Swedbank

The Baltic Outlook

Macro Outlook, The Baltic Region, April 2009

Estonia
Rapid adjustments will continue

Latvia
Economic recession – a challenge for structural reforms

Lithuania
Economy has fallen into an outright recession

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Abbreviations:

CB– central bank

CEE – Central and Eastern Europe

CPI- consumer price index

CSBL - Central Statistical Bureau of Latvia

ECB - European Central Bank

EKI - Estonian Institute of Economic Research

EP – Eesti Pank (central bank)

ESA– Estonian Statistical Office

EU – European Union

HICP – harmonized index of consumer prices

LaB – Latvias Banka (central bank)

LDS – Lithuanian Department of Statistics

LiB – Lietuvos Bankas (central bank)

MoF – Ministry of Finance

PPI – producer price index

REER – real effective exchange rate

Summary

	2003	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %								
Estonia	7.1	7.5	9.2	10.4	6.3	-3.6	-10.5	0.0
Latvia	7.2	8.7	10.6	12.2	10.0	-4.6	-15.0	-4.0
Lithuania	10.2	7.4	7.8	7.8	8.9	3.0	-13.0	-3.0
Average consumer price growth, %								
Estonia	1.3	3.1	4.1	5.1	6.6	10.4	-0.5	0.0
Latvia	2.9	6.2	6.7	6.5	10.1	15.4	2.0	-4.0
Lithuania	-1.1	1.2	2.7	3.7	5.7	10.9	5.0	2.0
Current and capital account balance, % of GDP								
Estonia	-10.6	-11.0	-9.2	-14.6	-16.9	-7.7	1.5	3.5
Latvia	-7.5	-11.8	-11.2	-21.3	-20.6	-9.8	1.5	3.0
Lithuania	-6.4	-6.4	-5.8	-9.5	-12.8	-9.7	-1.0	-0.5

As global economic processes continue to worsen, it is rather unlikely that the current global crisis, which some have called the Great Recession, will find its bottom this year. Nevertheless, most forecasts (e.g. IMF) expect that in 2010 the US economy and then Europe will start a gradual and slow recovery. It is extremely unlikely that the three Baltic countries will start recovery earlier than the global trend, although there might be some aspects (e.g. lower production costs), which could, if adequately addressed, help the economies recover sooner or at the same time as other regions. But the current economic processes in the Baltic region and investors' attitudes towards it are pointing to a lagged and painful recovery. Still, some economic processes may stabilize (i.e. not become worse) by the end of 2009 or early 2010.

We expect a very deep recession in the three countries this year: the Latvian economy is expected to fall by 15%, the Lithuanian by 13% and the Estonian by 10.5%. The next year may bring growth in Estonia (according to the optimistic scenario by ca 0.5%), but a slight decline is more likely. The Latvian and Lithuanian economies are forecast to decline 4% and 3%, respectively. So the first year of growth will be 2011 and even then it will be not impressive.

The economies are heavily affected by fallen external demand, and extremely weak domestic demand, which suffers from low confidence, growing unemployment, wage cuts, and the credit squeeze. All three economies have entered a painful adjustment process, which should end up with a more competitive and effective corporate and public sector. Estonia has gone through a bigger part of the adjustment process. Latvia faces the most challenges, while Lithuania entered into recession only at the end of 2008 and therefore may still have a relatively long way to go. However, the dire economic situation makes the adjustments swifter and more painful.

The adjustment process in economies has substantially lowered misbalances therein, and as the process continues, the misbalances, if they still exist, will be eroded very quickly. We expect consumer price inflation to slip into the negative side[1] this year in Estonia and Latvia. Lithuanian consumer prices are forecasted to grow this and next year as some administrative factors remain strong (or are not yet unsolved2) while the country replaces its electricity generation to the more expensive form (i.e. nuclear energy will be replaced with fossil fuels due to the closure of Ignalina NPS).

