Swedbank Economic Outlook January 2015

Global recovery underway – but policy support will remain crucial

- US upswing boosted by energy prices, but euro area still in need of aggressive policy support
- Risks concentrated to policy decisions, from handling the Chinese property market to EU fiscal policy over Russia's foreign policy
- Swedish growth prospects increasingly at the mercy of external developments; the Baltics take a hit from recession in Russia, but keep growing

Table of Contents

Executive Summary

A pickup in global growth despite a weak ending to 2014

We expect global growth to recover in 2015 and 2016, after momentum surprisingly slowed towards the end of 2014. It was mainly the business cycle in the euro area that weakened, but short-term indicators are pointing at a pickup in growth that should be boosted by the aggressive expansion of the ECB's assets purchase programme. Similarly, the US business cycle has clearly picked up on the back of strong developments in the labour market, and global growth will benefit from expansion in the developed economies. The outlook for emerging markets is more mixed. India, along with other energy-dependent economies, will benefit from lower oil prices, while commodity exporters such as Brazil will suffer. We expect growth in China to slowly be guided down by cautious authorities, but not without risks. Overall, we forecast a slow recovery of the global economy over the next two years, with growth rising to 3.7% in 2015, up from 3.4% in 2014, and 3.8% in 2016.

Risks to the forecast are evenly balanced

We believe that upside and downside risks to the outlook are evenly balanced. On the positive side, it is possible that the combined and dynamic effects of the surprisingly large monetary policy boost by the ECB, the pickup in US growth rates, and the effects of lower energy prices will be mutually reinforcing, with the net effect stronger than we expect. The negative risks remain unchanged from previous forecasts: geopolitical tensions from Russia and the Middle East having adverse effects on economic sentiments, and a disorderly unwinding of Chinese imbalances. Euro area unity has come under renewed strain due to the fresh Greek elections, although we do not expect this to lead to Greece's abandoning the euro. A bigger risk, in our view, is the spreading political discontent in Europe with the economic adjustment programmes. This could undermine resolve in pursuing the reforms and is likely to weaken the emphasis on fiscal austerity.

The Swedish outlook is dependent on external factors

Although we revise down the growth forecast for the Swedish economy in 2015, the underlying dynamics are roughly unchanged, and we expect a pickup in 2016, with growth reaching almost 3%. The Swedish economy is still reliant on domestic demand, in particular household consumption and housing construction, and this is a weakness. The external environment is mixed, with Norway and Russia suffering from the sharp oil price decline, while external demand from the euro area could improve. Swedish monetary policy is expected to remain expansionary, taking its cue from the ECB, while fiscal policy is likely to become restrictive as local governments raise taxes. There is clearly room, and need, for more fiscal expansion.

Downward revision of growth in the Baltics

We are revising down the growth outlook for the Baltic economies, mainly due to a deteriorating external environment. The escalating crisis in Russia, both economic and political, is mainly responsible for the sharply weaker exports. Also, business sentiments have been affected, leading to lower investments. However, we expect the Baltics to weather this downturn significantly better than during the global crisis of 2009, since other trading partners keep growing. Domestic balances have been restored, and external conditions in the euro area are improving. With Lithuania joining the European Monetary Union on January 1, all three countries share the same currency and also benefit from the recent stimulus policies of the ECB. Domestic demand is expected to remain solid, on the back of improving labour markets, lower energy prices, and real wage improvements.

Macroeconomic indicators, 2013 - 2016

	2013	2014f	2015f	2016f
Real GDP, annual change in %				
Sweden (calender adjusted)	1,3	1,9	2,2	2,9
Estonia	1,6	1,9	2,0	2,7
Latvia	4,2	2,4	1,9	3,5
Lithuania	3,3	3,0	2,3	3,5
Unemployment rate, % of labour force				
Sweden	8,0	7,9	7,8	7,5
Estonia	8,6	7,8	7,3	7,2
Latvia	11,9	10,8	10,2	9,2
Lithuania	11,8	10,7	9,7	8,5
Consumer price index, annual change in %				
Sweden	0,0	-0,2	0,4	1,6
Estonia	2,8	-0,1	0,3	2,6
Latvia	0,0	0,6	0,5	2,5
Lithuania	1,0	0,1	0,7	2,0
Current account balance, % of GDP				
Sweden	5,3	4,0	3,5	4,0
Estonia	-1,1	-0,6	-0,9	-1,3
Latvia	-2,3	-2,8	-2,6	-4,3
Lithuania	1,6	-0,3	-1,7	-3,2

Sources: National statistics authorities and Swedbank.

Swedbank

Global Outlook: Slow recovery under way

We are revising down our global growth forecast, but the underlying dynamics are positive and conditions are improving. The US economy has picked up significantly, while the ECB has doubled down on reinvigorating growth. In China, growth is slowly adjusting downwards, and in India it is set to pick up. In all these large economies, the oil price decline is beneficial. However, risks are not negligible. Commodity-dependent economies with large imbalances (Russia and Brazil) will see harder times, which could affect sentiment elsewhere. More important, should the euro area fail to raise growth in a sustainable manner and preserve the integrity and cohesion of the union, the negative fallout could be severe. Furthermore, a disorderly adjustment of the Chinese imbalances will clearly have global ramifications.

Last year ends weaker than expected

Global growth is picking up, albeit at a somewhat slower rate than we forecast in November. This is mainly the result of a slowdown in the second half of last year, in particular in Europe. Momentum in Germany dampened, along with in other large euro area economies, which suggests that confidence waned. In Asia, we saw India pursuing a tighter-than-expected policy, dampening activity in the short run, and yet again Japanese growth outturn disappointed. The impact is mainly seen in the forecasts for 2015, for which, mainly due to the lower starting point, we adjust down the forecast numbers.

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

	2013	2014f		2015f		2016f	
USA	2,2	2,4	(2,3)	3,2	(2,9)	2,8	(2,6)
EMU countries	-0,4	0,8	(0,7)	1,1	(1,3)	1,9	(1,9)
Germany	0,2	1,5	(1,4)	1,5	(1,5)	2,2	(2,2)
France	0,4	0,3	(0,3)	0,6	(0,9)	1,7	(1,6)
Italy	-1,9	-0,4	(-0,3)	0,0	(0,6)	1,2	(1,5)
Spain	-1,2	1,3	(1,3)	2,0	(2,1)	2,3	(2,4)
Finland	-1,2	-0,3	(-0,2)	0,0	(0,4)	0,8	(1,3)
UK	1,7	2,6	(3,0)	2,5	(2,6)	2,2	(2,1)
Denmark	-0,5	0,9	(0,9)	1,8	(1,7)	2,3	(2,2)
Norway	2,3	2,6	(2,4)	1,3	(1,5)	1,7	(1,8)
Japan	1,6	0,2	(1,0)	1,0	(1,0)	1,1	(0,9)
China	7,9	7,5	(7,4)	7,1	(7,0)	6,8	(6,6)
India	4,7	5,2	(5,3)	6,6	(6,9)	7,0	(6,7)
Brazil	2,5	0,2	(0,5)	0,7	(2,2)	1,8	(2,4)
Russia	1,3	0,5	(0,2)	-6,0	(-0,6)	-2,5	(1,0)
Global GDP in PPP [2/]	3,3	3,4	(3,4)	3,7	(3,9)	3,8	(3,8)

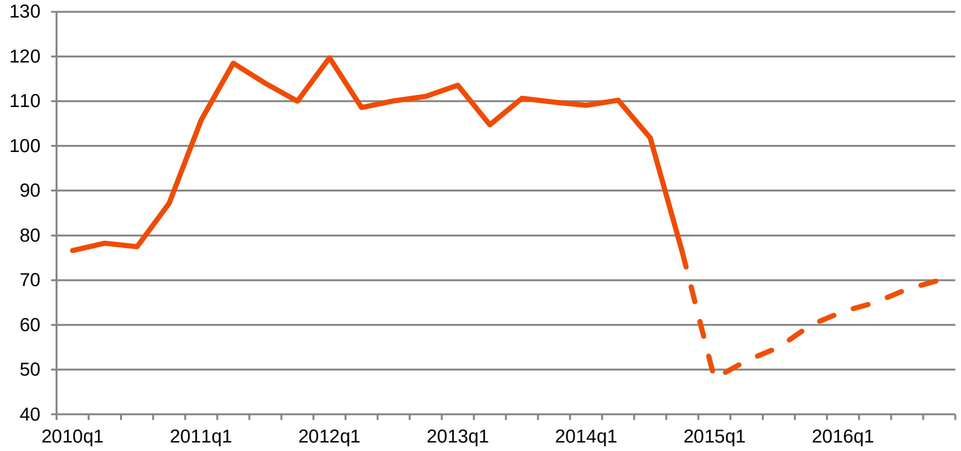
1/ November 2014 forecasts in parenthesis.

2/ World Bank weights (revised 2014). Sources: IMF and Swedbank.

Energy price decline will benefit overall global growth

Looking forward, however, we expect momentum to pick up in 2015 and 2016. It is clear that the impact of lower energy costs, brought about by the sharp decline in oil prices, will be beneficial for global growth. It is in effect a transfer of wealth from net energy producers to net energy consumers, who, on balance, have a higher propensity to consume. Thus, overall global aggregate demand will increase in the short term. Furthermore, manufacturing competitiveness will improve in the euro area and China, and thereby boost production.

Global: Swedbank's oil price forecast, Brent



Sources: IEA and Swedbank

Swedbank

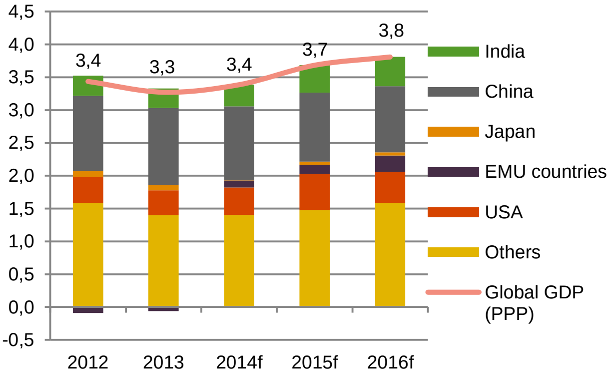
Monetary policies will remain expansionary, but not sufficiently so

With the ECB taking the plunge to expand its bond purchasing program to cover government bonds, the overall global monetary stance is set to remain expansionary over the forecast period, despite an expected tightening starting in the US mid-2016. While this will support a recovery, it will not be sufficient for a sustainable pickup in growth without a more accommodative fiscal policy and aggressive structural reforms. Aggregate demand needs to increase to entice the private sector to take advantage of the exceptionally low financing costs, in order to raise investments; also, productivity, which has been insufficient in much of the developed world, must pick up.

Old world – new world divergence to narrow

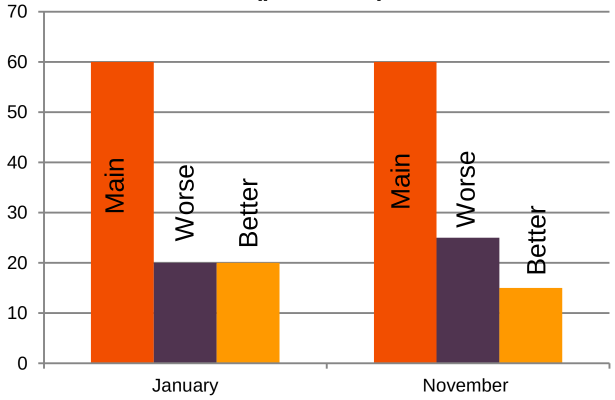
Although, on a net basis, emerging-market economies will remain the most important in terms of contributing to overall global growth, the developed economies are expected to close the growth gap over the next couple of years. However, it is clear that the populous Asian economies, China and India, will remain the backbone of global growth.

Contribution to global growth (ppt)



Sources: Reuters Ecowin and Swedbank's forecasts

Risks to the forecast (prob. in %)



Source: Swedbank

Risks are evenly balanced

We have revised down our growth forecasts slightly but, at the same time, expect the underlying dynamics to be more positive. Accordingly, we raise the probability of a better outcome. The main rationale for this is the possibility of a self-reinforcing process whereby, in particular, positive developments in Europe and the US feed off each other and also benefit other export-dependent economies, such as China and India. We could also be underestimating the positive effects of the sharp reduction of the oil price. Furthermore, the decisiveness of Mr. Draghi and ECB could have an unexpectedly strong effect on sentiments, which, together with fiscal relaxation – which is not currently in the forecast – could boost growth in Europe even more.

Downside risks should not be neglected

Negative risks remain, however. The largest of these, and with the biggest potential impact on the global business cycle, would be a disorderly unravelling of Chinese imbalances, leading to a financial panic that would spread to global markets. As risk taking has increased while yields on traditional instruments have declined, liquidity could dry up fast, closing down important markets. Furthermore, political risks have risen. The recent terror attacks have increased the tension in many crisis-struck European countries, and this is likely to strengthen support for populist parties already feeding off the discontent with the economic adjustment programmes. The Greek elections demonstrated strong support for the left-wing party, Syritza, and elections later this year could have a similar result in Spain. In France and the UK, right-wing parties are gaining popularity. What all these parties have in common is criticism of the economic adjustment programmes necessary to restore competitiveness and growth. Risks also differ across Swedbank's home markets, with the possible escalation of the Russian Ukrainian crisis having a larger negative impact on the Baltic economies.

Interest and exchange rate assumptions, %

	Outcome	Forecast			
	2015 23-Jan	2015 30 Jun	2015 31 Dec	2016 30 Jun	2016 31 Dec
Policy rates					
Federal Reserve, USA	0,25	0,25	0,75	1,25	1,75
European Central Bank	0,05	0,05	0,05	0,05	0,05
Bank of England	0,50	0,50	0,75	1,00	1,25
Bank of Japan	0,10	0,10	0,10	0,10	0,10
Government bond rates					
Germany 2y	-0,2	-0,2	0,0	0,1	0,5
Germany 10y	0,4	0,4	0,7	1,1	1,5
US 2y	0,5	0,8	1,6	2,2	2,6
US 10y	1,8	2,0	2,6	3,1	3,4
Exchange rates					
EUR/USD	1,12	1,10	1,05	1,03	1,10
USD/CNY	6,2	6,1	6,0	6,0	5,9
USD/JPY	118	123	130	125	125
EUR/GBP	0,75	0,75	0,75	0,73	0,72

Sources: Reuters Ecowin and Swedbank.

Spreads are increasing and so are exchange rate tensions

As the ECB is taking decisive steps to fight disinflation and strengthen growth, we also expect to see increased volatility and tension in the bond and currency markets. The value of the euro against the US dollar plunged to lows not seen since 2003, and other central banks have reacted proactively, starting with the Swiss central bank, which removed the peg against the euro and introduced a sharply lower policy rate. The Danish central bank is intervening in the currency market and has also lowered the deposit rate to prevent an exchange rate appreciation. We expect the euro to continue to depreciate and interest rate spreads to rise; this is likely to be associated with growing tensions and accusations of a currency war.

Euro area: Slowly regaining speed

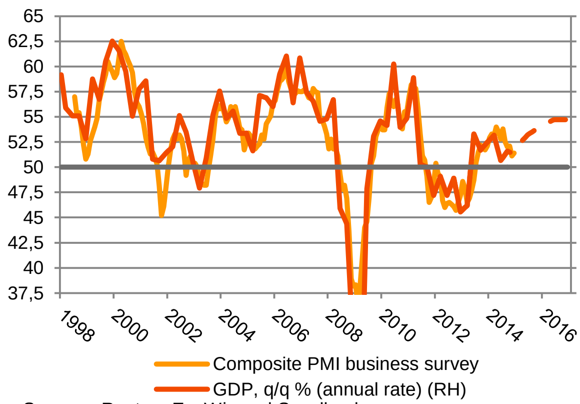
Surprising setback for EMU in 2014

After growth came back to the euro area in 2013, the scene was set for a continued upswing: private sector consolidation had come far in most countries, and many imbalances, including current accounts, had been corrected. The hardest part of fiscal tightening was also in the rear-view mirror. Unemployment was high but was heading downwards. The credit contraction was slowing, as the banking sector was much improved. Nevertheless, growth surprised on the downside last year, and surveys did not offer much consolation. In particular, the downturn in German production growth has been significant and hard to explain, given that record-high exports and low imports point to weaknesses in domestic, not foreign, demand; this in a situation where unemployment has fallen farther to a record-low level, employment continues to increase, and the number of vacancies is high. Sure, geopolitical uncertainty following the conflict in Ukraine may explain cautiousness, especially regarding business investments, but such conflicts are not usually important drivers for the business cycle, at least not if they are "far away".

Data continue to point in different directions

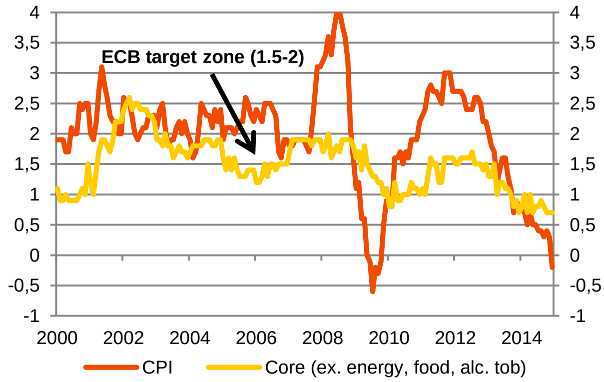
Even now, the data continue to point in different directions: Household demand is not that weak in the EMU, at least not in the third quarter according to detailed national accounts and not through November either, as evidenced by retail sales. Consumer confidence rebounded in January, and the level is well above average, suggesting consumption growth at 1.5%. Private credit is now slowly increasing, and banks are reporting a greater willingness to lend as they have strengthened their balance sheets further and passed last year's stress tests. Business investments continue to be weak, however, and remain far below pre-crisis growth paths. Seemingly, European businesses have yet to believe in a meaningful economic upswing, and, consequently, it is taking longer to materialise. We continue to believe that the economies in the euro area are improving, and that the recent setback is not the start of a new recession.

EMU: PMI vs. GDP



Sources: Reuters EcoWin and Swedbank

EMU: Inflation (% y/y, harmonised)



Sources: Reuters EcoWin and Swedbank

Inflation falls farther

In December, annual growth in overall consumer prices turned negative. This, however, was solely due to the continued fall in energy prices (and oil prices in particular). Core consumer prices – which exclude energy and food prices – have grown at a stable rate of just under 1% for more than a year. This is below the ECB's inflation target of below but close to 2%, but not a situation in which the word "deflation" would be appropriate. Consequently, we do not share the deflationary fears for Europe, and we certainly do not share the fear of a Japanese-like deflationary trap. Rather, we see the sharp fall in the oil price as good news for the European consumer, supporting real income growth of more than 1 percentage point by the end of last year, and will contribute even more at the start of 2015. Usually, lower inflation has supported retail sales (in volume terms) in Europe, as in the rest of the world.

ECB is set for large-scale asset purchases

This being said, with very high unemployment and lacklustre growth, we find it appropriate for the ECB to embark on large-scale purchases of government bonds in order to revive the economy, just like the other major central banks have done in recent years. The ECBs main refinancing rate is already at the zero bound, and it is offering very cheap loan arrangements for banks (TLTROs). The announced programme implies an expansion of the bank's balance sheet by more than EUR 1 trillion by September 2016, equivalent of more than 10% of euro area GDP, and close to 10% of government debt may be bought. The bank suggests it could extend the purchases if needed, in order to reach the inflation target.

The unconventional monetary measures – and expectations thereof – have contributed to a further fall in government bond yields in the EMU to new, record-low levels, and the euro has fallen farther. Whether these measures will be sufficient to bring inflation back to 2% remains questionable, but they undoubtedly work in the right direction. Moreover, the European Commission has signalled it would allow countries more time to reach the deficit limit of 3%, implying less fiscal tightening in both France and Italy. Uncertainties remain following the Greek election, but the Syriza government is likely to succeed in renegot country's debt will likely be renegotiated on more favourable terms, extending the time to make repayments without evoking outright default. Should a "Grexit" from the euro area materialise, it would surely be a messy affair. However, the euro area institutions seem better prepared to tackle such an event now. Credit losses will occur on many balance sheets, but the amounts are manageable – and there will, it is hoped, not be too many surprises.

We have revised our 2015 forecast down, even if several elements in our main scenario have strengthened, like more QE, a weaker euro, and much lower oil prices. The main reason is the euro area economy was weaker in the second half last year and entered 2015 at a slower speed than we assumed last autumn. Nevertheless, the risk for the European outlook is probably skewed to the upside.

In-depth 1: Oil price slump will lower global inflation, boost global growth

The spot oil price has more than halved since the peak last summer. The decline seems mostly due to supply-side factors, as production has accelerated. In recent years, production outside OPEC countries has grown, and, in particular, US shale oil production has skyrocketed. In addition, some OPEC countries increased their production last autumn. In response to this development, OPEC, under Saudi Arabian leadership, decided in November to keep their supply quotas intact, even if the immediate consequence was an oversupplied market. Saudi Arabia shows no willingness to cut production but rather wants market forces to push the highest cost producers out of the market. US shale oil production is expected to respond quickly due to short lead times from investment to production, but lower oil prices will also render many developments in deep waters and in arctic areas unprofitable, including several fields on the Norwegian continental shelf.

Growth in global demand for oil has been only marginally lower than expected, in the sense that demand is more or less in line with the approximately 3% growth in global GDP. Metal prices have fallen in recent weeks, but the decline is modest compared with the decline in the oil price. If a setback in global demand had been the main reason for the decline in oil prices, metal prices would have fallen in tandem, as in 2008. Moreover, part of the fall in metal prices may be due to the currency of measure: measured in SDRs (a global currency unit), metal prices are almost unchanged since last summer.

We expect oil prices to bottom out in the first half of 2015. Growth in the production of US shale oil will soon abate, as the number of active rigs is declining rapidly. It is also possible that countries that did not want to cut their production last autumn will become more cooperative as they witness their public sector budgets deteriorate rapidly. The decline in the oil price should also stimulate demand growth somewhat, making it easier to balance the market.

