Swedbank

Macro Research - August 27, 2013

Swedbank Economic Outlook

“Old” world resurges

The downturn has bottomed out in Europe, and the US economy is set for a sharper rebound. We see the main risks coming from emerging economies.

The Swedish economy benefits from recovering trading partners and from election-related spending. However, significant imbalances and structural challenges remain.

Steady growth expected in the Baltic economies in the coming two years. Latvia will adopt the euro in 2014, while Lithuania stays on track to adopt it in 2015.

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Executive Summary

Stronger growth in mature economies

There are signs that the global economy is shifting gears and composition. Short-term macro indicators such as purchasing managers indices and confidence measurements, suggests that the slowdown observed in the first half of 2013 has reached its bottom. At the same time, the momentum of global growth is shifting towards the US and Europe. We therefore raise the growth outlook for mature economies, while lowering it for emerging-market economies. In all, we make only limited revisions to our global growth forecast for 2013 and 2014. We expect this pattern to extend into 2015 and also foresee global growth to continue to gradually recover.

Main risks found in emerging markets

Despite the slightly more benign outlook, there is no lack of risks in the global economy. In this report we particularly point to the risks of a sharper slowdown of the Chinese economy. We saw during late spring that the rapid credit expansion has taken place, partly in the shadow banking system, caused significant spikes in interbank rates. We argue that although lower growth in China would primarily affect other emerging markets, a negative feedback loop could cause repercussions that extends back to China and spreads to the global economy. Other global risks include renewed political uncertainty in Europe and geopolitical crises that affect the supply of commodities, in particular oil.

Strong demand in Sweden although housing market is a vulnerability

The outlook for Swedbank's home markets remains stable, although there are specific areas that raise concerns. We expect Swedish growth to pick up, supported by both an expansionary fiscal policy and a better outlook for the main trading partners. However, the risky combination of rising housing prices and increasing household debt, shows no signs of disappearing. At the same time, the delayed implementation of macro prudential tools poses an increasing risk, together with low housing construction. We do an in-depth analysis comparing the situation in Sweden and Norway. We see an increasing and rather high risk for a price correction on the Norwegian housing market, while the risk is limited in the short run on the Swedish housing market.

Robust growth in the Baltics, euro adoption comes closer

Although growth patterns in the Baltics are becoming somewhat differentiated, growth in all three countries is expected to be robust and broad based during the next two years. Latvia will join the euro area in 2014, and, if the current price trends continue, Lithuania will follow suit in 2015 (this is our baseline scenario). Unemployment rates are falling rapidly, and wage and price pressures are likely to rise towards the end of the forecast horizon in Latvia and Lithuania, similarly to what Estonia is already experiencing.

Macroeconomic indicators, 2011 - 2015

	2011	2012	2013f	2014f	2015f
Real GDP, annual change in %					
Sweden (calender adjusted)	3.7	1.1	1.6	3.2	2.8
Estonia	8.3	3.2	1.9	3.9	4.2
Latvia	5.5	5.6	4.3	4.7	4.3
Lithuania	5.9	3.7	4.0	4.0	4.5
Unemployment rate, % of labour force					
Sweden	7.8	8.0	8.1	8.0	7.5
Estonia	12.5	10.2	8.9	8.4	8.3
Latvia	16.2	15.0	11.6	10.5	9.5
Lithuania	15.3	13.2	11.5	9.5	8.5
Consumer price index, annual change in %					
Sweden	3.0	0.9	0.2	1.8	2.8
Estonia	5.0	3.9	3.3	2.8	2.9
Latvia	4.4	2.3	0.4	3.0	2.7
Lithuania	4.1	3.1	1.5	2.5	3.0
Current account balance, % of GDP					
Sweden	7.3	7.0	6.6	6.4	5.6
Estonia	1.8	-1.8	-1.8	-2.1	-1.4
Latvia	-2.2	-1.7	-0.9	-2.6	-3.2
Lithuania	-3.7	-0.5	-0.8	-2.0	-3.0

Sources: National statistics authorities and Swedbank.

Global Outlook

Global growth will shift more towards the mature economies, and we expect the downturn to have bottomed out. The main downside revisions fall on emerging economies, where negative risks have increased. Markets are moving ahead, with interest rates up across all maturities. However, we expect policy rates to remain low, although a normalisation will be initiated towards the end of the forecast period.

An upward revision of growth in mature economies

Despite remaining significant challenges in the global economy, we are seeing some positive signs that suggest that the more mature economies are turning around. Confidence is strengthening, activity indicators, such as the purchasing managers' index (PMI) are up, and demand is recovering. Furthermore, fiscal policy adjustment is easing, while monetary policy will remain supportive throughout next year. Structural reforms to raise productivity and competitiveness need to be pursued. On the other hand, the outlook for emerging economies is more uncertain. The unwinding of imbalances will increase risks and slower growth momentum. Thus, in our new forecast we revise up growth for mature economies and down for emerging market economies.

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

	2011	2012	2013f		2014f		2015f
USA	1.8	2.8	1.8	(1.8)	2.9	(2.6)	3.0
EMU countries	1.5	-0.5	-0.5	(-0.6)	1.2	(1.0)	1.8
Germany	3.1	0.9	0.4	(0.6)	1.9	(1.9)	2.0
France	2.0	0.0	-0.1	(-0.8)	0.9	(0.5)	2.0
Italy	0.5	-2.4	-1.9	(-1.5)	0.6	(0.5)	1.5
Spain	0.4	-1.4	-1.4	(-1.8)	0.7	(0.5)	1.8
Finland	2.7	-0.8	-0.6	(0.7)	1.0	(1.8)	1.8
UK	1.2	0.1	1.2	(0.8)	2.0	(1.8)	2.7
Norway	2.6	3.3	1.8	(2.1)	2.0	(2.3)	2.0
Denmark	1.1	-0.4	0.3	(1.0)	1.6	(1.5)	1.9
Japan	-0.5	1.9	1.7	(1.3)	1.2	(1.6)	1.0
China	9.2	7.8	7.4	(8.3)	7.3	(8.0)	7.1
India	6.2	5.0	6.0	(6.4)	6.5	(6.8)	6.7
Brazil	2.7	0.9	2.7	(3.5)	3.9	(4.0)	4.1
Russia	4.3	3.7	1.3	(3.3)	3.2	(4.0)	3.0
Global GDP in PPP [2/]	3.9	3.1	2.9	(3.1)	3.6	(3.7)	3.8
Global GDP in i US$	2.9	2.6	2.3	(2.4)	3.0	(3.0)	3.4

1/ April 2013 forecast in parenthesis; Countries representing around 70 % of the global economy.

2/ Weights from World bank 2011 have been used. Sources: National statistics and Swedbank.

Main risks found in emerging economies

The risks surrounding our forecast have decline somewhat since our April *Outlook*, and we raise the probability of our main scenario from 65% to 70%. We also see the risks as more balanced with a 15% probability of both a better and a worse outcome. The main upside risk is a stronger-than-expected boost of domestic demand in mature economies. The main downside risks would be a sharper slowdown of Chinese growth, a resurgence of political turmoil in Europe, or a spike in commodity prices for geopolitical reasons. Currently, we project commodity prices to be on a downward path due to the easing of the commodity "super cycle" and our average oil price forecast per barrel is $108 in 2013, $104.5 in 2014, and $99 in 2015. Low, and even moderately falling, commodity prices will continue to support low inflation in the coming year, although the base effect will fade gradually.

Steeper yield curves and stronger US dollar

Stronger data during the summer have pushed up long-term interest rates. Still, short-term rates are capped at low levels as central banks are on hold, resulting in steeper yield curves. This holds mainly in the US, but, lately, this tendency is clear also in European economies. As the Federal Reserve (Fed) begins unwinding monetary policy stimulus during the fall, yields on short-dated bonds and long-term rates will rise in

Interest and exchange rate assumptions, %

	2013 23 Aug	2013 31 Dec	2014 30 Jun	2014 31 Dec	2015 30 Jun	2015 31 Dec
Policy rates						
Federal Reserve, USA	0.25	0.25	0.25	0.25	0.75	1.25
European Central Bank	0.50	0.50	0.50	0.50	0.75	0.75
Bank of England	0.50	0.50	0.50	0.50	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10
Exchange rates						
EUR/USD	1.34	1.27	1.23	1.25	1.30	1.35
USD/CNY	6.1	6.1	6.1	6.1	6.0	5.8
USD/JPY	99	103	105	107	108	110
EUR/GBP	0.86	0.85	0.83	0.83	0.80	0.80

Sources: Reuters Ecowin and Swedbank.

parallel; this will leave a steep yield curve until the Fed begins hiking policy rates in the first half of 2015. Also, in the Euro area the gradual recovery will drive long term-rates higher. European recovery is lagging, however, and the low policy rate will continue to cap European short-term bonds while the yield curve steepens further.

Euro area: A modest recovery under way

Finally, growth in Q2, outlook slightly better

A sharp turnaround, according to the business sector

The euro area returned to growth in the second quarter, following six quarters' consecutive decline, the longest recession in any rich country on record. We expect moderate growth in the coming quarters and years and have revised our growth forecasts up marginally. Even in the southern countries, capacity utilisation and employment will remain low, as will wages. We expected a gradual stabilisation in the euro area economy in our April *Outlook*, but, during the last four months, the economy staged a rather remarkable turnaround. In March, the PMI survey indicated a 1.5% speed of decline in GDP. However, the July PMI signalled a positive growth figure. In France and Italy, the PMIs changed from indicating a -3% to zero GDP growth. The difference between PMIs in the northern and southern countries of the euro area has evaporated. Consumer confidence has climbed steeply since last autumn, without the benefit of much encouraging economic news in the media.

Real GDP growth (%) and PMI

Source: Reuters EcoWin and Swedbank

Households and businesses are consolidating rapidly

Our rather positive outlook was – and still is – based on four solid economic pillars and one risky political assumption. The first pillar is that the decline in household and business demand (consumption and investments) is largely behind us. Both households and corporates are running record large cash surpluses and are consolidating rapidly. At one stage, demand will stabilise and recover--we may be witnessing it already. Banks are still undercapitalised, but less so, and they are not tightening their credit policy aggressively anymore.

Fiscal drag has peaked, will loosen

Second, much of the fiscal consolidation is done. Some countries are still running unsustainable deficits, but the academic and political, as well the electorate's, stance on austerity has softened. It is now acknowledged that the fiscal cleanup has to take time. Everybody cannot try to save at the same time, without killing the economy. More emphasis is put on sticking to long-term structural reforms. Greece has been granted another payout, even if it is recognised that a third debt write-down is likely (at least after the German election).

Rebalancing underway

Third, the euro area has regained some competitiveness and is running a record-high current account surplus, at 2.5% of GDP. Certainly, imports are weak but exports have kept up rather well. Also the crisis countries in southern Europe are back in balance or surplus on their current accounts, from a 10% deficit on average five years ago. The necessary cost rebalancing within the union is well under way.

Monetary policy will remain expansionary

Fourth, monetary policy will remain expansionary for a long while. Low wage and price inflation, a mild credit contraction, a 12% unemployment rate, and a currency still above the long-term average warrant an extremely expansionary policy stance. We expect the ECB to engage in some forward guidance in order to anchor short-term interest rate expectations. The policy rate is expected to remain at 0.5% well into 2015. The ECB will continue to keep the door open for buying government bonds in crisis countries, if needed, contributing to the sharp decline in government yields in southern Europe. We expect a gradual depreciation of the euro versus the US dollar, but down 1.25 by the end of next year.

Risk: Will policy remain on track

The risky policy assumption is that the electorate and the political systems in both northern and southern Europe are willing and able to continue the present adjustment and long-term reform policy. The risk for a breakdown will be significantly reduced if the real economy and, thereafter, the unemployment rate stabilise.

US: Growth returns, but beware of market volatility

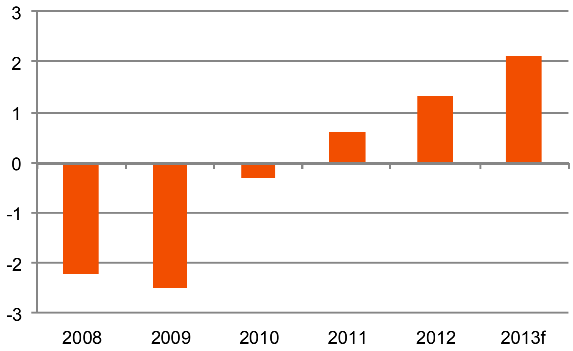
Fiscal drag is significant; underlying growth is picking up

A steady improvement in macro data during the summer suggests that the recovery in the US economy is taking hold. This follows weaker-than-expected growth in the first and second quarters, which were affected by a fiscal policy tightening and bad weather. Recently, better labour market developments point towards a pickup in the momentum of the economy, and this has fuelled speculations of a gradual reduction of the monetary stimulus. We expect the recovery to gain pace in 2014 and 2015, and have accordingly revised up our annual growth forecasts to 2.9% and 3.0%, respectively.

Debt ceiling and budget could derail economic policy

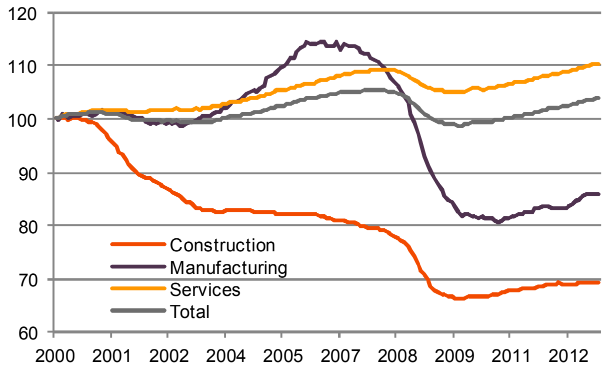
There are, however, still some weak spots in the economy. In particular, manufacturing is still lagging. Industrial production has been flat despite a pickup in the PMI. Fiscal policy will hold back growth in 2013, and during the autumn political gridlock could return to Washington. Federal borrowing needs will again hit the ceiling, and budget discussions will intensify.