External balances have also improved rapidly and we expect the process to continue, so that Estonia and Latvia will see close to a balance or surplus in their current accounts this year, and the Lithuanian deficit will be substantially lower than in previous years. The foreign capital inflows will diminish considerably, and private sector flows will turn (i.e. assets are returned and liabilities diminished). As of now, only Latvia is about to face a substantial increase in foreign debt due to the IMF Stand-by Arrangement.

Domestic financial sectors are already or are on the brink of the deleveraging process as foreign capital inflows are scarce, domestic savings low (but household savings growing), and pessimism in the corporate and household sector is high. The process will be rather intensive, and the level of non-performing loans will continue to increase, but we do not expect it to reach extremely high levels.

Governments of three countries have found themselves in a particularly difficult position: fragmented political landscapes, elections[3] and alienation from the public have made the

1 Deflation processes in the three countries should be assessed as good deflation, as the overly high price levels will be adjusted to the more appropriate levels, which recovers the competitiveness of economies and forces technological change. A substantial part of deflation is related to falling prices in global markets (e.g. oil).

2 E.g. it is unclear, whether the heating tariffs, which are under regulation, will be lowered or not.

3 The EU parliament in June, Estonia faces local elections

changes painful, having a lot of setbacks and hurdles. Governments have to make cuts in spending at the same time as other countries apply supportive measures, as the financing of the budget gap is very expensive or impossible. Only Estonia has reserves for covering the budget deficit, but without changes in the spending the reserves could be exhausted by mid-2010 or earlier. So the government policies are actually making the economic situation worse (cutting employment, wages, subsidies, etc) although they are targeted to create fiscal prudence and stabilize public sector finances. The latter is important due to continuously poor external perceptions, which has pushed up risk margins, scared investors off and forced some of them to leave, thus making developments for the corporate sector extremely difficult and pushing the prospect of economic recovery further back. However, on the positive side we can expect that the productivity and efficiency of the public sector will improve strongly.

We do not expect changes in current monetary policy, i.e. the currency systems in the three countries will remain as they are now until the Euro adoption. Devaluation will not be a solution for existing problems[4] and would create other, more serious problems, having also a spill-over effect on other economies (e.g. CEE, countries with substantial exposure to the CEE financial markets). We are of the opinion that Estonia has a window of opportunity for entering the Euro zone in 2011, but the government has to make very serious efforts to use this opportunity. The prospects for Latvia and Lithuania are in a more distant future (after 2012).

Maris Lauri

in October, Latvia in June, Lithuania had general elections in October 2008.

4 Adjustments in the economy are the way for addressing problems: cuts in employment, wages, increased efficiency etc.

General Assumptions

The global economic situation remains difficult and there are no clear signs of recovery yet. Swedbank expects the global economy to fall by 0.9% this year and show a rather modest 2.1% growth in 2010 with all the bigger economies contracting in 2009, and only a marginal recovery taking place in 2010[1]. However, as the world economy has remained extremely fragile there is a risk that the recovery in growth rates will be delayed. The IMF forecast in the latest World Economic Outlook (April 2009), which was published at the time we were finalizing the current outlook, is considerably more pessimistics.

Economic growth projections

			Swedbank*		IMF (Apr 09)	
	2007	2008	2009f	2010f	2009f	2010f
USA	2.0	1.2	-2.0	1.0	-2.8	0.0
Eurozone	2.6	0.8	-3.4	0.2	-4.2	-0.4
Germany	2.6	1.1	-4.0	0.3	-5.6	-1.0
Finland	4.2	0.9	-3.5	0.2	-5.2	-1.2
UK	3.0	0.8	-3.3	-0.2	-4.1	-0.4
Sweden	2.6	-0.2	-2.3	0.6	-4.3	0.2
Russia	8.1	6.0	-3.0	2.0	-6.0	0.5

** in the process of revision*

The global economy will be in its deepest post-World War II recession and the very fragile growth is expected only in 2010. The hopes of recovery are bound with the success of supportive measures governments of different countries have applied. Unfortunately, the success of these measures has so far been weaker than expected. The worst bouts of mistrust are over, but the real economy is still in deep trouble and risks around the financial markets have not disappeared. As mentioned before, the effectiveness of governments' supportive measures has so far been well below expectations, but room for additional measures is limited in many countries.