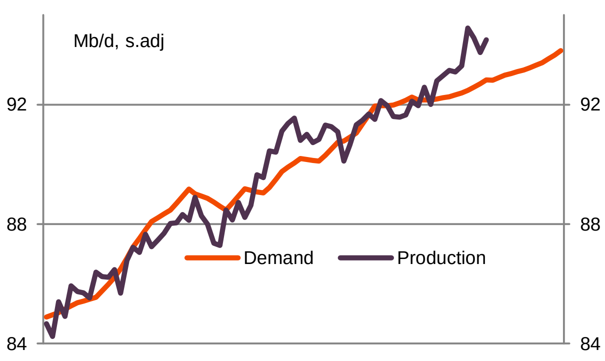
On the other hand, investment costs are now being pushed sharply down everywhere, and we do not expect oil prices to return to about the USD 100/barrel level in coming years. Gas, coal, and electricity prices have all fallen in recent years, including prices from alternative energy sources. In the short term, different energy sources may not be easily substitutable, but in the long term there are limits to the size of the price differentials.

While the fall in oil prices is bad news for oil-producing countries, it is good news for consumers worldwide, who see their purchasing power increasing. We expect global inflation to fall towards 1.5% from above 3% last autumn, thereby increasing households' income substantially. We expect this increase in purchasing power to be rapidly transferred into higher consumption growth in most countries. A lower oil price, even if could lead to negative headline CPI prints, as is now the case in the euro area, does not create a negative deflationary environment.

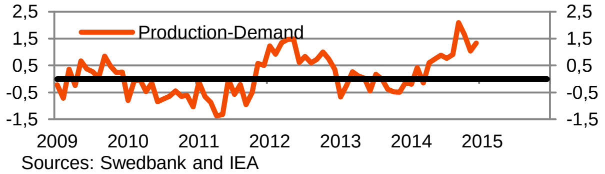
The impact of lower oil prices on global GDP growth is uncertain, as it depends on the circumstances, and on policy responses. A standard estimate, which is supported by IMF analysis, is a 0.1 – 0.2 percentage point (pp) increase in global GDP per a 10 USD/barrel decline in the oil price. As prices have fallen some 50 – 60 USD/barrel, global growth should be expected to increase by some 0.5 – 1 pp. So far, global retail sales have accelerated somewhat, but business surveys have not yet reported an uptick.

Despite the stimulus from lower oil prices, we have not raised our global growth forecasts, because the underlying growth momentum in several economies seems to have been slower than we originally expected.

Global Oil production & demand

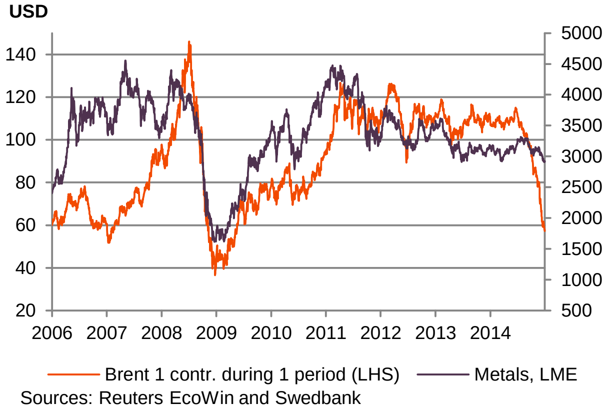


Production-Demand



Sources: Swedbank and IEA

Oil & Metal Prices



Sources: Reuters EcoWin and Swedbank

US: Firing on more cylinders

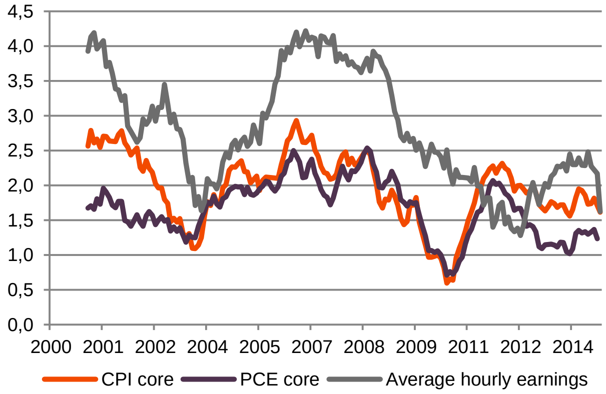
Sustained pickup of growth in 2014

The US economy has strengthened significantly since the summer; most indicators now suggest that the recovery has reached escape velocity, and that growth going forward will be self-sustaining. In the second and third quarters, annualised growth reached rates of 4.4% and 4.9%, respectively. This is to some extent the result of a rebound from the weather-related contraction in the first quarter, but there are also signs that underlying growth is picking up. Consumer confidence and demand have been bolstered by the very strong employment growth, although earnings remain muted. Also, the production side has responded well, with the purchasing managers' index for both manufacturing and services indicating increasing activity. The main risk to the outlook comes from external developments, although we expect that the US economy will be able to ride through the higher volatility that already in place.

Net balance of oil price fall positive

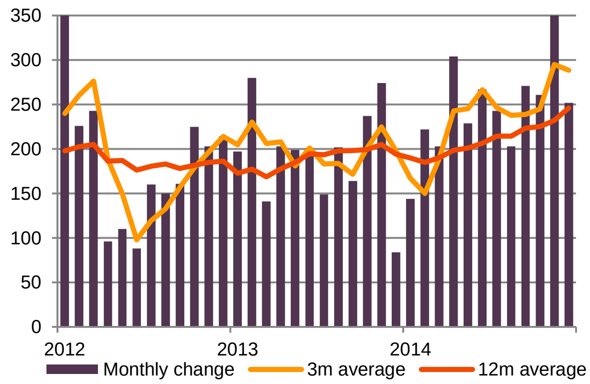
The decline in oil prices of more than 50% since the summer is largely beneficial to the US economy, despite the large investments that have been made in shale gas and shale oil production. American households are significant consumers of petrol, and it has been estimated that the average household will save about $1,000 a year due to the low prices. This is likely to boost consumer spending, at least in the short term. Also, manufacturing, outside the extraction industries, is likely to see its production costs decline, counteracting the decline in competitiveness that will follow from the strengthening dollar.

US: Core inflation and wages (%)



Source: Reuters Ecowin

US: Nonfarm payrolls (change in '000)



Source: Reuters Ecowin

Upswing levels off

We expect growth going forward to remain elevated, but over the forecast period to to slow to past trend levels. This year, annual real growth is estimated to reach 3.2%, largely an effect of the strong momentum at end-2014, and for 2016 annual growth will slow to 2.8%. Average annualised quarterly growth rates will be 2.8% in 2015 and 2.6% in 2016. Short-term indicators suggest a somewhat weaker momentum, but overall growth will remain strong. Not least, the housing sector, which has been weak, is showing signs of increasing activity, both in terms of housing starts and sales. We also expect fiscal policy to be neutral as the gridlock in Congress has worsened due to the success of the Republican Party in the midterm elections. The main weak point will be external demand as the exchange rate appreciation will erode competitiveness.

Medium-term challenges

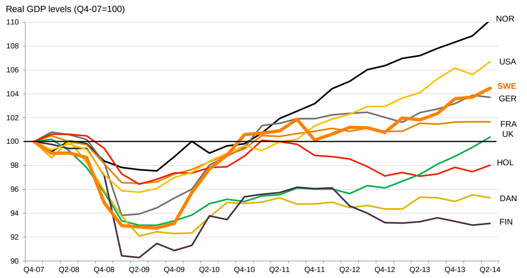
The US economy is facing a number of medium-term challenges. The lack of private sector investments limits potential growth and labour productivity. This, in turn, is detrimental to real earnings developments, which has lagged for quite some time. Labour supply, furthermore, has declined since the financial crisis, due not only to layoffs but also to structural reasons, such as the aging population. There is a risk that many of those who left the labour force will not return due to erosion of skills and the changing structure of the economy. Other, more immediate, risks to the outlook are interest and exchange rate volatility, which could lead to financial sector turmoil or a sharp decline in external demand from China.

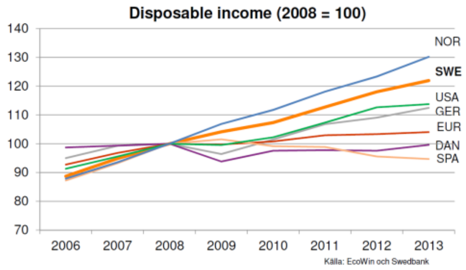
External factors delay Fed rate hike

We push back our forecast for the first Fed funds rate hike from the second quarter to the third this year, but this is not based on a materially worse outlook for the US economy. Instead, it can largely be attributed to external factors, as well as the remaining slack in the labour market and weak wage developments. Lower oil prices will push down headline inflation and also depress costs in related sectors. Given our oil price forecast, this is a one-off effect, and when oil prices increase from $50 to $70 per barrel (i.e., a 40% increase), price levels will again jump up. Furthermore, the aggressive move by the ECB to expand its bond-purchasing programme will raise relative yields in the US and attract capital inflows, strengthening the dollar further. Although trade is relatively less important in the US, cheaper imports will put pressure on prices.

In-depth 2: Diginomics and inequality - new productivity trends as a result?

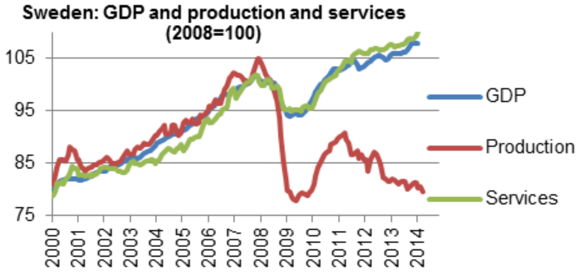
Sweden has been doing relatively well in comparison to other countries. GDP has grown more than in our neighboring countries (see graph 1).





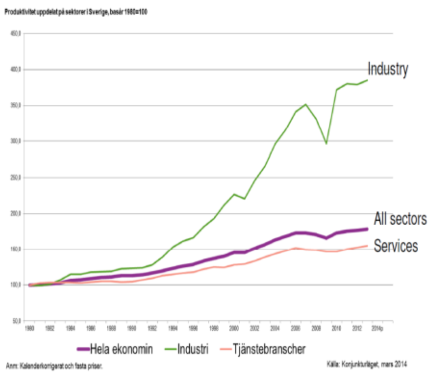
Households have been the main drivers of growth. Due to strong public finances, expansionary fiscal policy boosted government spending and tax cuts were targeted towards households during the financial crisis. Disposable incomes have grown by 20% since 2008 (see graph 2).

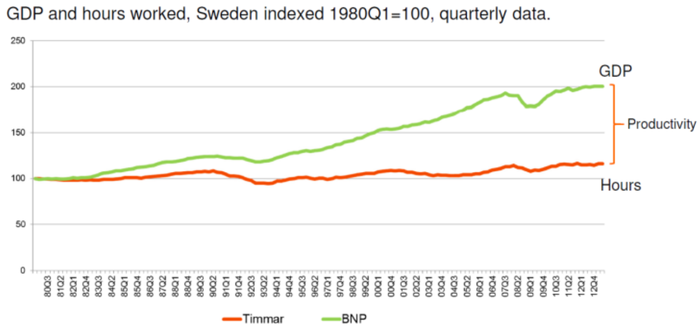
As a result of strong disposable income growth, private consumption and the service sector have boomed. There is a momentous shift towards services in Sweden (see graph 3) and all employment growth in Sweden has come within the services sector. The manufacturing sector has shredded jobs and production is 20% below its pre-crisis level.



Source: EcoWin, Swedbank
Note: Production and service indices are smoothed with a 3-month moving average

Since 2007, as services production has boomed, productivity growth has been very weak (see graph 4). What will drive GDP growth in the coming years when productivity growth is historically driven by the manufacturing sector? This is clearly seen also in Swedish data (see graph 5). As the Nobel Prize winning economist, Paul Krugman, has famously stated *“Productivity isn't everything, but in the long run it is almost everything*”.

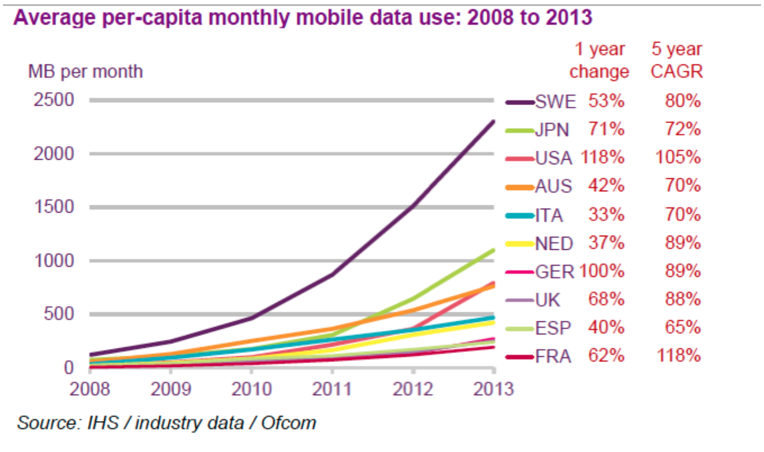




Some academics argue that the productivity gains from the IT breakthrough have faded and we are entering an era of slow productivity growth and secular stagnation (Gordon 2013).

In-depth 2: Diginomics and inequality - new productivity trends as a result? cont'd

We argue that as digitalisation is embraced by almost all sectors in the economy at the same time as IT is becoming increasingly mobile, we could be facing a new era of potential productivity gains. IT was defined as a General Purpose Technology, a breakthrough that caused a productivity up-shift.[1] Mobile IT, we want to argue, has the potential to become the new General Purpose Technology. As graph x shows, the shift towards mobile IT is rapid. Digitalization is disruptive through four horizontal layers; social, mobile, data and analytics. The social layer (e.g., Facebook, Twitter, LinkedIn) has had an notable impact on our lives. The data and analytics layers (big data and internet of things) will cause a remarkable change in most sectors and industries. The mobile layer, the fact that we act and interact with connected devices, could be the driving force to spur a productivity up-shift.



Yet, the productivity gains will be allocated more to high skilled relatively to low skilled, causing greater inequality. A prolonged period of expansionary monetary policy and technological change has created polarized labor markets with higher income inequality as a result. The effects of technological change on the labor market predate the financial crisis. This trend is the most pronounced in the US with wage growth decoupling from productivity growth more than 10 years ago.

Middle hands are being slashed or replaced due to software applications replacing mostly routine tasks. Furthermore, robots replace manual labor on the manufacturing side. These forces are causing a middle paying jobs squeeze and forcing the middle skilled to compete with jobs in the low skilled sector[2]. Thus, the wage pressure downwards in the low skilled sector increases. Such structural factors are holding back wage increases even in the current environment with a cyclical upswing in the US labor market. In Sweden, lower labor mobility and lower wage flexibility causes more wage rigidity compared to the US. Instead of lower wages, we see higher unemployment among the low skilled. Still the underlying forces are the same leading to greater inequality.

”Most crucial for sustainable growth is productivity and equality”, Ben Bernanke at Swedbank Summit October 2014.

Recent academic publications (for example see OECD 2014) argue that inequality hampers growth. The traditional argument is that some inequality spurs incentives for innovations and entrepreneurship. Those recent studies show the opposite. More important is that redistribution policies, used in an effective way have shown to have a positive effect on growth, thereby not causing a trade-off effect between growth and inequality.

An important share of productivity growth will come from digitalization which in turn is spurring income inequality. It is crucial for policymakers to adjust the overall economy and legal frameworks in order to embrace the potential productivity gains from digitalization. At the same time policy makers need to implement effective redistribution policies. Strong political leadership is the key.

[1] John Fernald, San Francisco Federal Reserve

[2] David Autor, MIT.

UK: Domestic demand to remain crucial for growth

Election will have limited impact on the economy

The solid economic growth in the UK is expected to weaken in 2015-2016, partly due to a weaker global outlook, and partly to increasing domestic uncertainty. The external slowdown will weight on firms' investment decisions, and the general elections in May could further increase uncertainty. The rise of the right-wing populist part UKIP is likely to make it more difficult to form a new government, and opinion polls suggest that neither of the two major parties, Labour or Conservative, will attain an outright majority. Our main scenario is, however, that the election result will have limited impact on the real economy this year, although it could affect consumer and business confidence prior to May. However, if the outcome results in a weak coalition government, this could foster doubts about the government's ability to be decisive going forward. In addition, a possible referendum on a British exit from the EU ("Brexit") increases uncertainty.

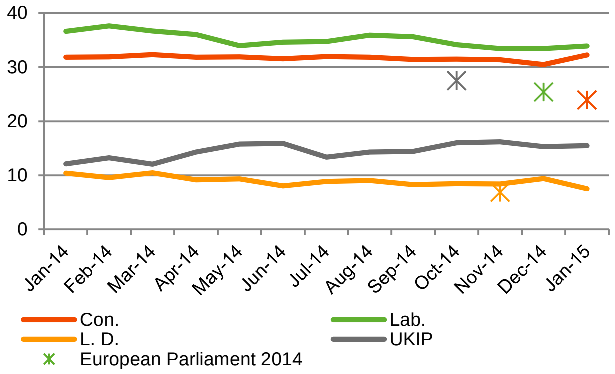
Economy benefits from lower oil prices

We expect that the UK recovery will be reliant on domestic demand, which is boosted by lower energy prices and rising real disposable income. Towards the end of last year, the housing market lost steam, but a reduction of the stamp duties and declining fixed rates make it difficult to be too pessimistic on price developments. The trade deficit may initially narrow as falling oil prices reduce the costs for manufacturers, and total imports may fall due to lower oil imports. Export growth, however, still faces difficulties as the euro area, which accounts for nearly half of all UK exports, remains weak.

Hike in the Bank rate is postponed to Q4 2015

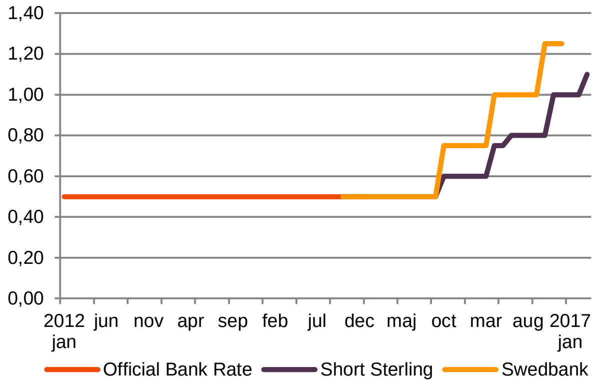
We expect GDP growth to reach 2.5% in 2015 and 2.2% in 2016. Low inflation, resulting in an explanatory letter from Governor Mark Carney to the Chancellor George Osborne, and falling inflation expectations during the autumn will likely force the Bank of England to postpone monetary policy tightening. The Bank rate is expected to be raised to 0.75% in the fourth quarter of 2015 and to be 1.25% by the end of the forecast horizon. Sterling will be relatively stable up until 2016, but we can expect some volatility around the time of the election.

UK: Voting intention



Note: Average over months and polls
Sources: YouGov, Ipsos-Mori, ICM, Oponium, ComRes, Populus & Swedbank

UK: Rate path



Sources: Swedbank, Bank of England and Bloomberg

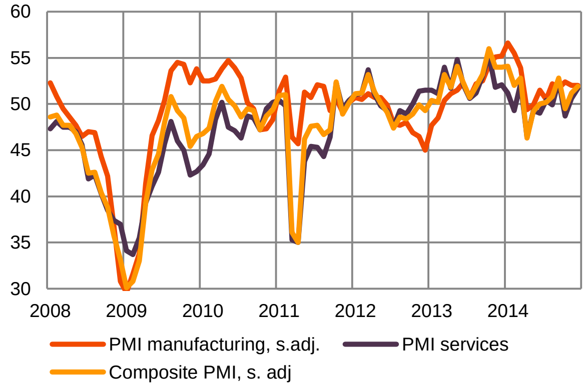
Japan: Recovery postponed

Moderate recovery expected in 2015

The Japanese economy is still struggling after a rise in the consumption tax rate last April, although a gradual recovery is expected from the fourth quarter of 2014 onwards. Growth in 2015-2016 should be around 1%, i.e., above potential, but still modest. Falling oil prices and a gradual restart of nuclear reactors will decrease imports and reduce production costs. Meanwhile, exports are expected to strengthen, based on a cheaper yen and strong demand in the US. Capital spending will get a boost from improved earnings, thanks to a weaker yen and higher stock prices. Consumption will be supported by a modest rise in wages and low unemployment.

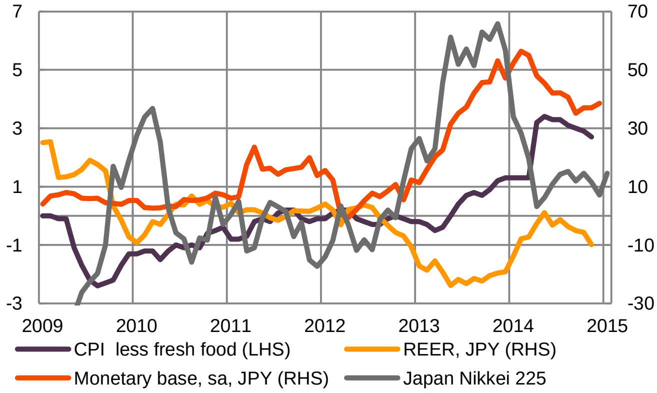
Additional monetary and fiscal stimulus will also help to underpin growth. A postponed value-added tax hike, as well as a planned reduction of the corporate tax rate, will lift investment and household spending. The success of "Abenomics" is, however, still highly uncertain. Third-quarter GDP figures came in much lower than expected, and inflation is decelerating. Achieving the inflation target of 2% by the end of the 2015's fiscal year will be challenging, especially after the huge drop in oil prices. Also, the implementation of the long-anticipated structural reforms has been slow.