Change in structural balance (% of GDP)



Source: IMF

Employment by sector (index, 2000=100)



Source: Bureau of Labor Statistics

Consumption underpinned by wealth gains and job growth

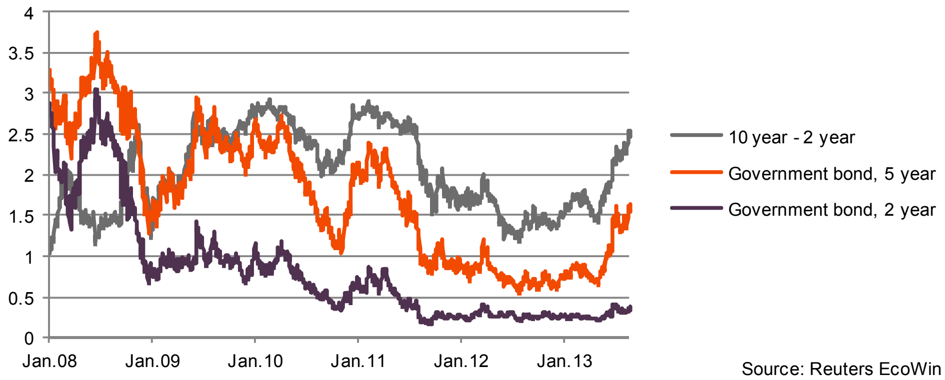
We foresee that household spending will be the main source of growth. Rising house prices and recovering stock markets have strengthened household balance sheets. Thus, household debt levels have declined, and pent-up demand, together with delayed household formation and housing starts is set to boost domestic demand. In addition, job creation is picking up lifting income growth. The unemployment rate is expected to decline slowly, counteracted to some extent by the depressed participation rate.

Tapering is in the cards, rate hike only in 2015

We expect the Fed to start unwinding the monetary policy stimulus early this fall by scaling back bond purchases. The economic recovery is progressing steadily, and, increasingly a common view among Fed officials has emerged in recent weeks. We expect to see a reduction of the purchases of treasury bonds (currently acquired at a rate of US$45 billion per month), and thereafter of mortgage-backed securities (US$40 billion per month), reaching a total phase out by mid-2014. The first upward adjustment of the Fed funds rate is expected in the first half of 2015.

The process of normalising monetary policy is not risk free, however, and we expect that there will be plenty of turbulence as markets adjust to the new policy path. Expectations of an end to the Fed's asset purchases could cause a sell-off of bonds, generating disruptive increases in long term-interest rates. At the same time, we do foresee rates increasing in tandem with the improved macroeconomic situation. The yield curve is expected to steepen until 2015, when short-term rates will increase. At the end of 2015, the rate of the 10-year government bond is expected to have reached 4 %.

Government bond yields, %



Source: Reuters EcoWin

UK: Renewed hopes of a comeback

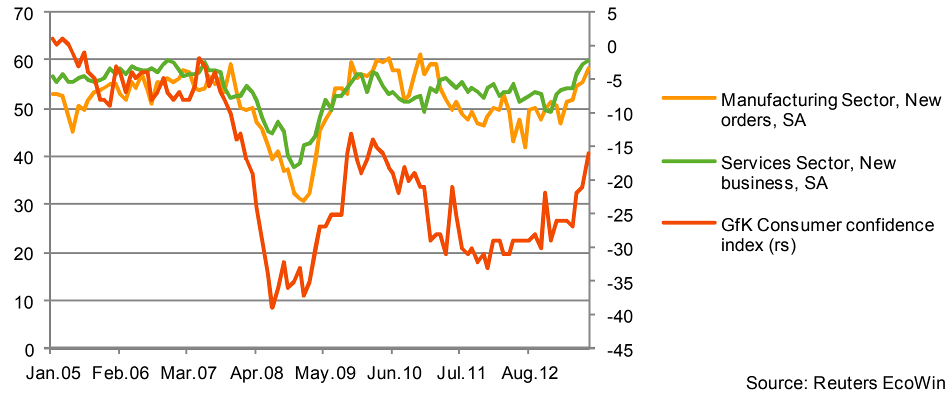
Confidence and activity picking up

Positive growth numbers in the first two quarters of 2013, together with stronger-than-expected short-term indicators, could point toward a nascent turnaround of the British economy. In particular, the PMI for both the manufacturing and services sectors, along with a strong performance of industrial output, suggest that activity is picking up. If we add to this the slightly better outturn of labour market numbers, there are reasons to believe the well-entrenched pessimism that has prevailed in the UK could start easing. Indeed, confidence indicators for both consumers and companies have picked up recently.

Monetary policy aggressiveness

The new governor of the Bank of England (BoE), Mark Carney, launched a fresh dose of monetary stimulus in the form of state-contingent forward guidance. The BoE committed, with a few exceptions related to higher inflation, to keep the policy rate unchanged until unemployment reached 7% (the rate is currently 7.8%). The immediate market reactions of lower short- and long-terms interest rates, a weaker pound, and rising equity prices was later moderated, suggesting that the new policy was not perceived to be entirely credible.

New orders and consumer confidence



Source: Reuters EcoWin

Solid demand will support the recovery

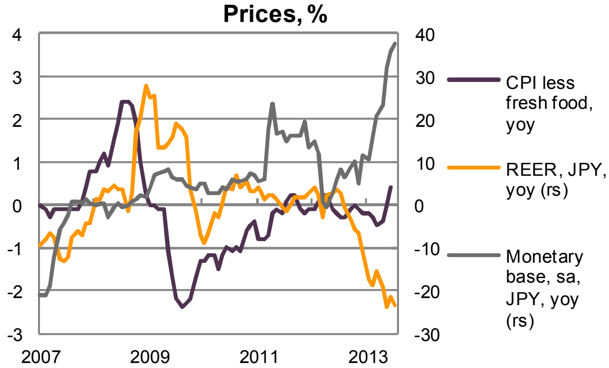
The British economy will benefit from a boost in external demand from both the euro area and the US. We expect the pound to remain competitive. In addition, domestic demand will be bolstered through higher housing prices and equity markets. However, the challenges to transform the British economy remain formidable. GDP is still far below pre-crisis levels, and the growth model of providing international financial services and relying on oil and gas from the North Sea is not repeatable. Instead, reforms aimed at restructuring the economy and raising productivity will have to be pursued while keeping fiscal policy tight.

Japan: Will it be different this time?

Political stability and ambitious economic reforms together with a massive monetary stimulus and an expansive budget, have pushed up Japan's GDP and stock market, and improved confidence indicators. GDP is expected to grow by at least 1% in the coming two years, supported by private consumption, private investment, exports and government consumption. GDP growth would slow in 2015 due to fiscal consolidation and higher prices.

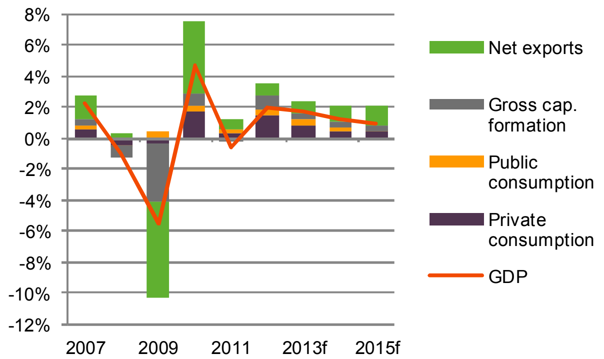
Deflation is expected to end during the second half of this year, and inflation is projected to accelerate in 2014, even without the planned consumption tax hike. Still, more quantitative easing might be needed to reach the 2% inflation target. The expansion of the monetary base, as well as the growth and interest rate differentials with the US, should push the yen lower against the US dollar. Although the economy is recovering and consumer prices started to increase in June, a bumpy road lies ahead. Japan's huge public (net) debt and an aging population pose major challenges for the government.

Prices, %



Source: Reuters, Swedbank

Japan's growth composition



Source: Eurostat, Swedbank

Emerging markets: Risk sentiments pick up in Asia

Downward revision of growth in India and Brazil

After being the backbone of global growth since the financial crisis in 2008-2009, emerging markets are now facing increased headwinds. This is especially true for big economies like India and Brazil. Lack of confidence in the Indian economy holds back investment and has led to increasing capital outflows, prompting a reduction in our growth forecast. A slowdown in growth in Brazil has eroded confidence and helped foment social unrest. We revise down growth significantly in 2013, before election related spending and the World Cup in football provide a rebound in 2014 and 2015. Both of these economies, which have large current account deficits, have seen sharp declines in their currencies, reflecting a loss in external confidence and concerns about dollar liquidity.

China: Moderating growth as a new model is embarked upon

A downward revision of Chinese growth, but not without risks

The fear of a hard landing of the Chinese economy, caused by a meltdown in the financial sector, has been gradually replaced by a more modest–and less alarming–outlook on growth (we discuss in more detail the risks of a more adverse scenario in Box 2). In our main scenario, we lower the growth forecast to between 7-7½% from 8-8½%, and foresee a gradual shift from a reliance on credit and investment to consumption-led growth. This is in line with the stated intentions of the Chinese authorities; at the same time, however, the transformation is unlikely to be smooth.

Orderly financial sector developments and job creation are key

There are two main concerns. Primarily, the significant expansion of the shadow banking system has to be controlled while not causing disruptions to the credit flows. We are likely to see defaults, but the financial resources of the government should remain sufficient to contain a wider fallout. Second, the new government intends to further promote urbanisation as a way to raise incomes and consumption, but this has to be matched by continued job creation and an expansion of the social safety net. If not, social unrest could spread.

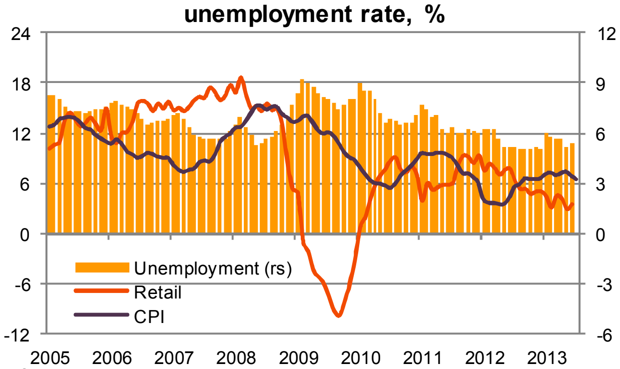
Recent short-term indicators support our view that the Chinese economy is slowing in an orderly fashion. Industrial production is keeping up and domestic demand is steady. We expect the Chinese policymakers to continue to be active in guiding the transformation, but the room for manoeuvre will be limited. The procyclical fiscal policy has helped to elevate deficits, and liquidity needs to be contained to dampen credit risks.

Russia: Shifting to a lower gear

Russia slides into recession

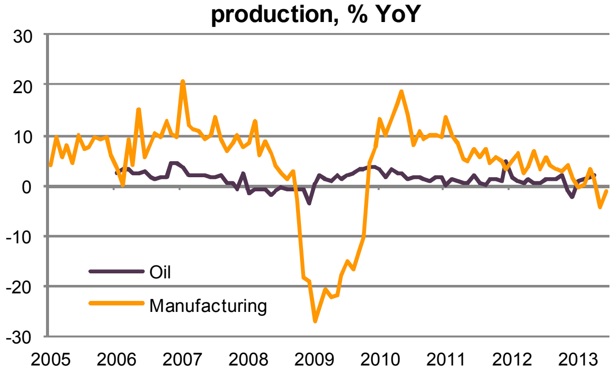
The recent data flow has been quite disappointing. Lower commodity prices have softened the government's fiscal balances and eaten into the current account surplus. Manufacturing output contracted as did investment in productive capacity. This was partly offset by a rise in oil and gas output, and robust consumer spending, supported by a strong labour market and receding inflation. Yet, this was not sufficient, and Russia slid into recession in the second quarter of 2013.

Annual growth of retail and CPI, and unemployment rate, %



Source: Reuters EcoWin

Output of manufacturing and oil production, % YoY



Source: Reuters EcoWin

We see Russia returning to growth in the second half of the year. A number of one-offs, such as this year's good harvest and the winter Olympics early next year will help. With inflation slowing, we expect the new head of the central bank, Elvira Nabiullina, to cut interest rates. The government has announced a new stimulus package that aims to boost infrastructure spending and improve financing conditions for small and medium-sized companies. The inventory cycle is likely to turn and provide boost to GDP somewhat.

Weak recovery weighed down by lack of reforms

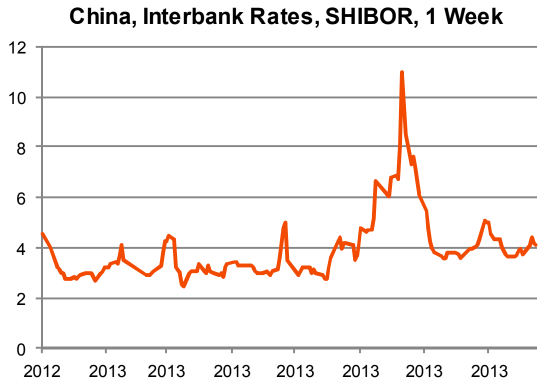
But the recovery will not be impressive. The stimulus package is small and takes time. There is hardly any labour market slack, and consumption cannot be boosted sustainably. The outlook for oil and commodities is weak. More important, at the core of the current weakness are structural issues (e.g., corruption, productivity) on which it is unlikely to expect fast progress. We revise down GDP growth this year to 1.3% and to roughly 3% per annum over the next two years. The weakening of the rouble is set to continue. Russia is accordingly shifting to a lower gear for the time being.

Box 1: Adverse China scenario – Impact on the global economy

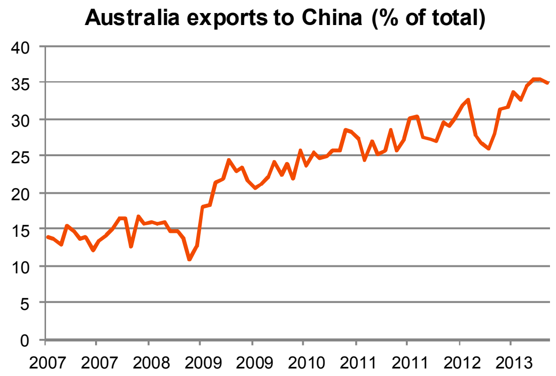
Concerns about a Chinese hard landing shot up in June when interbank rates rose sharply. Much of the worry was related to credit developments outside traditional banking, in the so-called shadow banking sector. However, this sector is not the main problem, as economic growth in China since the 2008 financial crisis largely has been driven by strong credit expansion in general. The total stock of credit was throughout most of the 2000s, relatively constant as a share of GDP. Since 2009, credit stock has increased by approximately 60 percentage points of GDP, with a decreasing connection between credit and economic growth. Furthermore, the cost of credit has lately gone up while nominal growth has slowed, increasing the risk for unprofitable investments. There are also reasons to believe that credit expansion since 2011 has mostly gone to finance property investments, which do not add much value to GDP.

