget will mainly focus on policy measures (which normally is the case), and prepare the ground for additional spending initiatives in the regular budget for 2014 (to be presented in September). In addition to the SKr 25 billion in unfinanced spending for 2013, we expect SKr 20 billion to be allocated in the 2014 budget. This will mainly be used to reduce youth unemployment and to lower the tax on pension incomes. Overall, the deficit is forecast at 1.1% of GDP in 2013 and 1.0% of GDP in 2014. This is not unreasonable, given the continued weak business cycle, but in our view this is the last year in this cycle in which fiscal policy will be able to support real economic activity.

Interest rate and currency outlook

	Outcome 2013 8 Apr	Forecast 2013 30 Jun	2013 31 Dec	2014 30 Jun	2014 31 Dec
Interest rates (%)					
Policy rate	1.00	1.00	1.00	1.25	1.75
10-yr. gvt bond	1.66	2.05	2.50	3.15	3.30
Exchange rates					
EUR/SEK	8.35	8.20	8.15	8.30	8.30
USD/SEK	6.42	6.40	6.60	6.90	6.65
KIX (SEK) 1/	101.0	100.7	101.2	103.9	103.3

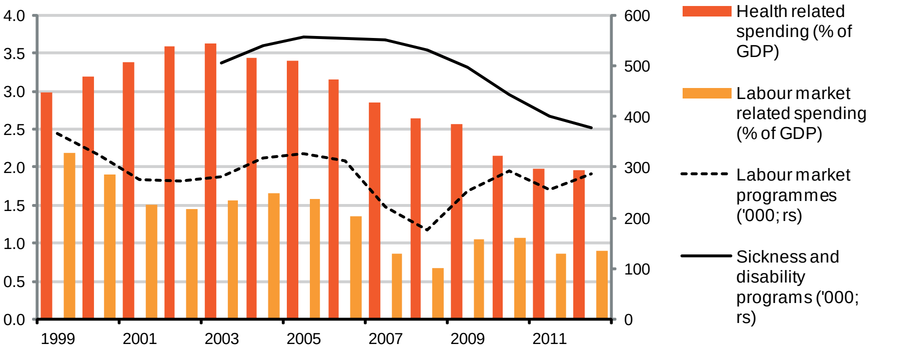
Sources: Reuters Ecowin and Swedbank.
1/ Total Competitiveness Weights (TCW: i.e. trade-weighted exchange rate index for SEK).

Although the deterioration of the fiscal balances over the next two years can, to some extent, be explained by the soft economy and weak economic growth, it is also partly a result of the structural changes that followed policy decisions. Revenues, as a share of GDP, will be lower due to both the in-work tax credits on labour income and the reduced tax rate on profits, which will permanently lower the tax take. This followed the abolition of the property and estate taxes. A partial compensation has been accomplished by lower spending relating to health and disability insurance. Also, spending on other public welfare programmes, such as unemployment insurance and child benefits, has not been raised in line with nominal GDP, thus reducing its share of the economy. This also means, in many instances, that the real value of these benefits has been eroded, and that pressures to restore them will increase.

The discussion of not only the fulfilment, but also the appropriateness, of the fiscal framework and the surplus target is, therefore, expected to intensify. At the current trajectory, in particular if the elections next year are associated with increased spending and lower tax rates, the need to tighten the fiscal stance to meet the targets will become even more urgent. Furthermore, if the real spending levels are to be preserved (i.e., no significant reductions in the volume or quality of the welfare system), tax rates need to be raised, or cuts be made in other areas. Thus, following the next elections, we expect to see a more fundamental debate on the overall extent of the public sector social policy commitments and on whether the relatively large reductions in the tax rates that have been implemented will mean a substantial shift in the Swedish welfare system. This should, in our view, already be the main focus in the election campaign.

Magnus Alvesson
Jörgen Kennemar
Knut Hallberg

Costs and number of persons in welfare programmes



Sources: SCB, NIER, and the Swedish Social Insurance Agency.

Estonia: External demand- how much we miss you

In 2012, Estonia's economic growth decelerated sharply to 3.2% from a high 8.3% a year before. On the supply side, GDP growth was negatively affected mainly by the contraction of manufacturing, mining, and real estate activities, while the construction and ITC sectors made the largest positive contributions. Manufacturing, the largest sector in the Estonian economy, depends considerably on foreign demand, which declined last year. Instead, economic growth was supported mainly by domestic demand.

Public investments in buildings and infrastructure financed by EU transfers and revenues from CO2 quota sales were the main driver behind the growth of domestic demand. These investments also led to a robust expansion in construction. Despite favourable lending conditions and increased profits, nonfinancial corporations invested sparingly, most likely due to the poor outlook on both the domestic and foreign markets. At the same time, companies have sufficient spare capacity to increase their output if demand should improve. The global economic slowdown and the recession in euro area countries, the latter affected by austerity policies, had a negative effect on Estonia's major trading partners in the Nordic area. This was reflected in the drop in new orders for subcontracting, on which Estonia's economy is heavily dependent. Exports were not broad based and were dominated by only a small number of activities. However, the last quarter of 2012 was a positive surprise, as GDP growth accelerated to 3.7%, mainly due to higher exports.

Although government finances in the euro area are starting to improve and the fiscal stance is gradually becoming less contractive, this is not enough for foreign demand to support considerable acceleration of Estonia's economic growth in 2013. In addition, we have revised down GDP growth forecast for Russia, one of our main trading partners. The business cycle is expected to pick up gradually at the end of this year, bringing about a recovery of economic activity in the euro area next year. Based mainly on domestic demand, GDP growth in Estonia is expected to reach 3.3% in 2013 and accelerate to 4.2% next year, with additional support from exports. The Estonian economy will grow close to its potential during the forecast period.

Risks to the Estonian economic outlook have both an external and internal origin. External inflation pressures are likely to diminish in the second half of 2013, as lower-than expected in our January forecast global food prices will pass through to the consumer level. Although, we have lowered estimates of global metal prices in euros for this year, these prices will grow faster than in 2012. The growth of oil prices is expected to accelerate modestly. However, if global demand for commodities exceeds supply, especially next year when economic growth is expected to accelerate, external price pressures could be bigger. Inflation could also rise more than expected due to domestic factors, in particularly wage pressures arising from the structural rigidity of the labour market that manifest themselves in a mismatching of supply and demand of labour. As unemployment has reached close to its equilibrium level (NAWRU),[1] an increase in labour demand, together with an acceleration of economic activity next year, could generate wage pressures. Last year, wage increases exceeded labour productivity gains and drove up unit labour costs (ULCs). ULCs of both export-oriented manufacturing and the total economy have been rising since the end of 2011. The increase in ULCs reduces the profit margin of corporations and puts upward pressure on prices to compensate it. This, in turn, puts pressure on the cost competitiveness of Estonian products on foreign markets and can dampen exports, especially when the ULC of a sector grow faster than the comparable one in our main trading partners. Therefore, a buildup of productivity is of the utmost importance for companies' competitiveness. One way to raise productivity is by improving the work process and skills of the labour force. Another, more fundamental, solution for the economy could be a move towards the production of higher-value-added output. A delayed recovery of the euro area economy and lower-than-expected economic growth in some of Estonia's main trading partners would worsen the situation for the export-oriented sector.

Foreign demand to pick up towards the end of the year

In 2012, export growth fell to 5.6% from 23.4% the year before, and the foreign trade balance deteriorated considerably. Weakened demand from Estonia's trading partners was one of the main reasons for the slowdown. Import growth decelerated as well (although at a slower pace), as the import content

Key Economic Indicators, 2011 - 2014 1/

	2011	2012	2013f	2014f
Real GDP	8.3	3.2	3.3	4.2
Nominal GDP, billion euro	16.0	17.0	18.1	19.4
Consumer prices (average)	5.0	3.9	3.3	2.9
Unemployment rate, % 2/	12.5	10.2	9.5	8.9
Real gross monthly wage	0.4	1.9	3.0	3.6
Exports of goods and services (nominal)	28.3	7.7	7.2	9.7
Imports of goods and services (nominal)	34.1	11.9	7.7	9.5
Balance of goods and services, % of GDP	6.4	2.3	1.7	1.8
Current account balance, % of GDP	2.1	-1.2	-2.5	-2.7
FDI inflow, % of GDP	1.2	6.7	6.1	6.2
Gross external debt, % of GDP	97.1	98	95	91.3
General government budget balance, % of GDP 3/	1.2	-0.3	-0.5	-0.1
General government debt, % of GDP	6.2	10.1	10.2	9.9

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.