Baltic countries are small and very open to global developments, so weak demand in their main export markets is the biggest concern. The sharpest fall in industrial production and exports in the three countries took place simultaneously with Germany's, Sweden's, Finland's and the UK's. Therefore, it would be very difficult to show improvement if the economic situation in those countries remains weak.

The Russian economy has also started to decline and a rather deep one is expected this year, making the reorientation of exports impossible. There is a concern that Russian economic policy is becoming more protective, and the same may happen in other countries outside the EU (it is less possible in the EU).

1 Swedbank's forecast: http://www.swedbank.com/sst/inf/out/infOutWww1/0,,218849,00.html.

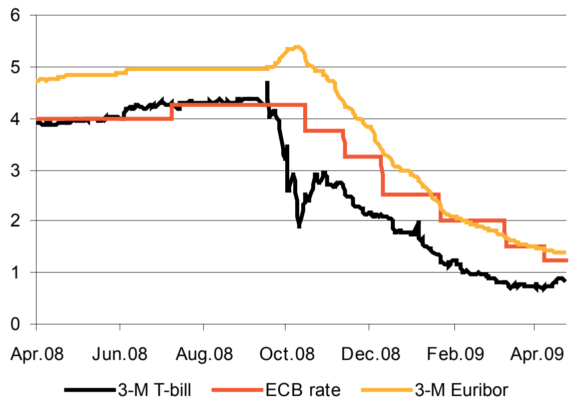
The economies of the three Baltic countries are tightly connected, and processes in one country may affect others as well. However, this mutual dependency should not be overestimated, as a lot of trade between the three countries is actually mediated products from other countries[2]. The indirect impact has recently been the concern and this is felt through investors' and trading partners' attitudes.

Despite the high risks there are challenges opened in the crisis if local companies manage to make needed adjustments and diminish mistrust toward Baltic countries.

1. These difficult times force companies and consumers to look more closely at the prices of the products. In these terms, Baltic countries could benefit from transferring production from more expensive countries, and so making wider selling possibilities like what happened in the beginning of the decade. This factor is particularly supported by the strong cost cutting and deflation pressures in the three countries.
2. Although trade volumes have fallen globally, Russia's interest in exporting has grown, so the trade volumes originating from Russia would probably remain relatively strong (but they will still decline).

The situation in global financial markets remains tense, although there have been brief periods of optimism (the recent ones in March and April ended with another deterioration at the end of the month).

Euro-zone interest rates



Source: ReutersEcoWin

2 E.g. transport vehicles took 15.1% of Estonian trade with Latvia and Lithuania in 2007, and 10.1% in 2008. The fall was almost 29% in 2008 (trade itself grew by 6.5%).

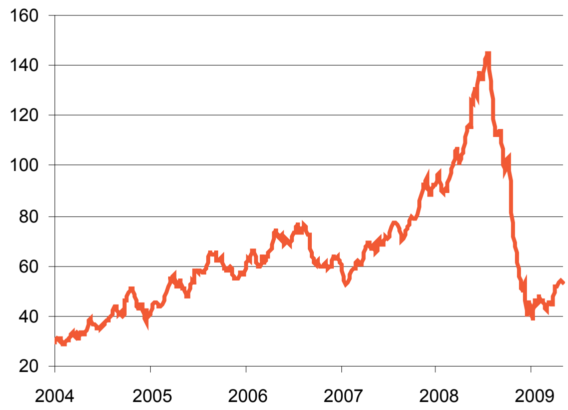
Global interest rates have continued to decline as central banks cut rates and risk margins diminish together with a very gradual recovery of trust. The situation is different in "risk regions" where the three Baltic countries belong. So, although interest rates in Estonia and Lithuania have stabilized, risk margins are up. Latvian interest rates have continued to increase until recently, as the economic situation there continues to deteriorate and the outlook for further problems in the budget is evident (see country texts).