The rapid credit expansion has mainly taken place in shadow banking, which in itself is less of a problem. Wealth management products and trust loans are the main products, and these started as ways for banks to circumvent interest rate controls and thereby offer clients a better return on deposits and give less creditworthy borrowers access to credit. The problem with shadow financing is, instead, that it is less regulated and more difficult to control than bank lending. There is also a large maturity mismatch as investments are generally short (about three-six months); meanwhile, loans often fund projects with longer maturities. These products could therefore create financial instability if a sudden shock were to trigger a run.

Given the unsustainably high credit growth, politicians have started to contain liquidity and thereby limiting their growth objectives. This process is not without risks as tighter credit conditions may lead to defaults for less creditworthy entities, even including banks that are not of systemic importance. The direct risk to the banking system is not great, but there are reasons to believe that banks will step in and, at a major liquidity crisis, compensate key clients in an emergency situation. In addition, the government has sufficient resources to counteract a potential shock, which would reduce the likelihood of a disorderly development. However, it is not unlikely that the slowdown of credit growth will from time to time be subject to interference, causing financial market stress. It is very important that financial reforms be introduced and implemented in a timely manner to reduce the risks of future shocks.



Source: Reuters EcoWin and Swedbank



Source: Reuters EcoWin and Swedbank

The external risks are still largely related to a renewed downturn in growth in the euro area or a setback in the US economy (not our main scenarios). Another, maybe more severe source of external risk is the formulation of a negative feedback loop in other emerging countries that have trade relations with China. Many of these countries are already in a vulnerable position. Large economies like India, Brazil, and Indonesia have big current account deficits, attenuated external confidence, and deficiencies in domestic policymaking. Since US Treasury yields started to rise in May, countries with negative developments in their external balances have seen their currencies in a free fall. This is also a reflection of poor economic management in some of the countries in which imbalances have been built up. At the same time, they have become dependent on Chinese demand for their exports and on Chinese direct investments.

The risks to the rest of the world from a sharp slowdown of the Chinese economy are significant. Primarily, risk sentiment would go down with, negative effects on financial markets around the world. Second, demand from the Chinese economy would drop, threatening the recovery in more mature economies in Europe and the Americas. However, some of the decline could be compensated for by lower commodity prices; these would benefit import-dependent countries, while it would be detrimental to net exporters.

However, the biggest risk in our view is the possible negative feedback loop that could arise between China and other Asian countries, not least Australia because of its high export share to China. This could reverse the current upward trajectory of the entire global economy. In turn, a slowdown in emerging economies would negatively affect an already weak and vulnerable Chinese economy. The risk has increased that countries like Brazil, India, and Indonesia may incur further balance of payments problems if the current negative market environment continues. Such a development would add downside risks to Chinese growth.

Nordic area: Still diverging

Norway is slowing down:

Growth was much weaker in H1 than expected, domestic demand has slowed

Mainland GDP growth has slowed to a growth rates of than 2% growth from 3.5% last year. Employment growth has slowed, too, and the unemployment has inched marginally up, dampened by a reduction in the participation rate. The housing market has cooled down, following years of rapid price increases. Foreign demand cannot take much of the blame as domestic demand has weakened–mostly mainland investments, most likely hurt by a mild credit tightening last year and into 2013. China's investment boom is probably over, and the global raw material super cycle is most likely going into reverse. The Norwegian terms of trade (export prices versus. import prices) are trending down, and Norwegian income growth has slowed more than GDP.

.. even if the economy probably gained speed through Q2

Even though GDP growth surprised on the downside in the second quarter, other news from the economy has been marginally upbeat: manufacturing activity has surged, retail demand is not weak, and unemployment has stabilised. Banks have turned less restrictive regarding commercial real estate and are not tightening conditions for households or enterprises. The fiscal stance is marginally expansionary, and monetary policy is loose. We expect growth to pick up somewhat in the second half.

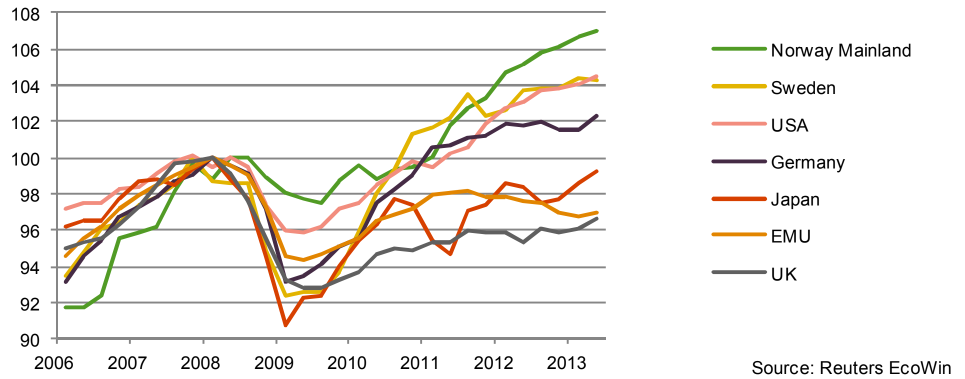
Some headwinds ahead

We have adjusted our forecasts down marginally. A surge in oil sector investments was an important driving force in the 2010 – 2012 recovery. Domestic suppliers have a 60% - 70% market share, and, production and employment in the oil-related sectors have boomed. Now, the oil companies are becoming more cautious in their investment spending, following the global investment spending spree. They are cash constrained, even at an oil price above US$ 100 per barrel. In addition, new regions are competing for these limited investment budgets. Shale gas and oil plays, as well as other conventional fields in many countries, are alternatives for the oil companies. Gas prices are under pressure in Europe, due to coal exports from the US, where gas prices are at rock bottom because of the shale revolution. We expect a decline in investments on the Norwegian shelf, starting in 2015.

Housing investments may already have peaked at the current high level after strong growth in recent years. An unprecedented wave of immigration may partly explain the boom in home prices and construction, even if the price and availability of credit and strong income growth are more important. Anyway, a general growth slowdown in Norway, alongside a recovery in other parts of Europe, will certainly lower immigration, as we may already be experiencing.

Thus, the best scenario is that Norway will become more "normal", at least growth wise. Still, unemployment is very low, at 3%, and the public sector fiscal position is unparalleled. In addition, wage inflation has slowed, and price inflation is at about 1.5%, well below the 2.5% inflation target.

GDP levels, peaks in 2007/08=100



Source: Reuters EcoWin

Some room for policy maneuver

In our base case, we do not expect Norges Bank to cut the policy rate from the present 1.5%. If growth should slow more than we expect, the bank has more room for manoeuvre than most others. The Norwegian krone has weakened substantially in recent months, illustrating that this not a one-way bet. This decline also shows that, if needed, the exchange rate will contribute to a rebalancing of the economy. The cost level is still most likely too high, but an internal devaluation is not needed, as an external one will do the dirty job. Some inflationary impact is likely but inevitable, and it will only contribute to a necessary slowdown in real disposable income. The banking sector – which is quite well capitalised – will, if needed, get a helping hand from the government.

The outlook for the Norwegian housing market is discussed in Box 2. The downside risk, although substantial, is most likely manageable, from a macroeconomic perspective.

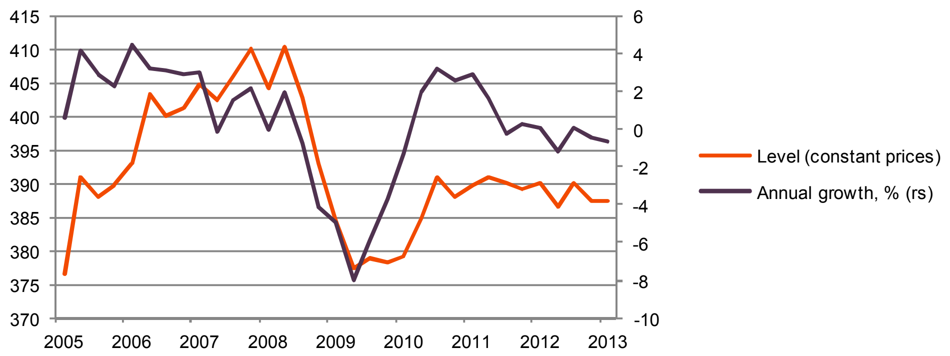
Denmark: Recovering slowly

The Danish economy has come far in its much-needed adjustment following the financial crisis and overheating of its housing and labour markets. House prices have fallen by around 20%, wages growth has slowed sharply, and companies have increased their saving considerably. The adjustment provides room for economic growth. This, together with expectations of a gradual improvement in the European economies, is the main reason we expect a shift away from the close-to-zero growth rates of the past three years.

In the aftermath of the financial crisis, the business investment ratio fell to record-low levels due to tightening credit standards and weak global demand. We foresee a recovery in investments during 2014-2015, when global demand is strengthening. Business investment is expected to pick up due to large infrastructure projects. An end of the recession in the euro area and stronger competitiveness among Danish exporters mean brighter prospects for exports. Exporters in Denmark have been affected by a weak demand in euro area, which is their largest market. The stabilisation on the housing market and improved global outlook has strengthened consumer confidence, and we foresee stronger private consumption growth during 2014-2015. Although consumption relative disposable income has fallen sharply, we do not expect a strong rebound in private consumption during the forecast period. Households are still interest rate sensitive and the fiscal policy is expected to be less expansionary in 2014-2015, so as to strengthen public finances.

Overall, we foresee GDP growth of close to 0.5% in 2013, which includes a decent recovery during the second half year. In 2014 and 2015, growth will gradually pick up to 2% driven by stronger domestic demand.

Real GDP



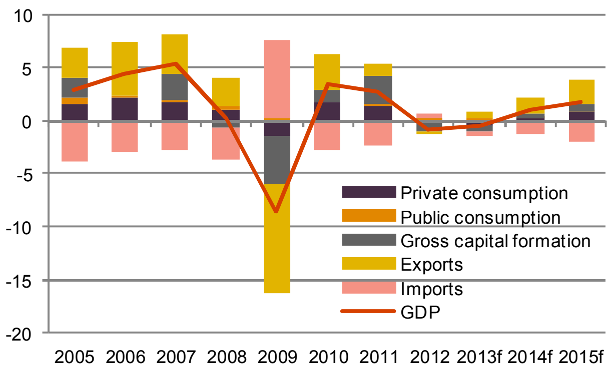
Source: Reuters EcoWin and Swedbank

Finland – all hopes lie on the export

The global financial crisis, followed by historically slow growth in the euro area, has revealed structural problems in the Finnish economy. Traditional sectors, such as electronics and paper, are struggling with low external demand, eroding competitiveness, and increasing competition from Asia. However, the second-quarter growth rates of 2013 and positive signals from the global economy add to hopes for a gradual, export-led recovery.

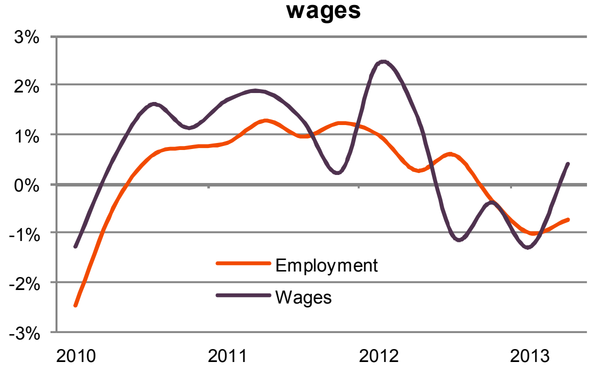
The pickup in the growth rate is expected to stem from exports, as well as from private consumption, which in 2013 has been dampened by a substantial increase in indirect taxes. Also, investment, currently suppressed by low levels of orders and capacity utilisation, is expected to turn around once production volumes start to increase.

Finland's growth composition, pp



Source: Eurostat, Swedbank

Annual growth of employment and real wages



Source: Statistics Finland

Sweden: Favourable developments at home and abroad raise growth

The Swedish economy is strengthened in the second half of 2013 and during 2014. Positive global development favours export industries while domestic demand is driven by expansionary fiscal and monetary policies. Long-term market rates climb initially before the Riksbank starts raising the key interest rate in the spring of 2014. The forecast risks still remain, primarily concerning the housing sector and high household debt ratio.

The economy in 2013 strengthens following a weak first six months

The Swedish economy experienced mixed fortunes in the first six months of 2013. Growth was respectable, but the underlying dynamics were weak. Companies saw their inventories grow, which can be a sign of lower demand than expected. The increase in household consumption was partly due to the cold weather. During the spring and summer, confidence indicators have strengthened for households and businesses while the global growth outlook has also brightened. We expect growth to rise in the latter part of 2013.

Key Economic indicators, 2012-2015 1/

	2012	2013f	2014f	2015f
Real GDP (calendar adjusted)	1.1	1.6	3.2	2.8
Industrial production	-3.2	-2.5	4.0	5.2
CPI index, average	0.9	0.2	1.8	2.8
CPI, end of period	-0.1	0.8	2.4	3.0
CPIF, average 2/	1.0	1.0	1.7	2.0
CPIF, end of period	1.0	1.3	1.8	2.1
Labour force (15-74)	0.8	1.0	0.6	0.5
Unemployment rate (15-74), % of labor force	8.0	8.0	7.9	7.4
Employment (15-74)	0.6	0.9	0.8	1.0
Nominal hourly w age w hole economy, average	3.1	2.9	3.0	3.2
Nominal hourly w age industry, average	3.9	2.8	2.9	3.0
Savings ratio (households), %	11.9	11.3	10.7	8.8
Real disposable income (households)	3.1	2.5	2.7	1.3
Current account balance, % of GDP	7.0	6.6	6.4	5.6
General government budget balance, % of GDP 3/	-0.6	-1.2	-1.1	-0.3
General government debt, % of GDP 4/	38.1	41.5	40.3	38.6

1/ Annual percentage growth, unless otherwise indicated. 2/ CPI with fixed interest rates.
3/ As measured by general gov ernment net lending. 4/ According to the Maastricht criterion.
Sources: Statistics Sweden and Swedbank.