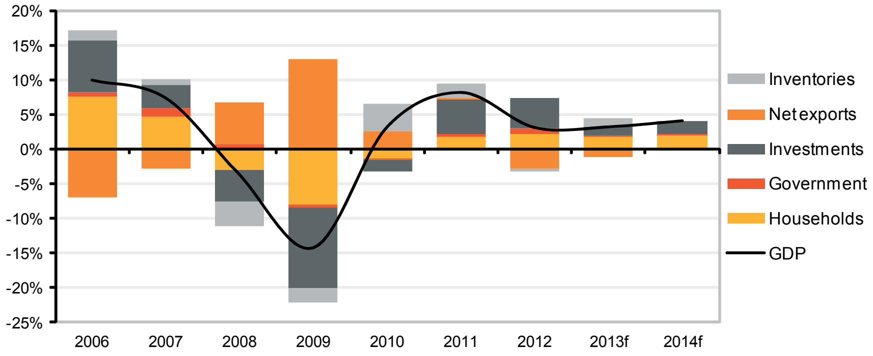
1 Nonaccelerating wage rate of unemployment.

in Estonian production is considerable. More than 60% of the value of imports is used in intermediate consumption of the production process. The share of imported goods for processing (subcontracting) and storage (re-exports) has increased in exports. Robust public investments, however, moderated the decline in imports.

The share of both total exports and imports in GDP has already risen to above 90%. Manufacturing is the major industry contributing to the growth in exports of goods in Estonia. Last year, the share of exports in manufacturing sales was 71%. The dominant contribution came from exports of computer and electronics production, of which the main part (99%) was exported. Exports of manufacturing output, with the strongest contribution from computers and electronic products, improved in the last quarter of 2012. An expected pickup of foreign demand will open the opportunity for more broad-based exports.

Estonia's largest export partners have been mainly its neighboring countries. Although the share of the euro area in exports of goods has diminished to less than 30%, its economic performance affects Estonia's main trading partners outside the area as well. Therefore, the influence of euro area countries on Estonia's export sector can be larger than the data on countries of export destination may express. Economic conditions in two of Estonia's main trading partners, Sweden and Finland, worsened in the second half of 2012; in Finland, somewhat earlier. This was partially compensated by stronger exports to the other Baltic countries and to Russia. In 2012, Estonia's trade surplus was the largest with Russia and Sweden. Although Russia has become a more important export partner, a considerable share of total exports to Russia is re-exports.

Contributions to GDP growth



Sources: Statistics Estonia, Swedbank forecast

We expect the recovery of the European economy and the acceleration of global growth to be protracted. Considering Estonia's main trading partners, we have revised down the GDP growth forecasts for the euro area and Russia for this year. On the contrary, growth projections of Sweden and Finland have been revised up slightly. As the economic outlook will not support the considerable improvement of foreign demand, the growth of Estonia's export of goods and services will decelerate to 4.7% in real terms in 2013. We expect the recovery of its main trading partners will contribute to Estonia's export growth, starting in the second half of 2013. Next year, export growth is forecast at 6.2%.

Import growth will be based mainly on goods for final consumption by households and on corporate investments in machinery and equipment. Growth will decelerate to 6.1% this year (from 9.1% in 2012) and will grow by 6.2% in the next. Since import prices have increased faster than export prices, Estonia's terms of trade have worsened. Due to higher imports of investment goods (e.g., machinery and equipment, industrial equipment, and rail transport), and to the worsening terms of trade, the foreign trade balance deteriorated considerably in 2012. After three years of positive results, the current account recorded a deficit of 1.2% of GDP. The balances of the other transactions of the current account did not change much. As exports grow less than imports, the external balance will worsen this year and the next; however, the current account deficit remains sustainable.

Decreasing contribution by government will bring down investment growth

Last year's investment growth was mainly supported by government investments in buildings and infrastructure, which were financed by EU transfers and revenues from CO2 quota sales. Corporations invested moderately, primarily in machinery and equipment, but also in buildings and infrastructure. External financing from EU transfers and the CO2 revenues will decrease sharply this year, even more the next and government investments are set to decrease both in 2013 and 2014. The slowdown of investment growth started already at the end of last year. EU-funded transfers in the new EU budget for 2014-2020 will take time to reach the Estonian economy. However, private sector borrowing has gradually recovered and started to

Swedbank's GDP Forecast – Estonia

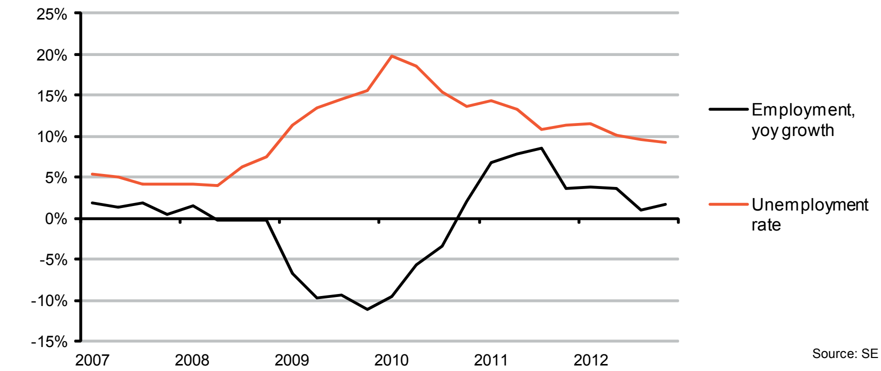
Changes in volume, %	2011	2012[1/]		2013f[1/]		2014f[1/]	
Household consumption	3.5	4.5	(4.5)	3.5	(3.5)	3.9	(4.1)
General government consumption	1.4	4.0	(3.0)	1.3	(1.3)	1.5	(2.0)
Gross fixed capital formation	25.9	20.9	(22.9)	4.8	(1.7)	6.3	(2.7)
Inventories [2/]	2.1	-0.3	(-0.2)	1.1	(-1.5)	0.0	(0.1)
Exports of goods and services	23.4	5.6	(5.8)	4.7	(4.9)	6.2	(6.2)
Imports of goods and services	25.0	9.1	(10.4)	6.1	(6.2)	6.2	(4.9)
GDP	8.3	3.2	(3.0)	3.3	(3.1)	4.2	(4.5)
Domestic demand (excl. inventories) [2/]	9.8	7.3	(6.6)	3.4	(2.8)	4.1	(3.3)
Net export [2/]	0.1	-2.9	(-3.8)	-1.2	(-1.2)	0.0	(1.3)

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

grow in the last quarter of 2012. This consisted mainly of loans for asset purchases and expansion of business activity, which refers to the increase in capacity utilization. Despite favourable lending conditions, the share of loan capital in investments has been relatively small. As corporate balance sheets have been strong, a considerable part of investments have been financed from retained earnings. Although profits have increased, we expect companies to continue to invest moderately this year, primarily due to the still-uncertain outlook for foreign demand. Companies have sufficient spare capacity to increase their output if demand should improve. Therefore, we expect that corporate investment growth will not pick up and total investment growth will decelerate this year to 4.8% in real terms from 20.9% in 2012. In conjunction with the expected improvement in the economic outlook and, as a result, stronger economic activity towards the end of the year, corporate investments are forecast to rise moderately. Investments in machinery and equipment are likely to increase the most. We expect lending conditions to remain favourable, supported by low interest rates. In 2014, total investment growth is set to accelerate to 6.3%.