Japan: Economic sentiment



Source: Markit Economics

Japan: Prices (% YoY)



Sources: Reuters EcoWin and Swedbank

Emerging markets: Growth divergence ahead

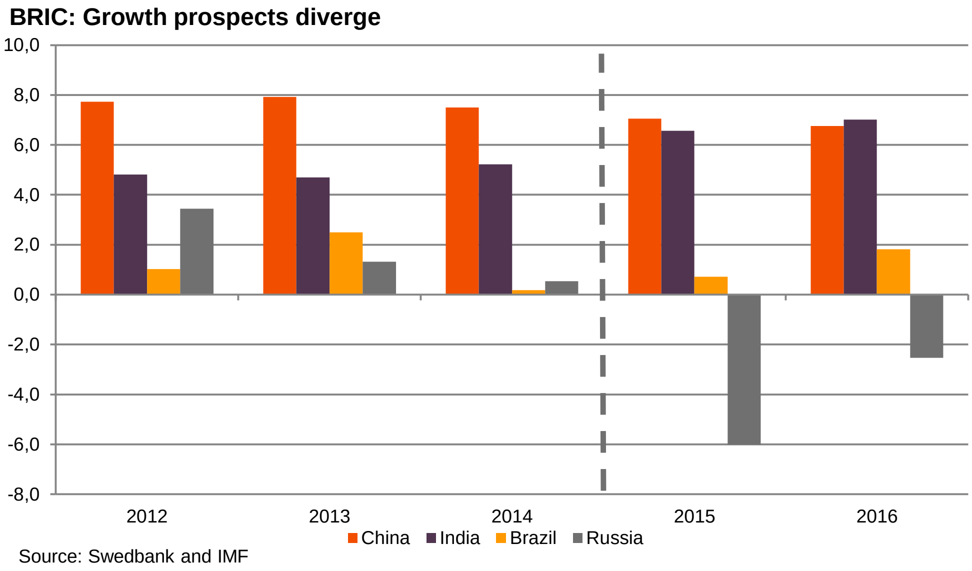
Sifting the wheat from the chaff

The diverging trends amongst emerging-market economies are becoming even more exacerbated. China is struggling to contain imbalances emanating from the housing sector and spreading into the nonbank financial sector without precipitating a spike in risk sentiment. We expect growth to gradually taper off, and that the Chinese authorities, with their large reserves and control of the economy, will be able to manage the transition. In India, we are looking at the opposite trend. A new, strong, and reform-oriented government is aiming to raise growth, but not necessarily in the short term. Instead, it is looking at building support and momentum to gradually modernise the Indian economy without succumbing to use of short-term stimulus. Of the two resource-dependent economies, Brazil is faring relatively well, but that is only in comparison to the much worse outlook for Russia. Brazil will have to address not only falling commodity prices, but also a long period of growing domestic imbalances. Russia is clearly in the most difficult situation. Heavily oil dependent for export earnings and fiscal revenues, it has ostracised itself by military aggression in Ukraine.

Oil price and Fed in risk focus

Against this background, we expect growth prospects in the main emerging-market economies to continue to diverge. China and India are expected to grow at about 7% annually, with India being on an upward trajectory and China gradually slowing. Brazil will see a slow rise in its growth rate towards 2%, but we expect a sharp contraction in Russia. In fact, the outlook for Russia is highly uncertain as financial sector unrest could very well produce a worse outcome, while a reversal in oil prices and external relations could dampen the downturn. Important for capital-dependent emerging markets are also the future policy changes of the Federal Reserve; however, most larger emerging markets are in a better position now than in 2013, when capital flows sharply reversed.

Swedbank



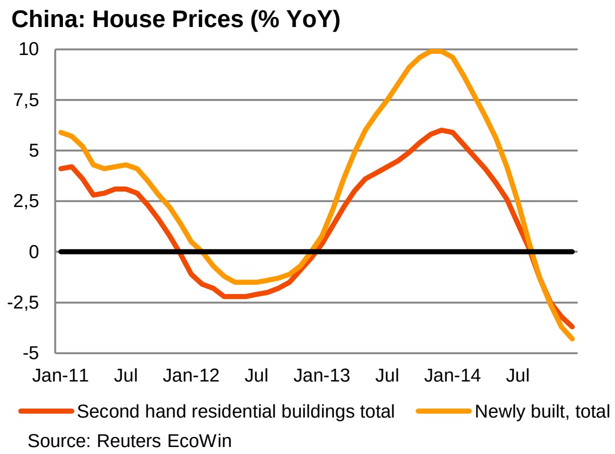
China: Managing risks as property market imbalances are reduced

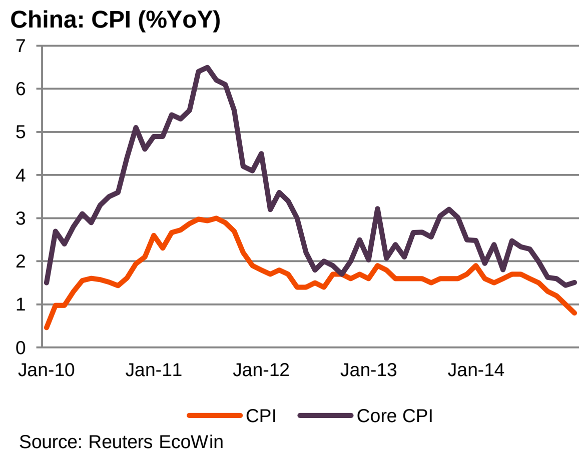
Weak property market lowers growth

The pattern of decelerating economic growth continues in China. We expect the government to set the official growth target at 7% for 2015, down from 7.5% in 2014. The main contributor to lower growth is the weak property market. House prices are falling despite easing of house purchase restrictions and lower mortgage rates. Construction activity needs to slow to dampen the oversupply of houses. Inventories of residential property are currently the highest in five years. The adjustment in the property market will put more downward pressure on growth, with the risk of negative spillover effects into related sectors. This, together with smaller corporate profits, will put pressure on wages and household consumption. The central bank has cut policy rates and will probably stimulate with more rate cuts and cuts of the reserve requirement ratio. Inflation is no barrier for more monetary stimulus as consumer prices rose by just 1.5% annually in December 2014 -- the lowest rate since January 2010. However, we do not expect aggressive rate cuts as credit growth is still higher than nominal economic growth, which implies that debt is continuing to rise as a share of GDP.

Proactive policies to manage transition

We expect the government to front-load investments in infrastructure to partly offset declining property investments. This should smooth out the adjustment and lead to short-term stabilisation in the property sector. However, it will probably take years to erase the structural imbalance in the property sector. Credit growth slowed during 2014 to its lowest rate since 2006. The biggest adjustment occurred in the shadow banking sector on the back of new regulations to bring down off-balance-sheet lending. The government will continue to use economic stimulus measures to manage an orderly transition. In an environment of falling house prices and weak growth, the risks are large that banks will face losses. However, the government still has large reserves to use and the external debt is low. Fiscal problems in local governments are another factor that suggests policy at the central level will be more expansionary. When house prices were rising, the local governments were financing infrastructure projects through leveraged financing vehicles. The local governments were subsidising the vehicles by selling land to developers. With a weak property market, borrowing will be harder and more expensive as it will be more difficult for local governments to use these vehicles to finance their expenditures.





External demand contributes to growth

Our forecast for GDP growth is 7.1% for 2015 and 6.8% for 2016. We expect that economic growth will be driven by an expansionary policy and net exports. Export growth has been holding up while lower commodity prices have been pushing import growth down. This has created a record-high trade surplus (annual rate). We expect export growth to strengthen on the back of higher US demand.

India: Steady and stable increase in growth

Lower oil prices a boon to the Indian economy

India is one of the big winners from the last six months' drop of almost 50% in oil prices. Inflation pressures are easing and the government budget has strengthened, thanks to a reduction in energy subsidies. The current account deficit is improving because of a smaller bill for oil imports. The improved external position and lower inflation pressures led the Reserve Bank of India to cut policy rates in a surprise meeting in January this year and we expect more rate cuts this year that will support growth.

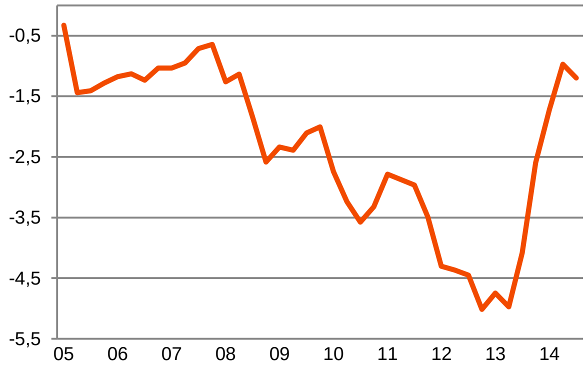
Ambitious medium-term reform agenda

The new government was elected with a majority in the lower house and on a strong reform agenda. However, it appears that they will have chosen a long term perspective, focussing on building support on the state level to ultimately control also the upper house. Prime Minister Modi is aiming to launch an extensive reform package to improve the business climate and increase the country's growth potential. One of the most important reforms is a unified nation-wide goods and services tax (GST), which is expected to raise long-term growth by 1-1.5% when introduced in 2016. Another goal is to raise manufacturing as a share of the economy from its current level of about 13% to 25% by 2022. The energy sector will be reformed, which is important since external dependence is high and energy distribution unreliable. Labour market reforms are also identified as key for raising productivity and competitiveness in the medium term.

Steady increase in growth

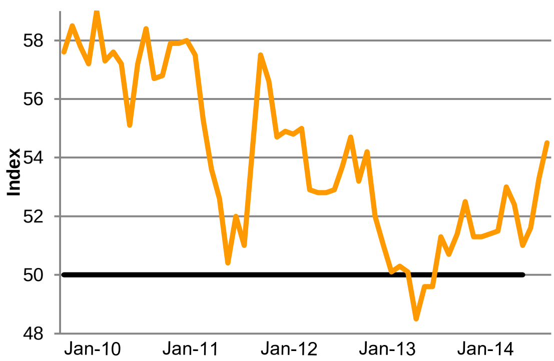
Fiscal policy will be tightened in 2015 to reduce the budget deficit to 4% of GDP. This will hold back growth, and economic activity has so far been modest. Production and exports have been treading water. However, business and consumer sentiment indicators are rising, which point to a cyclical upswing. We thus revise down our annual growth estimate for 2015 from 6.9% to 6.6%. As reforms are implemented, growth is forecast to pick up to around 7% in 2016. The reform agenda bodes well for growth, but we expect only a gradual improvement, as it may take time to pass and implement new reforms due to the complex and challenging nature of the political system in India.

India: Current Account (% of GDP)



Source: Reuters EcoWin

India: PMI - Manufacturing Sector



Source: Reuters Ecowin

Risks are mainly in the external environment

Inflation has decelerated quickly, with wholesale price growth currently at zero. The consumer price inflation rate has been cut in half since December 2013 and rose by 5% in December last year. This, coupled with low oil prices, makes it probable that the inflation target of 6% by January 2016 will be met, paving the way for further rate cuts of 50-75 bps during the first half of 2015. This is likely to support investment growth, whereas a consumption-led recovery would lead to inflation and/or a larger current account deficit. Credit growth is very low as Indian banks are still suffering from bad loans and a lack of domestic savings. Rate cuts are therefore very important in order to boost growth. We believe that the external financial vulnerability is much lower now than in the summer 2013, when the rupee fell by 15% against the dollar. The main risks are if the US starts to raise rates aggressively or if the oil price declines quickly.

Brazil: Fighting imbalances and rebuilding confidence

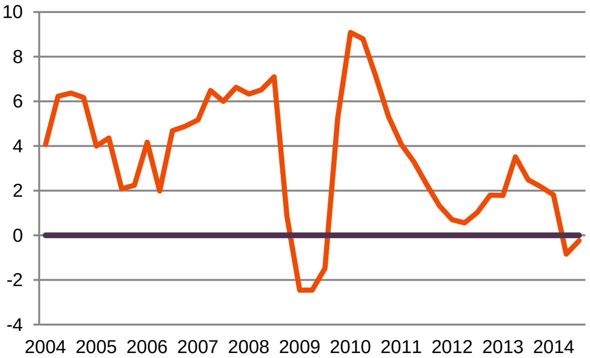
Long, hard struggle ahead

The Brazilian economy slowed substantially last year, with negative growth in the first half of the year. Although we estimate a slight uptick towards the end of the year, annual growth will barely register in positive territory, at 0.2%. A number of factors are contributing to this. The Petrobras corruption scandal, falling commodity prices, and generally weak confidence in economic policies are the main factors that have put pressure on growth. Exports have collapsed and thereby put further pressure on the current account balance deficit, which increased to 4% of GDP in November. The Brazilian real fell in December to its lowest level against the dollar since the Lehman crisis.

Past sins catch up

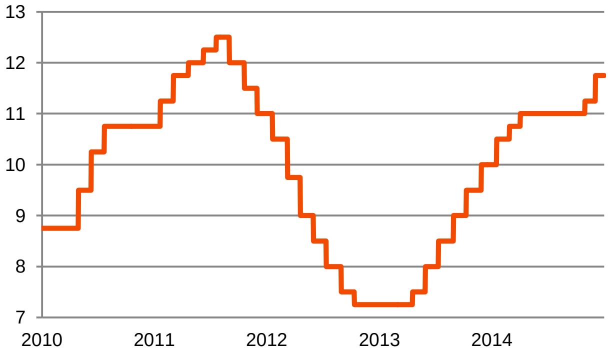
The investment outlook is very poor, and the Petrobras bribery scandal will most likely lead to a further decline in investments because of its size in the Brazilian economy. The situation has become so severe that Brazil runs a great risk of a ratings downgrade and of losing its investment-grade status. Against this background, President Dilma Rousseff recently formed a new economic team to implement reform policies, put the public finances in order, and improve the business climate. Joaquim Levy was appointed the new Finance Minister and tasked with tightening fiscal policy. He has already announced a number of cost-saving measures and a primary fiscal surplus target of 1.2% of GDP for 2015 and at least 2.0% of GDP thereafter. This may be the beginning of a change in economic policy, away from the fiscal deterioration that has characterised the political landscape the last couple of years. However, it remains to be seen how much support Levy will have for budgetary savings if economic growth does not recover fast enough.

Brazil: GDP, Constant Prices (%YoY)



Source: Reuters EcoWin

Brazil: Policy Rate (%)



Source: Reuters EcoWin

Rebuilding confidence

Economic growth will not likely improve in the near term. Household consumption is being held back by a weak job market and high loan rates. At the same time, inflation remains sticky, at around 6%, which is at the upper end of the central bank's tolerance band. The central bank, trying to build credibility for its monetary policy, raised its benchmark rate by 50 bps to 12.25% in December. We see a risk of more rate hikes to ensure that inflationary pressures ease. Accordingly, economic policy will be tight from both the fiscal and monetary sides, which will keep growth slow in 2015 and 2016.

Russia: Nose-diving into recession

Much deeper recession than previously forecast…

The situation has moved from bad to worse. With the rouble depreciation and ensuing massive financial squeeze, Russia will fall into a much deeper recession than earlier forecast. In the baseline scenario we pencil in a 6% GDP contraction this year and an additional 2.5% in 2016, but risks are tilted downwards and more negative outcomes are possible. Note that headline GDP tends to disguise the sharpness of the contraction – e.g., in 2015 we forecast consumption and gross fixed capital formation to shrink by 10% and 20%, respectively, and the fall in headline GDP is milder only because of a double-digit contraction of imports. For companies exporting to Russia, this means that demand for their goods and/or services will shrink in multiples of the headline decrease in Russia's GDP.

… as sharply falling oil price drags down the rouble and the Russian economy

About two-thirds of Russia's exports and more than half of federal budget revenues are from hydrocarbons; thus, the sharp fall in oil prices is painful. With Brent down about 55% from a year ago, the rouble has fallen almost 50% against the dollar. The exchange rate adjustment helps the government (i.e., revenues in foreign exchange whereas expenditures in roubles), but brings havoc elsewhere. To calm the panic, the Bank of Russia lifted its policy rate to 17% on December 16, but such levels are unlikely to stop the rouble from weakening if oil prices decrease further. With depreciation, inflation is to pick up (to about 15% for 2015 on average) and hit consumption – especially towards spring, when the path-through into prices starts to mature. Investments will flop along, with corporates' financial standing worsening, prohibitively expensive imports, high interest rates and credit squeeze, and higher uncertainty – all of this will undercut import substitution ability and push up prices farther. To add to the private sector's woes, policymakers talk of slashing federal budget spending by about 10%. In 2014, capital outflows hit a historic high of USD 155 billion, reducing central bank reserves to below USD 400 billion. With widespread implicit (but still-limited official) capital controls and a strong trade balance surplus (we expect the rouble to fall a tad more than oil), Russia has foreign exchange reserves to meet its due external debt (about USD 120 billion in 2015) despite capital outflows, but is short of funds for investment, which will constrain its future recovery.

We see two major scenarios for 2015-2016:

But further developments will be mainly shaped by Russia's political risks

A. The rouble performs a tad worse than oil price, i.e., some further depreciation. Massive financial squeeze and credit crunch, limited bank runs and bailouts. Implicit capital controls to reduce build-up of speculative attacks and curtail residents' ability to shift into foreign exchange, but no wide official capital controls. Investments shrink dramatically, inflation into double digits, consumption falls. No major social unrest. Russia loses its investment-grade rating. With the latest escalation of the conflict in Ukraine, additional sanctions (but not very costly) could be imposed onto Russia. Sanctions have some possibility of easing in 2016, but this requires Russia to signal a change of attitude towards Ukraine (i.e., see the Minsk agreement). The above-described scenario means GDP contraction of 6% and 2.5% in 2015-2016, and presumes very iffy if any recovery in late 2016.

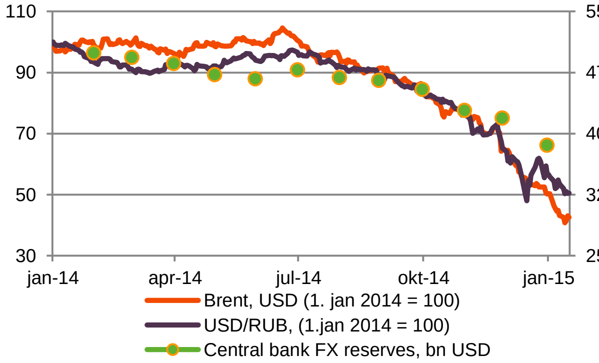
B. It gets worse than that.

High risks of renewed volatility and downward pressures

The probability of these scenarios is closely matched, but the first one is somewhat more likely. More positive scenarios (they would soften the recession but not evade it) would require a quick lifting of Western sanctions, but this can happen only upon a sharp improvement in the Russia-Ukraine conflict, which does not seem that likely very soon. A positive twist to the story could follow after Merkel's offer of free trade deal for peace in Ukraine. A sharp rebound in oil prices would help to soften the recession, but it is unlikely as well. Also, a realistic oil price rebound would only buy more time for Russia – unless access to foreign capital (which again depends on the Russia-Ukraine conflict and other structural issues such as the rule of law in Russia) would improve, economy will remain in a very poor state.

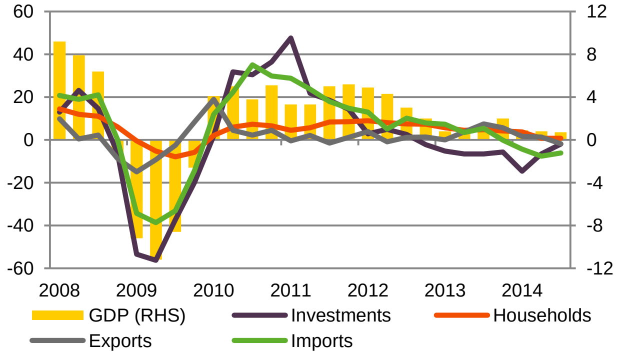
There are many drivers for renewed market volatility and downward pressures. Answers to the following questions will be crucial. Is the oil price to weaken further? For how long will it remain low? Will the financial squeeze spill over into a systemic run on banks? Will explicit capital controls be introduced? Will Russia opt for selective debt defaults? Will sanctions be broadened? Will it scale down its geopolitical ambitions, and what is the chance of sanctions being eased or lifted? The major risks to the Russian outlook are political ones, and the drama is certainly not over yet.

Russia: Exchange rate, oil price and FX reserves



Source: Reuters Ecowin

Russia: Annual growth of GDP components (%)



Källa: Reuters Ecowin

In-depth 3: Russian economy down – impact on the Baltics

Russia: no reason to expect sanctions to be lifted any time soon

For the past couple of years, our view has been that the Russian growth model has run out of steam – an oil price rally a la the 2000s, prior the Lehman crash, is unlikely to be repeated, but growth in sectors other than commodities is held down by corruption and poor rule of law. We saw investment starting to contract already in 2012. There was a chance to muddle through with low positive growth rates, but the Russian incursion into Ukraine in early 2014, with the ensuing uncertainty, capital flight, and sanctions, put Russia on the path to recession. The sharp drop in the oil price late last year and the following massive depreciation of the rouble made the situation worse. Russia is set to experience a very deep recession with an iffy, if any, recovery towards late 2016. Recovery – both its timing and strength – will very much depend on the oil price and the lifting of the Western sanctions.

Our baseline scenario expects some oil price recovery (see the section on commodities), but the oil price is notoriously difficult to forecast and the outlook must be taken with a heavy pinch of salt. As for the sanctions, lifting them depends on Russia's changing its stance on Ukraine, i.e., at least adhering to the Minsk agreement to deescalate the conflict in eastern Ukraine. So far, no such change has been seen, and, from the current rhetoric, it seems that Russia is unlikely to take a sharp U-turn in its foreign policy anytime soon. Quite the opposite, the conflict in Ukraine has escalated and insurgents seem aiming to establish a land route from Russia to Crimea. Adding to this, there is news that in South Ossetia (part of Georgia, which has been in a frozen conflict with Russia since 2008) a referendum is likely to be organised to decide whether to join the Russian Federation – this resembles the Crimea story and would escalate rather than calm down Russia's conflict with the West.