Consumption is growing, but there are risks in the housing sector

We are revising our growth forecast for 2014 to 3.2% (compared with 2.7 in April), and predict that growth for 2015 will be 2.8%. Positive employment growth and an expansionary fiscal policy to stimulate private consumption are reinforcing the economic upturn. The negative risks to the forecast mainly concern rising house prices and high household debt levels as well as possible setbacks abroad. An even quicker slowdown in emerging economies or renewed political turmoil in Europe would have negative consequences for the Swedish economy. In the short term, household debt and the housing market also pose positive forecast risks, which may fuel domestic demand and therefore growth.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2012		2013f		2014f		2015f
Households' consumption exper	1.5	(1.5)	2.5	(2.5)	3.4	(2.9)	3.4
Government consumption exper	0.7	(0.8)	1.0	(1.0)	1.1	(1.2)	1.0
Gross fixed capital formation	3.2	(3.4)	-3.4	(1.1)	4.7	(4.2)	7.7
private, excl. housing	6.8	(7.3)	-5.6	(2.8)	6.2	(4.8)	9.5
public	3.7	(3.9)	-0.2	(2.3)	1.2	(3.8)	2.8
housing	-8.2	(-9.1)	1.3	(-6.4)	3.2	(2.3)	7.4
Change in inventories 1/	-1.1	(-1.1)	0.8	(0.0)	0.0	(-0.0)	0.0
Exports, goods and services	0.8	(0.7)	-2.2	(0.9)	4.8	(4.2)	6.6
Imports, goods and services	0.1	(-0.1)	-2.4	(1.2)	4.7	(4.7)	8.2
GDP	0.7	(0.8)	1.6	(1.6)	3.1	(2.6)	3.0
GDP, calendar adjusted	1.1	(1.2)	1.6	(1.6)	3.2	(2.7)	2.8
Domestic demand 1/	1.5	(1.6)	0.8	(1.6)	2.8	(2.5)	3.3
Net exports 1/	0.4	(0.4)	0.0	(-0.1)	0.3	(0.0)	-0.3

1/ Contribution to GDP growth. Sources: Statistics Sweden and Swedbank.

Expansionary election year budget strengthens the economic upturn

Unfinanced reforms equivalent to SEK 25 billion

Fiscal policy contributes to accelerating growth in 2014 and 2015. The budget will mainly focus on strengthening the purchasing power of households. Swedish households have more money in their wallets as a result of tax cuts, most probably through a fifth in-work tax credit, a heightened threshold for state income tax, and lower taxes for pensioners. We also expect to see investment in schools, infrastructure, housing and employment measures. To combat youth unemployment, initiatives are expected to focus on jobs for young people such as vocational preparation contracts and the abolition of differentiated fees for unemployment benefits. We expect the government to invest up to SEK 25 billion in unfinanced reforms in the election year 2014.

Financial savings in 2012 were slightly lower than expected at -0.6%. Financial savings for the current year have fallen as a result of weak growth and lower tax revenues. Income tax cuts and increased spending in the election year will result in negative financial saving also in 2014 despite the accelerating growth. Government debt (the Maastricht debt) rises in 2013 from 38.1% of GDP to 41.5%. This is mainly due to borrowing by the Swedish National Debt Office in order to strengthen international reserves. An expansionary budget risks jeopardizes the surplus target. The surplus target stipulates that financial savings must be one per cent over the economic cycle. It is important to maintain the fiscal policy framework that has created confidence among the financial markets concerning the Swedish economy. Meanwhile it is fair to look at how large the surplus target should be in the long run.

Investments in schools, infrastructure and construction enhance competitiveness

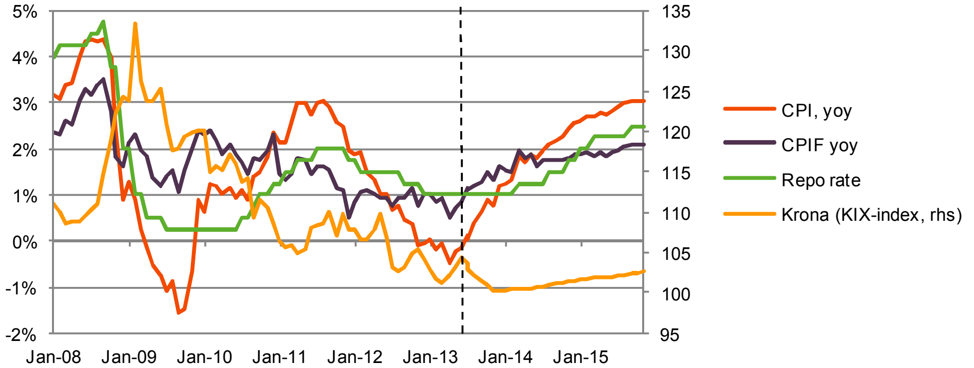
The expansive election year budget strengthens the economic recovery that starts in the second half of 2013. In particular, private consumption is accelerating as a result of income tax cuts. Investments in infrastructure and housing are key reforms that stimulate domestic demand and thereby contribute to increased growth in the short and long term. Investment in education does not provide the same short-term effects, but helps in the long run to increased productivity and higher potential growth. Investment in infrastructure and housing also offers long-term positive effects on potential growth. Housing and infrastructure complement one another and are necessary investments as the lack of housing in metropolitan regions suppresses mobility in the labour market and growth. Taken together, the expansionary fiscal policy contributes to growth in 2014 and 2015 and reduces the risk that temporary setbacks abroad and in Sweden once again dampen household spending.

One unwelcome effect of an expansionary election year budget is that signs of overheating on the Swedish housing market could worsen. The housing shortage in urban areas may mean that households will use part of their income tax cuts for increased indebtedness, driving up house prices. The Riksbank takes household debt into account in monetary policy decisions, as financial imbalances could ultimately jeopardise both the real economic stability and price stability. This dilemma is complicated by uncertainty about how macro-prudential supervision will be organised in the future. Fiscal policy could therefore contribute to financial imbalances and hinder an effective monetary policy, combined with an absence of strong measures to stimulate construction.

The Riksbank's next move is a raise – already in the spring of 2014

In July, the Riksbank left the repo rate and its path unchanged, as forecast by Swedbank. Growth is now strengthened, not least because of domestic demand, and Swedbank's forecast therefore that the next step by the Riksbank will be to raise interest already in the spring of 2014. There is, however, plenty of slack in the economy so it will take time for inflation and inflation expectations to rise from the current very low levels. We expect that the Riksbank's will raise the repo rate in the years 2014-2015 by 150 points. High household debt and high interest rate sensitivity mean that a rise in interest rates will have a negative impact on the housing market and private consumption at a relatively early stage. This is illustrated by the experience of the relatively modest tightening of monetary policy in 2011.

Inflation, the repo rate and the exchange rate



Sources: Riksbanken, Statistics Sweden and Swedbank.

Inflation rises during the forecast period

We also expect that inflation will rise over the forecast period, mainly as a result of domestic factors. Rising housing costs are the main driving force, caused primarily by higher interest expenses. This explains the reversal between the CPI and CPIF during the forecast period. Rising interest expenses also leads to slightly higher rent increases, mainly in 2015. We expect relatively strong growth in household consumption, which will be reflected in a relatively broad increase in prices. The low international capacity utilisation means that we expect relatively stable commodity prices throughout the forecast period, with some upward pressure in the latter part of the forecast period. The price of oil, in U.S. dollars, is expected to drop slightly. Meanwhile, however, we expect a stronger U.S. dollar, which overall means that the price of oil, expressed in SEK, will rise slightly with marginally higher fuel prices as a result, mainly during the next year.

Continued balancing problem for the Riksbank

Household debt and higher house prices pose a continuing headache for the Riksbank. High debt increases households' sensitivity to shocks. According to the Riksbank, the current interest rate path therefore offers a reasonable balance which means that inflation and the real economy stabilise in the short term, while longer-term risks associated with household debt are taken into account. The Riksbank has been criticized for not cutting the repo rate given the weak economic situation and low inflation, yet has referred to the financial imbalances. The Riksbank emphasises, however, that monetary policy alone cannot manage the risks associated with high household indebtedness. Initiatives in other policy areas must also be considered. Some have already been taken, such as the introduction of mortgage ceilings and higher risk weights for mortgages. But the Riksbank considers that there is still considerable uncertainty about the impact of these measures and whether they are sufficient. As a partial result of this, the discussion about macro-prudential supervision and macro-prudential supervision tools has intensified (see the information box 1). We have previously argued for further cuts in the key interest rate with reference to the economic situation, but given that we are seeing a stronger recovery, we believe that the current level is appropriate. However, we forecast a calmer cycle of increases than the Riksbank does.

Krona unchanged

We anticipate that the krona will strengthen during the autumn and then decrease slightly until the end of 2015. The gain will mainly be against the Euro, but as the global economy picks up, the krona will fall in value, partly as a result of increased risk sentiment. Over the entire period, the krona will be largely unchanged and competitiveness (measured by the real effective exchange rate) is at a level comparable with the years before the financial crisis.

Rising interest rates

Rising international interest rates and higher growth produces upward pressure on bond yields throughout the forecast period. An unchanged key interest rate in the coming year will initially hold back the rise in short-term bond yields. As we approach a rise in the repo rate, short-term rates will also rise, a trend that is accentuated during the first half of 2014. Higher bond yields also impact on higher mortgage rates, partly through a general rise in interest rates and partly because we expect a slight increase in the interest rate differential between government and mortgage bonds. The differential at present is historically low, especially for bonds with shorter maturities. Gradually, rising interest rates also mean that we expect households will increasingly choose to fix their mortgages. This development leads to mortgage institutions increasing their borrowing through mortgage bonds, which contributes to higher mortgage spreads. Interest rate rises become more pronounced in 2014 and we anticipate that the trend of rising interest rates will not level off until mid-2015.

Interest and exchange rate assumptions

	Outcome	Forecast				
	2013	2013	2014	2014	2015	2015
	23-aug	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates (%)						
Policy rate	1,00	1,00	1,25	1,75	2,25	2,50
10-yr. gvt bond	2,51	3,00	3,10	3,40	3,65	3,80
Exchange rates						
EUR/SEK	8,7	8,4	8,3	8,4	8,5	8,7
USD/SEK	6,5	6,6	6,8	6,7	6,5	6,4
KIX (SEK) 1/	102,7	100,2	100,6	101,4	101,9	102,7

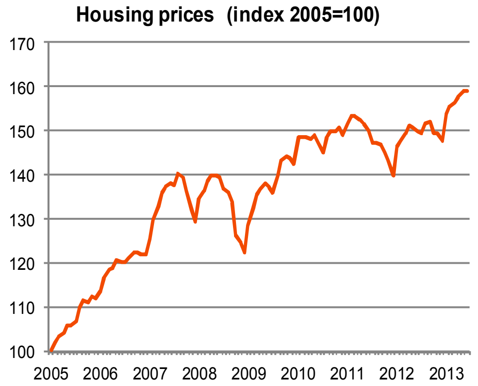
1/ Total competitiveness weights. Trade-weighted exchange rate index for SEK.

Sources: Reuters Ecowin and Swedbank.

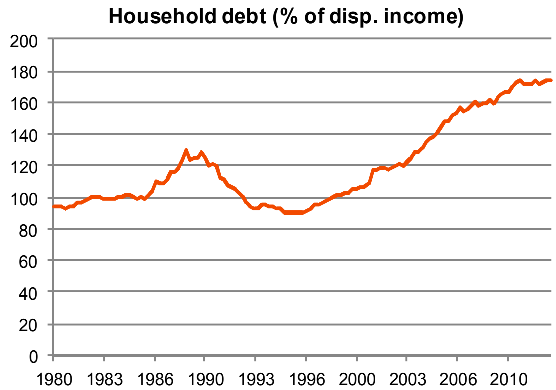
Box 1: Macro-prudential supervision is crucial for monetary policy effectiveness

The Swedish government recently announced that the Financial Supervisory Authority (FSA) will have responsibility for a range of new macro-prudential tools aimed at strengthening financial stability. The FSA will be responsible for contra-cyclical buffers to be introduced next year. In addition, a the government announced that the banks will partake in financing the currency reserve, that a formalised coordinating council will be introduced, and that the stability fund will be made permanent and have its own assets.

The purpose of macro-prudential supervision is to identify, analyse and counteract risks to the financial system as a whole. This differs from traditional financial supervision that focuses on the health of individual financial institutions. The issue of macro-prudential supervision may have a considerable bearing on the shape of monetary policy in the coming years. If the tool is introduced and it has an impact on household debt, the Riksbank, ceteris paribus, can avoid using interest rates as a weapon and interest rates will not have to be increased as much. On the other hand, if the introduction of the tool is delayed or only has a limited impact on household debt, this may increase the burden on monetary policy to household debt into account. In this perspective, the organisational aspect is key.



Source: Valueguard



Source: SCB

Last spring, the Financial Crisis Committee (FKK) suggested the introduction of a macro-prudential supervision council where the Riksbank and the Swedish Financial Supervisory Authority will consult one another before deciding on any actions. FKK proposed that both authorities will have a statutory responsibility for macro-prudential supervision and may be assigned to these tools. Several bodies objected to the proposal because it gives an unclear division of responsibilities, but these bodies have drawn different conclusions about who should have the main responsibility. The Riksbank considers that it has sound fundamentals, in terms of skills and organisationally, to assume sole responsibility for macro-prudential supervision. The synergies that exist with monetary policy would enable the Riksbank to achieve the goals of price stability and financial stability. Many bodies think instead that it is natural for the responsibility to reside with the Swedish Financial Supervisory Authority. The fact that the Riksbank is an independent authority may constitute a democratic problem if the arsenal of macro-prudential tools becomes widespread. The Riksbank's solution is that with more tools for macro-prudential supervision, one can decide whether it is be more appropriate to place the responsibility for decisions regarding macro-prudential measures on a specially appointed decision-making committee within the Riksbank. At present, the Swedish Financial Supervisory Authority is only responsible for regulating the financial sector. Since 2012, there has been a coordinating council for macro-prudential supervision that includes the Riksbank and the Swedish Financial Supervisory Authority. In the coordinating council, the authorities must consult and exchange information about risk assessments concerning the financial system as a whole and discuss appropriate measures to prevent risks.