Although the growth of investments will come mainly from the corporate sector, households' residential investments will keep growing moderately as well. Households' borrowing will be boosted by the improved sentiment, low interest rates, and higher incomes. Activity on the real estate market has already strengthened. The number of transactions, as well as the

Labour market indicators



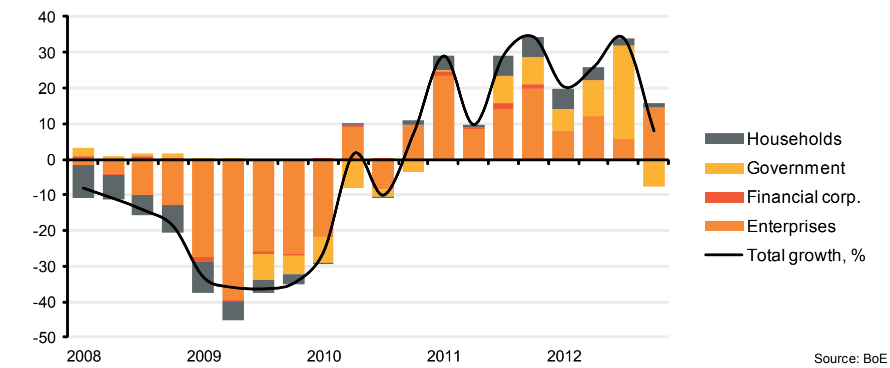
prices of dwellings, has risen moderately. We expect that this activity will pick up further as the economic situation strengthens.

Raising labour productivity will be inevitable

Despite a deceleration in employment growth in 2012 to 2.5%, the unemployment rate fell to 10.2% from 12.5% the year before. In the second half of the year, unemployment fell below 10%, as 63,800 people were unemployed in the last quarter of 2012. Employment growth decelerated mostly because of the decrease in the number of employees in manufacturing and mining. Employment in manufacturing fell by approximately 3% due to the weak economic performance and diminishing profits of the sector. At the same time, employment in education, administrative and supportive activities increased considerably.

The labour force participation rate has risen to its highest level, at around 68%, and the employment rate has also increased considerably, to around 61%. Even though there is still a relatively large number of unemployed people, corporations have difficulties in finding personnel. Structural unemployment and an adverse demographic situation limit the potential growth of employment and the possibility of significantly reducing unemployment during the forecast period. The location and skills of labour do not match sufficiently well the needs of corporations. In particular, the lack of qualified labour is increasingly becoming a restriction. Therefore, the government should address the issue of retraining and enhancing the skills of those currently unemployed. We expect that employment growth will decelerate considerably during the forecast period, to 0.4-0.5%. An improvement in economic activity in 2014 will support employment growth only marginally and we expect that unemployment will decrease to 9.5% this year and 8.9% in 2014.

Contributions to investment growth, pp



Despite the increasing scarcity of qualified labour, wage pressures have been contained. In 2012, wages increased by 5.9% in nominal and by 1.9% in real terms.

Last year, wage increases exceeded labour productivity gains and drove up ULCs. According to our estimates, labour productivity will increase during the forecast period. We expect that corporations, on average, will keep their labour costs under control and the gap between wage growth and productivity growth will shrink. A buildup of labour productivity is of the utmost importance for companies' competitiveness. This presumes an improvement in both the work process and labour skills. Wages are expected to rise in nominal terms by 6.3% this year and 6.6% in 2014. As employment growth will decelerate, the contribution of labour productivity to economic growth will increase.

External inflation pressures are likely to fall this year

In 2012, higher prices on food and motor fuel, together with increased housing costs, limited the purchasing power of households. Driven considerably by price pressures of global commodities, consumer prices increased annually by 3.9%. A hike in electricity prices in the beginning of this year, as a result of the opening of electricity market, together with an increase in excise taxes on alcohol and tobacco, were partially compensated by lower transport costs due to the introduction of free local public transport service in Tallinn. External inflation pressures are likely to diminish in the second half of 2013, as lower-than-expected in our January forecast global food prices will pass through to the consumer level. In addition, we have lowered estimates of global metal prices for this year, although these prices will grow faster than in 2012. Oil prices are expected to grow modestly. Electricity prices, higher than last year, will have a considerable effect on consumer prices this year, especially during the heating period, but the effect will recede next year because of the base effect. At the same time, the expected wage increase could raise prices of services and somewhat accelerate core inflation. In 2014, both oil and food prices are expected to increase modestly. We expect inflation to slow to 3.3% this year and further to 2.9% in 2014.

Private consumption will be the main driver of economic growth

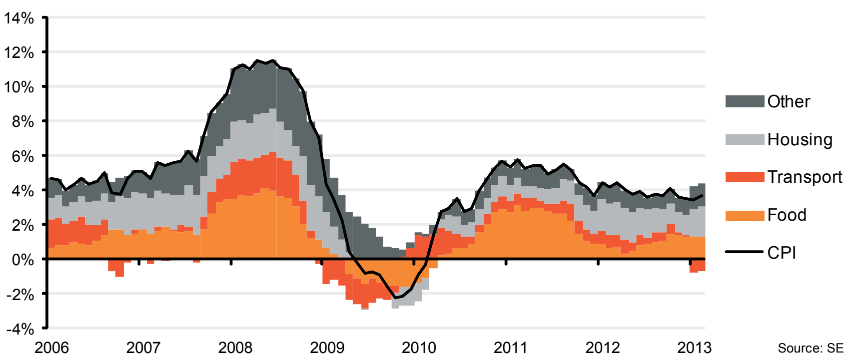
In 2012, private consumption developed in line with the wage bill and rose in real terms by 4.5% with its growth accelerated in the second half of the year. Households' deposits continued to increase last year as the growth of demand deposit stock exceeded the slowdown in savings deposits. In this connection, low interest rates have made saving less attractive. However, the increase in households' deposits has been uneven, with larger deposits growing considerably faster than other deposits. The increase in demand deposits in excess of savings deposits has raised liquidity for many households, which could have a positive effect on final consumption.

The government has committed itself to easing the tax burden[2] and shifting it partially from direct income taxation to consumption, the use of natural resources and environmental pollution. Consumption of alcohol, tobacco, and fuel will be made more costly by an increase in excise taxes, with income taxes lowered by a reduction in the unemployment insurance premium and income tax (from 21% to 20% in 2015).

We expect some deceleration in the growth of private consumption, to 3.5% this year and 3.9% in 2014. Although wages will increase both in nominal and real terms in 2013, the slowdown in employment growth will also slow the growth of the wage bill and final consumption. At the same time, the reduction in the unemployment insurance premium, as well as the increase in the minimum wage and pensions (beginning April of this year), will boost households' purchasing power and final consumption. The wage bill will accelerate next year, together with the growth in wages and employment. Private consumption will be a substantial contributor to GDP growth during the forecast period.

2 32.9% in 2013 and 32.1% in 2014.

Contributions to CPI annual growth



Public finance will remain under control

Estonian public finances are among the strongest in the euro area. Although, after two years of surplus, the general government budget fell into a deficit of 0.3% in 2012, this was a bit less than expected in our January forecast. The result was influenced primarily by the expenses made in the account of proceeds from assigned amount units[3] received in previous years and the investments. Postponing some government investments from CO2 quota sales revenues will have a negative impact on the 2013 budget balance. However, government investments will decrease by 8% this year, and investments from CO2 quota sales revenues will decline by 11%.

The government is determined to implement a tight fiscal policy. During the next few years, nonpermanent expenditures will be reduced, limiting expenditure growth. However, increases in public sector wages and pensions, the reduction in the unemployment insurance premium, and anticipation of the elections (local elections in October 2013 and the general election in March 2015) may have a negative impact on the budget balance. We expect general government nominal budget deficit of 0.5% of GDP in 2013 and 0.1% in 2014.

Estonia's government debt has been by far the lowest in the euro area. In 2012, the general government consolidated debt rose to 10.1% of GDP. This was influenced considerably by a loan from the European Investment Bank for the construction of roads and the co-financing of foreign projects, as well as by guarantees given to the European Financial Stability Facility (EFSF) (2.1% of the GDP). We expect that the contribution of EFSF will increase slightly. As the rest of the central government debt will decrease and local government debt will increase modestly, the general government debt is expected to stay around 10% during the forecasted period.

Tõnu Mertsina
Teele Reivik

3 CO2 quota sales revenues

Latvia: On track towards the euro

Economic growth has exceeded 5% for two years now, and growth remained robust throughout last year. In 2012, exports were the fundamental source of growth, supporting both private consumption and investments. At the same time, import growth was weak, due partly to businesses' reducing their inventories and partly to a swing in investment composition from machinery and equipment towards buildings and structures. Vigorous job creation (4.8% employment growth net of active labour market programmes) lowered the unemployment rate, but also lured previously inactive people to the labour market. Meanwhile, job vacancy rates have remained low and new openings are filling up quite quickly. Domestic inflationary pressures have been low.