The EU sanctions have a built-in sunset clause. The next review is due in March and mainly deals with certain individuals as a response to the annexing of Crimea. These sanctions will not be lifted as the Crimea issue is a dead end for the foreseeable future. But they matter little to the Russian economy per se. The summer review is much more crucial as those sanctions limit Russia's access to financial markets, oil exploration/extraction technologies, etc. There are EU countries that will make the extension of these sanctions difficult, e.g. Hungary. Equally, it is very difficult to expect sanctions being lifted unless Russia honours the Minsk agreement. The easing of sanctions will require negotiations successfully reconciling the 28 different views on what is to be eased and what is not. Hence, unless it is a very clear case, negotiations may follow the "all-or-nothing" strategy and the sanctions would remain. The EU partnership with the US, whose view is likely to be more hawkish and straightforward (e.g., only one country to form a view, rather than 28 different sovereigns with different levels of economic integration and political ties with Russia to reach agreement), may support the case for extending the sanctions. All in all, currently it seems that in 2015 we could see sanctions against Russia broadened rather than eased; sanctions could perhaps be very timidly eased only in 2016. It seems, changing Russia's geopolitical ambitions needs a much steeper and deeper economic recession than it has seen this far (e.g., Putin's approval ratings have not budged yet as well).

The recession in Russia is closing in fast and will deepen sharply. Investments have been retreating for a couple of years now, and sharply reduced access to foreign financing is making the situation worse. But there is even worse to come. Our estimates show that the strongest correlation between the oil price and investments is with a lag of two quarters, and, thus, the sharpest free fall in investment activity is likely to occur only in the spring. The study by Ponomarev, Trunin, and Ulyukaev (2014)1 finds that the exchange rate pass-through onto the consumer price index over 12 months stands at 47.7% (at 74.7% for the nonfood products' price index). With a rouble devaluation of about 50%, this would mean consumer prices rising by nearly 25%, or about 15% on average, for 2015. This would produce a massive hit to consumption. This recession in Russia is likely to be about as deep as the one in 2008-2009 (i.e., then a cumulative drop of about 9%) or even deeper than that.

The Baltics: recession in Russia is costly, but manageable; an extra boost to future resilience

While, at the time, Russia's imposed food product embargo on August 7 2014 was all over news headlines, its overall impact on the Baltic economies has been very limited (see Swedbank Macro Focus from August 2014 for details2). It hit only certain industries, like milk, dairy, and fish producers, and companies were active to exploit the multiple possibilities to evade such trade restrictions. The overall weakness of Russian demand as the economy dives into recession (and, particularly, the weakness of the rouble) is a different matter – it will hit exporters of all industries selling to Russia. This is a matter of less demand, not barriers to trade that can be circumvented. Furthermore, this will hamper Baltic exports not only to Russia but also to the countries closely integrated with Russia. For instance, about half of Belorussian exports go to Russia, and depreciation of the Russian rouble is pulling down also its currency.

So far, the negative impact on exports to Russia has been quite contained, though quite different across the three countries. Namely, during January-November 2014, Estonian goods exports to Russia fell by 14% in annual terms. Over the same period, Latvian exports were down by 3%, whereas Lithuanian exports grew by 6%. The latter is only due to reexports, since exports of Lithuanian-origin goods fell by 15%. In 2014, about 88% of Lithuanian exports to Russia were reexports (up from 85% the year before). Unfortunately, there are no explicit reexport data for Latvia or Estonia. The Bank of Estonia estimates that 77% of Estonian exports to Russia in 2013 were reexports, but data are lacking for earlier years.

In-depth 3: Russian economy down – impact on the Baltics, cont'd

Latvian exporters have been able to compensate for the fall in exports to Russia by growing sales to other markets, and total goods exports grew by 2% in the first 11 months of 2014. Estonia and Lithuania were less successful; their exports fell by 2% and 1%, respectively (Lithuanian-origin goods exports declined by 7%). Services exports, especially road transportation, have also taken a hit in Latvia – services exports to Russia declined by 2% in the first 9 months of 2014 (these balance of payments data are less reliable, though, as they underestimate Russia's share). Estonia was able to grow its services exports to Russia by 8% over the same period. No comparable data are available for Lithuania.

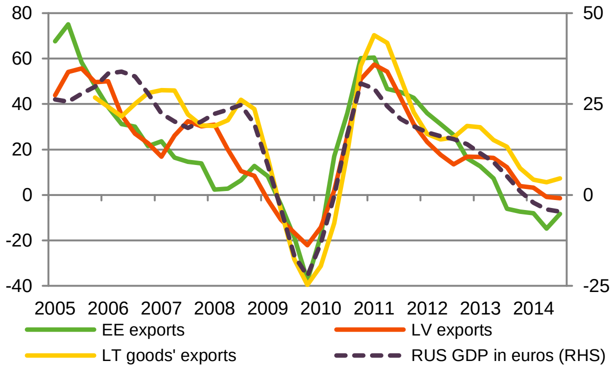
What next? Given that the recession in Russia is just settling in, most of the negative impact on the Baltics is still to be felt. The hit will get worse. It is instructive to observe (see the graph to the left) that Baltic exports to Russia closely follow Russian nominal GDP growth. If the past data are of any guidance, a 1 percentage point fall in Russian GDP implies approximately a 1.5 percentage point fall in Baltic exports to Russia. Combining the rouble depreciation, falling economic activity, and rising consumer price inflation, Russian GDP, as expressed in the euro currency, can easily fall by about 25% or more in 2015. A 25% contraction would imply a fall of about a third in Baltic exports to Russia. A tough ride, but not as totally devastating as it may seem. For instance, in the case of Latvia, if its exports to Russia were to fall by a third, exports to other countries would need to rise by about 4% to counteract the fall and keep total export value unchanged. Not that dramatic. In the first 9 months of 2014, we saw the value of Latvian exports to other countries excluding Russia expand by 2%.

The above on the back-of-envelope calculation may overrate export sensitivity as the financial stance of companies now is typically stronger (i.e., deleveraging has run deep) and their export markets have become more diversified. Whatever the exact numbers will be, the current situation in Russia will, of course, have a negative impact on Baltic exports. The impact will come not only directly through falling exports to Russia, but also through tougher competition from Russian companies in overlapping export markets due to the Russians' increased price competitiveness (i.e., the cheaper rouble). Even if the overall impact on the Baltics is forecast to be manageable, there can be substantial problems with liquidity or solvency for corporates, particularly those with large direct exposure to Russia. In our current baseline scenario for 2015, we anticipate a double-digit fall in exports to Russia for all three countries. Total exports are expected to grow just marginally for Estonia and Latvia. For Lithuania, a slight decrease is pencilled in, but only due to falling prices, as volumes are expected to remain flat.

This means that the dependence on exports to Russia for the Baltic economies will lessen, and integration with the EU, especially, and the rest of the world in general will strengthen. We saw a similar trend after the collapse of the Soviet Union and the 1998 Russian crisis. With the recent shifts in Russian geopolitical ambitions and extremely high political uncertainty, the decrease in importance of exports to Russia is set to continue. This will only make the Baltic economies more diversified and resilient. It is not a good idea to rely on a falling (in the longer term, stagnating) market, anyway.

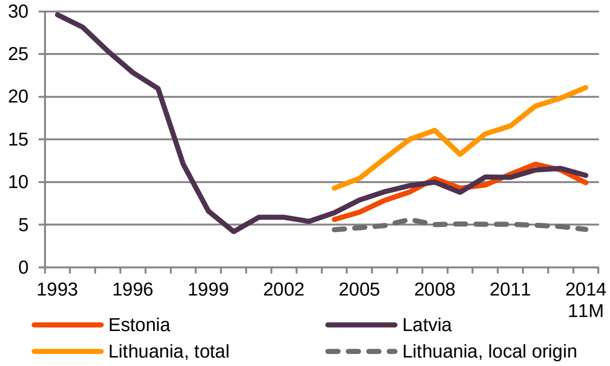
With Russia sliding deeper into recession, its willingness to boost its own exports to raise its foreign exchange proceeds will increase. This opens opportunities for cheaper imports from Russia into the Baltic markets, i.e., more competition for domestic producers, but also opportunities to use such imports for reexports or as inputs for exports.

Russia: Baltic exports to Russia and Russian nominal GDP, (YoY, %)



Source: National statistics

Russia: Share of goods' exports to Russia, %



Source: National statistics

References:

[1] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2458881

[2] http://www.swedbank-research.com/english/macro_focus/2014/augusti/index.csp

Nordic area: Mixed impact from global events

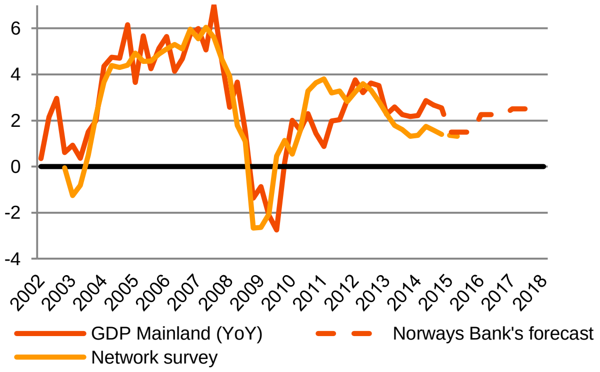
Norway: Prospects slump with oil price

Prospects for the Norwegian economy deteriorated significantly through the end of last year. Businesses in Norges Bank's regional network have reported significantly lower expectations, currently projecting a growth rate of only 1.3% in the months ahead. Other business surveys have confirmed this development. The main weakness lies in the oil-related sectors. Statistics Norway's survey suggested a significant fall in oil investments already before the oil price started to fall. Lower prices put increasing pressure on profitability, suggesting significant downside risks not only to investment plans but also to margins and cash flows of oil companies and their suppliers. Oil-related industrial production, which has boomed in recent years, is now set to fall. New orders are deteriorating rapidly, and reports of layoffs are recurring in the news. On the basis of these weakening prospects, Norges Bank decided to cut the policy rate by 25 basis points to 1.25% in December.

Limited spillovers to the broader economy so far

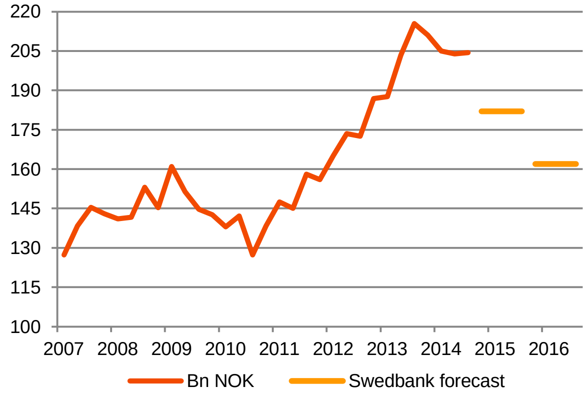
Total registered unemployment remained unchanged in December at 2.8%, and open unemployment actually fell. Labour Force Survey unemployment did indeed jump up in October, but high variability from month to month makes this indicator unreliable. On the other hand, domestic demand has been weak for quite some time, and weaker than Norges Bank had predicted. Growth in household demand has been muted for almost two years, and developments in retail sales remained modest through November. Demand for labour is also very weak, as evidenced by the few new vacancies and falling employment surveys, and suggests weak employment growth ahead. It is becoming increasingly clear that wage growth has come down as well, further slowing growth in total income. In the year ahead, we expect domestic demand to remain weak and unemployment to rise, in particular as layoffs in oil-related sectors and their repercussions take hold. Wage inflation is slowing, and real wages are also being hit by higher inflation.

Norway: Actual vs. reported growth GDP vs. NB's Regional Network



Sources: Reuters EcoWin and Swedbank

Norway: Investmenst in oil and gas



Sources: Reuters EcoWin and Swedbank

Two or three more rate cuts this year

Even though Norges Bank lowered its projections significantly in the December report on monetary policy, we continue to see most, if not all, of the risks on the downside and expect two or three more cuts in the policy rate this year, to 0.5-0.75%. We expect the bank to largely see through the fact that core inflation (which was 2.4% in December) is likely to rise well above the inflation target in the year ahead, as prices on imported goods will rise with the weaker Norwegian krone. In our opinion, the bank does not need to worry that higher consumer price inflation will feed over to wage growth and induce domestic cost pressures in a situation where the domestic economy is slowing. As the bank cuts interest rates, worries about financial stability remain. House price growth continued through the fourth quarter, and the underlying growth rate has reached 10%. This usually indicates further growth in credit ahead, already at a very high level (although actual household credit growth was low in November). Between the lines, Norges Bank now suggests that the Norwegian Financial Supervisory Authority needs to take additional measures to contain excessive credit growth.

Fall in oil is not the end of the Norwegian economy

Over time, non-oil-related sectors will expand and compensate for the downturn, in particular as the weaker Norwegian krone improves the situation for many export-oriented firms, and firms that compete with foreign producers in the domestic market. If the krone remains at present levels, net exports should contribute significantly to growth in the mainland economy in the years ahead. A recent investment survey was clearly better than we expected, possibly already reflecting the weakening of the krone in 2013. Household debt is high but so are savings, and a large savings shock is unlikely. Fiscal policy has unlimited room for manoeuvre, and we expect some measures to be announced in the spring revised budget.

Denmark: Growth to pick up, aided by lower oil prices

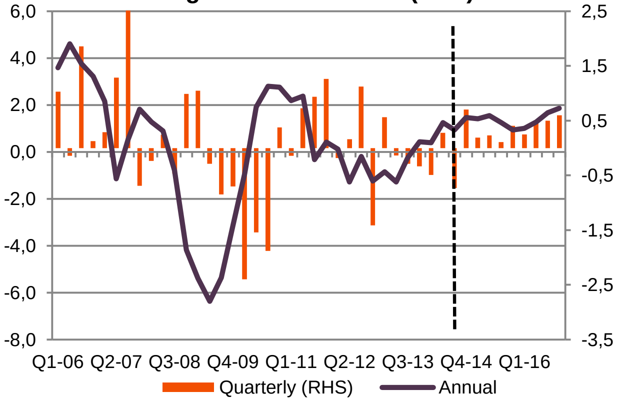
Rebalancing of the economy is now bearing fruit

For the first time since 2011, Denmark is estimated to have reached positive growth last year, with the last five quarters showing an expansion. We estimate real economic growth at 0.9%, and the recovery is broad based. This has come after a long period of low growth due to fiscal consolidation, the rebalancing of the housing market, consolidation of the financial sector, and a structural decline of the oil extraction sector. Although not without risks, the Danish economy now looks set to extend the positive development for the next two years.

Being a net exporter, Denmark benefits from oil price decline

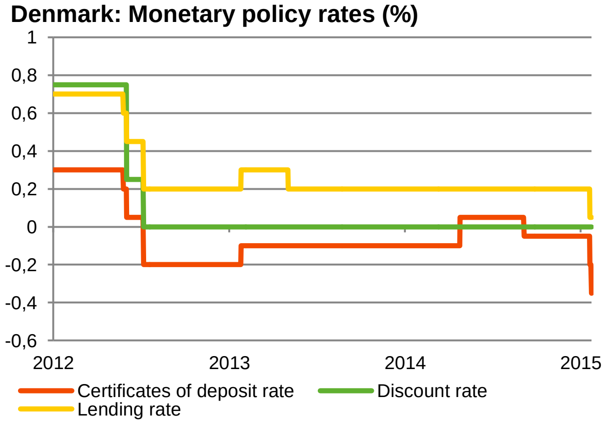
Conditions for a growth pickup in Denmark are looking good but are not without risks. On the positive side, consumer confidence is strengthening, and we expect growth to be generated to a large extent by household spending. Exports have been constrained by the slowdown in the main trading partners, and we expect only a modest pickup in the forecast period as imports will continue to increase. Overall, we forecast real growth to reach 1.8% in 2015 and 2% in 2016.

Denmark: GDP growth & forecasts (in %)



Sources: Reures Ecowin and Swedbank

Denmark: Monetary policy rates (%)



Source: Danmarks Nationalbank

Economic policy to become more expansionary

Economic policy in Denmark has been guided, on the one side, by adherence to the 3% budget deficit limit as defined in the Maastricht agreement, and, on the other, by the currency peg to the euro. The negative impact on growth from fiscal consolidation is now largely over, and, with elections coming up this year, there is likely to be some relaxation in fiscal discipline. Monetary policy is set to become more expansionary as the ECB continues to grow its balance sheet and the Swiss National Bank abandoned its peg to the euro. Denmark's National Bank moved its deposit rate farther into negative territory to deter capital inflows and a strengthening of the krone. Still, further pressure on the Danish krone cannot be ruled out.

Finland: Recovery still fragile

The Finnish economy has now fallen off for three years in a row. GDP decreased by 0.3% last year, as consumption and investments, as well as exports, failed to produce positive results. The biggest drag came from the steep decline in private investments due to insufficient demand, both domestic and foreign, uncertainty, and weak confidence. At the same time, employment is falling, unemployment has increased, and wage growth is very moderate, all therefore having a negative impact on private consumption. Weakening domestic demand has depressed demand for imports and thereby increased net exports. There are some positive signs in the Finnish economy, as the decline in Finland's industrial output has gradually slowed and the increase in services' turnover accelerated in the course of last year.

Domestic demand continues to decline

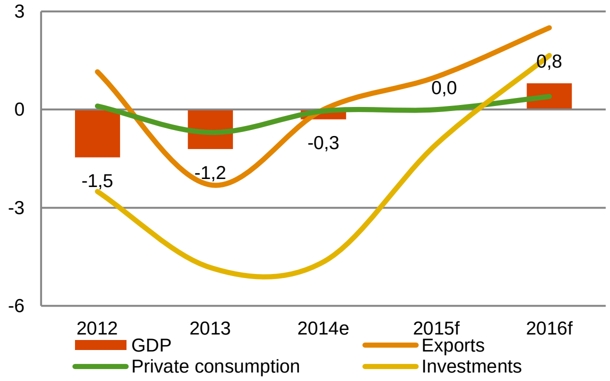
The bad news is that the aggregated foreign demand of Finland's main export partners will not improve this year. The substantial weakening of the Russian economy, sanctions on several agricultural and food products and rouble depreciation have had a major negative spill-over effect on Finland. Although the growth of unit labour costs has come down from the highs in 2012, it is still not sufficient to enhance the price competitiveness of Finnish production against many of its export partners. However, as two-thirds of Finland's exports of goods are directed to countries outside the euro area, the depreciation of the euro will give some support to the price competitiveness of its exports. We expect only modest export growth from Finland this year. At the same time, domestic demand continues to decline. Due to the decrease in employment, modest wage growth, and lower savings ratio, households' consumption will not improve this year. Some positive effect comes from the lower fuel prices, which will leave additional money for households, but it is too early to say how much of this will be used for consumption and how much for increasing savings. Low confidence, the wretched outlook for improving domestic and foreign demand, and the historically low level of capacity utilisation are depressing investment decisions. We expect that capital investments will decrease this year.

Tight fiscal policy will not contribute to economic growth

The tight fiscal policy will not contribute to economic growth this year and will have only a relatively modest impact next year as well. We expect that the Finnish government will manage to keep its budget deficit within the limits of the Maastricht criteria, but that debt will exceed the permitted maximum level this year.

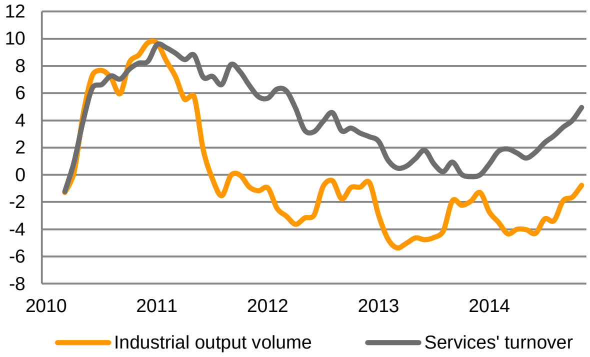
Due to the weak domestic demand, Finland's GDP will continue in its marginal recession in 2015, decreasing by 0.1%. Improving domestic and export demand, including higher net exports, will contribute to economic growth up to 0.8% next year.

Finland: GDP growth (YoY)



Sources: Statistics Finland and Swedbank

Finland: Industrial output volume & services' turnover (YoY %)



Source: Statistics Finland

Sweden: A small open economy

We are revising down the growth forecast for 2015, while expecting activity to pick up in 2016, reaching almost 3%. Swedish policymakers have only a limited influence on Swedish economic development in an external environment that is subject to large fluctuations. Weak export demand is slowing down the entire business sector, in particular investment, while households are benefiting from the falling price of oil. However, this is contributing to increased inflationary pressure, and although we expect further measures from the Riksbank, interest rate movements are largely being controlled by the ECB's increasingly expansive policy. The labour market is also exposed to the external environment, with a growing labour supply and increased wage competition. However, there is broad agreement among politicians that the fiscal policy, which could have an effect when the key interest rate is zero, should remain tight

Slowing of momentum towards the end of

Surprisingly, growth lost its impetus from the middle of last year, both internationally and in Sweden. Export demand was particularly constrained by weaker demand from the eurozone, while the US upturn has not been of equal importance to Swedish companies. Household finances remained strong, although consumption was dampened by a certain caution, as well as reduced energy costs and falling interest rates, which also affected aggregate demand. The labour market continues to be characterised by an increase in supply and inertia in unemployment. There has been a further weakening in inflationary pressure and the Riksbank has largely exhausted the conventional measures. Post-election politics have been dominated by confrontation and this has led to uncertainty about fiscal policy.