Policy rates will be not increased in near future; actually markets are still counting on additional cuts in the Euro zone. However, in many countries (e.g. the USA) the possibility of interest rate cuts has (almost) exhausted as interest rates are close to zero. The increase in policy rates will most likely take place only in 2010 if the global economy starts to recover and inflation risks pick up.

The dollar has strengthened after September's events in the financial sector, as markets assessed the economic policy of the Euro zone (and the EU as a whole) as not being effective and targeted enough , which highly contradicted the assessments given to the proposed steps of the US government. Starting from December, euro/dollar exchange rate has fluctuated depending on expectations regarding US government policy. However, there is a very strong fundamental reason to expect that the dollar will weaken in future as US government debt is about to increase substantially, while the Euro zone's debt growth will remain modest according to currently-known plans. It probably will not happen in 2009 as the Euro zone economy is considered to be less successful than the US this year.

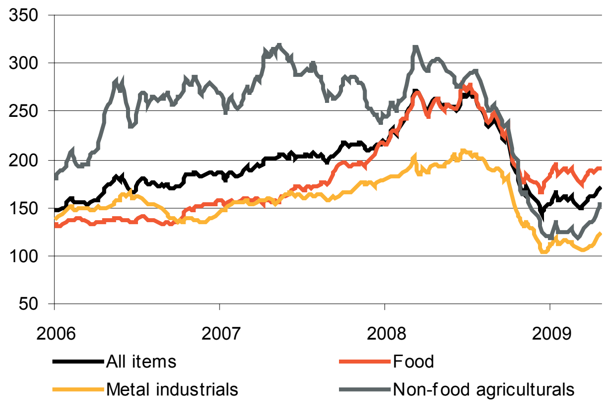
After a sharp fall in autumn (Sept-Oct) prices of industrials and raw materials have been more-or-less stable starting from late December. The production cuts have kept prices from falling further, while weak demand is a major obstacle for the growth. This applies to oil and food prices, although in the timber and paper sectors price developments have been contradictory. Namely, the prices of timber have continued to decline, as the construction sector remains in trouble all over the world, while paper and pulp prices have stabilized similar to the prices of

Oil Price, Brent, USD



Source: ReutersEcoWin

The Economist commodity price index, USD



other commodities. Food prices have fallen to very low levels, thus putting very strong pressure on the industry in the Baltic countries (particularly on the dairy sector).

Weak demand and the burst of the price bubble have ended up with oil price fluctuating around USD 40-50 for several months. OPEC has kept the price level with the help of several production cuts. It seems that a further fall in oil prices is unlikely, but an increase of price levels also looks unlikely in next months. However, a recovery in the global economy will end up with a higher level of energy prices.