Latvia formally applied for euro area membership in early March. Convergence reports by the European Central Bank and the European Commission (EC) assessing Latvian readiness to adopt the euro are expected in early June. The final decision by the Economic and Financial Affairs Council will be taken in July, and our base scenario foresees Latvia joining the euro area on January 1, 2014.

Acknowledging the strong and balanced economic recovery and significant improvements in Latvia's public finances, Moody's was the last of the major rating agencies to raise Latvia's sovereign rating, to Baa2 (the same as a BBB by Fitch and S&P, i.e., two notches above the speculative grade), with a positive outlook. Moody's rating for Estonia is still four notches − and, for Lithuania, one notch − above that of Latvia. We expect Latvia's sovereign ratings to continue to improve towards the end of the year.

We retain our view that economic growth will slow somewhat this year due to weak external demand and rising competition in export markets. Yet, we have revised up our GDP growth forecast to 4.3% for 2013 (4.1% before), as lower consumer price inflation implies stronger purchasing power and, thus, private consumption growth. We forecast also marginally better export growth due to better-than-expected developments in late 2012 feeding into 2013. We retain our forecast of 5% GDP growth in 2014, owing to better external demand as the global outlook improves and rising domestic demand supported by local labour tax cuts and improving confidence.

We see investment growth to speed up in 2013, as we expect a slight rebound in inventories after last year's fall. As a result, imports will rise. With imports picking up, the current account deficit will widen to 3.8% in 2014. The deficits will be comfortably financed by foreign direct investment and capital inflows, which are forecast to remain. EU fund inflows alone are expected to cover the current account shortfall in 2013.

Due to monthly deflation in early 2013, we are cutting the forecast for average consumer price growth from 1.9% to 1.1% for this year. We are keeping our 3.5% forecast for 2014 – inflation is anticipated to accelerate due to growing global commodity prices and a weaker euro exchange rate, as well as gradual return of timid domestic price pressures. Job creation is seen to keep decelerating − the unemployment rate will continue to fall (to 11.5% in 2014), and the activity rate will rise more slowly than last year. In a view of lower inflation forecast for 2013, we expect average real net wages to rise more quickly, by 3.6% (2.7% before), but we retain our 2014 forecast of 2.9%.

The scenario outlined above is a "muddling-through" type. Risks are somewhat skewed to the negative side. Externally, weaker global demand would weigh down Latvian exports, while higher commodity prices would lift inflation and hurt consumption. Domestically, the forthcoming municipal elections in June 2013 and general elections in the autumn of 2014 are building up populist sentiments that could result in a reshuffle of the government. This is likely to dampen the reform process and negatively affect medium-term growth. Given that the euro accession is already partly priced in (e.g., as lower sovereign borrowing cost), not joining the EMU in 2014 for whatever reason (although such likelihood is small) would have a negative impact on our baseline scenario. A negative risk is the financial difficulties and shareholders' disagreements of Latvia's largest metal industry company, Liepājas Metalurgs, which accounted for about 6-7% of total manufacturing sales in 2012 and employs about 2,300 persons. If the company were to become unable to meet its obligations, the government would be liable for credit guarantees of EUR 73.6 million, or 0.3% of GDP. It would also hurt exports, as well as labour market in Liepaja region spurring emigration.

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012	2013f	2014f
Real GDP	5.5	5.6	4.3	5.0
Nominal GDP, billion euro	20.3	22.1	23.5	25.9
Consumer prices (average)	4.4	2.3	1.1	3.5
Unemployment rate, % [2/]	16.2	14.9	13.5	11.5
Real net monthly wage	0.1	1.5	3.6	2.9
Exports of goods and services (nominal)	22.4	13.1	8.9	11.8
Imports of goods and services (nominal)	29.4	10.5	11.0	12.9
Balance of goods and services, % of GDP	-4.3	-3.0	-4.4	-5.0
Current account balance, % of GDP	-2.2	-1.7	-2.8	-3.8
Current and capital account balance, % of GDP	0.0	1.3	0.5	-1.7
FDI inflow, % of GDP	5.1	3.5	3.5	3.8
Gross external debt, % of GDP	145	136	132	124
General government budget balance, % of GDP [3/]	-3.4	-1.5	-1.0	-0.5
General government debt, % of GDP	42.2	40.8	43.0	40.0

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.

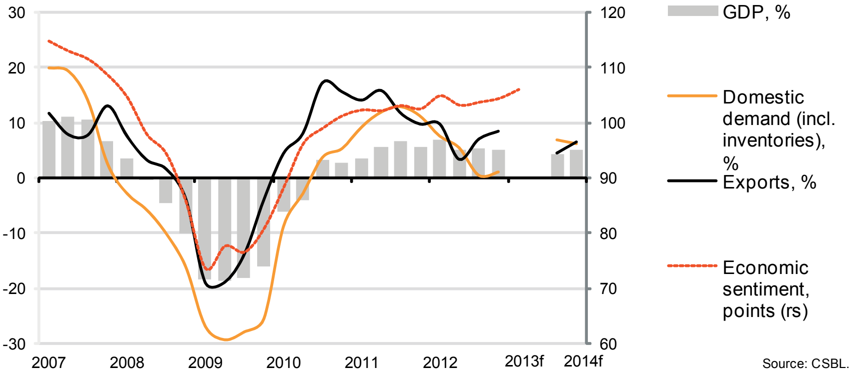
Slowing, but brisk export growth

In the second half of 2012, growth of goods exports was temporary boosted by record grain crops, while volumes of services exports shrank, mainly due to falling freight transportation (owing to bottlenecks in the railway network, tough competition and weak demand). Overall export growth in 2012 slowed from 2011, but still exceeded our expectations. We foresee that export volume growth will slow from 7.1% in 2012 to 4.5% in 2013, before picking up again to 6.5% in 2014.

Industrial confidence in Latvia has been edging up, but held back a bit in early March. We see manufacturers investing in branding and marketing, which might help to boost sales. We retain our outlook that this year the main obstacle to export growth will be the weak global economy and tougher competition, which will make it harder to keep gaining market shares. While the export growth from gaining market shares is expected to slow, the impetus will increasingly come from the recovery in external markets as global economy improves.

Capacity constraints are being addressed, but investments take time and results will lag. Cost competitiveness remains strong, although risks of labour cost pressures (especially for services, where productivity improvements have been slower) and rising electricity costs (particularly important for manufacturers) remain for the medium term. Non-price competitiveness (i.e., in quality and branding) is expected to continue to improve, helping to retain profit margins and support growth.

Annual growth of GDP and its components and economic sentiment



Source: CSBL.

Import growth to be driven by investment needs

Gross fixed capital formation growth plummeted in the second half of last year but remained positive, in the low single digits. Growth was driven mainly by buildings and structures (including public infrastructure and production buildings), while the contribution of machinery and equipment was smaller. We retain our view that gross fixed capital formation growth will remain robust, at about 9-11%, during 2013-2014 (12.3% last year).

The need and potential for investment is still high (see our recent monthly newsletter for more details[1]), especially in export production capacity and in public infrastructure. The corporate sector has the means to invest, since balance sheets and profit margins are strong. Along with heightened global uncertainty, a factor that could partly explain the lower investment growth in the second half of last year is the high real lending interest rates − although nominal interest rates in euro terms declined to historically lowest levels, the unexpectedly low inflation pushed up real rates (in 2004-2008, these were negative).

We expect much stronger growth in total investments this year due to both robust gross fixed capital formation growth and a rebound in inventories after last year's decline (at least partly due to the optimisation of supply chains and improvements in inventory management). This will require more imports. We also anticipate that the share of investments in machinery and equipment will again rise this year after last year's halt, i.e., companies that were building up premises last year will fill them up with machinery this year. Since these investments are more import intensive than construction, import growth will thus pick up as well.

As a result, we now forecast stronger import volume growth this year – we expect this to accelerate from 3.1% last year to 8.6% in 2013 and to remain at about 8% in 2014. Thus, the net export contribution to growth will again become negative, and the trade deficit will rise gradually to about 5% of GDP in 2014. This implies a somewhat larger current account deficit, reaching 3.8% of GDP in 2014. However, it will be fully financed by foreign direct investment and capital account inflows. The latter mostly consist of EU fund inflows, which will remain high in the coming two years (nearly half of the allocated funding for the 2007-2013 period has not yet been disbursed, and the window is open until the end of 2015). The current and capital account balance is expected to turn slightly negative in 2014.