Swedbank welcomes the fact that the government has made a decision and the clarification of responsibilities. The decision, however, poses risks for monetary policy as it is unclear how fast and to what extent the FSA can implement the new tools. It limits the possibilities for synergies with monetary policy. And, it does not take advantage of the Riksbank’s knowledge and experience of financial stability. We expect the Riksbank to take a cautionary stance until the effects of the new tolls become visible. As a consequence, the Riksbank will continue, for some time, to consider house prices and household debt in their monetary policy decisions.

Businesses gearing up from low levels

Low capacity utilisation and uncertainty about the strength of the economy contributed to investment plans for 2013 being revised downwards during the spring among both engineering and service providing businesses. During the summer, business confidence has strengthened, while the global growth outlook has been revised upwards. Yet due to the weak investment trend at the start of the year, we expect that the total investment volume in the Swedish economy will shrink by almost 3.5% in 2013, substantially weaker than we predicted in the spring.

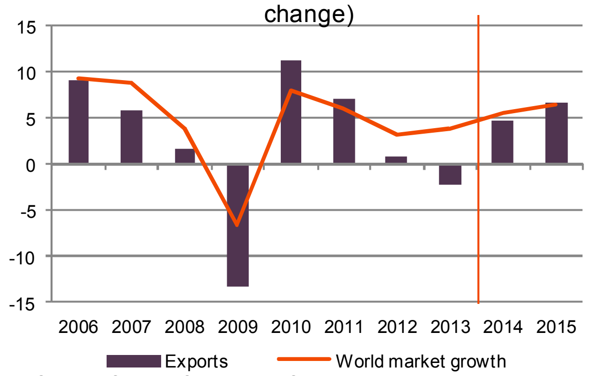
Service sector investment picks up first

We believe that investment plans will be revised upwards in the autumn. Capacity utilisation and production will not rise until 2014, as investments in industry gather pace. According to both the PMI and National Institute of Economic Research service barometers, companies have adjusted their production plans during the summer months. We expect the private service sector is where investment will first gather pace as domestic demand grows. Households' increased purchasing power is expected to lead to higher investments in trade and domestic service companies. The growing service segment in the Swedish economy and the emergence of new companies is also expected to lead to increased investment in the commercially oriented service sector. Increased housing shortages, higher household purchasing power and a growing population will boost housing investment in 2014-2015, albeit from low levels. The government's long term investments in infrastructure as well as improved finances for local governments are expected to lead to higher public investment in 2015. Overall, we estimate gross investment to rise by 4.7% in 2014 and by almost eight per cent in 2015. This means that the Swedish investment volume will once again reach the level in 2008.

Weak exports so far in 2013

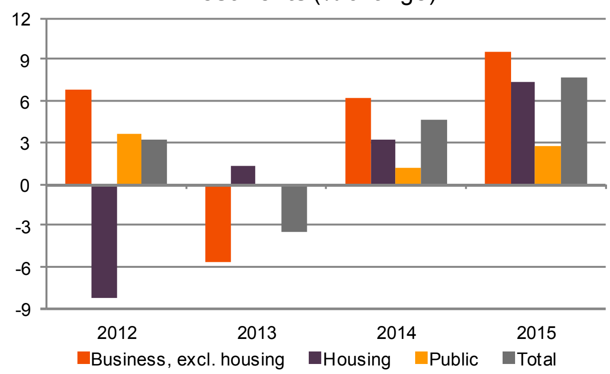
The weak global demand took its toll on Swedish export companies during the first half of 2013, and the volume of exports fell by an annualised rate of just over 3%. Capital goods and raw materials have seen the greatest decline, while exports of services rose slightly. Swedish companies have been cautious about raising export prices, probably to avoid losing market share. This means that the decline in exports in nominal terms has been greater than in volume terms. The decline in exports and the low investment activity have also suppressed imports, which has limited the negative impact on growth of net exports.

World market growth and export (% change)



Sources: Statitics Sweden and Swedbank.

Investments (% change)



Sources: Statitics Sweden and Swedbank.

Turn in export activity in sight

The economic recovery in Europe in the second quarter has not yet been reflected in the order books of Swedish export companies. The expectations of industrial firms in the barometer for the National Institute of Economic Research indicate that orders from the export market will improve in the coming quarters. We believe that exports have passed the bottom level but the weak start so far this year means that Swedish export volume will decrease by more than two per cent this year.

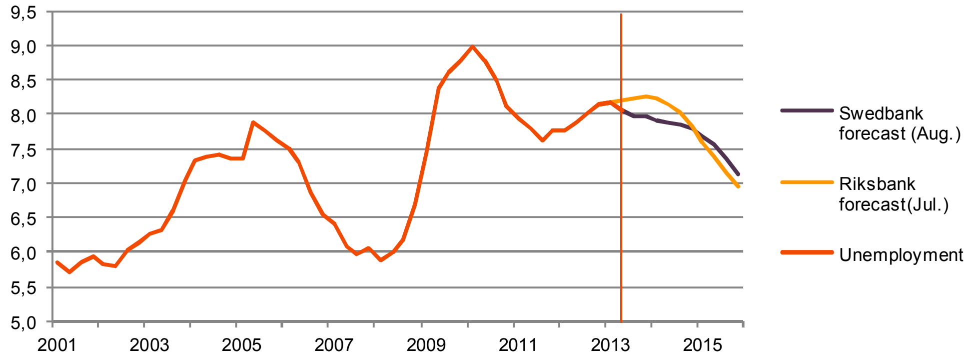
The shift in the global increase in growth from the emerging economies to the OECD countries is favourable for the Swedish export industry since the majority of exports are to OECD countries. Global market growth for Swedish exports is forecast to rise by 5.5% next year and by more than 6.5% in 2015 compared to a modest 3% this year. Because the utilisation of resources is still far below its potential in a number of OECD countries, investments will be restrained in 2014, which will constrain the Swedish export industry. We expect that the global investment economy to pick up in 2015. Unit labour costs in Sweden are expected to rise at a slower pace in 2014 and 2015 due to greater increases in productivity and moderate wage increases, with Swedish competitiveness remaining solid. Overall, we expect the total volume of exports to increase by 4.8% in 2014. For 2015, we anticipate a more robust recovery in exports by more than 6.5% as global demand strengthens. The contribution made by net exports to GDP growth is expected to be negative in 2015 as domestic demand also strengthens.

Strong employment, but unemployment remains high

Increased employment matched by a growing workforce

Employment developed better than expected in the first half of the year. However, unemployment is creeping up as the labour force continues to grow surprisingly quickly. Economic indicators such as PMI and the NIER barometer have strengthened over the summer, pointing to a gradual increase in job vacancies. The Swedish Employment Service's statistics regarding job vacancies and the number of redundancies indicates an imminent improvement. We anticipate that unemployment will stabilise this year at just over 8%. A new population projection from Statistics Sweden also indicates that the working age population will increase faster than previously assumed. Against this background, it will be well into 2014 before the unemployment rate falls more clearly below 8%. Employment is expected to continue to increase at a healthy pace over the next few years, about 0.8% in 2013 and 2014 and about 1% in 2015.

Unemployment rate (% of labour force, seas. adj.)



Sources: Statistics Sweden, Riksbank and Swedbank.

The supply of labour is expected by most to increase relatively rapidly during the coming years. Since 2006, labour force participation has increased by 265,000 people and an additional in-work tax credit will increase incentives for groups outside the labour market. At the same time, during a transitional period, tax cuts will help to keep unemployment figures up as it takes time for people entering the labour market to find jobs. This tendency is reinforced by the fact that if often takes longer than average for these people to find a job, partly because of an over-representation of people of foreign origin, with lower levels of education or those on long-term sick leave.

There are also factors that counteract rising unemployment. The economic upturn will contribute to an increased demand for labour. The new labour market policy measures are also expected to increase youth employment. During an economic upturn however, growth tends to gain momentum before unemployment declines as companies have available resources and can initially meet increased demand by increasing the number of hours. We will not see clear improvements in the labour market until 2015 when the unemployment rate is then expected to reach 7.5% on average.

Wage increases are expected to be relatively modest in the coming years as a result of the recently concluded wage agreements and the slack in the labour market. In 2015, however, wage drift is expected to increase marginally as the labour market strengthens more clearly and with increased matching problems.

The composition of the workforce continues to change. More and more older people are remaining in the labour market, and this is particularly noticeable for the 55-74 year age groups. Furthermore, the proportion of foreign-born people in the labour market is gradually increasing, from just over 65% in 2006 to about 70% this year. In this perspective, government policy has been successful.

Many challenges remain. Youth unemployment is high and the number of long-term unemployed has increased. Coupled with the fact that the proportion of foreign-born people in the labour market is growing, it is likely that the non-accelerating-inflation rate of unemployment rose slightly, at least in the short term. It will require training and employment support aimed at weaker groups. Various measures are being implemented or planned to reduce youth unemployment. Further measures are expected in the autumn budget and in the wage negotiations, several agreements were concluded regarding work experience for young people, e.g. within commerce.

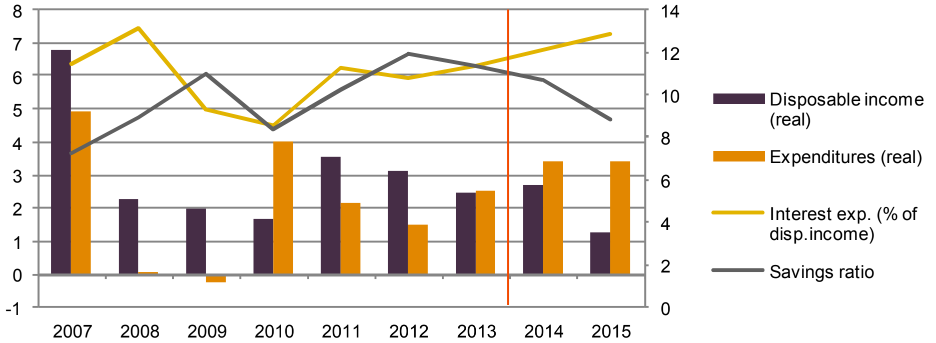
Household finances are strong, but not without risks

Household consumption has gradually strengthened during the first quarters of the year. After some weak late winter months, retail sales gained momentum in May and June, increasing by 3.1% and 3.6% respectively (in real terms, calendar effects). Consumer confidence has improved and the confidence indicator for July was slightly above the historical average. Households' assessment of both their own finances and the Swedish economy has gradually become brighter, and fears about the labour market trend and the personal risk of unemployment have fallen significantly.

Ample room for increased consumption

Household consumption is supported by a sound level of disposable income, which we expect to continue over the next few years. It is mainly a gradual rise in employment and fiscal stimulus that favours the household economy. Further tax cuts in particular will stimulate the growth in consumption in 2014 and the following year. Lower taxes for pensioners are particularly effective in stimulating private consumption. Household savings have risen in recent years; a trend that we expect will be reversed in the coming years as confidence improves. Household savings, however, by all accounts remain at a relatively high level, historically, in the light of an increased need for pension and precautionary saving.

Household income and expenditures (% change)



Source:s Statitsics Sweden and Sewedbank.

Healthy household balance sheets increase the propensity to consume. House prices have risen rapidly in recent times, affecting household wealth positively. Household balance sheets have also benefited from positive developments in the stock market and increased savings. However, the growth of credit to households has increased slightly this year and now stands at just under 5%. Household debt remains high by historical and international standards and represents about 170% of disposable income. But in light of improved household balance sheets, we expect that the wealth position will contribute to growing consumption in the coming years.

Overall, we are raising our forecast for private consumption to 3.4% for both 2014 and 2015, compared to just 3% in our April forecast. This means that we continue to regard consumption as the primary driver of Swedish growth. The risk spectrum, at least in the long term, consists particularly of households' interest rate sensitivity. With a high proportion of variable loans, higher interest rates rapidly make an impact on household margins.

Box 2: Risks linked to imbalances in the Swedish and Norwegian housing market

In Sweden, real house prices have increased by 71% and Norway 80% since the turn of the millennium. The corresponding figure for the Euro zone is 15%. Discussions about the problem, and the reason behind the high house prices, have intensified in both Sweden and Norway. There are many similarities in the Swedish and Norwegian housing market, but the problem is different in key respects. The Swedish housing market is characterised by low construction and a small supply, which is pushing up prices, while Norwegian house prices are mainly a result of demand-driven factors. In Norway, the housing market valuations are higher than permitted by the fundamentals and we expect that there is a high probability that house prices will fall. In Sweden, household debt constitutes a risk factor both for economic and financial stability, but the probability of a fall in house prices is less than it is in Norway.

Rising real disposable incomes and growing debt in both Norway and Sweden

A number of common factors have contributed to strong increases in house price in both countries: low mortgage interest rates, lack of competition and high costs in the construction sector, insufficient investment in infrastructure, a growing population and rising real disposable incomes. The last two factors historically have developed in similar ways, but they may differ in the future. The Swedish population is increasing rapidly, and since the early 1990s it has risen by about 14%. In Stockholm, the growth rate during the same period has been even higher, with a population increase of 29%. In Norway, there has been a substantial migration of the labour force, especially to the metropolitan areas. The positive trends concerning disposable income in both Sweden and Norway are a contributing factor behind the sharp increase in house prices. Between 1991 and 2012 the real disposable income per capita rose by an average of 78% in Norway and 34% in Sweden.

In Norway, house prices have risen more than disposable incomes, rents and building costs

A number of short-term factors that have caused the increase in house prices in Norway will subside. Domestic demand has slowed, immigration has peaked, financial regulations have been tightened and unemployment has increased. This clarifies the factors, which means that house prices in Norway are overvalued. Norway and Sweden differ with respect to the housing market's structure, household debt, and the supply of housing.

Norwegian households are far more indebted than Swedish.

Indebtedness[1] has reached levels of 170% and 210% in Sweden and Norway, which is high compared to the rest of Europe. This difference can be partly explained by political decisions in which the Norwegian government has long held the aim of enabling as many people as possible to own their own home. This has been realised with favourable loans from the state's Central bank while there is also a municipal credit guarantee for so-called start-up loans[1]. Even at todays record low interest rates, more than one fifth of Norwegian households use more than 20% of their disposable income on interest payments, and many are forced to use as much as 30%.