Key Economic indicators, 2013-2016 [1/]

	2013	2014e	2015f	2016f
Real GDP (calendar adjusted)	1,3	1,9	2,2	2,9
Industrial production	-0,6	-2,4	1,0	4,2
CPI index, average	0,0	-0,2	0,4	1,6
CPI, end of period	0,1	-0,4	1,0	2,1
CPIF, average [2/]	0,9	0,4	0,8	1,5
CPIF, end of period	0,8	0,3	1,1	1,6
Labour force (15-74)	1,1	1,3	1,3	0,6
Unemployment rate (15-74), % of labor force	8,0	7,9	7,8	7,5
Employment (15-74)	1,0	1,4	1,3	0,9
Nominal hourly w age w hole economy, average	2,6	3,0	3,0	3,3
Savings ratio (households), %	12,5	13,3	13,5	13,1
Real disposable income (households)	2,5	3,3	3,3	1,6
Current account balance, % of GDP	5,3	4,0	3,5	4,0
General government budget balance, % of GDP [3/]	-1,2	-2,1	-1,9	-1,3
General government debt, % of GDP [4/]	39,5	40,5	40,9	40,2

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

Signs of rising growth

The outlook for the Swedish economy over the next two years is relatively good, although not without risks. We have made a slight downward adjustment of growth for 2015. However, the underlying dynamic is positive and with a favourable external environment, growth should edge up to 3% in 2016. The role of households is decreasing, while companies are contributing increasingly to activity with higher exports and rising investment. Fiscal policy is becoming tighter, notably through tax increases in the municipalities, while the Riksbank is facing increasing pressure to become even more expansive after the ECB's decision to buy government bonds. We mainly expect negative deposit rates and a postponement of the next increase in interest rates, but do not rule out unconventional measures.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2013	2014e		2015f		2016f	
Households' consumption exper	1,9	2,4	(2,8)	2,7	(2,5)	2,3	(2,1)
Government consumption exper	0,7	1,4	(1,0)	2,0	(2,1)	2,1	(1,9)
Gross fixed capital formation	-0,4	4,6	(4,3)	5,3	(5,6)	6,3	(5,8)
private, excl. housing	-1,6	0,8	(-0,7)	3,4	(3,8)	6,7	(6,4)
public	1,7	5,1	(5,7)	4,8	(5,1)	4,3	(3,4)
housing	2,1	19,3	(22,5)	12,4	(12,1)	6,8	(6,4)
Change in inventories [1/]	0,0	0,3	(0,2)	0,0	(0,0)	0,0	(-0,0)
Exports, goods and services	-0,2	2,1	(2,2)	3,5	(3,8)	5,2	(5,6)
Imports, goods and services	-0,7	5,1	(4,1)	5,3	(5,1)	5,5	(5,8)
GDP	1,2	1,8	(2,1)	2,4	(2,6)	3,2	(2,9)
GDP, calendar adjusted	1,3	1,9	(2,2)	2,2	(2,4)	2,9	(2,7)
Domestic demand [1/]	1,0	2,5	(2,5)	3,0	(3,0)	3,1	(2,8)
Net exports [1/]	0,2	-1,0	(-0,6)	-0,6	(-0,4)	0,1	(0,1)

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

Persistently low export demand

Weakened Swedish competitiveness

Swedish export volumes rose by just over 2% in the first three quarters of 2014 compared with the same period the previous year. The increase was driven by an increase in exports of services, while exports of goods continued to struggle to rise. This was particularly the case for capital goods exports, such as machinery and road vehicles, which showed a decline in the third quarter compared with the previous quarter. The sluggishness of goods exports is in contrast to imports, which showed volume growth of 5% during the same period, and resulted in net exports giving a larger negative contribution to GDP in 2014 than we forecast in our November outlook. In addition to solid domestic demand, imports are driven by a growing import content in the production of both goods and services. Business and industry is becoming increasingly specialised, with outsourcing of operations, which raises questions about Swedish competitiveness from both a cost and a strategic perspective. In nominal terms, unit labour costs per unit produced have risen faster in Sweden than in the Eurozone countries, while Swedish industry is losing market shares.

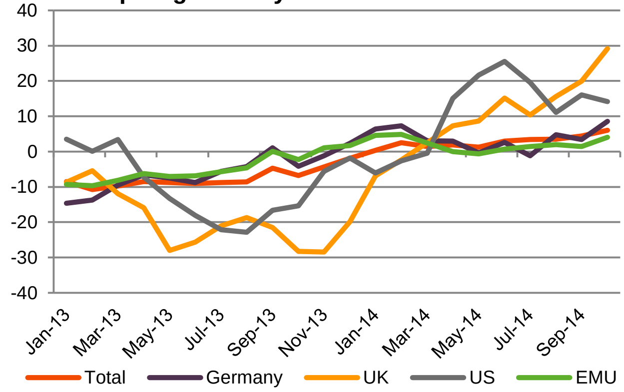
Global market growth slowing

The downward revision of the global growth outlook for 2015 and 2016 means that we are also downgrading global market growth for Swedish export companies to 5% this year and 5.8% next year. The largest downward revisions have been for the euro area, which we expect to have a more constraining effect on Swedish export opportunities than we forecast in November. We expect total Swedish exports to rise by 3.5% in volume in 2015, accelerating to 5.2% in 2016 as the global growth rate increases. This increase in exports is lower than in previous economic upturns.

The oil price decline may have adverse effects on Swedish exports

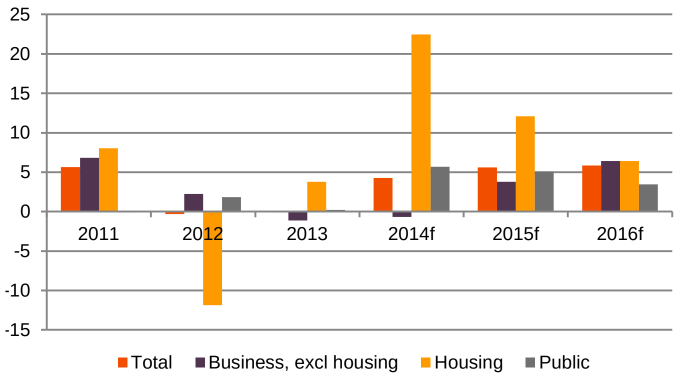
Low resource utilisation and modest investment activity in Europe will act as a constraint on Swedish exports of capital goods. The oil price decline and its effects on the Norwegian economy and the sharp decline in Russia's GDP are expected to have adverse effects, both direct and indirect, on Swedish exports. This is particularly the case for capital goods. In addition to weaker growth in external demand, we expect a less favourable competitive situation for the Swedish export industry. Unit labour costs are expected to rise at a faster rate during 2015-2016 compared with our largest competitors in the face of low productivity growth and expectations of higher wage increases. At the same time, we expect the krona to appreciate during the forecast period, particularly against the euro. With an increasing import content in the Swedish economy, net exports are expected to make a negative contribution to GDP growth in 2015, albeit less negative than in 2014. Net exports are not expected to make a positive contribution until 2016.

Sweden: Export growth by countries



Source: Reuters EcoWin

Sweden: Investment in different sectors %



Source: Statistics Sweden

Investment on the rise

Investment rise after two years' decline

Total gross investment showed a recovery in 2014 after the declines in 2012 and 2013. On average, investment rose by 4.6% over the first three quarters of last year, with housing (+20%) and public investment (+5%) accounting for most of the increase. Business investment excluding housing was weak and increased by just 1% in the same period, with investments in industry continuing to decline in the wake of weak exports and reduced industrial production.

Business investments gradually take over

We estimate that total investment will grow by just over 5% this year and about 6% in 2016. This would result in the investment ratio reaching 25% of GDP next year at constant prices, touching the levels seen before the global financial crisis in 2008. Low interest rates and a recovery in global demand point to a large increase in business investment during the forecast period. Business investment volumes have been largely unchanged since 2012. Lower oil prices may also have a positive effect on business investment through lower prices of inputs. Investment in the service sector is the prime driver of the upturn in early 2015. On the other hand, we have revised our industrial investment forecast downwards due to weaker export growth. We do not expect to see a broader upturn in business investment until 2016, but at the same time we believe that pent-up investment demand is likely. Also this year, we expect housing investment to make a significant contribution to growth, although this is expected to slow during 2016, mainly due to increasing supply obstacles such as lack of land for building and shortage of labour. Stricter repayment requirements are also likely to have a dampening effect on residential construction. However, underlying demand for housing will continue to be strong in the face of low interest rates and a growing population. We have made a downward adjustment of Swedbank's November forecast for public investment this year and next year. This applies to government investment, as we believe that a more strained fiscal situation will restrict investment in 2015-2016. In contrast, we anticipate continuing growth in investments in the municipal sector.

Household consumption losing momentum

2014 ended with a slowdown in consumption

Private consumption has been a major driving force in the recovery of recent years, while a strong household sector has contributed to a strong rise in housing investments. However, consumption slowed down somewhat in the third quarter of last year, partly due to a mild autumn, which, alongside falling interest rates, had a dampening effect on the housing category.

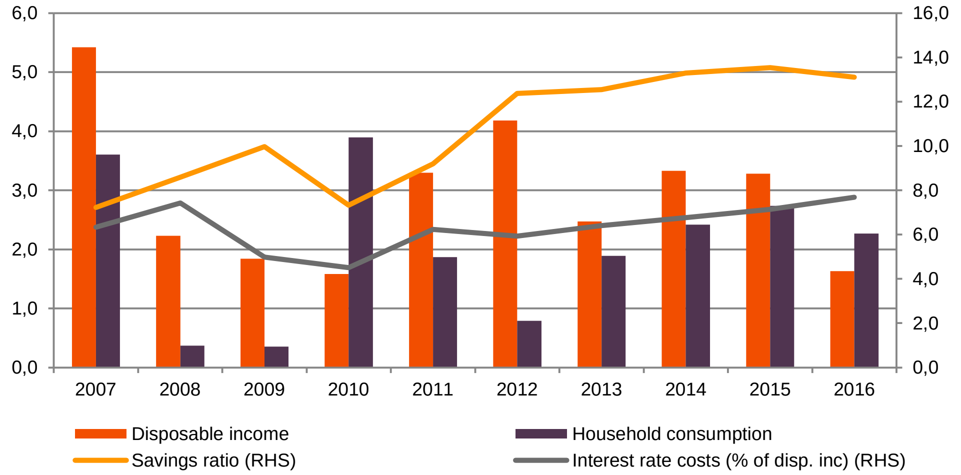
Strong but slowing disposable income growth

The fundamental driving forces behind household consumption will largely continue during the forecast period, although their strength will gradually diminish. With employment growth remaining strong and the current very low inflation rate, we expect real disposable income to rise by almost 3% this year. The increase will be less marked in 2016, due to rising inflation, although we expect growth in the order of 2%. A positive contribution from record low interest rates is also clearly evident this year and slowly rising interest rates will have a moderately restraining effect during the forecast period.

Higher taxes likely

Despite increased uncertainty, our baseline scenario expectation is for household consumption propensity to hold up relatively well. However, the saving rate is set to rise slightly this year, primarily due to the introduction of a repayment requirement. This will hold back consumption, starting in the second half of this year (we expect the requirement to be introduced in the second quarter). At the same time, there is increasing fiscal policy uncertainty. In particular, municipal taxes, which directly affect households, will be higher this year. There is considerable uncertainty about fiscal policy developments over the next few years. For next year, we expect a shift in fiscal policy in line with the government's previous draft budget. This mainly involves a redistribution of income, which will have a moderate impact on aggregate consumption.

Sweden: Household income and consumption



Sources: Statistics Sweden and Swedbank

Continuing high saving...

Overall, we see household consumption remaining a key driver in the Swedish economy, albeit with a smaller contribution to growth. We expect an increase in consumption of about 2.5% this year. Next year will see a slowdown in consumption growth. Here, we expect the strong growth in durable consumption to fall back, partly due to a saturation effect, and partly due to real disposable income growing at a slower pace, while a change in fiscal policy will have the effect of reducing demand for capital goods. The household saving rate will remain high, at about 13%, throughout the forecast period.

…points to continuing caution

Despite a marked increase in household disposable income over the last three years (averaging +3.1% per year), favourable labour market developments and continuously falling interest rates, the consumer confidence indicator has shown a modest rise since it bottomed out in autumn 2011, and growth for last year is just above the historical average. This suggests that households are showing a certain vigilance with regard to macroeconomic developments.

Weak wage and productivity growth are long-term challenges for the labour market

Slow decline in unemployment

The labour market continued to improve in 2014. Employment rose by about 1.5% and the number of hours worked by nearly 2%. Forward-looking indicators offer reason for further optimism in the short term. Employment is expected to increase by 1-1.5% annually in the years ahead. But at the same time the labour force continues to grow at a surprisingly rapid rate, at least in the short term, keeping unemployment stuck at just under 8%. Not until next year is it expected to drop much, to about 7.5%. In recent years the labour market has broadened significantly. Among other things, labour force participation among older and foreign-born workers has seen major gains. Fundamentally this is very positive, and certainly from a socioeconomic perspective, but it puts pressure on productivity growth and raises the need for job creating policies. Sweden's demographic challenges have now eased due to the increase in net immigration and population growth in recent years. The need for new jobs is growing, however.

Forward-looking indicators positive

Forward-looking indicators offer reason to expect a continued strong labour market at the start of 2015. According to the National Institute of Economic Research's surveys, hiring plans have increased. The employment component in the PMI also improved at the end of 2014 for both manufacturing and the service sector. Data from the Swedish Public Employment Service show that the number of layoffs remains at a low level at the same time that there was a significant increase in the number of new job openings in the second half of last year.

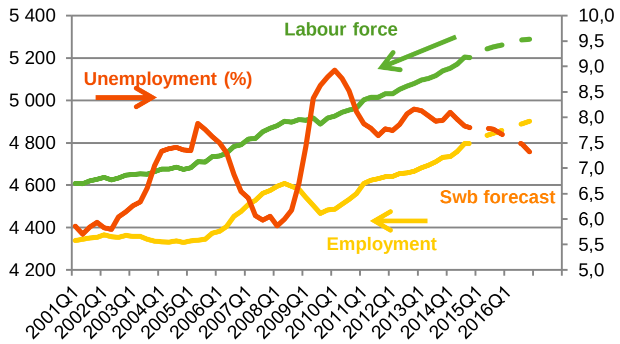
Labour supply has surprised

Despite job growth, unemployment is stuck. In 2014 the labour supply continued to surprise on the upside, confounding forecasters in a pattern we have seen in recent years. Population growth has exceeded all estimates, due in no small part to surprisingly high net immigration, usually people of working age (see the demographic in-depth). By all indications the alliance government's supply reforms have also continued to have an impact, even long after they have been implemented, as indicated by the growing share of older workers who remain in the labour market and a continued rise in labour force participation among foreign-born workers. In fall 2014 the participation rate for foreign-born workers exceeded 71%, up from 65% in fall 2006. During the same period the participation rate in the native-born population generally stayed at around 73%.

Risk that policy reversals could affect labor supply again

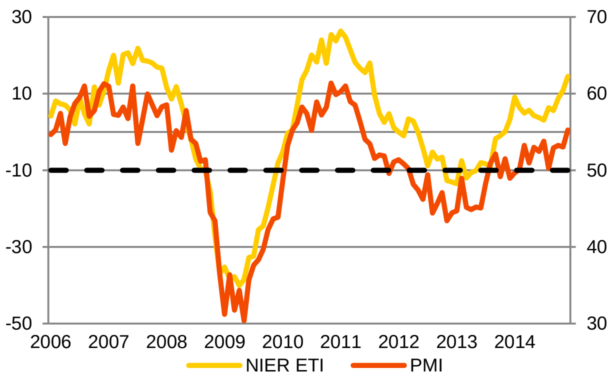
In its budget for 2015 the government presented several proposals designed at least in part to roll back some of the previous administration's supply policies. This includes higher unemployment compensation, higher employer fees for retirees, reduced in-work tax credits for high wage earners and the elimination of reduced employer fees for hiring young workers. Although it was the alliance budget that received a majority of support in parliament, the government has already said it may offer more proposals in its spring bill in April, or no later than the 2016 budget bill. We expect that the government's proposal will gradually slow the labour supply and that the rate of growth in the labour force will drop to 0.6% in 2016 from 1.2% this year.

Sweden: Employment, labour force & unemployment



Sources: Statistics Sweden and Swedbank

Sweden: Employment plans



Source: Reuters EcoWin

Weak productivity here to stay

Swedish productivity growth has struggled to recover to previous levels after the financial crisis. One obvious reason is the broadening of the labour market in years with an increased share of the low-productivity service jobs at the same time that manufacturing jobs are shrinking. This is a trend we expect will continue in the years ahead, even if the Red-Green government hopes to increase productivity. As a result, we estimate that productivity will rise only modestly to upwards of 1.5%.

Risk of small wage increases has risen

Nominal wage increases are subdued in the wake of the low central three-year wage agreements reached last year (which call for increases of about 2.3% per year). There isn't much question of wage drift either. There are still plenty of available resources in the labour market. Low wage increases in Europe in the wake of the protracted economic slowdown in the Eurozone are also affecting wages in Sweden. In this sense you could say that the Swedish the labour market is gradually becoming more integrated with Europe's. The next major wage negotiations begin this fall. According to our economic scenario, they should be conducted under more normal economic conditions, paving the way for slightly higher increases (of at least 2.5%). Uncertainty has increased, however. The survey firm Prospera reports that long-term inflation and wage expectations have fallen in recent quarters, not least among social partners. This has increased the risk that wage increases will remain low in coming years as well, which would make it more difficult for the Riksbank to raise inflation to its target level within a reasonable time.

Inflation – a Sisyphean task for the Riksbank

Inflation continues to be troublesome for the Riksbank

Swedish inflation is expected to remain low, still falling short of the Riksbank's inflation target of 2% at the end of 2016. The weak growth is largely due to the sharp fall in the price of oil and depressed global prices. The price of oil, which is thought to have bottomed out, will have an impact on the housing category by keeping down electricity prices in spring. It is our assessment that in the first half of the year, fuel prices, which track the price of crude oil in SEK, will also fall more than previously forecast. However, transport costs will begin to rise towards the end of 2015, although the impact on CPI inflation will be tempered by the Swedish krona strengthening at the same time. The increase in indirect taxes on alcohol and tobacco implemented on 1 January this year will not have an impact on the annual rate of inflation, but base effects will cause an increase in the monthly rate.

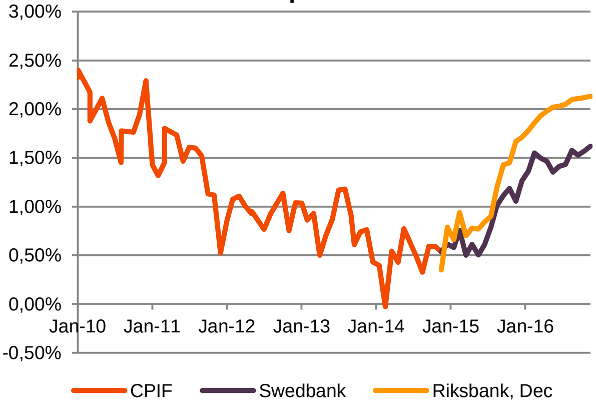
Rising costs for households have positive CPI impact

During 2016, inflationary pressure will increase as the global economy slowly recovers and world commodity prices rise. The combination of this and an easing of the Russian embargoes will stimulate food prices, which will have been kept up in 2015 by a weaker krona. Rising interest rates and rental costs are driving up inflation after having contributed little to price growth in historical terms. The service sector is showing a more restrained trend, with falling prices in post & telecommunications, restaurants & accommodation and recreation & culture. Price pressures for these sectors are expected to be more intense than previously. A gradual strengthening of the krona will also result in slower import price inflation over the next year.

Underlying – increasing price pressure

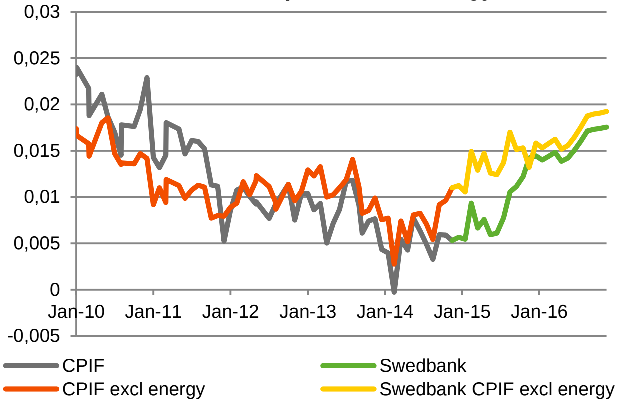
Overall, we expect consumer prices to rise by 0.4% this year, followed by 1.6% in 2016. This corresponds to an underlying inflation, measured as CPIF, of 0.8% in 2015 and 1.5% in 2016. CPIF inflation, net of energy prices, will be 1.3% even this year, which indicates a not too gloomy scenario.

Sweden: Inflation development



Sources: Swedbank, Statistics Sweden and Riksbanken

Sweden: Inflation development excl energy



Sources: Statistics Sweden and Swedbank

In-depth 4: Demographics, surplus target and household debt

The global population is aging. In many countries, including many developing economies, the working age population is growing. In Sweden and other developed economies, on the other hand, the trend has reversed. Sweden's working age population peaked in 2010 and is expected to continue to decline over the next 40 years. How pensions will be financed is one of the issues that have been discussed for some time, as has the cost of increased healthcare. This is the main reason why the Swedish budget surplus target was introduced. In earlier years public spending did not rise, since the growing share of older Swedes was neutralized by a decline in younger people. Our estimates show that the effects of age structure on total public spending today are the lowest since 1994, but that the costs will increase over the next 40 years. The unexpected population growth in recent years, not least in the working age population, has reduced the cost challenges, however, and may necessitate a reassessment of the surplus target.