1 http://www.swedbank-research.com/english/latvian_economy/2013/februari/index.csp

Swedbank's GDP Forecast – Latvia

Changes in volume, %	2011	2012 1/		2013f 1/		2014f 1/	
Household consumption	4.8	5.4	(5.2)	4.1	(3.8)	4.5	(4.5)
General government consumption	1.1	-0.2	(-4.0)	1.6	(1.1)	2.0	(0.9)
Gross fixed capital formation	27.9	12.3	(12.1)	9.0	(9.0)	11.0	(11.0)
Inventories 2/	2.6	-3.2	(-1.8)	1.8	(0.5)	0.3	(0.4)
Exports of goods and services	12.7	7.1	(6.6)	4.5	(4.0)	6.5	(6.4)
Imports of goods and services	22.7	3.1	(3.8)	8.6	(5.9)	8.0	(8.0)
GDP	5.5	5.6	(5.4)	4.3	(4.1)	5.0	(5.0)
Domestic demand (excl. inventories) 2/	9.2	6.8	(6.0)	5.4	(5.2)	6.4	(6.3)
Net export 2/	-6.3	2.0	(1.2)	-3.0	(-1.6)	-1.7	(-1.7)

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

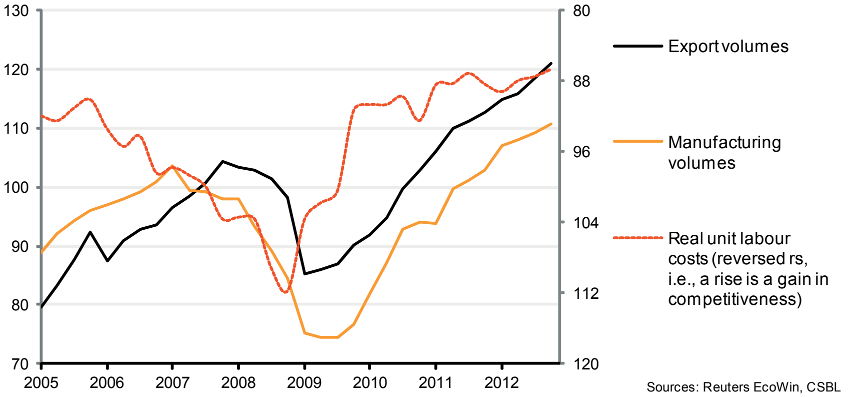
Slower job creation, but take-home pay boosted by tax cuts

Employment growth was at solid 4.8% last year (net of active labour market programmes), and the unemployment rate fell despite a notable increase in the activity rate. This year, we expect job creation to dampen (as economic growth somewhat slows) before picking up again in 2014. Labour force activity rates are forecast to rise slower, since they are already close to the peak of the 2007 level (i.e., when the labour market was overheating). We anticipate the unemployment rate to continue declining to about 11.5% in 2014 on average.

Job vacancy rates are still very low and new openings are filling up quite quickly, indicating no large-scale problems so far with matching demands of employers and skills of employees. As a result, gross wage growth remains moderate and is broadly in line with productivity gains. We expect gross wage growth to remain close to 4% per annum in 2013-2014. The purchasing power of employees will rise swifter than gross wages due to the planned personal income tax cuts (1 percentage point this year and 2 percentage points next year), as well as to a slight increase in tax-free allowances for dependants in mid-2013.

A further rise in tax-free allowances and an increase in the minimum wage as of January 2014 are being discussed; however, a final decision is still to be made and we thus have not yet included it in our forecast. The Ministries of Finance and Welfare propose to raise the minimum wage from LVL 200 to LVL 225, which could add about 3 percentage points to annual wage growth. A minimum wage hike is intended to spur legalisation of incomes in the private sector (currently about one-third of employees receives a minimum wage according to official statistics, which is not plausible), but it may also deter job creation for low-skilled labour (especially in less-developed regions).

Exports, manufacturing and cost competiveness (2007=100, sa)



Sources: Reuters EcoWin, CSBL

Currently about half of those currently unemployed have been seeking jobs for more than a year and nearly one-third for more than two years, making it harder for them to get jobs. The unemployment rate is falling quite steeply, and it may reach 10% (arguably close to its natural level) by 2015 and start causing wage and inflation pressures (similar to what Estonia seems to be experiencing already now). To reduce them, productivity growth must be promoted to permit for sustainable wage growth and participation rates must be raised to lessen wage demands through larger labour supply.

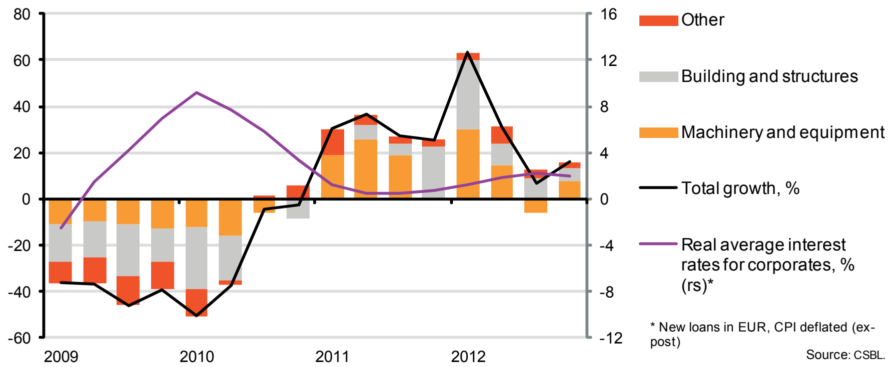
Below-potential economy holds down inflation

Consumer price inflation has surprised on the downside in recent months. Annual price growth stood at just 0.2% in March and is likely to be close to zero in the next couple of months. This is explained both by favourable global commodity price dynamics and very weak internal price pressures. Core inflation (i.e., excluding energy and unprocessed food) has already been fluctuating around zero since July 2012.

Such weak internal price pressures can be partly justified by the continuing operation of the economy below its potential (i.e., it is underemploying available capital and labour). The pickup in price growth in 2011 was largely explained by global price developments and a value-added tax hike (eliminating reduced rates for a number of products and services). According to estimations by the EC, although the output gap in Latvia (i.e., the difference between actual and potential GDP) was narrowing quite quickly in the last two years, it is still negative. These estimations are certainly subject to great uncertainty, but show realistic dynamics. They suggest that the output gap will close in the coming couple of years, implying a return of domestic price pressures.

One of the factors expected to raise consumer prices this autumn is intended liberalisation of the electricity market for households, since some of the currently regulated tariffs (that will be discarded) are below market cost. At the same time, as global food and oil prices in euro terms are anticipated to be largely unchanged in 2013, fuel, gas, and central heating prices in Latvia are expected to remain flat, but food prices to rise only slightly. We are lowering our average consumer price growth forecast for this year to 1.1% due to the

Contribution to annual growth of nonfinancial investment (current prices), percentage points



Source: CSBL.

weaker developments early in the year. We retain our 3.5% forecast for 2014, owing to rising global commodity prices and the somewhat stronger internal price pressures (the closing of the output gap and the one-off expenses due to the euro changeover).

Recent announcements by the Minister of the Economics suggest that the liberalisation of the electricity market for households may be postponed, since broader changes are necessary to limit the possible increase in the price of electricity. The current framework of feed-in tariffs (where all users pay for subsidizing local electricity production) comprises elements of excessive subsidies and rent seeking, which undermine the overall cost competitiveness of the economy in coming years. If liberalization is postponed, inflation will be lower in 2013 and 2014.