More houses are being built in Norway than in Sweden

In the past decade, more than twice the number of properties per thousand inhabitants has been built in Norway compared with Sweden and the Norwegian production rate is three times greater than other European countries. Housing construction in Sweden is at a low level where the number of properties per capita is only half compared to other countries. In 2012, 20% fewer properties started to be built than in 2011.[1]

The Norwegian market is dominated by owner-occupied apartments, with nearly eight out of ten living in a property that they own. This can largely be explained by the so-called "own line". This policy is similar to Sweden's "Million Program", with the difference that Sweden invested in rental properties and Norway on owner-occupied housing. The Norwegian rental market, in contrast to that of Swedish, is characterised by private property rental where three-quarters of rented properties are privately owned. 37% of the Swedish market is made up of rental properties with the proportion in Stockholm slightly lower1. Unlike Norway, Sweden has statutory rental regulations, which means that property rental is not freely determined. This has an inhibitory effect on the willingness to invest in rental housing. This is reflected in the development of housing in Sweden, where the number of rental properties fell by about four per cent between 1998 and 2011 while the number of owner-occupied apartments rose by 40%.

Greater risks to financial stability in Norway than in Sweden

High house prices, combined with historically high leverage are risks financial stability in Sweden and Norway. Sweden's Riksbank and Norway's Bank favour different approaches however. Sweden's Riksbank has clearly highlighted the risks of household debt over the past year while Norway's Bank believes that the risks in Norway are small. The high leverage makes Norwegian households very sensitive to changes in house prices. This is reinforced by the high proportion of owner-occupied apartments. A fall in house prices in Norway is likely to have a relatively limited impact on the Norwegian economy compared with housing price decline during the early 1990s. The banks are well capitalised, the currency is liquid and public finances are strong.

Box 2: Risks linked to imbalances in the Swedish and Norwegian housing market (cont'd)

What can Sweden and Norway learn from each other?

The strong fall in house prices in the USA and parts of Europe shows what far-reaching effects a poorly functioning housing market can have on the real economy. Even without sharp price falls, a poorly functioning housing market can affect the economy. The Swedish National Board of Housing, Building and Planning and the consultancy WSP recently presented reports showing that economic growth in Sweden is adversely affected in municipalities where the population density has increased. A sustained period with insufficient construction relative to population growth increases the risk of major adverse effects on the economy than shown in the report from the Swedish National Board of Housing, Building and Planning. Property owners estimate that bottlenecks in the Stockholm County housing market cost SEK 12.5 billion per year in lost growth during the years 2010-2030.

Young people are affected by shortages in the housing market

The need of a flexible labour market increases when the shift in the Swedish economy goes from an export driven to more service oriented economy. The jobs in the service sector are mainly in the large cities but with significantly lack of housing. The employment plans are most expansive in the service sector and it's in this sector youth and immigrants have the largest possibilities to enter the labour market. A low mobility on the housing market will particularly hurt the youth when they enter the labour market.

Sweden can learn from the greater mobility in the Norwegian housing market

The housing market's structure, rules and transaction costs associated with relocation promotes mobility in Norway to a greater extent than in Sweden. The Norwegian rental regulation was abolished in 2010, resulting in market priced rents. This creates incentives for home-owners to rent out part of their home, which is tax-free providing less than half the property is rented out. Market mobility thereby increases. During the past year, the market supply has risen sharply and landlords have had to lower prices to meet demand. This trend in the rental market thus contradicts the argument that higher rents explain the increase in housing prices.

When selling property in Norway, the buyer must pay a documentation fee to the state of approximately 2.5% of the property's value while the seller pays the sales costs (estate agent's fees and advertising). Norway has basically a 28% tax on profit from the sale of property. However, this capital gains tax is excluded if the seller has owned the property for at least two years and has lived in the home for longer than one year. There is no difference in taxes for different types of owned properties and property tax is now a voluntary municipal tax that must not exceed 0.7% of the assessed tax value. These tax rules, combined with deductible interest rates, means there are favourable tax subsidies for ownership of property. Sweden has a much higher relocation taxes (capital gains tax, stamp duties and transfer taxes). The Swedish tax rate is 22% for the sale of a residence no matter how long the seller has lived in the house, while other countries do not apply any capital gains tax at all on sales if the seller lived in the house for a longer period.

There should be more focus on financial stability in Norway

Norway can learn from the Swedish model, which has focused on household debt. The Riksbank has clearly communicated that they take the financial stability into account in their interest rate decisions as financial imbalances in the long term could hurt the real economy and price stability. Norway should also consider having a more even distribution between the percentage of rental properties and owner-occupied properties. This would reduce the leverage and pressure on the financial market. As in Sweden, it is young people who are most affected by shortages in the housing market. The shortage of rental property combined with the possibility to borrow up to 100% means that many young people are taking out large loans. Highly leveraged young people are therefore the group most exposed to a fall in house prices.

The shortages in the residential markets in Sweden and Norway highlight the need for effective macro-prudential supervision. The purpose of macro-prudential supervision is to identify, analyse and counteract risks to the financial system as a whole. This differs from traditional financial supervision that focuses on the health of individual financial institutions. This holistic approach is what is needed to counteract the rise in household debt to unsustainable levels.

More measures required

Sweden and Norway have taken steps to address the imbalances in the housing markets, but they have been insufficient. In Sweden, the measures are mainly intended to facilitate the construction of new housing and the use of existing housing stock, while the objective of the Norwegian measures is primarily to reduce household debt. We propose that decisions regarding construction should be made through greater collaboration between state, local government and private operators, both in Sweden and in Norway. There are currently strict requirements for housing to be quiet, climate-neutral and accessible. We think that there should be more focus on creating housing for young people and lower the requirements for these. Rental property is the most flexible form of housing and the intentions of the new Rent Act must be met so that the location and quality are clearly appropriate for rental.

Estonia: Better outlook after temporary slowdown

Although GDP growth decelerates temporarily in 2013, it will pick up again from 2014 with the recovery of foreign demand and investments. The economy is moving towards more balanced growth with current account balance improving by the end of the forecast horizon and government fiscal stance remaining strong. Estonian economy is still struggling to find sources for growth in the still sluggish growth environment in Europe.

Key economic indicators, 2011-2015 [1/]

	2012	2013f		2014f		2015f
Real GDP growth, %	3.2	1.9	(3.3)	3.9	(4.2)	4.2
Consumer price growth, %	3.9	3.3	(3.3)	2.8	(2.9)	2.9
Unemployment rate, % [2/]	10.2	8.9	(9.5)	8.4	(8.9)	8.3
Real gross monthly wage growth, %	1.9	2.1	(3.0)	3.4	(3.6)	3.5
Current account balance, % of GDP	-1.8	-1.8	(-2.5)	-2.1	(-2.7)	-1.4
General government budget balance, % of GDP [3/]	-0.3	-0.5	(-0.5)	-0.1	(-0.1)	0.1

1/ April 2013 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: Statistics Estonia, Bank of Estonia and Swedbank.

Estonia's export is expected to benefit from stronger demand in 2014 and 2015

With its export share above 90% of GDP and its manufacturing sector enterprises exporting more than 70% of their sales, economic growth in Estonia depends substantially on foreign demand. The continuing deterioration of the economic situation in the euro area and in some of Estonia's main trading partners at the beginning of this year impeded GDP growth. At the same time worsening domestic demand, especially from the fast decrease in investments, caused the output annual growth to decelerate to 1.2% in real terms in the first half of 2013 - even though, in nominal terms the growth has been relatively strong.

External demand is weakening in 2013 compared with 2012, mainly because of slower economic growth in Russia and Latvia. The economic activity of Estonia's main trading partners is expected to pick up at the end of this year, and Estonia's exports should therefore benefit from stronger demand on its export markets in 2014 and 2015. The acceleration of the growth rate of exports will be more gradual than the pickup in external demand in 2014 because the export figures of 2013 were lifted by a one-off transaction with ferries. The growth of goods and services imports will decelerate in 2013 in line with the slowdown of domestic demand and exports. The growth of imports will then accelerate again in 2014 and 2015, thanks to increasing import demand for intermediate, capital and consumption goods.

Investments will be contributed mostly by corporations

EU transfers and Estonia's government revenues from carbon dioxide quota sales, which contributed to the fast growth of government investments in buildings and infrastructure last year, will diminish during the forecast period. Besides that, government investments will decrease considerably from 2014 onwards due to the switch to the new EU financial framework in 2014-2020. Since utilisation of the new EU funds requires thorough preparations, they will not, most likely, affect investments in 2014 and have only a modest impact in 2015. We expect investments to fall temporarily this year, but increase again in 2014 and 2015. With government investments decreasing, we expect that total investment growth will be based on investments by the corporate sector.

Deleveraging has proceeded well

Deleveraging in nonfinancial corporations and the household sector has proceeded well, especially in the household sector, where the loan stock has diminished gradually from its highest level of 59% of GDP at the beginning of 2010 to 43% in the first quarter of this year. This has left more financial resources for final consumption and investments.

In 2012, a considerable part of corporations' investments were financed from retained earnings. However, the growth of profits of nonfinancial corporations has decreased and their profit share in turnover diminished. Still, corporations' and households' lending growth has accelerated, whereas the growth of the loan stock has stood on the positive side since September 2012. Households' mortgage loan stock started to increase again in April this year after contracting for 3.5 years. From the supply side, lending is supported by the strong capitalisation of the Estonian banking sector and record-low interest rates, as well as by the increased stock of deposits. From the demand side, improved consumer confidence has stimulated household borrowing.

In line with the deceleration of economic growth, we expect that wage growth will decelerate temporarily this year, as corporations have to keep labour costs under control. Together with the rising foreign demand and domestic economic activity, wage growth will accelerate from

2014. As the inflation rate is decelerating, the real growth of wages will accelerate during the forecast period. This year, we expect the increase in households' disposable income to decelerate in line with the slowdown in employment. This is hindering the growth of private consumption, which is forecast to decelerate this year. Besides the continued deceleration in employment, wages will rise, both in nominal and real terms, increasing the total wage bill for consumption and contributing to the acceleration of the growth of private consumption in 2014 and 2015.

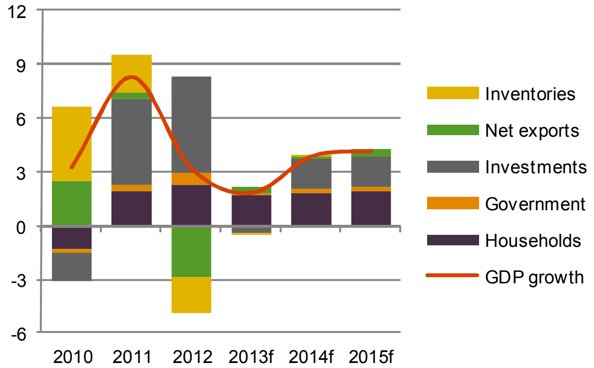
Unemployment will decrease gradually

We expect employment growth to decelerate further during the forecast period due to cyclical and structural reasons and the shrinking of Estonian working-age population, especially from 2015 onwards. During the forecast period, the unemployment rate will fall below the non-accelerating wage rate of unemployment (NAWRU), thus putting upward pressure on wages. We expect the unemployment rate to decrease to 8.9% this year and even further in 2014 and 2015. Although the unemployment rate remains relatively high, corporations are facing difficulties in finding suitable matches in the labour force. Last year, wage increases exceeded labour productivity gains and drove up unit labour costs (ULCs). Since in the first quarter of 2013 labour costs increased faster than productivity, the increase in ULCs continued to accelerate as well. We expect that labour costs will not be raised at the expense of profits for a longer term. Since employment growth will decelerate, the contribution of labour productivity to economic growth has to be increased.

Strengthening domestic demand pushes up core inflation

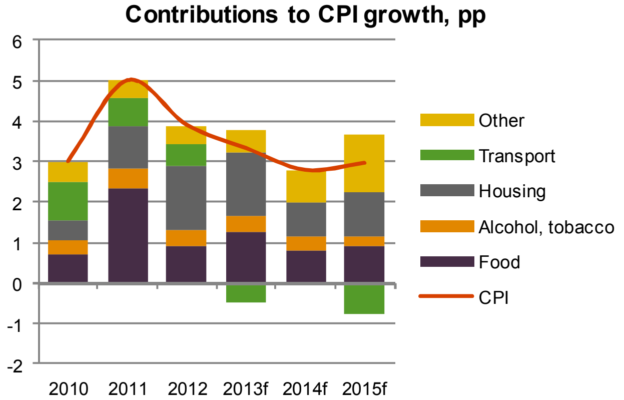
In 2013, consumer prices are expected to increase by 3.3%, mostly driven by a hike in electricity prices in January and growing food prices throughout the year. In 2014, inflation will decelerate as the impact of the electricity price hike fades away; also food prices are expected to increase less than in 2013. The decline in the price of oil in US dollars will be somewhat compensated for by a weakening of the euro against the dollar; the oil price in euros will therefore only marginally decline compared to 2013. The prices of most services will also be on an upward trend as strengthening domestic demand pushes up core inflation. In 2015, the growth of consumer prices will accelerate somewhat as the economy is expected to grow above its potential and cost pressures, especially labour costs, increase. Only the price of oil will decline as supply rises more than demand, bringing down Estonia's transport costs.

Contributions to GDP growth, pp



Source:Statistics Estonia, Swedbank

Contributions to CPI growth, pp



Source: Statistics Estonia, Swedbank

Economic growth will slow in 2013 but accelerate again from 2014

Primarily due to the weaker-than-expected domestic demand associated with the decrease in investments we have revised downwards GDP growth in Estonia to 1.9% in 2013 (from the 3.3% forecast in April *Outlook)*. We expect growth to accelerate towards the end of the year; this, together with the improving foreign demand, will push GDP growth to 3.9% next year and 4.2% in 2015.

In 2013, private consumption is contributing the most to GDP growth, while in 2014 and 2015 a substantial contribution from investments will be added. A more balanced contribution by final consumption and investments will ensure more sustainable economic growth.

The main risk for the acceleration of economic growth forecast in 2014 and 2015 could come from a delayed recovery of demand by Estonia's trading partners. However, this risk has diminished since April. Another risk could stem from the labour market. The private sector is suffering from an insufficient labour force. Although the number of unemployed persons is gradually decreasing, structural unemployment is still a problem. The lack of qualified labour could become a more serious problem when demand improves and the private sector will increase its output. This could cause wage pressures. If wages grow faster than productivity, unit labour costs could rise and worsen competitiveness.