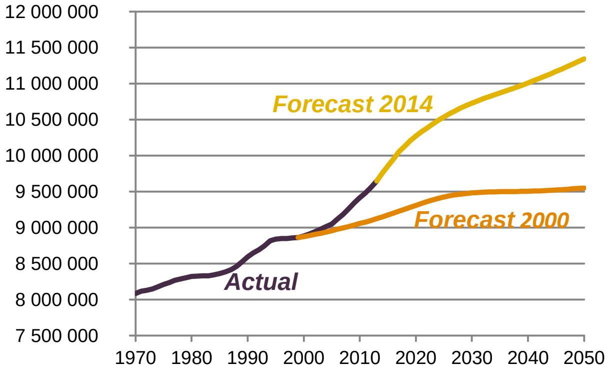
Compared with many other developed economies, Sweden has maintained a fairly high age dependency ratio (ratio of older dependents to working age population). But the trend looks slightly brighter. In 2010 the ratio was higher in Sweden than Finland, Germany and Denmark. Within a couple of years the OECD expects Finland to pass Sweden and around 2030 Germany and Denmark are also expected to have higher age dependency ratios than Sweden. This trend poses a major future challenges for the economic systems in Denmark, Finland and Germany.

Population estimates are beset with uncertainty, as Statistics Sweden has acknowledged. In 2000 it was estimated that the Swedish population would exceed 9.5 million by 2050. In fact, the population exceeded this level in 2012, and the latest forecast predicts that it will exceed 11.3 million by 2050, an increase of around 1.8 million compared with the 2000 forecast (see figure below). In terms of age dependency ratio, the differences are small, but it is worth noting that the older share of the population has shrunk while the younger has grown. All else being equal, this will have a positive effect on the age dependency ratio going forward.

The increased population is mainly due to higher than expected immigration. The fact is that net immigration has generally exceeded the rate of natural increase since the mid-1970s and that net immigration almost by itself explains why the 2000 forecast for 2050 was reached as early as 2012. Immigration, especially asylum-seekers from countries such as Syria, Iraq and Lebanon, nearly doubled in 2014 and is expected to continue to rise in 2015, according to new forecasts from the Migration Board. Furthermore, the average age of foreign-born Swedish residents is lower than that of the population as a whole. For example, about 13% of the population born abroad is 65 or older. The corresponding figure for the entire population is about 20%. So given the age structure of those who migrate to Sweden, immigration tends to lower the age dependency ratio. Obviously, we can't give too much weight to such a blunt measure as age dependency ratio. Depending on how we want to look at the effects on production in the economy, on either an aggregate or per capita basis, the working age population relative to the population as a whole is a better measure of potential welfare. For this measure to be positively impacted by immigration, the talents of those who come to this country must be utilized and the skills they lack must be acquired in an effective way and in the right areas. One challenge that Sweden faces is polarization in the labor market, where unemployment remains high among those with low educations and expanding digitization is automating many manufacturing and service jobs.

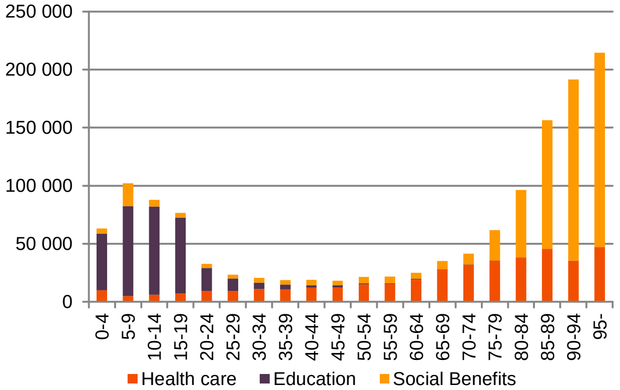
There are also a couple of factors that are worth looking at when evaluating age structures. One is how financial assets and liabilities (in general) tend to change with age. As a rule, financial assets rise with age and peak among those over the age of 75. When we measure average financial assets in each age category based on Swedish data, we clearly see that they will rise until the mid-2040s as a result of changing age structures. In terms of liabilities, data from Statistics Sweden show that they generally peak for individuals between 30 and 64. This age group grew as a share of the population until 2005, but has since declined. Our estimates show that total liabilities have risen because highly indebted age groups have historically constituted a large and growing share of the population. Since the 80s debt ratios have increased faster when the age structure of the population has trended in a way that has meant higher total liabilities, all else being equal. An aging population is likely to mean that a growing share of financial assets will be owned by individuals in the upper age range and thereby slow the rate at which debts are rising, which in general would support a lower normal equilibrium rate.

Sweden: Total population, 1970-2050



Sources: Statistics Sweden population f'cast and Swedbank

Sweden: Public consumption, age & type



Sources: NIER

Riksbank on the trigger

The Riksbank continued to cut the repo rate last fall down to a record low level of 0% in the wake of unexpectedly low inflation. In recent months inflation has remained in line with the Swedish central bank's forecasts. This gave it the breathing room to delay any major decisions beyond its December meeting. The Riksbank sufficed by delaying its first rate hike by a quarter from summer to fall 2016. The weaker krona, especially against the dollar, provides an inflation impulse, but at the same time oil prices have fallen substantially and as a whole inflation is expected to remain very low in 2015. What's worse, long-term inflation and wage expectations are now falling, according to the latest survey from Prospera. This is troubling from a monetary perspective. In less than one year the next round of contractual wage negotiations will begin and if the inflation target is going to be reached on a consistent basis, wages, especially in domestic sectors, will have to rise in the years ahead. This will require credibility in the Riksbank's inflation target of 2%.

Impending wage negotiations are stressing the Riksbank

Interest and exchange rate assumptions

	Outcome 2014 23-jan	2015 30 Jun	2015 31 Dec	2016 30 Jun	2016 31 Dec
Interest rates (%)					
Policy rate	0.00	0.00	0.00	0.00	0.25
10-yr. gvt bond	0.67	0.70	1.20	1.70	2.10
Exchange rates					
EUR/SEK	9.3	9.2	9.0	9.0	9.0
USD/SEK	8.3	8.3	8.6	8.6	8.5
KIX (SEK) [1/]	113.0	110.5	109.8	109.5	109.0

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

Sources: Reuters Ecowin and Swedbank

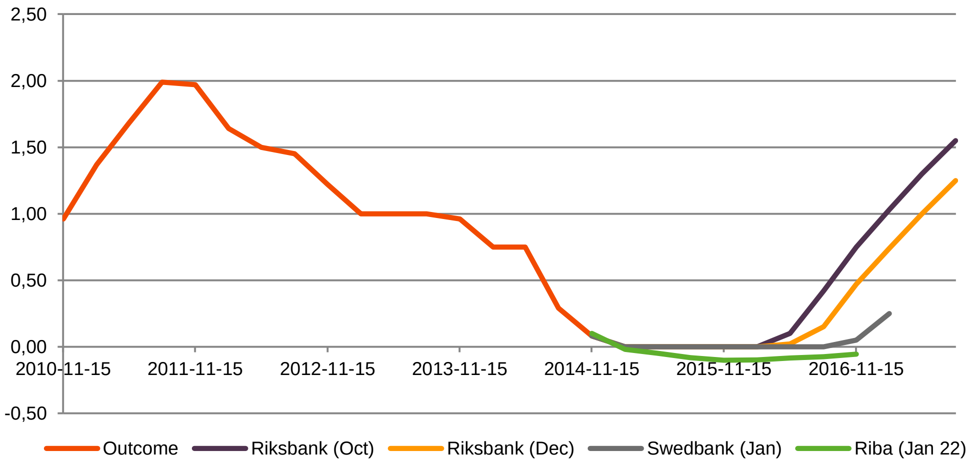
Switzerland and ECB pressure the Riksbank

In December the Riksbank stressed that it is prepared to take unconventional measures as soon as its February meeting. In Swedbank's opinion, a negative fine-tuning deposit rate at -0.2% will be implemented already at the upcoming Monetary Policy Meeting in February. Furthermore, in our opinion, there is a high probability that also the repo rate will be set slightly negative. We also expect that the timing of the first rate hike will be further delayed slightly. As a result, the rate differential in the short-term fixed income market vis-à-vis the eurozone could decline, which would slightly weaken the krona at the same time that short-term lending rates could fall slightly. A negative rate could be combined with other tools later in if necessary. The most likely choices, according to Riksbank Governor Stefan Ingves, would be a long-term loan to the banks or bond purchases. Currency interventions don't seem likely at this point for the Riksbank. The probability of a currency floor is basically gone after the Swiss central bank's decision to scrap its peg to the euro. Instead Switzerland has introduced a significantly negative benchmark rate, which reinforces our opinion that a negative rate is the most likely measure from the Riksbank.

No repo rate cut until 2016

Swedbank expects inflation to gradually rise but that it will take some time before underlying inflation more consistently exceeds 1.5%. There is a risk that inflation expectations will stay below 2% for quite a while. *Swedbank estimates that it will take until the end of 2016 before we see an initial rate hike. At the end of 2016 we forecast that the repo rate will have been raised once to 0.25%.*

Sweden: Interest Rate Path



Sources: Swedbank, Riksbank and Bloomberg

In-depth 5: Diginomics and policy implications for the Riksbank

Diginomics (Breman and Felländer, 2014) is spurring globalization, creating greater price transparency and a downward pressure on prices. These changing mechanisms are working on both the supply and on the demand side. On the demand side, e-commerce and other digital platforms contribute to increased price competition. As a result, new markets open up and new companies are created, so called born globals and micro-multinationals, accessing the global market from the start. Even previously protected local services find themselves facing global competition. Supply and demand is more perfectly matched due to digital platforms (such as AirBnB and Uber), slashing or replacing traditional middle hands. On the supply side, marginal costs are falling on digital services and there is a supply shock of software (the costs of copying, distributing and transporting digital services are close to zero).

In addition, productivity from digitization is not fully captured in official statistics. GDP measures the value of a country's total output of goods and services, while free digital services create a consumer surplus that is not captured.[3] Time optimization was not in GDP before and it is not now, but the measurement error is larger now. Digital services create time optimization and falling marginal costs, but there are also falling marginal benefits[4]. Hence, the underestimation of productivity is important, but the amount of lost productivity in the general statistics is hard to measure. As a result, the underestimated productivity growth could be one factor contributing to low price pressures.

All major current price trends[5] are pushing inflation lower. The crucial question is what kind of strategy the Riksbank can use to fight disinflation in this environment where both supply and demand factors occur simultaneously. Also, how harmful is disinflation due to supply side effects? The key challenge is to distinguish between supply and demand factors. We see three main options for the Riksbank;

First, wait and see until the output gap is closed. That happens when resource utilization is normalized and growth is close to its potential path. Then you can distinguish from the cyclical factors, and it becomes easier to evaluate the magnitude of the structural mechanisms. However, we find this strategy to be risky as inflation expectations have already fallen and further falling expectations might be highly harmful. Inflation expectations are one of the key channels that can be used to push actual inflation higher. In addition, output gaps are theoretical concept that cannot be readily observed and measured.

Second, even more expansionary monetary policy in order to influence the demand side is a possible strategy. With the repo rate at zero, unconventional tools such as a negative repo rate, QE or refinancing operations are possible options available to the Riksbank. In our opinion further expansionary policy will continue to have limited ability to feed into the real economy (see the in-depth analysis on fiscal and monetary policy). In addition, such unconventional monetary policy tools risks creating asset inflation, causing financial instability in the longer run.

Third, a return to a flexible inflation target would signal that inflation can deviate from the target for a relatively extended period of time. Still, that would be a shift in the monetary policy stance. We think that it is too early to make such a substantial change before we understand the underlying mechanisms on a comprehensive level.

We would recommend an in-depth study to deeper understand the underlying price mechanism from digitalisation. We want to argue that Swedish inflation has been affected quite a lot compared to other countries by Diginomics[6]. Digital maturity and IT penetration in Sweden is among the highest in the world.

Fiscal policy can contribute to create a better environment for innovative start-ups and help position Sweden as a leader in the digital era. Better access to housing in cities with high-tech cluster, funding for research and development at universities and improved infrastructure can help strengthen Sweden's competitiveness in attracting and fostering the next generation of digital companies. At the same time, such reforms would boost domestic demand and reduce disinflationary pressures.

Due to continuing increasing household debt, macro prudential tools are stepping in to address household debt imbalances. Lending ceiling and amortization requirements could be increasing the "Inside-Outside effect" on the housing market, and very seriously decrease mobility. What is needed is structural reforms to decrease barriers to mobility. Hopefully, these issues will be addressed through broad political agreements. Lack of a political agenda to address this issue could have a severally detrimental effect on our long-term competitive power.

[3] Discussion with Hal Varian, Googles Chief Economist, December 16 2014

[4] Discussion with John Fernald, San Francisco Federal Reserve Dec 16 2014.

[5] There are several factors pushing inflation downwards globally; both on the supply and on the demand side. A prolonged period of spare capacity, particularly on labor markets, is keeping wage pressure and inflation low. On top of that, falling oil prices are feeding into low energy prices. Globalization is increasing transparency and opening up local companies to higher competition. Due to the prolonged period of low inflation, inflation expectations have been falling.

Fiscal policy misses unique opportunity to boost growth and competiveness

Fiscal policy effective with repo rate at zero lower bound

The effect of fiscal policy on economic development and growth increases when monetary policy reaches zero interest rates. It is our assessment that any unconventional measures that the Riksbank might take would have a limited impact on Swedish growth (see in-depth 6). With low inflation, weak global demand and limited manoeuvrability for households, the Swedish economy is dependent on domestic public stimulus measures to boost growth. The announced fiscal policy will not fill the void left by the monetary policy, despite the very favourable conditions. In addition, there is a pressing need for structural reforms as Swedish competitiveness has been eroded in recent years and imbalances have developed in the Swedish economy with high household debt and weak industrial production.

December agreement temporary truce

The December agreement concluded on 27 December brings a temporary truce between the alliance (M, MP, FP and C) and the coalition government (S and MP). The agreement, which is valid until 2022, makes it possible for a minority government to push through a budget. As the government's draft budget was not adopted by parliament, the alliance's budget for 2015 is currently in force. Finance Minister Magdalena Andersson has announced that the government intends to present an amending budget with the Spring Fiscal Policy Bill in April. If this goes through parliament, government expenditure and revenue may be subject to change during the current year. For this reason, any forecasts on public finances for 2015 and 2016 must make a number of assumptions.

Amended budget in Spring Budget Bill

Our forecast is based on the following assumptions: (i) The Government presents an amending budget and it is voted through in parliament, (ii) the amending budget builds on the government's original bill (BP15) that was rejected in December, but contains certain changes, (iii) the main changes from the rejected draft budget are no higher income tax for incomes above SEK 50,000, higher environmental taxes, (iv) all new expenditure reforms are fully funded.

It is our assessment that the impact of the fiscal turmoil on the Swedish economy will be negative. In the short term, the effects are limited and consist mainly of a missed opportunity to stimulate the economy. The budget deficit is expected to amount to 1.9% in 2015 and 1.3% in 2016. Public debt is expected to fall from 40.9% of GDP to 40.2% of GDP in 2016. The Spring Budget Bill will include tax increases and a redistribution from private to public consumption. However, the effect on private consumption will be small as the expected raising of the unemployment insurance will give households with low incomes and high consumption propensity a higher disposable income. The effect on Swedish growth is expected to be neutral.

Lower trend growth in Sweden

In the longer term, the impact on the Swedish economy will be negative. The lack of "alliance-crossing" solutions and the deadlock of an over-tight budget from both the government and opposition means that the ability to implement fiscal stimulus measures and structural reforms will be lost. An economy with declining industrial production, low productivity, highly indebted households and a high dependence on private consumption is very vulnerable to unexpected shocks. Swedish competitiveness has deteriorated in recent years as many other countries have adjusted wages and implemented structural reforms. Unless the government and opposition agree on reforms to strengthen long-term competitiveness in the near future, the Swedish economy will grow at a moderate rate. With a decimated industrial sector which normally drives productivity growth and an ageing population, there will be significantly lower trend growth than Sweden experienced during the 1990s and early 2000s. Even with a stronger economic upturn internationally, the most likely scenario in the long term is growth below 2%.

The effect of fiscal policy on economic development and growth increases when monetary policy reaches zero interest rates. It is our assessment that any unconventional measures that the Riksbank might take would have a limited impact on Swedish growth (see in-depth 6). With low inflation, weak global demand and limited manoeuvrability for households, the Swedish economy is dependent on domestic public stimulus measures to boost growth. The announced fiscal policy will not fill the void left by the monetary policy, despite the very favourable very good conditions. In addition, there is a pressing need for structural reforms as Swedish competitiveness has been eroded in recent years and imbalances have developed in the Swedish economy with high household debt and weak production in industry.

In-depth 6: What is optimal fiscal policy with the repo rate at zero?

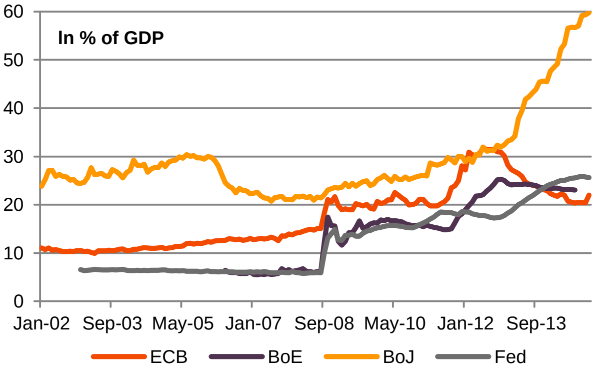
The government and opposition commitment to fully fund any new fiscal reforms increases the pressure on the Riksbank to further ease monetary policy. We compare the relative effectiveness of further expansionary fiscal and monetary policy. Our assessment is that the costs of unconventional monetary policy in Sweden at present time are potentially very high, while the effect on inflation is marginal. This stands in sharp contrast with fiscal policy that can boost private and public investments, increase employment, and increase GDP growth with a positive multiplier.

The effectiveness of fiscal and monetary policy are intertwined

With interest rates at the Zero Lower bound, fiscal policy has a unique opportunity to boost growth. At the ZLB, fsical policy can contribute to higher GDP growth with a positive multiplier effect (see, e.g., Blachard and Leigh 2013, Eichengreen and O'Rourke 2012). Each additional krona in fiscal stimulus generates more than 1 krona in higher growth as demand increases and employment grows. This is possible as expansionary fiscal policy is not counteracted by monetary tightening when interest rates are anchored at the ZLB. Well-designed fiscal stimulus measures can increase domestic demand and contribute to higher inflation. For example, improved infrastructure can both boost demand in the short run but also contribute to higher long-term growth and the economy's productive capacity is expanded.

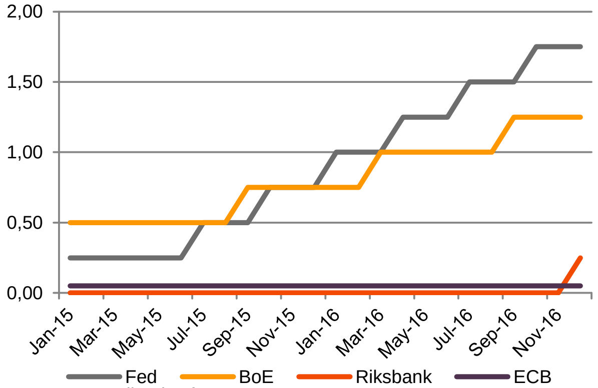
The effects of monetary and fiscal policies are closely intertwined. Expansionary fiscal policy tends to be ineffective during a boom as it leads to tighter monetary policy as higher budget deficits. Conversely, fiscal tightening when the economy is suffering from negative output gaps will increases the pressure on monetary policy to boost demand. Fiscal contraction in the US was cited by the Federal Reserve as a reason to embark on the third round of QE in September 2013. A prolonged period of fiscal consolidation in the eurozone has contributed to low demand and disinflation, contributing to the need for a massive QE programs just revealed by the ECB.

Sweden: Major central banks' balance sheets



Source: Reuters Ecowin

Sweden: Central bank policy rates



Source: Swedbank's forecast

Unconventional monetary policy tools and their effectiveness in Sweden

The Riksbank has signaled readiness to employ unconventional monetary policy tools at the upcoming monetary policy meeting in February. Among potential tools are; (i) Quantitative easing (QE), (ii) long-term refinancing operations (LTROs) (iii), currency interventions, and (iv) negative deposit and repo rate. In the current low inflation, these tools should be evaluated in terms of their effectiveness in boosting inflation and inflation expectations as compared to their potential costs.

At the present time, Swedbank's assessment is that a currency floor would be the most effective monetary policy tool to move inflation back towards the target. Higher import prices and better competiveness for Swedish export can contribute to higher imported inflation and higher production and employment. The recent Swiss abandonment of their currency floor points to the potentially very large costs of currency interventions.

QE (purchases of assets such as covered bonds or government bonds) provide liquidity and affects the economy through multiple channels; the price of the assets bought, portfolio rebalancing, exchange rate depreciation and signaling. Our assessment is that QE and LTROs (which is another way of providing liquidity to the financial system) would be ineffective in boosting Swedish inflation at this time. Interest rates are already low and are likely to stay low due to QE in the euro zone. There is no credit crunch in Sweden as lending to households and companies are widely available. As market interest rates are already well below the Riksbank repo rate path, signaling low rates for long is neither effective nor necessary. The effect of QE on the real economy is expected to be marginal.

In-depth 6: What is optimal fiscal policy with the repo rate at zero? cont'd

The benefits need to be weighed against the potential costs of QE and LTROs. The Riksbank balance sheet would grow substantially. The Riksbank has recently stated that its financing has deteriorated and that it might make a loss in the coming years (see speech by deputy governor Kerstin af Jochnich on January 23 2015). A larger balance sheet would increase the risk of losses, which is a potential cost to tax payers. In addition, exiting from unconventional monetary policy may come at the cost of high volatility the effects of winding down large balance sheets are unprecedented and hence unknown. The Swiss example shows the complexity of existing from unconventional monetary policy.

Negative rates – money in the mattress or the Riksbank's best friend?

Since currency interventions are costly and QE ineffective at the present time, the most likely policy tool employed by the Riksbank is negative deposit and/or negative repo rate. A negative deposit rate is relatively uncontroversial, and the main effect tend to be a to weaken the domestic currency. It entails that financial institutions have to pay to deposit money at the Riksbank. The ECB, the SNB and the Danish central bank all currently employ negative deposit rates.