A rise in household incomes will be spent

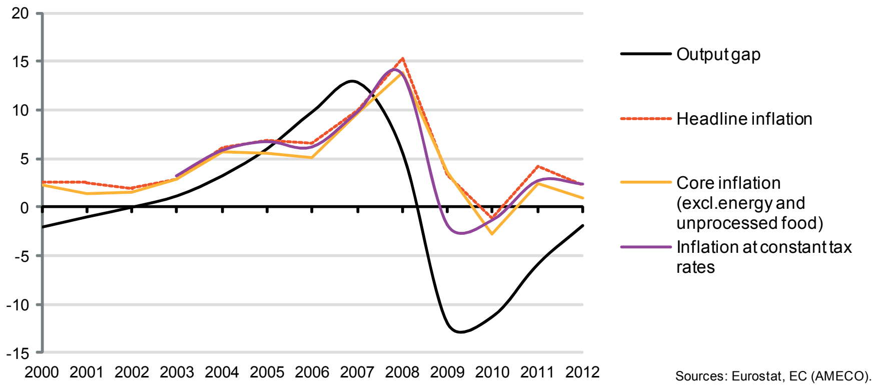
Household spending growth decelerated somewhat towards the end of last year, while income growth was quite robust. Household savings rates seem to have gone up last year; e.g., household net lending (i.e., available resources after consumption and investments have been made) was 1.1% of GDP in the first nine months of 2012 (-1.6% a year earlier). At the same time, consumer confidence improved during the year, although it has been held back a bit in the beginning of 2013.

If consumer confidence remains robust, we expect savings rates to decline again this year and households to spend their increase in incomes. Owing to lower inflation this year, purchasing power is forecast to rise faster and result in stronger household consumption growth than previously forecast. However, with more modest job creation this year, we foresee that consumption growth will slow to 4.1% from 5.4% last year and will pick up only marginally to 4.5% in 2014.

Public spending should be targeted to support reforms

Latvia has included the principles of the EU fiscal compact in its national legislation – the Fiscal Discipline Law passed on January 31, 2013 is set to

Annual consumer price inflation and output gap, %



Sources: Eurostat, EC (AMECO).

strengthen the institutionalisation of fiscal sustainability. The public finances remain good; in the first three months of this year, tax revenues were up 6% from a year before, or 1% above the plan. We foresee the budget deficit of the general government shrinking to about 1% this year and further to 0.5% of GDP in 2014.

The probability of positive surprises and smaller deficits is smaller than last year (for which the estimate is 1.5%, compared with the initial deficit forecast of 2.5% of GDP), since the potential for much faster GDP growth is limited (e.g., the ECB's "monetary bazooka" has partly played its part). Also, the overall tax burden is set to ease (because of lower personal income taxes and higher tax-free allowances), and the reduction of the grey economy is unlikely to be sufficient to significantly boost tax revenues. Overall, we do not envisage problems of excessive fiscal spending; rather, we see challenges in directing it to benefit long-term goals.

In 2014 and 2015, Latvia needs to roll over government debt of about 5-6% of GDP annually, and we expect the Treasury to continue its strategy of borrowing beforehand when financial market conditions are favourable. This explains the higher trajectory of general government debt as a percent of GDP than in our previous forecast, i.e., we expect a temporary buildup of debt prior to its repayment.

As mentioned in our previous Outlook, income inequality is becoming increasingly prominent in the policy debate. We support raising the minimum wage and tax-free allowances in principle, but a detailed policy discussion on the amount of the increase must wait until April/May − when the results of the World Bank's study of the welfare system will be published. This will be the first study in Latvia to merge fragmented databases to assess the efficacy of the welfare system. Such a study has been long overdue, and earlier decisions have often been made in the dark, without recourse to hard data analysis.

The advocates of the reform agenda remain vocal, but execution has slowed. Amongst signs of recent progress, one must note the introduction of temporary mobility benefits for those finding jobs at least 20 kilometres away from their residence. This will help ease labour market pressures, but the program is tiny (funding for 300 individuals only), and much more needs to be done. The Ministry of Economics is drafting suggestions to reduce electricity feed-in tariffs in order to eliminate rent seeking and lower electricity costs, which are putting at risk manufacturers' competitiveness. The ministry has also been pushing through measures to improve corporate governance of state- and municipality-owned companies, but so far with little success, as political backing from the ruling coalition is patchy.

Latvia is once again at the crossroads – over the last years much has been done and most of imbalances have been corrected. Yet, unless further decisive reforms to boost growth potential are swiftly implemented, cost pressures will rise, putting at risk competitiveness, permanently slowing growth, and jeopardizing economic and social sustainability.

Lija Strašuna
Māritņš Kazāks

Lithuania: All eyes on inflation

The Lithuanian economy grew somewhat faster last year than we had forecast, mainly due to very strong exports and higher household consumption. Export volume expanded by 11.2%, which was faster than forecast and also exceeded the growth of imports. Exports were boosted by a record grain harvest, but the growth of manufactured goods and reexports was equally strong.

At the same time, the outlook of companies was weakened by developments in the euro area. Companies not only postponed some of their investments, but also significantly slashed their inventories, which had the largest negative impact on GDP growth since 2009. Households were wary as well and invested less in housing. Bad sentiment was the main (if not the only) reason companies and household held back their investments last year. We do not see the underinvestment trend continuing – although Europe is not out of the woods yet, business expectations have improved and companies will increase their investments and inventories.

Weak investments and contracting inventories lowered the demand for imports, and Lithuanian foreign trade was in surplus for the first time since the reinstatement of independence in 1990. The foreign trade surplus was 0.6% of GDP last year, but we expect it to fall back into a small deficit as imports of investment and consumer goods recover.

The biggest change in our forecast compared with our January Outlook concerns inflation. At the beginning of this year, we were expecting slightly higher inflation in 2013 due to increases in electricity prices, excise duties on diesel and tobacco, and the minimum wage. However, consumer prices have barely changed, and global commodity trends look more favourable than they did in January; thus, we are lowering the inflation forecast to 2.5% for this year.

The government has set the beginning of 2015 as the target date for euro adoption. The main obstacle to joining the euro area is likely to be too-high inflation, which currently exceeds the Maastricht criterion and is likely still to be very close to it next spring, when Lithuania's convergence will be assessed by the European Commission. We see the probability of Lithuania's joining the euro area in 2015 as close to 50%.

External risks remain elevated

Since the publication of our last Outlook in January, we have witnessed a not-very-smooth bailout of Cyprus, followed by only slightly higher volatility in the financial markets. Despite recent tensions, the risk of deeper recession in Europe and a bigger negative external shock remains unchanged – at around 20%.

Domestic risks are subdued – the new government, which took office at the end of last year, has taken slow and measured steps (with some exceptions) in revising social and economic policies. The main risks (both positive and negative) stem from two reforms that will be introduced this year – a new national energy strategy and a reform of the tax system. The splitting of the Ukio Bank into "bad" and "good" banks was carried out smoothly and did not rattle confidence in the banking sector – consumer confidence continued to rise, reaching the highest level since the beginning of 2008.

Investments to accelerate, construction to recover

In 2012, gross fixed capital formation contracted by 2.5%, due to lower household investment in housing. Investments in fixed tangible assets increased by 0.5% last year, less than expected. In nominal terms, investments shrank in the public sector by 7.7% but increased by 10.7% in the private sector. The main reason gross fixed capital formation is still 37% below the pre-crisis peak is the downturn in the construction sector.

After a strong recovery in 2011, the construction sector contracted by 5% in 2012 and was one of the two sectors that did not grow last year (besides the financial intermediation and insurance sector, whose value added shrank by 0.8%). The construction sector contracted the most during the crisis, and in 2012 its value added was still 42.3% below the pre-crisis peak. The lack of development in this sector is one of the main reasons for Lithuania's large structural unemployment – at the end of last year, the sector employed 92,800 fewer employees than before the crisis. This is almost half the number of the total currently unemployed. The sluggish recovery of this sector is related to lower demand from the public sector and low confidence in the private sec-

Key Economic Indicators, 2011 - 2014 [1/]

	2011	2012	2013f	2014f
Real GDP	5.9	3.6	4.0	4.0
Nominal GDP, billion euro	30.8	32.8	34.8	37.3
Consumer prices (average)	4.1	3.1	2.5	3.4
Unemployment rate, % [2/]	15.3	13.2	11.5	10.0
Real net monthly wage	-1,3	1.1	2.0	2.5
Exports of goods and services (nominal)	27.5	15.8	6.7	10.5
Imports of goods and services (nominal)	28.2	11.2	7.5	12.0
Balance of goods and services, % of GDP	-2.6	0.6	-0.1	-1.3
Current account balance, % of GDP	-3.7	-0.5	-0.9	-2.3
Current and capital account balance, % of GDP	-1.3	1.7	1.1	-0.1
Net FDI, % of GDP	3.4	2.0	3.5	3.8
Gross external debt, % of GDP	77.8	75.6	73.6	70.7
General government budget balance, % of GDP [3/]	-5.5	-3.0	-2.5	-2.0
General government debt, % of GDP	38.5	40.7	39.1	37.9