Latvia: Sailing despite underwater rocks

Growth remains decent and is expected to be stout in the coming years. The export weakness is temporary and will have no marked negative impact on labour market or private consumption. The political cycle is not reform favourable, undermining the medium-term growth potential and raising risks of labour market and price pressures building up towards the end of the forecast period. Latvia will adopt the euro in 2014.

Key economic indicators, 2011-2015 1/

	2012	2013f		2014f		2015f
Real GDP growth, %	5.6	4.3	(4.3)	4.7	(5.0)	4.3
Consumer price growth, %	2.3	0.4	(1.1)	3.0	(3.5)	2.7
Unemployment rate, % 2/	15.0	11.6	(13.5)	10.5	(11.5)	9.5
Real net monthly wage growth, %	1.6	4.6	(3.6)	3.4	(2.9)	4.2
Current account balance, % of GDP	-1.7	-0.9	(-2.8)	-2.6	(-3.8)	-3.2
General government budget balance, % of GDP 3/	-1.2	-1.5	(-1.0)	-0.9	(-0.5)	-0.7

1/ April 2013 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.
Sources: CSBL and Swedbank.

Economic growth to pick up in the second half of 2013 and 2014

Quarterly GDP growth slowed to 0.5% in the second quarter of 2013 (1.2% a quarter before), with exports feeling the bite of EU recession and a few local one-off factors, like the standstill at the largest steel plant, Liepājas Metalurgs. We believe that this was the lowest point and quarterly growth will pick up going forward. We keep unchanged the GDP growth forecast at 4.3% for this year − household consumption temporarily becomes the main driver, rising swifter than investments and exports. We expect exports and investments to accelerate in 2014, boosting GDP growth to 4.7%. As the growth outlook for the main trading partners is now bleaker than in the April *Outlook* (especially for Russia and Estonia), Latvia's export and GDP growth numbers have been revised a tad lower. Investment growth is expected to weaken again in 2015 due to waiting for the new planning period's EU funds soon becoming available, which will slow overall economic growth to 4.3%. If global economy improves slower than anticipated, Latvian growth will suffer as well.

Wage and price pressures to start building up in 2015…

Stronger economic activity will continue to improve the labour market. We expect employment growth to slow from a strong 3.2% in first half of 2013 to below 2% per annum in the next two years, with exporting sectors becoming more active in hiring (especially services). The participation rate is forecast to grow, additionally pushed up by an increase in the pension age (by six months over 2014-2015). We foresee the unemployment rate sliding below its pre-boom 2002-2006 average of about 10% in 2015, causing a gradual build-up of wage pressures with risks to inflation and external competitiveness.

… somewhat mitigated by labour tax cuts and benign global commodity prices

Price pressures will be mitigated by (i) labour tax cuts, and (ii) favourable global commodity price developments (see the global outlook chapter). Overall, we forecast consumer price growth to step up from this year's extremely low levels to about 3% per annum in the coming two years. In 2014, inflation is forecast to be slightly higher than in 2015, due to the liberalisation of electricity market for households. The liberalisation was initially planned to take place in 2013 but has been postponed. Our forecast assumes that it is done next spring but it may be postponed until later, given (i) the approaching general elections in the autumn of 2014, and (ii) the difficulties of setting up a compensatory scheme for low-income households and the rearrangement of feed-in tariffs for electricity producers.

Robust household consumption, backed by rise in real incomes

We see the current export weakness as temporary; it will not cut into consumer confidence, and household spending will remain robust. We now anticipate somewhat stronger private consumption growth in 2013 than in our April *Outlook* as inflation so far has been weaker and job creation swifter than we had expected. With elections approaching, pension indexation has been brought forward by a year, which will also support consumers. Specifically, in September, small pensions (covering about 75% of retirees) will rise by 4%. With household deleveraging gradually losing steam, more support to consumption will come from credit as both demand and supply conditions improve.

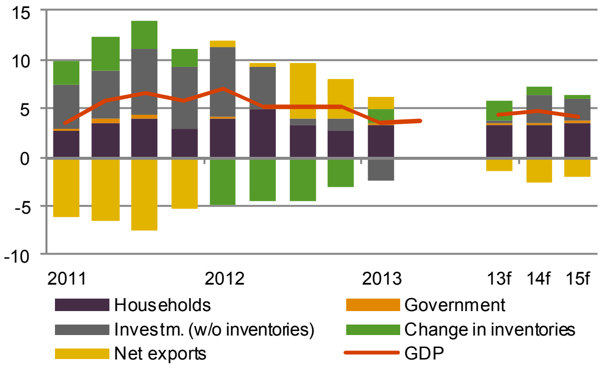
The standstill since late spring at Liepājas Metalurgs (liquidity problems and shareholder disputes) has cut into manufacturing output, exports, and imports, thus materialising the negative risk we outlined in the April *Outlook*. The state treasury was forced to repay a EUR 73 million loan (0.3% of GDP) it had guaranteed for the company that the company's creditor had called in; this raises the government's 2013 budget deficit accordingly. Overall, the ripple effects from the company's misfortunes have so far been limited. We expect it to remain a regional issue and not have a major impact on confidence or consumption in the country overall. We expect that production at the plant will be partially resumed next year.

Companies need to invest to build up capacity for future growth, but hesitant so far

Latvian exporters' market shares have kept rising; it is paramount that they keep investing to continue improving productivity and competitiveness to fend off tightening competition. The concerns that we voiced last year have turned out to be valid – so far this year investments have been very weak, both in machinery and equipment and in buildings and structures. Companies have become cautious about investing, possibly due to (i) the uneven recovery of trade partners and Latvian companies' wishes to find new orders before investing, and (ii) the time it is taking for earlier investments to pay off. Since capacity utilisation is at pre-crisis levels or even above it in some sectors (e.g., manufacturing of machinery and equipment, transport, and wood), producers need to invest to build up future export growth. The positive second-quarter data from the EU must serve to boost investment activity.

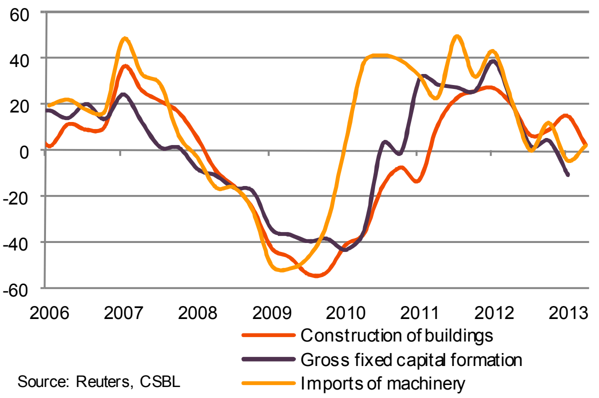
On the back of the weaker-than-expected first half of the year, we are reducing the forecast for gross fixed capital formation growth for 2013; however, we foresee investments picking up towards the end of this year and into next year as the global economy improves. Deleveraging has been deep, the loan-to-deposit ratio has declined below the levels of 2005, and companies should be able to invest when their optimism on growth perspectives improves. We believe that those businesses in need of investments in 2014 will invest then and not wait until late 2015 and 2016, when the EU funds from the new planning period are expected to become available. In 2015, however, we see investment growth weakening somewhat as companies postpone their investments to gain advantage of new EU funds.

Contribution to GDP growth, pp



Source: CSBL, Swedbank forecasts

Annual real growth of investments, %



Source: Reuters, CSBL

Imports in 2013 have so far been very weak, due to feeble investments and other factors, for instance, the dwindling flow of military freight to Afghanistan (e.g., as NATO troops withdraw, there is less transit of oil products). Imports are forecast to accelerate gradually in the coming years, supported by robust consumption and stronger exports and investments.

In 2014, Latvia will become the 18th member of the euro area. ECOFIN's decision permitting Latvia to adopt euro has improved its sovereign ratings. The current gap of four notches versus Estonia is too wide, and we should expect further increases in Latvian ratings early next year, if macroeconomic stability is maintained. We do not expect large, immediate growth effects from euro adoption; yet, there should be some pickup in foreign direct investment inflows and positive confidence effects (similarly to what Estonia experienced).

Labour tax burden likely to ease slower, with larger emphasis on curbing income inequality

The fiscal situation remains good; tax revenues in January-July were 6.5% larger than a year ago (2.7% above plan). The process of drafting the 2014 budget is heated as spending demands are coming from all sides and exceeding manifold the indicated fiscal space. The plan to ease the labour tax burden is still in place, but the government has backed off from its last year's promise to cut the personal income tax rate (PIT) by 4 percentage points by 2015. The path of labour tax cuts is now likely to be slower and, quite adequately, aiming at reducing income inequality. The design and dynamics of tax changes are not clear yet but will most likely be a mix of cuts in PIT and employees' social contributions, together with higher tax-deductible allowances.

The recent crisis has underscored the importance of fiscal responsibility, and the budget deficit is kept close to balance. A reduction in the labour tax wedge is needed to diminish income inequality and improve competitiveness. However, in policymaking a systemic long-term view seems lost again. Currently, Latvia collects about 28% of GDP in tax revenues (the EU average is at 39%; the respective numbers for expenditures are 38% and 49%). The Ministry of Finance medium-term target for tax revenues is about 33%, but the recent policy suggestions are forecast to result in a decline in the total tax burden. If so, it will not be possible to significantly boost spending on health care, the social safety net, defence (where it falls below the NATO requirement of 2% of GDP), or capital investment, amongst other needs. Labour taxes should be cut, but this should be counterweighted with a heavier tax burden somewhere else, most appropriately as a higher residential real estate tax, which is least distortive to economic growth. This is not in the government agenda, though. At least not until after the autumn 2014 general elections.

Lithuania: On track for euro adoption

Growth momentum was not lost in the first half of this year – the Lithuanian economy expanded by 3.6% compared with the same period a year ago (4.2%, if growth is adjusted for seasonality and the number of working days). We keep our forecast for 2013 and 2014 unchanged – GDP is expected to grow by 4.0% in both years and to accelerate to 4.5% in 2015. Recent decline in inflation indicates that euro adoption is most likely in 2015.

Key economic indicators, 2011-2015 [1/]

	2012	2013f		2014f		2015f
Real GDP growth, %	3.7	4.0	(4.0)	4.0	(4.0)	4.5
Consumer price growth, %	3.1	1.5	(2.5)	2.5	(3.4)	3.0
Unemployment rate, % [2/]	13.2	11.5	(11.5)	9.5	(10.0)	8.5
Real net monthly wage growth, %	0.4	2.8	(2.0)	2.8	(2.5)	3.0
Current account balance, % of GDP	-0.5	-0.8	(-0.9)	-2.0	(-2.3)	-3.0
General government budget balance, % of GDP [3/]	-3.2	-2.7	(-2.5)	-1.7	(-2.0)	-0.7

1/ April 2013 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

GDP growth will remain robust; domestic demand will take over baton from exports

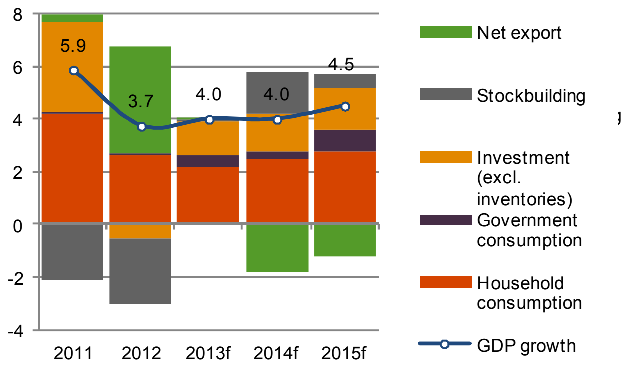
Quarterly growth rates indicate that the second quarter of this year was weaker, mainly due to ebbing manufacturing and export growth; however, there were signs of recovering household consumption. We expect this shift in growth composition to continue in the second half of this year – exports will slow further, whereas domestic demand should pick up.

Inflation declined faster than we anticipated in the spring – in July, consumer prices were only 0.5% higher than a year ago. Lower oil prices, cheaper food products, and other positive developments in commodities markets were the main factor behind lower inflation. Somewhat unexpectedly, companies have not increased prices, despite the more expensive electricity and higher minimum wage – producer prices (except for oil products) have been contracting for the past four months. Thus, we have lowered our inflation forecast to 1.5% in 2013 and 2.5% in 2014. This means that the probability of Lithuania's meeting the Maastricht price stability criterion is much higher than it was at the beginning of this year.

Inflation will be lower than previously expected; euro adoption in 2015 is very likely

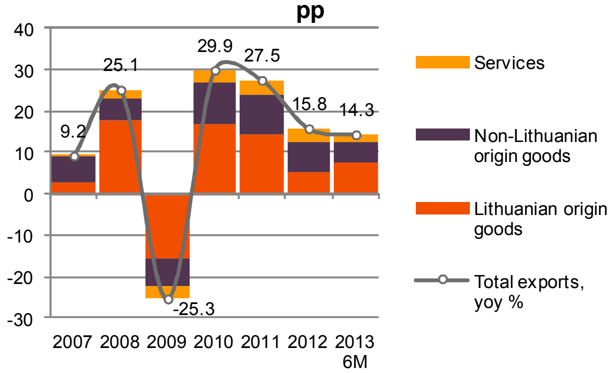
The budget deficit is also set to decline, to 2.7% of GDP this year, which means that in our base scenario Lithuania will adopt the euro at the beginning of 2015. Some uncertainty still remains (prices may still spike), but perhaps the largest risk is political – one of the political parties in the ruling coalition has called for a referendum regarding euro adoption (and public support for the common European currency, not surprisingly, is not very high). Furthermore, there is an abundance of political propositions to increase government spending and introduce tax exemptions in 2014, which, if adopted, could knock Lithuania off the fiscal consolidation path and yield a negative assessment from the European Commission. However, we think that the risks are relatively low, and that in 2015 all three Baltic countries will share the same currency, together with the other 16 euro area countries.

Contributions to GDP growth, pp



Sources: Statistics Lithuania and Swedbank.
Sources: Statistics Lithuania and Swedbank.