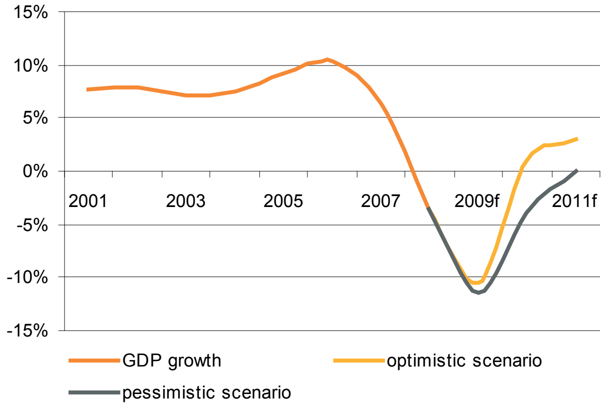
Maris Lauri

Estonia

	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	7.5	9.2	10.4	6.3	-3.6	-10.5	0.0
GDP, EURm	9,651	11,091	13,104	15,270	15,860	14,100	14,000
GDP per capita, th kroons	111.9	128.9	152.6	178.1	185.1	165.0	165.0
euros	7,153	8,239	9,754	11,381	11,830	10,550	10,550
Growth of industrial production, %	10.5	10.9	10.0	6.8	-6.2	-15.0	3.0
Growth of GDP deflator, %	3.3	5.3	7.0	9.6	6.8	-2.0	-1.5
Growth of consumer prices, %	3.1	4.1	5.1	6.6	10.4	-0.5	0.0
Growth of harmonized consumer price index, %	3.0	4.1	4.5	6.7	10.6	-0.3	0.2
Growth of producer prices, %	2.9	2.1	4.5	8.3	7.2	-3.0	0.0
Harmonized unemployment rate (average), %	9.7	7.9	5.9	4.7	5.5	12.0	13.0
Real growth of average monthly gross wage, %	5.1	6.1	10.5	13.0	3.5	-3.0	0.0
Growth of exports of goods and services, %	16.8	26.0	19.2	6.9	6.6	-16.0	2.0
Growth of imports of goods and services, %	16.2	23.5	26.6	7.5	-2.3	-22.0	0.5
Balance of goods and services, % of GDP	-7.4	-6.4	-11.8	-11.3	-4.3	1.0	2.5
Balance of current and capital account, % of GDP	-11.0	-9.2	-14.6	-16.9	-7.7	1.5	3.5
Inflow of FDI, % of GDP	7.4	20.8	14.6	12.8	8.6	4.0	5.5
Foreign gross debt, % of GDP	76.1	86.2	97.4	112.3	108.1	105.0	100.0
General government budget position, % of GDP	1.7	1.5	2.9	2.7	-3.0	-3.0	-3.5
General government debt, % of GDP	5.0	4.4	4.0	3.0	2.6	3.5	5.5

The outlook for the near future is not good for the Estonian economy. Risks in the global economy remain high, although uncertainty in the global economy has somewhat lessened compared to autumn 2008. However, the approaching elections (the EU parliament on June 7th, local on Oct 18th) are affecting relations inside the coalition, making decision-making difficult. Even the optimistic scenario, which assumes that the negative risks will not materialize, will end up with the Estonian economy falling 8-10% in 2009 and showing only a slight recovery in 2010. Our base scenario is based on the assumption that some of the negative risks will materialize partly, and these will cause a ca 10-12% decline in the economy this year, a slight decline in 2010, and a recovery starting only in mid-2011. Our pessimistic scenario is based on the assumption that some of the negative risks will materialize fully (e.g. very deep global recession, failure of the government to adapt budget for fulfilling Maastricht budget criterion).

Real Growth of GDP



Source: ESA, SB forecast

We expect consumer prices to decline by 0.5% this year. The next year will bring a slight growth if the economy develops according to our optimistic or base scenario and a deeper fall in price level in case a pessimistic scenario unfolds. The average unemployment rate will reach ca 12% this year and 13% next year, decline starts only if the economic developments follow the optimistic or base scenario. The current and capital account will have a surplus in this and the next years, but the size of the surplus will depend on the deepness and length of the economic decline.

We estimate that the probability of the Estonian economy proceeding according to the optimistic scenario is ca 25%, the base scenario 55% and pessimistic scenario ca 20%. The risk scenarios are most of all dependent on external developments, but they include also failure to adapt euro in 2011. The optimistic and base scenarios end with Estonia entering the Euro zone in 2011.

We see three major negative risks for the Estonian economy now[1]. First, from the prolonged and deep global recession, a further escalation of the financial crisis, and bigger countries' ineffectiveness in dealing with the crisis affecting Estonian

1 There is also a deflation risk as in other countries. We are of the opinion that this risk will not materialize in Estonia in this year due to the flexibility of the economy and a high dependence on exports-imports. Still, the external developments, i.e. deep deflation in main trading countries, may have a rather serious impact on the Estonian economy as well.