A negative repo rate would be more unconventional and its consequences are uncertain and untested. SNB recently implemented a negative range for the libor of -0,25 to – 1,25% as it gave up its currency peg. If a negative repo rate results in negative rates on bank accounts for ordinary households and companies, households and companies may withdraw money from the banks to spend and invest. Theoretically, a negative rate could thus increase demand and spur inflation. It can also result in people moving money out from savings accounts into riskier assets, and increase assets prices. One scenario is money in the mattress and more cash management. The worst case scenario is a bank run with many depositors withdrawing money from the banks, causing defaults and instability in the financial system.

Unconventional monetary policy and passive fiscal policy is a suboptimal policy mix

Swedbank's assessment is that a more expansionary fiscal policy would be more effective than unconventional monetary policy, at the present time, to strengthen domestic demand and increase inflation. The Swedish economy is not suffering from a balance sheet recession nor a high government debt. QE, which has the potential to help the struggling Eurozone recovery, is unlikely to be effective in a Swedish context. A negative deposit rate to weaken the krona, potentially in combination with a negative repo rate is likely to be more efficient in the Swedish context.

Still, the most effective policy mix in Sweden in 2015 is a shift, from only relying on expansionary monetary policy, to fiscal stimulus. The Swedish economy has been heavily relying on private consumption, while investments and industrial production have remained below their pre-crisis levels (see in-depth 2 on productivity growth and digitalization). With the repo rate at the ZLB, fiscal policy has a unique opportunity to contribute to both short.-term and long-term growth. Investments in infrastructure projects, housing and education can improve the balance between investments and consumption; improve matching on the labor market, and increase long-term competitiveness.

Swedbank

Estonia: Uncertainty hasn't forsaken it

The economic growth forecast in 2015 was revised down, primarily due to a weaker external economic environment and its negative impact on exports and business sector investments. At the same time, private consumption, supported by a robust growth of wages and super-low inflation, will contribute strongly. Economic growth will accelerate in Estonia in 2016 as the economic environment in the region improves.

Key economic indicators, 2012-2016 1/

	2012	2013	2014e		2015f		2016f	
Real GDP growth, %	4.7	1.6	1.9	(2.0)	2.0	(2.5)	2.7	(3.0)
Consumer price growth, %	3.9	2.8	-0.1	(0.0)	0.3	(1.3)	2.6	(2.0)
Unemployment rate, % 2/	10.0	8.6	7.8	(7.5)	7.3	(7.2)	7.2	(7.1)
Real net monthly wage growth, %	1.5	4.5	5.3	(5.2)	6.5	(6.0)	3.3	(4.4)
Current and capital account balance, % of GDP	-1.5	0.6	-0.2	(-0.2)	-0.4	(1.8)	-1.0	(2.0)
General government budget balance, % of GDP 3/	-0.3	-0.5	-0.4	(-0.5)	-0.4	(-0.4)	-0.2	(-0.2)

1/ November 2014 forecast in parenthesis

Sources: Statistics Estonia, Bank of Estonia, Swedbank.

Weaker export growth in 2015

Export growth accelerated in the second half of last year. The growth was supported by a robust improvement in the production of electronics and its exports primarily to Sweden and thence to the global market, and larger volumes of sea transport services. The continuation of the current robust growth in the production and export of electronics equipment and its impact on GDP growth has certain risks, as this comes primarily from a single producer. Exports of goods to the Russian market fell considerably, especially towards the end of last year. The worsening economic situation in Russia and the embargo on certain food products will strike Estonia's exports to the eastern market even more this year. Although the embargo has hit considerably Estonian producers of some agricultural and food products, especially dairy, fish, and meat, the direct impact on the Estonian economy as a whole has been rather modest so far. However, the decline in import demand in Russia and rouble depreciation are worsening the economic situation of several of the main trade partners, amplifying the negative impact on Estonia's export possibilities.

Estonia's export volumes are small, and it still have a price advantage compared with the Nordic and Western European producers. This facilitates finding new export markets in an overall sluggish growth environment characterised by an oversupply of certain products due to Russia's economy's weakness and trade restrictions. According to our baseline scenario, the growth of Estonian exports will decelerate in 2015 due to weaker foreign demand. In 2016, the economic situation of Estonia's trade partners will improve, lifting export growth.

Households' savings ratio will stay strong

Despite the business sector turnover and profits' staying at around the previous year's level in 2014, the corporations' financial situation remains good. Due to a modest growth of new loan volumes, corporations' financial leverage has fallen to its lowest level in the past 10 years. Because of a rapid rise in households' nominal and real disposable income, we expect the households' savings rate to stay strong in the forecast period. A robust financial position enables both nonfinancial corporations and households to finance a considerable share of their investments from their own funds. Enterprises and households both have financial buffers, protecting them against possible downward risks.

Investments will recover slowly

. Given weak export demand, we expect that investments by nonfinancial corporations will grow very modestly in 2015. Corporations need to increase productivity more than production capacity; therefore, the share of investments in machinery and equipment in overall investment volumes is expected to rise. The continued demand for dwellings supports a moderate growth of households' investments. At the same time, public investments will decrease somewhat in 2015, and more strongly in 2016, as investments from the government's own funds, and next year also from the EU funds, will decline. Total investments will recover sluggishly this year, to which households will contribute the most. The expected improvement of foreign demand in 2016 will induce corporations to invest more, both in efficiency and volumes, and, therefore, their contribution to the growth of total investments will increase.

Strong wage growth will continue

The labour market remains tight, even though the external economic environment is still fragile. Finding suitable labour will only get harder in 2015-2016 as the working-age population and the number of unemployed will decrease further. The share of labour costs in enterprises' turnover has increased as wages continue rising fast, even as sales have been falling a bit. Employment will decrease marginally during this and the next year because of lower supply of and demand for labour (the latter thanks to investment in higher efficiency). Shale oil and food industries will probably reduce their labour force after the recent dramatic drop in the prices of oil, and lower prices and less export of food products. But so far, the impact of smaller revenues in these sectors on total employment has been limited (around 0.05% of employment), and the people laid off there will probably find jobs elsewhere.

Gross wage growth will stay at around last year's level in 2015 and then accelerate somewhat in 2016, in line with the improvement in the general macroeconomic situation. Net wages will get an additional boost in 2015 from a reduction in labour income taxes of around 1.6 percentage points at the beginning of the year. As inflation will be low, labour income will increase by more than 6% in real terms this year. Minimum wages will be increased by around 10% a year both in 2015 and 2016. Higher wages of public workers and a rise in pensions and other social benefits will give additional support to private consumption, which will be the biggest contributor to growth both in 2015 and 2016.

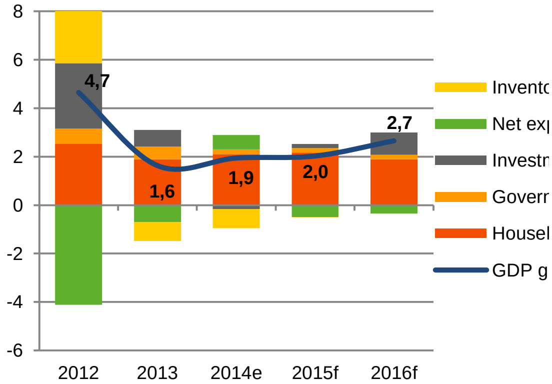
Modest price increase in 2015

Prices, especially energy and food prices, will start to increase gradually during the second half of 2015. The price of crude oil is forecast to decline by around half in US dollars and by around one-third in euros in 2015, compared with 2014. However, the prices of motor fuels in Estonia are expected to decline much less, as taxes amount to half of the retail price of gasoline. Lower oil prices will also press down the price of heating. In Estonia, the biggest winners of the lower fuel prices are the transport sector, which can reduce its costs, and households, which can save or spend more.

Food prices are currently weak globally due to abundant supply and slower growth of demand in some leading importers, like China and Russia. Food prices are expected to increase in the second half of this year, when food demand will catch up with food supply. The biggest push to inflation in Estonia will come from an increase in excise tax rates, which will lift inflation by around 0.5 percentage point at the beginning of the year. The prices of imports are being raised somewhat by the cheaper euro. Strong wage growth adds pressure to the prices of labour-intensive goods and services produced locally.

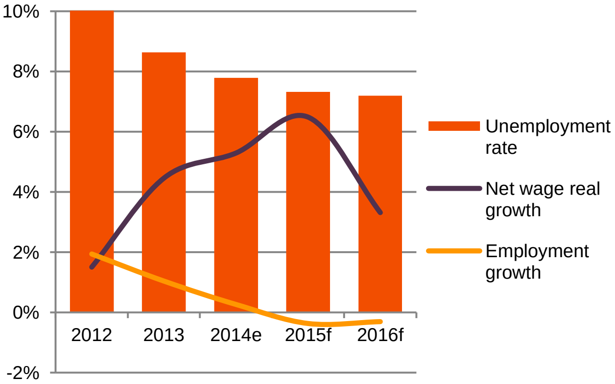
In 2016, inflation will accelerate, as global energy and food prices are forecast to increase. We expect the price of crude oil to recover by around 30% in euros, pushing up the prices of transport and heating. Regulated prices will rise thanks to another round of excise tax hikes.

Estonia: Contributions to GDP growth, pp



Sources: Statistics Estonia and Swedbank

Estonia: Labour market indicators



Sources: Statistics Estonia and Swedbank

The current forecast assumes that the upcoming parliamentary elections in March this year will not bring significant changes in Estonia's economic policy. The main downward risk to the current forecast is related to Russia. If the situation in Russia gets worse than what we assume in our baseline scenario (see the Russia section for more details), the economic growth of Estonia and its trade partners will be harder hit. In addition to Russia, and perhaps even more important, the economic and political uncertainties related to the euro area have increased since our previous forecast in November, hurting Estonia's export and investment growth prospects.

Swedbank

Latvia: In search for exports

We lower the growth forecast for 2015 to 1.9% (2.6% before) owing to weaker external demand growth and, particularly, a massive Russian rouble depreciation. Continued wage growth and cheaper energy will support the purchasing power of Latvian households. GDP growth will remain mostly consumption driven this year, but exports and investments will pick up in 2016, as the global economy speeds up and the situation in Russia stabilises.

Key economic indicators, 2013-2016 [1/]

	2013	2014e		2015f		2016f	
Real GDP growth, %	4.2	2.4	(2.3)	1.9	(2.6)	3.5	(3.5)
Consumer price growth, %	0.0	0.6	(0.8)	0.5	(2.1)	2.5	(2.5)
Unemployment rate, % [2/]	11.9	10.8	(10.7)	10.2	(9.9)	9.2	(8.8)
Real net monthly wage growth, %	5.7	8.1	(7.4)	5.5	(3.3)	3.9	(3.9)
Current account balance, % of GDP	-2.3	-2.8	(-2.1)	-2.6	(-2.1)	-4.3	(-2.9)
General government budget balance, % of GDP [3/]	-0.9	-1.6	(-1.0)	-1.5	(-1.5)	-1.2	(-0.8)

1/ November 2014 forecast in parenthesis.
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: CSBL and Swedbank.

In 2014, we estimate economic growth to have been at 2.4% (similar as in the first three quarters). Yet, growth in the fourth quarter most likely was weaker than in the third. Household consumption growth has been weaker than we expected and slower than income growth, implying that household saving rates have risen. Investments suffered from geopolitical uncertainty and weaker-than-expected external demand, falling in annual terms in the third quarter. Export growth was slower than that of consumption or investments, but held up relatively well.

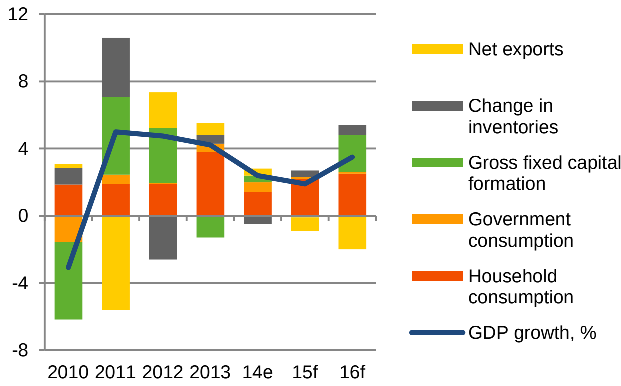
Cheaper oil and weaker rouble force outlook revisions

Since our November Outlook, two key developments have prompted our forecast revision. On the positive side, a sharp decline in global oil prices implies much lower inflation in Latvia and, thus, stronger purchasing power and, possibly, household consumption growth. On the negative side, a dramatic depreciation of the rouble will result in much deeper recession in Russia than previously anticipated and, thus, a larger fall in exports to Russia. This is already affecting long-haul truck businesses and hotels, and will have an even larger impact on Latvian exporters in the spring, when higher inflation in Russia will reduce their household spending.

Lower growth in 2015, to remain mostly driven by household consumption

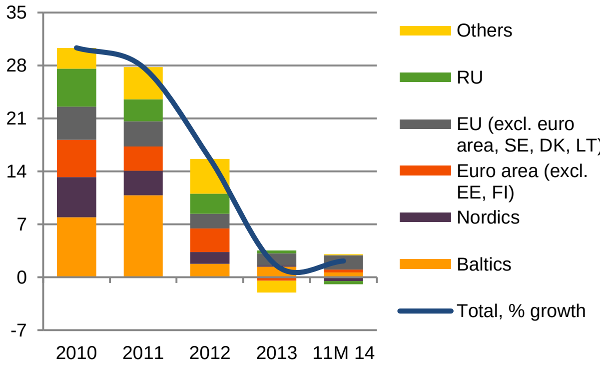
We forecast weaker exports and investments for this year due to the somewhat weaker external environment (lower growth in the euro area, deeper recession, and the financial squeeze in Russia) and thus revise downwards our 2015 GDP forecast to 1.9% (2.6% before). We expect household consumption growth to remain robust, owing to lower inflation and growing net wages. We keep the 2016 forecast unchanged at 3.5%, with exports and investments recovering due to (i) the anticipated stabilisation of the geopolitical situation in Russia and the slow recovery of its economy starting in the second half of the year, as well as improving growth in Europe, and (ii) a more active allocation of EU funds filling in for the previously postponed investment projects of the last couple of years, and perhaps also some help from the so-called Juncker plan (planned to promote investments in Europe, but still in development phase). Risks are skewed to the downside, though.

Latvia: Contributions to GDP YoY, pp



Sources: CSBL and Swedbank's forecasts

Latvia: Trade partners' contributions to goods' exports growth, pp



Source: CSBL

Export growth running out of steam, but still positive

External demand growth this year is forecast to be weaker than in 2014. At the same time, the resumption of production at the Liepājas Metalurgs steel plant would add at least 1 percentage point to export growth (it is not yet clear what will be the export markets, though). We expect the fall in Latvia's exports to Russia to be in double digits in 2015 (goods exports down by 3.5% in the first 11 months of 2014) due to the rouble depreciation and recession. However, this can be compensated for by expansion in other markets (about 11% of total goods exports went to Russia in 2014). Although in the past two years Latvian external competitiveness has slightly weakened due to wages growing faster than productivity, it is still good enough to continue expanding in European markets and penetrating more distant ones, e.g., Asia.

Minor fall in investments

Nonfinancial investments in manufacturing were growing in 2014, but overall investments weakened. Anecdotal evidence suggests that businesses are very cautious about new investments, and demand for new loans is very weak. This can be explained by the fragile external environment, but businesses are also postponing some of necessary investment projects, waiting for EU funds from the 2014-2020 planning period to become available. We see a fall in investment activity in the beginning of this year, but expect it to pick up towards the end of 2015 and in 2016, with the inflow of EU funds and perhaps the slow phasing in of the Juncker plan for related investment. At the same time, public infrastructure projects are on their way, e.g., in energy, railways, and ports. The distribution of the new period's EU funds in agriculture and road maintenance seems to start already during 2015.

Slower price growth due to cheaper oil

With substantially lower global oil prices than previously anticipated, we revise downwards the consumer price growth forecast for 2015 to 0.5% (2.1% before). The weakening euro and will not be able to outweigh the fall in oil prices, resulting in cheaper fuel, natural gas, and heating in Latvia. This will compensate for the hike in electricity tariffs as of January 2015 due to the liberalisation of the market for households. The lower energy costs are likely to decelerate price growth for other goods and services as well. We keep the inflation forecast at 2.5% for 2016, with global commodity prices recovering.

Slower economic activity growth and the diminishing labour force will dampen employment, and jobs are expected to be created this year only very marginally, if at all. We forecast the unemployment rate to continue falling, mostly due to emigration and the aging population, but somewhat slower than previously anticipated. In 2016, as economic growth picks up, we expect marginal positive employment growth, and the unemployment rate is likely to slide below 9% during the year.

Weaker wage growth this year than in 2014, supported by minimum wage hike…

Wage pressures are anticipated to calm down a bit this year; however, an increase in the minimum wage of another 12.5% in January 2015 (similar to the hike at the beginning of 2014) to EUR 360 will support wage growth. We expect 5% gross wage growth in 2015 and 5.5% in 2016; the latter will be higher if the minimum wage is raised again (which is likely). A decline in the personal income tax rate of 1 percentage point this year to 23% and of a further 1 percentage point in 2016 will support net wage growth. There are also plans to introduce a progressive tax-free allowance to reduce the tax burden for lower-income households, as well as to raise tax allowances for families with two or more children, but it is still unclear whether and how these will be implemented.

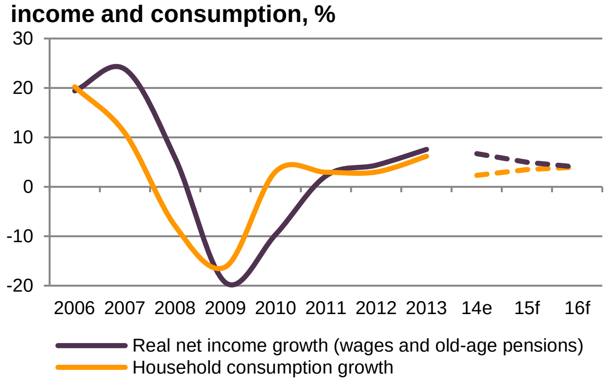
… but purchasing power growth stronger than expected due to lower inflation

Overall, lower inflation and net wage growth will support household spending. However, we believe that the minimum wage hike will mostly result in income legalisation and thus not add to consumption so much. Excluding the minimum wage impact, we now anticipate somewhat slower net wage growth in 2015 than in the November Outlook. In addition, household spending is forecast to remain rather cautious. However, cheaper fuel and heating will support spending, and we expect robust consumption going forward.

Higher budget deficit unless tax collection improves and/or spending is cut

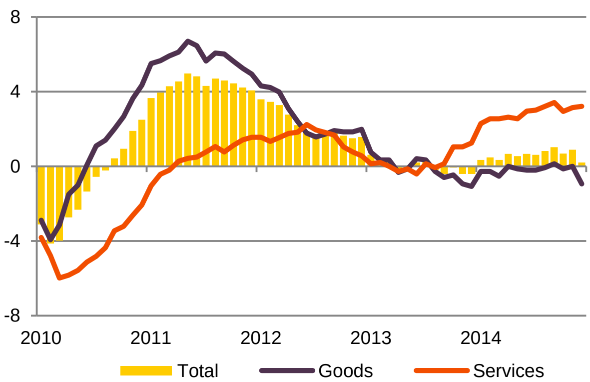
Lower economic growth and lower inflation than currently assumed in the 2015 Budget Law will hurt the government budget. The budget is planned under an assumption of 5% nominal GDP growth in 2015; however, we expect it marginally above 3%, implying a smaller taxable base. We anticipate budget deficits higher than the 1% and 0.9% of GDP planned for 2015-2016 unless tax collection improves substantially and/or spending is cut. There is a risk that a fiscal correction mechanism will have to be launched in 2016 (as set in the Fiscal Discipline Law), since both the 2014 and 2015 budget deficits are likely to exceed targets.

Latvia: Annual growth of household income and consumption, %



Sources: CSBL and Swedbank's forecasts

Latvia: Annual CPI, %



Source: CSBL

Lithuania: Enduring love, wrong partner

Despite the political tensions, economic sanctions, embargo, and falling rouble, Lithuania's exports to Russia continued increasing in 2014. With Russia facing a recession this year almost as big as in 2009, this enduring love of Lithuanian exporters is going to sting. Exports to Russia will probably shrink by more than 10%, and business investments will be negatively affected. The good news is that the same force that crippled Russia – cheap oil – will also boost Lithuanian consumers.

Key economic indicators, 2013-2016 [1/]

	2013	2014e		2015f		2016f	
Real GDP growth, %	3.3	3.0	(3.0)	2.3	(3.3)	3.5	(3.8)
Consumer price growth, %	1.0	0.1	(0.2)	0.7	(1.5)	2.0	(2.0)
Unemployment rate, % [2/]	11.8	10.7	(10.9)	9.7	(9.7)	8.5	(8.5)
Real net monthly wage growth, %	3.8	4.9	(4.7)	4.2	(3.8)	4.5	(5.1)
Current account balance, % of GDP	1.6	-0.3	(-0.7)	-1.7	(-1.5)	-3.2	(-2.1)
General government budget balance, % of GDP [3/]	-2.6	-1.3	(-1.3)	-1.6	(-1.3)	-1.0	(-1.0)

1/ November 2014 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

Exposure to Russia's recession is big, but only some sectors will feel the sting

During the first 11 months of last year, exports of goods to Russia increased by 6.5%, and the Russian market was the destination of 21.1% of total exports, compared with 19.8% in 2013. In other words, the exposure has increased, at least for some sectors, and these exporters are going to be burned in 2015. What was not achieved by sanctions will be delivered by the cheap rouble and loss of Russian consumers' purchasing power. However, the effect on the overall Lithuanian economy will be limited, as the majority of the goods sold in Russia are not of Lithuanian origin, but are reexported. Because only 4.5% of exports of Lithuanian-origin goods are sold in the Russian market, Lithuanian farmers and manufacturers are relatively safe; the biggest casualty is likely to be transport and logistics sectors.