Contribution to nominal export growth, pp



Source: Statistics Lithuania, Bank of Lithuania, Swedbank

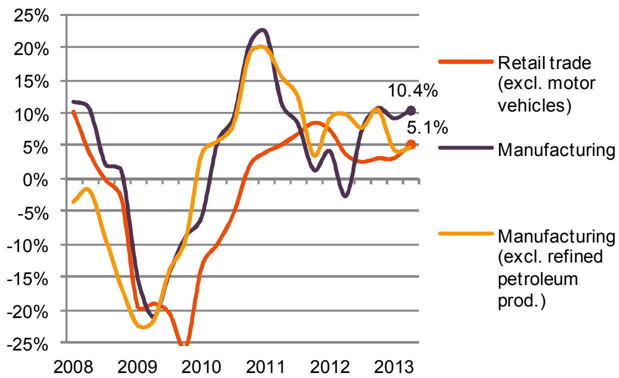
After contracting by 2.5% in 2012, gross fixed capital formation recovered in the first half of this year. In the first quarter, annual growth reached 6.4% and will probably continue at a similar pace throughout this year. Growth was boosted by infrastructure projects, especially road construction – a make-up before Lithuania assumed the presidency of the EU Council.

Investments grew faster this year and are likely to accelerate further

Households reacquired a taste for residential real estate – household investments in housing increased at the beginning of the year and continue increasing this year and the next. Growth of investments in fixed tangible assets accelerated to 12.1% in the second quarter, mainly due to investments in machinery and equipment. As a share of GDP, they increased to 13.8%, from the meagre 10.0% at the beginning of this year. We expect all public, household, and business investments (gross fixed capital formation) to grow faster in 2014 and 2015, by 7.0% and 8.0%, respectively. Increasing (if not peaking) capacity utilisation rates, low interest rates, favourable lending conditions, and improving expectations will continue supporting investment growth. The government also extended for another five years the duration of the profit tax exemption for investments, which enables companies to lower their tax rates by 50%.

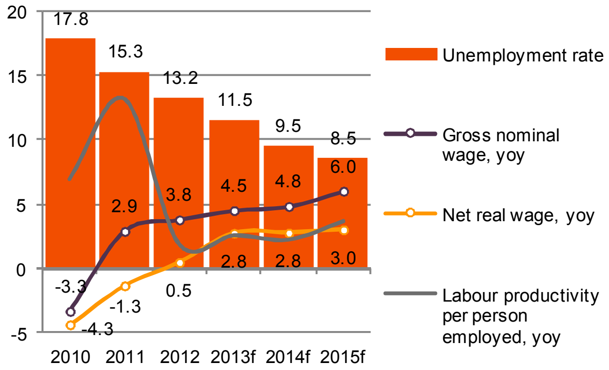
Financial support from the EU budget in the 2014-2020 framework will be almost 10% higher than in the previous financial period. In order to reap the maximum benefit from EU structural funds, it is crucial to make the allocation of these funds more transparent and efficient. Many of the companies that acquired EU financial support (one way or another) have already gone bankrupt, and thus these funds were wasted – they provided a one-off boost to GDP but have not improved potential output or hastened Lithuania's real convergence (as much as they could have).

Retail trade and manufacturing, yoy



Source: Statistics Lithuania

Labour market indicators, %



Sources: Statistics LIthuania and Swedbank.

Due to tighter competition and fading one-off effects, export growth will slow

Export growth remained strong in the first half of this year, when it expanded by 14.3% (at current prices) over the same period a year ago. Due to weak export markets and tightening competition, as well as fading one-off effects, Lithuanian export growth rates will moderate in the second half of 2013 and in upcoming years. The effect of the record grain harvest of last year has already started to wane, and the rapid growth of exports of mineral fuels, which was largely due to the very low base of May 2012, when the oil refinery was closed for maintenance, will slow, thus no longer boosting growth numbers. The euro area has emerged from recession and Russia's growth is expected to accelerate to 3% in the coming two years, but this will not have a very substantial impact on growth of exports. However, improving prospects in the export markets could encourage companies to increase their investments.

Declining unemployment, accelerating real net wage growth, and improving expectations will stimulate household consumption

Unemployment continues to decline this year, and we expect it to fall to 9.5% next year and 8.5% in 2015. Job vacancies remain close to all-time highs, but unemployment is not likely to return to the pre-crisis level in the foreseeable future. Already the signs of structural unemployment are visible – job vacancies have not been filled, either because of skills mismatches or the unwillingness of the unemployed to relocate.

Declining unemployment and a lack of skilled labour, as well as the higher minimum monthly wage, will be pushing the average wage upwards at an accelerated pace – after growing by 4.5% this year, it will accelerate to 4.8% and 6.0% in 2014 and 2015. Next year, net wages will be boosted by an increase in the tax-exempt income of low earners and families with children. Although this will not provide a substantial boost to net income, more changes in this direction are likely. In 2015, wage growth can also be expected in the public sector. Growing employment and wages, somewhat lower taxes, declining inflation, and improving consumer confidence suggest that household consumption growth will accelerate from 3.5% this year to 4.0% in 2014 and 4.5% in 2015.

Overall economic growth remains sustainable, and imbalances are not building up – foreign trade remains in surplus this year, wages are growing in line with productivity, and the budget deficit is expected to fall to 0.7% of GDP in 2015.

Appendix

ESTONIA: Key economic indicators, 2011-2015 [1/]

	2011	2012	2013f		2014f		2015f
Real GDP growth, %	8.3	3.2	1.9	(3.3)	3.9	(4.2)	4.2
Household consumption	3.6	4.4	3.2	(3.5)	3.6	(3.9)	3.8
Government consumption	1.4	4.0	0.6	(1.3)	1.0	(1.5)	1.0
Gross fixed capital formation	25.9	20.9	-0.6	(4.8)	6.2	(6.3)	5.8
Exports of goods and services	23.4	5.6	5.5	(4.7)	5.7	(6.2)	7.3
Imports of goods and services	25.0	9.1	5.3	(6.1)	5.9	(6.2)	7.1
Consumer price growth, %	5.0	3.9	3.3	(3.3)	2.8	(2.9)	2.9
Unemployment rate, % [2/]	12.5	10.2	8.9	(9.5)	8.4	(8.9)	8.3
Real gross monthly wage growth, %	0.4	1.9	2.1	(3.0)	3.4	(3.6)	3.5
Nominal GDP, billion euro	16.0	17.0	18.0	(18.1)	19.2	(19.4)	20.6
Exports of goods and services (nominal), % growth	28.3	7.7	6.1	(7.2)	6.5	(9.7)	7.6
Imports of goods and services (nominal), % growth	34.1	11.9	5.6	(7.7)	6.6	(9.5)	7.2
Balance of goods and services, % of GDP	3.9	0.5	0.9	(1.7)	0.9	(1.8)	1.2
Current account balance, % of GDP	1.8	-1.8	-1.8	(-2.5)	-2.1	(-2.7)	-1.4
Current and capital account balance, % of GDP	6.0	1.7	1.7	(6.1)	1.2	(6.2)	1.7
FDI inflow, % of GDP	1.5	6.9	4.7	(6.1)	4.7	(6.2)	4.4
Gross external debt, % of GDP	95.6	97.8	94.2	(95.0)	90.1	(91.3)	85.5
General government budget balance, % of GDP [3/]	1.2	-0.3	-0.5	(-0.5)	-0.1	(-0.1)	0.1
General government debt, % of GDP	6.2	10.1	10.2	(10.2)	9.7	(9.9)	9.2

1/ April 2013 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Estonia, Bank of Estonia and Swedbank.

LATVIA: Key economic indicators, 2011-2015 [1/]

	2012	2013f		2014f		2015f
Real GDP growth, %	5.6	4.3	(4.3)	4.7	(5.0)	4.3
Household consumption	5.4	4.7	(4.1)	4.5	(4.5)	5.1
Government consumption	-0.2	1.6	(1.6)	2.3	(2.0)	2.5
Gross fixed capital formation	12.3	0.5	(9.0)	11.0	(11.0)	8.0
Exports of goods and services	8.3	2.3	(4.5)	5.3	(6.5)	7.0
Imports of goods and services	2.9	3.5	(8.6)	8.7	(8.0)	9.0
Consumer price growth, %	2.3	0.4	(1.1)	3.0	(3.5)	2.7
Unemployment rate, % [2/]	15.0	11.6	(13.5)	10.5	(11.5)	9.5
Real net monthly wage growth, %	1.6	4.6	(3.6)	3.4	(2.9)	4.2
Nominal GDP, billion euro	22.1	23.4	(23.4)	25.6	(25.5)	28.0
Exports of goods and services (nominal), % growth	13.1	5.4	(8.9)	9.8	(11.8)	11.3
Imports of goods and services (nominal), % growth	10.5	4.2	(11.0)	12.5	(12.9)	12.3
Balance of goods and services, % of GDP	-3.0	-2.3	(-4.4)	-3.9	(-5.0)	-4.5
Current account balance, % of GDP	-1.7	-0.9	(-2.8)	-2.6	(-3.8)	-3.2
Current and capital account balance, % of GDP	1.3	1.8	(0.5)	-0.4	(-1.7)	-0.6
FDI inflow, % of GDP	3.5	3.3	(3.5)	3.8	(3.8)	3.7
Gross external debt, % of GDP	136.2	136.3	(132.0)	129.8	(124.4)	120.5
General government budget balance, % of GDP [3/]	-1.2	-1.5	(-1.0)	-0.9	(-0.5)	-0.7
General government debt, % of GDP	40.7	43.2	(43.0)	40.0	(40.0)	33.1

[1/] April 2013 forecast in parenthesis
[2/] According to Labour force survey.
[3/] According to Maastricht criterion.

Sources: CSBL and Swedbank.

LITHUANIA: Key economic indicators, 2011-2015 [1/]

	2011	2012	2013f		2014f		2015f
Real GDP growth, %	5.9	3.7	4.0	(4.0)	4.0	(4.0)	4.5
Household consumption	6.9	4.3	3.5	(3.3)	4.0	(3.8)	4.5
Government consumption	0.5	0.4	3.0	(1.0)	2.0	(1.5)	5.0
Gross fixed capital formation	18.3	-2.5	6.5	(8.0)	7.0	(8.0)	8.0
Exports of goods and services	14.1	11.9	9.5	(4.0)	7.0	(6.5)	6.0
Imports of goods and services	13.7	6.6	10.0	(5.0)	9.5	(7.5)	7.5
Consumer price growth, %	4.1	3.1	1.5	(2.5)	2.5	(3.4)	3.0
Unemployment rate, % [2/]	15.3	13.2	11.5	(11.5)	9.5	(10.0)	8.5
Real net monthly wage growth, %	-1.3	0.4	2.8	(2.0)	2.8	(2.5)	3.0
Nominal GDP, billion euro	30.8	32.9	34.6	(34.8)	36.8	(37.3)	39.6
Exports of goods and services (nominal), % growth	27.5	15.8	10.0	(6.7)	8.0	(10.5)	9.0
Imports of goods and services (nominal), % growth	28.2	11.2	10.5	(7.5)	9.5	(12.0)	10.5
Balance of goods and services, % of GDP	-2.6	0.6	0.2	(-0.1)	-1.0	(-1.3)	-2.3
Current account balance, % of GDP	-3.7	-0.5	-0.8	(-0.9)	-2.0	(-2.3)	-3.0
Current and capital account balance, % of GDP	-1.3	1.7	1.2	(1.1)	0.3	(-0.1)	-0.3
FDI inflow, % of GDP	3.4	2.0	3.0	(3.5)	3.5	(3.8)	4.0
Gross external debt, % of GDP	77.8	75.4	74.1	(73.6)	71.7	(-70.7)	68.2
General government budget balance, % of GDP [3/]	-5.5	-3.2	-2.7	(-2.5)	-1.7	(-2.0)	-0.7
General government debt, % of GDP	38.5	40.7	39.5	(39.1)	38.6	(37.9)	36.5

1/ April 2013 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

Contact Information

Strategy & Macro Research

Acting chief economist
Anna Felländer
Tel: +46 8 700 99 64
e-mail: anna.fellander@swedbank.se

Chief economist Norway
Harald Magnus Andreassen
Tel: +47 2323 8260
e-mail: harald.magnus.andreassen@swedbank.no

Chief economist Estonia
Tõnu Mertsina
Tel: +372 888 7589
e-mail: tonu.mertsina@swedbank.ee

Chief economist Latvia
Mārtiņš Kazāks
Tel: +371 67 445 859
e-mail: Mārtiņš.Kazāks@swedbank.lv

Chief economist Lithuania
Nerijus Mačiulis
Tel: +370 5 258 2237
e-mail: nerijus.maciulis@swedbank.lt

Sweden
Knut Hallberg
Tel: +46 8 700 93 17
e-mail: knut.hallberg@swedbank.se

Jörgen Kennemar
Tel: +46 8 700 98 04
e-mail: jorgen.kennemar@swedbank.se

Åke Gustafsson
Tel: +46 8 700 91 45
e-mail: ake.gustafsson@swedbank.se

Magnus Alvesson
Tel: +46 8 5859 33 41
e-mail: magnus.alvesson@swedbank.se

Anna Breman
Tel: +46 70 314 95 87
e-mail: anna.breman@swedbank.se

Cathrine Danin
Tel: +46 8 5859 34 92
e-mail:
cathrine.danin@swedbank.se

FX
Anders Eklöf
Tel: +46 8 700 9138
e-mail: anders.eklof@swedbank.se

FX Emerging markets
Hans Gustafson
Tel: +46 8 700 91 47
e-mail: hans.gustafson@swedbank.se

FI
Jerk Matero
e-mail: jerk.matero@swedbank.se

Norway
Dan Erik Glover
Tel: +47 2323 8261
e-mail:
dan.erik.harlem.glover@swedbank.no

Estonia
Liis Elmik
Tel: +372 888 7206
e-mail: liis.elmik@swedbank.ee

Teele Reivik
Tel: +372 888 7925
e-mail: teele.reivik@swedbank.ee

Latvia
Lija Strašuna
Tel: +371 67 445 875
e-mail: lija.strasuna@swedbank.lv

Kristilla Skrūzkalne
Tel: +37167445844
e-mail: kristilla.skruzkalne@swedbank.lv

Lithuania
Vaiva Šečkutė
Tel: +370 5 258 2156
e-mail: vaiva.seckute@swedbank.lt

Laura Galdikienė
Tel: +370 5 258 2275
e-mail: laura.galdikiene@swedbank.lt

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Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.

Visiting address: Regeringsgatan 13, Stockholm