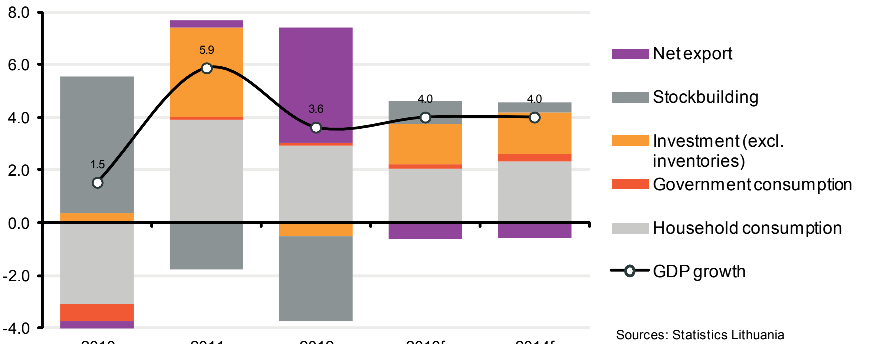
Sources: Statistics Lithuania and Swedbank.
1/ Annual percentage change unless otherwise indicated.
2/ According to labour force survey.
3/ According to Maastricht criterion.

tor. However, a rapid recovery of the construction sector to its previous peak should not be expected because before the crisis it had been expanding in an unsustainable way.

On the positive side, an increase in the number of new residential building permits and the probability of a more active renovation of Soviet-era buildings could boost activity in this sector in 2013 and, especially, 2014. The government has pushed forward with its new model of renovation, in which financial liabilities arising from construction are assumed by municipal enterprises, not the households. Last year, the number of permits for new houses increased for the first time since 2007 and was 11.5% higher than in the previous year. The construction sector's expectations regarding future demand and employment at the beginning of this year were significantly higher than at the same time a year ago.

Business investments in machinery and equipment grew by 11.6% last year in nominal terms, but, as a share of GDP (3.9%), they remain well below pre-crisis levels. Strengthening domestic demand, a recovery in the euro area, increasing capacity utilisation, low interest rates, and high retained earnings will encourage companies to invest more this year and the next. Furthermore, the government's investment programme is projected to increase by 10.3% this year. Nevertheless, in the face of continued uncertainties in the euro area, we have adjusted this year's forecast for gross fixed capital formation growth to a more modest 8%.

Contributions to GDP growth, pp



Sources: Statistics Lithuania and Swedbank.

In 2014 and onwards, investments will receive additional stimulus from EU funds. Even though the EU 2014-2020 budget has been significantly reduced, Lithuania has managed to negotiate an increase of LTL 4 billion (EUR 1.1 billion) in its financial package, compared with the 2007-2013 framework. In the EU budget, the overall level of its financial support for Lithuania will increase by almost 10%, amounting to LTL 44.5 billion (EUR 12.9 billion). Although the European Parliament has rejected the budget, most probably further negotiations and agreements on the EU budget will not introduce substantial changes to the financial package for Lithuania.

Export growth will moderate

In 2012, for the first time since the reinstatement of Lithuanian independence, the trade balance was in surplus. This was due to a 15.8% expansion of exports, coupled with much weaker (11.2%) growth of imports, the latter of which was affected by sluggish investments and contracting inventories. We do not forecast the foreign trade surplus to become permanent – at least not until Lithuania's dependence on imported energy resources decreases, which is beyond our forecast period.

The foreign trade surplus was achieved even though, since the shutdown of the nuclear power plant at the beginning of 2010, Lithuania has had to import almost 70% of its electricity needs. Lithuania has not only successfully eliminated all external imbalances (before the crisis, the trade deficit exceeded 13% of GDP), but, on the back of improved competitiveness, has also demonstrated a very rapid export growth despite the ongoing euro area recession.

Export growth, however, is set to moderate. A big source of growth last year was the record grain harvest, which is unlikely to be repeated this year. While Lithuanian exports of goods to the euro area increased last year by only 5.7%, exports have been growing rapidly to Russia and other CIS countries. This year, it is going to be more difficult to keep the same pace, as Russian economic growth is set to decline to 3.3%. In 2014, however, as Europe emerges from the recession, export growth is likely to pick up and reach 6.5%.

Inflation is lower, but not low enough

Average annual inflation slipped below 3% at the beginning of this year and is set to decline a bit more later this year. Despite the increases in electricity prices and the minimum monthly wage, companies have not yet transferred these higher costs to final consumer prices. This may still happen later this year, but a somewhat stronger euro and favourable developments in commodity prices have encouraged us to cut this year's inflation forecast to 2.5%.

Swedbank's GDP Forecast – Lithuania

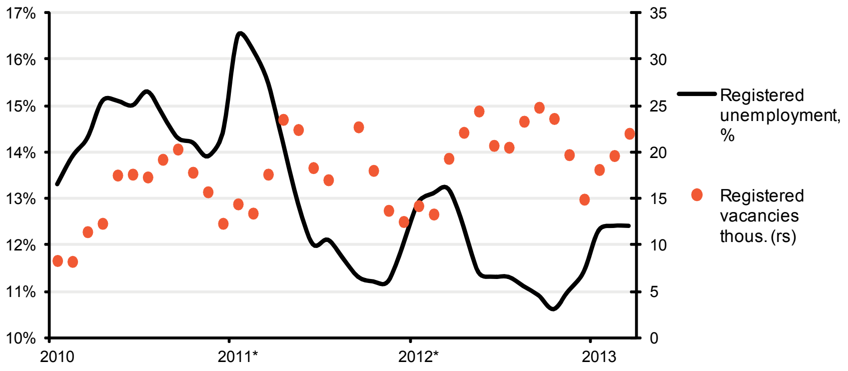
Changes in volume, %	2011	2012 1/		2013f 1/		2014f 1/	
Household consumption	6.4	4.7	(4.0)	3.3	(3.0)	3.8	(3.5)
General government consumption	0.5	0.7	(0.0)	1.0	(1.0)	1.5	(2.0)
Gross fixed capital formation	18.3	-2.5	(3.0)	8.0	(10.0)	8.0	(8.0)
Inventories 2/	-1.8	-3.3	(-1.0)	0.8	(0.3)	0.4	(-0.3)
Exports of goods and services	14.1	11.2	(6.5)	4.0	(4.0)	6.5	(6.5)
Imports of goods and services	13.7	5.6	(5.0)	5.0	(4.5)	7.5	(6.5)
GDP	5.9	3.6	(3.3)	4.0	(4.0)	4.0	(4.0)
Domestic demand (excl. inventories) 2/	7.4	2.5	(3.1)	3.8	(4.1)	4.2	(4.2)
Net export 2/	0.3	4.3	(1.2)	-0.6	(-0.3)	-0.5	(0.1)

Sources: Statistics Lithuania and Swedbank.

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

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

Registered unemployment and vacancies



* the number of working age population is updated according to census results

Source: Lithuanian Labour exchange

Next year, however, more expensive commodities and rising labour costs will push inflation back above 3%.

Although the Maastricht price stability criterion is currently at 2.6%, it is set to decline further this year. However, average annual inflation in Lithuania will jump at the beginning of next year (due to the base effect from deflation at the end of 2012). Accordingly, we estimate that Lithuania's chances of meeting the inflation criterion at the beginning of next year do not exceed 50%. The government needs to do more to ensure price stability and competition in order to safeguard the adoption of the euro in 2015. As inflation will likely pick up in 2014, adopting the euro in 2016 would be a much more difficult task.

Some reasonable actions are being taken by the government to curb inflation. The parliament adopted an amendment to the Heat Sector Law, allowing independent heat producers to join the heat transmission network and sell heat to suppliers. It also gave greater power to the national price and energy regulation authority to determine competition conditions for the heat producers. The new amendment is expected to enhance competition in the heat sector and to reduce heating prices for consumers, beginning with the 2013/2014 heating season.

Lower taxes will affect net real wage growth…

Already in the second half of last year, wage growth was being influenced by an increase in the minimum monthly wage, a factor that will have an even bigger effect this year (the minimum monthly wage was increased by an additional 17.6% at the beginning of this year). Average nominal net wage growth will reach 4.5% this year, after last year's 4.2%, before accelerating further to 5.9% in 2014.