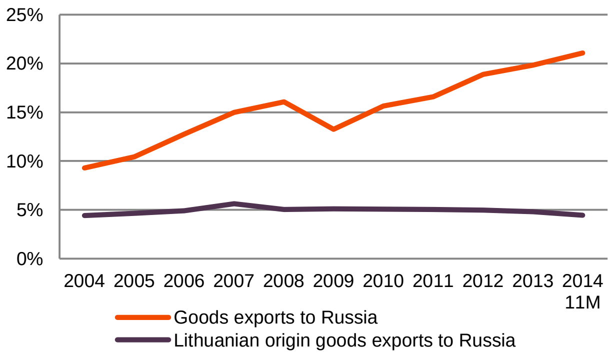
Total exports are not expected to grow this year; investments will be affected by weak confidence

It is likely that exports to other CIS countries will also suffer, as they are going to be negatively affected by Russia's economic woes. Last year, 33% of total Lithuanian exports were sold in CIS markets. However, exports to most of the EU countries are likely to grow; thus we forecast that total exports will remain unchanged in 2015, before regaining growth momentum in 2016. Investments will also take a hit, especially in sectors relying on external demand, as the uncertainty will be high and confidence will remain weak.

Number of tourists from Belarus and Russia is likely to fall this year

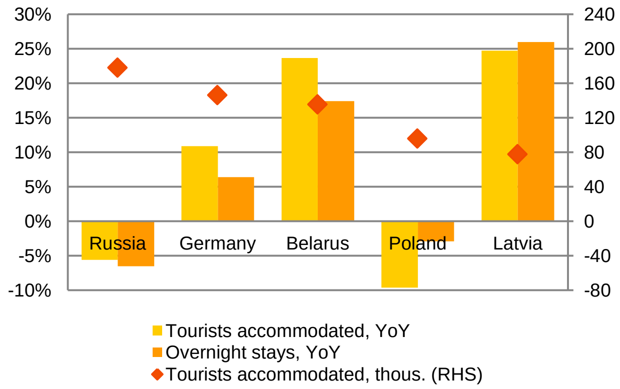
Accommodations, catering, and, to some extent, retail sectors are also likely to be negatively affected by the recession in Russia and the depreciating CIS currencies. During the first three quarters of last year, the number of tourists accommodated in Lithuania increased by 9.5% over the same period in 2013. But, since then, the rouble has lost half of its value, and Belarus was forced to impose restrictions on the conversion of its national currency to foreign currencies – these factors are not going to disappear this year and are going to hurt the purchasing power and flows of tourists. Around 30% of all tourists come to Lithuania from Russia and Belarus.

Lithuania: Share of goods' exports to Russia



Sources: Statistics Lithuania and Swedbank.

Lithuania: Tourism, 2014 Jan-Sep



Sources: Statistics Lithuania and Swedbank

For these reasons we have cut the forecast of GDP growth in 2015 by 1 percentage point, to 2.3%. Growth will rebound to 3.5% in 2016, although it will be somewhat smaller than we expected in our recent Swedbank Economic Outlook. Despite the new wave of EU funds, gross fixed capital formation is expected to grow by only 2% this year. Unfortunately, this is insufficient to sustain, let alone improve, the competitiveness of companies. Investments, as a share of GDP will remain unchanged this year (at 19%), much below the long-term average and the level in, e.g., other Baltic countries. Our composite leading indicators are warning of a downturn of the business cycle (you can read more about this in our recent Macro Focus 1).

Households will benefit from cheaper oil, but they will probably save more, not consume

The negative effect of the storm in the east would be bigger were it not mitigated by cheaper oil and gas, which will increase households' purchasing power. We forecast that the average price of oil, calculated in euros, will be 35% lower this year compared with 2014. Drivers will save EUR 236 million, or 1% of total household consumption. However, we do not expect this to significantly boost household consumption, as discretionary income in the volatile and uncertain environment is likely to be saved. We have lowered our household consumption growth forecast to 4.0% this year but expect it to accelerate to 4.7% in 2016.

Despite all the uncertainties, wage growth is not likely to ebb

There is, however, room for a positive surprise here, especially if geopolitical risks ease, the euro area starts growing more rapidly, and confidence recovers. Labour market fundamentals are pointing in the right direction. Real growth of the wage bill (total wages paid to all employees) is going to remain strong – 4.4% this year and 4.8% in 2016. We forecast nominal wage growth to accelerate to 5.0% this year – recalculating wages in euros and shrinking supply of skilled labour will boost employees' negotiating power, at least in some sectors. Last year, wages in IT and communications, real estate operations, and the agriculture and construction sectors were increasing most rapidly, while most public sector employees barely saw any income growth. Wage growth is expected to become more broad based only in 2016, when the pre-election period will encourage politicians to raise the minimum wage and public sector wages.

Employment growth will be weak, but emigration and unemployment will continue declining

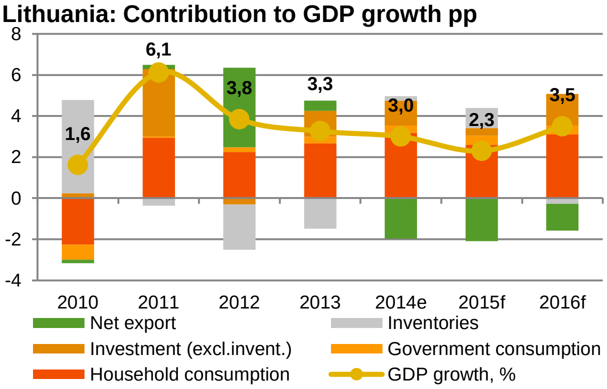
Employment growth is likely to be weaker – after an estimated 1.5% surge last year, it will probably increase by only 0.2% in 2015. However, unemployment is still going to decline to 9.7% this year and 8.5% in 2016, mainly due to the aging population. Net emigration declined to 12,600 last year, the lowest level since 2002. Although emigration remains relatively high, immigration increased by 17.5% last year, and around 80% of all immigrants were returning Lithuanians. We forecast that net migration will continue approaching zero due to both the declining emigration and slightly increasing immigration.

During the first three quarters of last year, remittances increased to 4.5% of GDP and are likely to remain an important source of household income. Currently, 620,000 Lithuanians live abroad – more than one-fifth of the population living in Lithuania. There must be more ways to tap into the huge potential of this diaspora, besides relying on their remittances. Government and companies should grasp this opportunity.

The budget deficit is probably going to be larger than expected, but that's good news

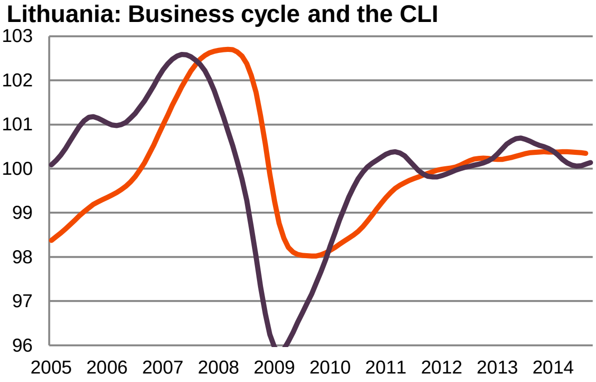
The government has a plan to increase the minimum monthly wage by 25 euros (or 8.3%) this summer, but that is conditional on budget revenues, which we forecast to fall behind the plan. Thus it is likely that any further increase in the minimum monthly wage will be postponed until 2016. We estimate that government consumption is going to increase by 2.5% this year, but, unfortunately, the state investment programme is going to shrink by 8.4%. This is probably not a good time to cut investments, but the government had little room to manoeuvre – pensions have to be compensated for and there is a broad consensus to dramatically increase spending on defence. We forecast that the general government budget deficit will increase to 1.6% of GDP – higher than is expected by the Ministry of Finance and higher than last year. But government borrowing costs have never been this low and are likely to drop further – we forecast that long-term government bond yields will fall below 1% this year. Thus, if there were ever a good time to implement good old Keynesian stimulus policies, then that time is now. Let's hope the stimulus will be transparent, and efficient, and the government will not get addicted to it. Again.

Lithuania: Contribution to GDP growth pp



Sources: Statistics Lithuania and Swedbank forecasts

Lithuania: Business cycle and the CLI



Source: Swedbank

[1] http://www.swedbank-research.com/english/macro_focus/2014/september/index.csp

Swedbank

Appendix

ESTONIA: Key economic indicators, 2013-2016 [1/]

	2013	2014e		2015f		2016f	
Real GDP growth, %	1,6	1,9	(2,0)	2,0	(2,5)	2,7	(3,0)
Household consumption	3,8	4,1	(3,6)	4,2	(3,8)	3,6	(3,4)
Government consumption	2,8	1,1	(0,5)	1,0	(1,0)	1,0	(1,0)
Gross fixed capital formation	2,5	-0,6	(2,5)	0,6	(3,0)	3,5	(4,5)
Exports of goods and services	2,4	2,3	(1,5)	1,6	(2,0)	3,7	(4,0)
Imports of goods and services	3,3	1,6	(1,0)	2,1	(2,5)	4,2	(5,0)
Consumer price growth, %	2,8	-0,1	(0,0)	0,3	(1,3)	2,6	(2,0)
Unemployment rate, % [2/]	8,6	7,8	(7,5)	7,3	(7,2)	7,2	(7,1)
Real net monthly wage growth, %	4,5	5,3	(5,2)	6,5	(6,0)	3,3	(4,4)
Nominal GDP, billion euro	18,7	19,5	(19,5)	20,4	(20,6)	21,7	(21,9)
Exports of goods and services (nominal), % growth	3,4	2,1	(1,8)	1,5	(2,5)	4,2	(5,1)
Imports of goods and services (nominal), % growth	2,9	0,7	(0,0)	1,9	(2,5)	4,7	(5,6)
Balance of goods and services, % of GDP	1,4	2,7	(2,5)	2,4	(2,7)	2,2	(3,0)
Current account balance, % of GDP	-1,1	-0,6	(-0.6)	-0,9	(-0.6)	-1,3	(-0.5)
Current and capital account balance, % of GDP	0,6	-0,2	(-0.2)	-0,4	(1,8)	-1,0	(2,0)
FDI inflow, % of GDP	3,6	7,6	(4,1)	3,9	(3,9)	3,7	(3,7)
Gross external debt, % of GDP	93,5	90,6	(90,4)	87,2	(86,1)	83,3	(81,6)
General government budget balance, % of GDP [3/]	-0,5	-0,4	(-0.5)	-0,4	(-0.4)	-0,2	(-0.2)
General government debt, % of GDP	10,1	10,0	(10,0)	9,8	(9,8)	9,5	(9,5)

1/ November 2014 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, 2013-2016 [1/]

	2013	2014e		2015f		2016f	
Real GDP growth, %	4,2	2,4	(2,3)	1,9	(2,6)	3,5	(3,5)
Household consumption	6,2	2,3	(3,3)	3,5	(3,5)	4,0	(4,0)
Government consumption	2,9	3,7	(2,6)	0,7	(1,6)	0,5	(1,0)
Gross fixed capital formation	-5,2	1,8	(2,5)	-0,5	(2,0)	10,0	(7,0)
Exports of goods and services	1,5	1,4	(0,9)	1,0	(3,0)	4,0	(4,5)
Imports of goods and services	0,3	0,5	(1,0)	2,2	(3,3)	7,0	(6,0)
Consumer price growth, %	0,0	0,6	(0,8)	0,5	(2,1)	2,5	(2,5)
Unemployment rate, % [2/]	11,9	10,8	(10,7)	10,2	(9,9)	9,2	(8,8)
Real net monthly wage growth, %	5,7	8,1	(7,4)	5,5	(3,3)	3,9	(3,9)
Nominal GDP, billion euro	23,2	24,1	(24,5)	24,9	(26,0)	26,4	(27,7)
Exports of goods and services (nominal), % growth	2,2	1,2	(0,5)	1,1	(4,9)	5,9	(6,6)
Imports of goods and services (nominal), % growth	0,9	0,4	(-0,0)	1,6	(4,8)	8,9	(8,1)
Balance of goods and services, % of GDP	-3,3	-2,8	(-2,9)	-3,0	(-2,8)	-4,7	(-3,7)
Current account balance, % of GDP	-2,3	-2,8	(-2,1)	-2,6	(-2,1)	-4,3	(-2,9)
Current and capital account balance, % of GDP	0,1	0,1	(0,5)	-0,2	(1,0)	-2,8	(-1,8)
FDI inflow, % of GDP	2,9	1,2	(1,2)	2,4	(2,3)	3,0	(2,9)
Gross external debt, % of GDP	131,3	139,6	(130,4)	136,9	(124,2)	133,7	(119,8)
General government budget balance, % of GDP [3/]	-0,9	-1,6	(-1,0)	-1,5	(-1,5)	-1,2	(-0,8)
General government debt, % of GDP	38,2	40,7	(39,3)	39,4	(34,1)	38,5	(33,5)

[1/] November 2014 forecast in parenthesis, 2013 figures are updated according to new ESA2010 methodology.
[2/] According to Labour force survey.
[3/] According to Maastricht criterion.

Sources: CSBL and Swedbank.

LITHUANIA: Key economic indicators, 2013-2016 [1/]

	2013	2014e		2015f		2016f	
Real GDP growth, %	3,3	3,0	(3.0)	2,3	(3.3)	3,5	(3.8)
Household consumption	4,2	5,0	(5.0)	4,0	(4.5)	4,7	(4.7)
Government consumption	1,8	2,0	(2.0)	2,5	(2.5)	2,5	(3.0)
Gross fixed capital formation	7,0	6,5	(6.5)	2,0	(6.0)	8,0	(10.0)
Exports of goods and services	9,4	2,8	(-1.0)	0,0	(3.5)	7,0	(5.0)
Imports of goods and services	9,0	5,4	(2.0)	2,6	(5.2)	8,5	(7.2)
Consumer price growth, %	1,0	0,1	(0.2)	0,7	(1.5)	2,0	(2.0)
Unemployment rate, % [2/]	11,8	10,7	(10.9)	9,7	(9.7)	8,5	(8.5)
Real net monthly wage growth, %	3,8	4,9	(4.7)	4,2	(3.8)	4,5	(5.1)
Nominal GDP, billion euro	35,0	36,4	(36.0)	37,7	(37.8)	39,7	(39.9)
Exports of goods and services (nominal), % growth	8,0	1,0	(-2.5)	-2,5	(4.5)	8,0	(7.0)
Imports of goods and services (nominal), % growth	7,5	2,0	(1.0)	-0,5	(5.5)	10,0	(8.0)
Balance of goods and services, % of GDP	1,3	0,4	(-1.6)	-1,2	(-2.4)	-2,7	(-3.2)
Current account balance, % of GDP	1,6	-0,3	(-0.7)	-1,7	(-1.5)	-3,2	(-2.1)
Current and capital account balance, % of GDP	4,6	1,8	(1.6)	0,9	(0.8)	-0,7	(0.2)
FDI inflow, % of GDP	1,5	1,0	(2.5)	1,5	(3.0)	2,0	(4.0)
Gross external debt, % of GDP	69,8	69,7	(66.5)	68,2	(65.0)	65,8	(62.7)
General government budget balance, % of GDP [3/]	-2,6	-1,3	(-1.3)	-1,6	(-1.3)	-1,0	(-1.0)
General government debt, % of GDP	39,0	41,0	(41.6)	42,6	(42.4)	38,2	(38.1)

1/ November 2014 forecast in parenthesis, 2013 figures are updated according to new ESA2010 methodology
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

Contacts

Macro Research

Olof Manner
olof.manner@swedbank.se
Head of Macro
+46 (0)70 567 9312

Anna Felländer
anna.fellander@swedbank.se
Group Chief Economist
+46 (0)8 5859 39 34

Harald-Magnus Andreassen
hma@swedbank.no
Chief Economist NO
+47 23 11 82 60

Tõnu Mertsina
tonu.mertsina@swedbank.ee
Chief Economist EE
+372 888 75 89

Nerijus Mačiulis
nerijus.maciulis@swedbank.lt
Chief Economist LT
+370 5258 22 37

Mārtiņš Kazāks
martins.kazaks@swedbank.lv
Deputy Group Chief Economist, Chief Economist LV
+371 6744 58 59

Magnus Alvesson
magnus.alvesson@swedbank.se
Head of Economic Forecasting
+46 (0)8 700 94 56

Knut Hallberg
knut.hallberg@swedbank.se
Senior Economist
+46 (0)8 700 93 17

Jörgen Kennemar
jorgen.kennemar@swedbank.se
Senior Economist
+46 (0)8 700 98 04

Åke Gustafsson
ake.gustafsson@swedbank.se
Senior Economist
+46 (0)8 700 91 45

Anna Breman
anna.breman@swedbank.se
Senior Economist
+46 (0)8 700 91 42

Cathrine Danin
cathrine.danin@swedbank.se
Economist
+46 (0)8 700 92 97

Martin Bolander
martin.bolander@swedbank.se
Senior Economist
+46 8 700 92 99

Sihem Nekrouf
sihem.nekrouf@swedbank.se
Economist, EA to Anna Felländer
+46 (0) 725 88 39 34

Øystein Børsum
ob@swedbank.no
Senior Economist
+47 99 50 03 92

Helene Stangebye Olsen
hso@swedbank.no
Reserach Assistant
+47 23 23 82 47

Liis Elmik
liis.elmik@swedbank.ee
Senior Economist
+372 888 72 06

Teele Aksalu
teele.aksalu@swedbank.ee
Economist
+372 888 79 25

Andrejs Semjonovs
andrejs.semjonovs@swedbank.lv
Economist
+371 6744 58 44

Lija Strašuna
lija.strasuna@swedbank.lv
Senior Economist
+371 6744 58 75

Vaiva Šečkutė
vaiva.seckute@swedbank.lt
Senior Economist
+370 5258 21 56

Strategy

MadeleinePulk
madeleine.pulk@swedbank.se
Head of Strategy and Allocation
+46 (0)72 53 23 533

Anders Eklöf
anders.eklof@swedbank.se
Chief FX Strategist
+46 (0)8 700 91 38

Jerk Matero
jerk.matero@swedbank.se
Chief IR Strategist
+46 (0)8 700 99 76

Hans Gustafson
hans.gustafson@swedbank.se
Chief EM Economist & Strategist
+46 (0)8 700 91 47

Swedbank

General disclaimer

This research report has been prepared by analysts of Swedbank Macro Research, a unit within Swedbank Large Corporates & Institutions,. The Macro Research department consists of research units in Estonia, Latvia, Lithuania, Norway and Sweden, and is responsible for preparing reports on global and home market economic developments.

Analyst's certification

The analyst(s) responsible for the content of this report hereby confirm that notwithstanding the existence of any such potential conflicts of interest referred to herein, the views expressed in this report accurately reflect their personal and professional views.

Research reports are independent and based solely on publicly available information.

Issuer, distribution & recipients

This report by Swedbank Macro Research, a unit within Swedbank Research that belongs to Large Corporates & Institutions, is issued by the Swedbank Large Corporates & Institutions business area within Swedbank AB (publ) ("Swedbank"). Swedbank is under the supervision of the Swedish Financial Supervisory Authority (Finansinspektionen).

In no instance is this report altered by the distributor before distribution.

In Finland this report is distributed by Swedbank's branch in Helsinki, which is under the supervision of the Finnish Financial Supervisory Authority (Finanssivalvonta).

In Norway this report is distributed by Swedbank's branch in Oslo, which is under the supervision of the Financial Supervisory Authority of Norway (Finanstilsynet).

In Estonia this report is distributed by Swedbank AS, which is under the supervision of the Estonian Financial Supervisory Authority (Finantsinspektsioon).

In Lithuania this report is distributed by "Swedbank" AB, which is under the supervision of the Central Bank of the Republic of Lithuania (Lietuvos bankas).

In Latvia this report is distributed by Swedbank AS, which is under the supervision of The Financial and Capital Market Commission (Finanšu un kapitala tirgus komisija).

In the United States this report is distributed by Swedbank First Securities LLC ('Swedbank First'), which accepts responsibility for its contents. This report is for distribution only to institutional investors. Any United States institutional investor receiving the report, who wishes to effect a transaction in any security based on the view in this document, should do so only through Swedbank First. Swedbank First is a U.S. broker-dealer, registered with the Securities and Exchange Commission, and is a member of the Financial Industry Regulatory Authority. Swedbank First is part of Swedbank Group.

For important U.S. disclosures, please reference: http://www.swedbankfs.com/disclaimer/index.htm

In the United Kingdom this communication is for distribution only to and directed only at "relevant persons". This communication must not be acted on – or relied on – by persons who are not "relevant persons". Any investment or investment activity to which this document relates is available only to "relevant persons" and will be engaged in only with "relevant persons". By "relevant persons" we mean persons who:

- Have professional experience in matters relating to investments falling within Article 19(5) of the Financial Promotions Order.
- Are persons falling within Article 49(2)(a) to (d) of the Financial Promotion Order ("high net worth companies, unincorporated associations etc").
- Are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) – in connection with the issue or sale of any securities – may otherwise lawfully be communicated or caused to be communicated.

Limitation of liability

All information, including statements of fact, contained in this research report has been obtained and compiled in good faith from sources believed to be reliable. However, no representation or warranty, express or implied, is made by Swedbank with respect to the completeness or accuracy of its contents, and it is not to be relied upon as authoritative and should not be taken in substitution for the exercise of reasoned, independent judgment by you.

Opinions contained in the report represent the analyst's present opinion only and may be subject to change. In the event that the analyst's opinion should change or a new analyst with a different opinion becomes responsible for our coverage, we shall endeavour (but do not undertake) to disseminate any such change, within the constraints of any regulations, applicable laws, internal procedures within Swedbank, or other circumstances.

Swedbank is not advising nor soliciting any action based upon this report. This report is not, and should not be construed as, an offer to sell or as a solicitation of an offer to buy any securities.

To the extent permitted by applicable law, no liability whatsoever is accepted by Swedbank for any direct or consequential loss arising from the use of this report.

Reproduction & dissemination

Produced by Swedbank Research, a unit within Large Corporates & Institutions.

Address
Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Landsvägen 40, 172 63 Sundbyberg