The growth of real wages will be somewhat faster than we had forecast at the beginning of this year. In 2013, real net wage growth will be affected positively by lower inflation. In 2014, an even stronger positive effect will come from the shrinking of the tax wedge on labour. Although the government has not passed any laws yet, the working group on taxes and the Prime Minister have signalled that the main objective is to increase the threshold of nontaxable income. We estimate that this threshold will be raised by some 30% from the current LTL 470 (EUR 136) per month; this would push up net wage growth by 0.6 percentage point.

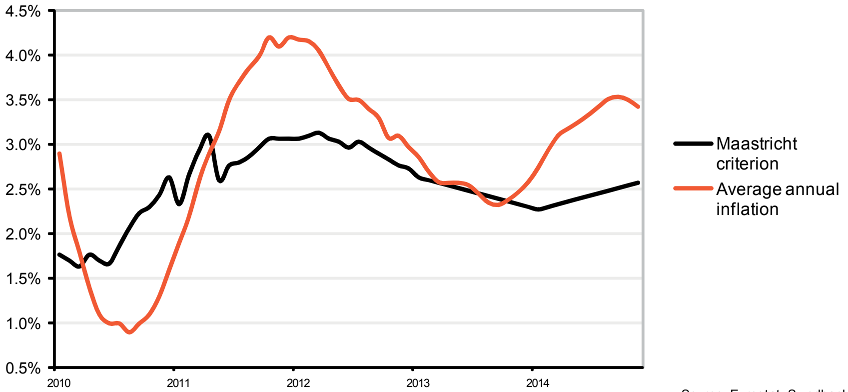
The government budget would lose some LTL 200 million in revenues due to this change; however, this can easily be compensated for by eliminating harmful tax exemptions and loopholes. We think that there is a possibility of doubling the current threshold of non-taxable income and bringing it close to the level of the minimum monthly wage (currently, LTL 1,000 per month). This would add 2% to the average net wage, all of which would benefit low-wage earners.

After a healthy growth in employment in 2012 (1.8%), the pace is likely to slow this year and the next; however, the number of jobs will still rise by 0.9% in 2013 and 0.8% in 2014. Amidst the heightened political uncertainty after the elections (see our last Outlook), unemployment rose and job vacancies dropped at the end of 2012. They recovered somewhat at the beginning of this year, but this was partially due to seasonal effects. Although the number of job vacancies remains below last year's peaks, this was not unexpected; thus, we are keeping our unemployment rate unchanged – it will drop to 11.5% this year and will decline further to 10.0% in 2014.

…and will stimulate household consumption

Household consumption slowed further in the final quarter of last year, when it was 3.2% higher than in the previous year. Overall in 2012, household consumption increased by 4.7%, more than the wage bill, which increased by only 2.8%. In line with the higher real wage bill forecast for 2013 and 2014 (2.9% and 3.3%, respectively), we are also raising also the forecast for household consumption, which we expect to increase by 3.3% and 3.8%, respectively.

Average annual inflation and Maastricht criterion



Source: Eurostat, Swedbank

The risks, however, are skewed to the positive side. Consumer confidence has been increasing and in March it reached its highest level since the spring of 2008. Household borrowing was still contracting last year, mainly due to sluggish household investments in housing. Nonfinancial corporations already began reversing the trend at the beginning of last year, and their loan portfolios have been expanding. Because of improving expectations and growing wages, households are likely to follow this trend, probably in the second half of this year and in 2014.

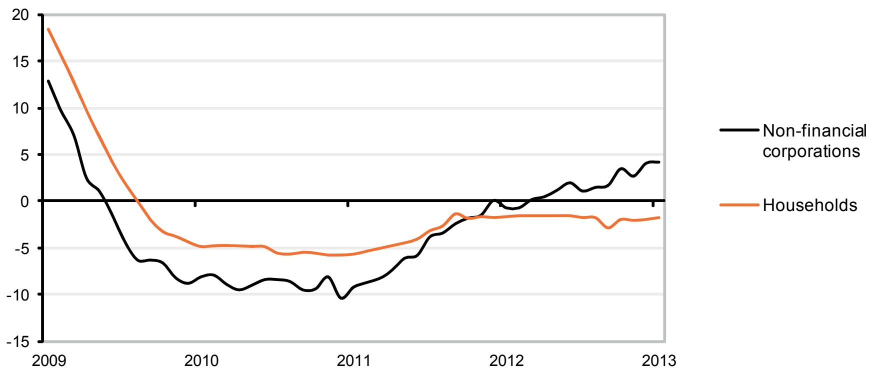
In the second half of this year, Lithuania will take over the presidency of the Council of the European Union. The Ministry of Foreign Affairs estimates that during this half-year 30,000 guests – politicians, experts, journalists, and family members – will visit Lithuania. Besides having an immediate direct positive impact on the economy, this will be an opportunity to advertise the country and attract investments and tourists in the future.

Limited possibilities to increase public spending

We are keeping unchanged our forecast for the budget deficit this year and the next– at 2.5% and 2.0%, respectively. There are no immediate pressures on public finances – budget revenues in the first two months of this year were in line with the plan. Debt peaked at 40.7% of GDP last year and will decline to 37.9% in 2014.

Fiscal discipline has not been abandoned; however, risks will arise when next year's budget has to be confirmed at the end of this year, as pressure to increase spending is building up. The Fiscal Discipline Law restricts growth in government spending as long as the general government budget is in deficit. According to our calculations, this law will allow state budget expenditures to increase by 1%, or LTL 190 million (EUR 55 million), in 2014.

Domestic credit growth, yoy, %



Source: Bank of Lithuania

The government has not been pushing its reform agenda and did not reverse many of the sensible initiatives of the previous government (as was promised before the elections). However, we see that the momentum for important new structural reforms has been lost. The reform of state-owned enterprises, which aimed to increase transparency, efficiency, and accountability, has stalled and was not mentioned as one of the government's priorities. The shadow economy remains uncomfortably large; e.g., in the final quarter of 2012, the share of smuggled cigarettes smoked in the country increased to 35.4%. Furthermore, no new measures were introduced to improve border controls, lower tax evasion, or discourage unreported economic activity in general.

Another area that has been forgotten, despite lively discussions last year, is labour market flexibility. The World Economic Forum's Global Competitiveness Report 2012-2013 shows that Lithuania ranks 118th in the world according to the hiring-and-firing practices criterion, and 109th according to the redundancy costs criterion. Even more important, the same report shows that, based on the effect and extent of taxation, Lithuania is only in 125th place. This suggests that Lithuania's tax system could benefit from a serious revamping – not just cosmetic surgery.

Finally, the government is aiming to update its long-term energy strategy and to have all major political parties endorse it. This would be a welcome change, since during the past 20 years there has been no strategic planning – each new government started new initiatives. Finding common ground, however, will not be easy. Energy sector reforms, together with changes in the tax system, could significantly affect – for better or worse – the long-term competitiveness of the economy and welfare of the population. Thus, these reforms should be handled with exceptional care, and the possible impact of narrow interest groups on the decisions taken should be guarded against.

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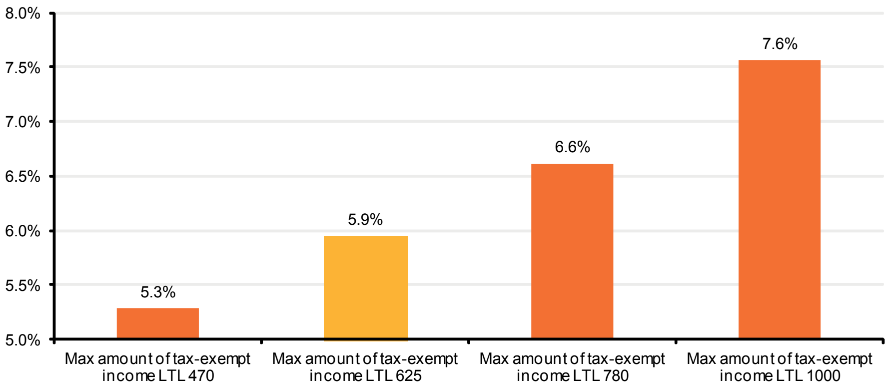
Conditional net wage growth in 2014, %



Source: Swedbank

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