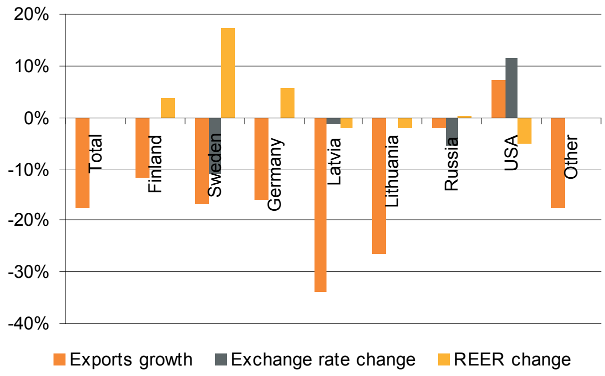
Please see important disclosures on last page

exports and investments negatively. Second, a sharply deteriorating situation in neighbouring countries, especially in Latvia, would negatively affect the economic relations and financial situation of Estonia, forcing authorities to take extraordinary measures, which will sharply worsen domestic demand. The third risk is related to domestic policy: that the Estonian coalition government will fail to make timely steps for keeping the budget deficit in the 3% of GDP limit. The worst outcome of this risk scenario would be a prolonged political crisis.

1. External Demand

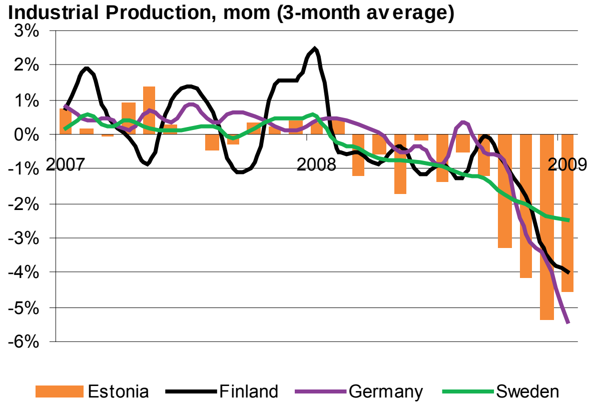
We are of the opinion that the sharpest quarterly fall in demand was in the 4th quarter of 2008, however the 1st quarter of 2009 will be not very easy as well, and we will see the sharpest annual decline in the 1st and 2nd quarter. The sharp fall in the demand has affected Estonia's main export countries – Finland, Sweden and Germany – and that has ended up with falling industrial production and exports of Estonian-produced products. We cannot expect a significant improvement in merchandise exports until those three countries show even the slightest recovery. The weak demand in Latvia, Lithuania and Russia is most of all affecting mediated trade flows (i.e. exports and imports of goods, and related services), but is also setting limits for Estonian-produced exports. The services exports are affected by weak global demand as well, but have

Exports in Nov 2008- Jan 2009, annual growth rates



Source: ESA, EcoWin, EP, SB calulations

Estonian, Finnish, Swedish and German Industrial Production, mom (3-month average)



Source: EcoWin, SB calculations

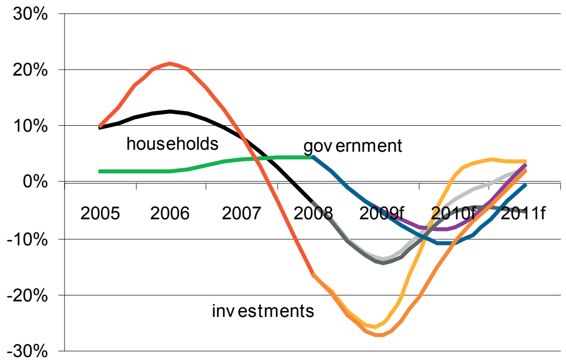
better room for expansion once the global economic situation stabilizes and Estonian companies have passed majority of the adjustment process (see below).

If the global economic situation stabilizes, then there is a possibility of an exports recovery in Estonia. However, there is risk that the recovery in the global economy will be delayed and that it will affect Estonian producers and exports as well. That in turn will affect the Estonian economic recovery, as this is dependent most of all on exports. We also want to stress that the annual growth rates of exports will remain negative at least throughout 2009.

2. Domestic Demand

Domestic demand will fall sharply in 2009, and annual growth will resume at best in the 2nd half of 2010, but the pessimistic scenario foresees recovery only in 2011.

Growth Rates of Domestic Demand Components in different scenarios



Source: ESA, SB estimates

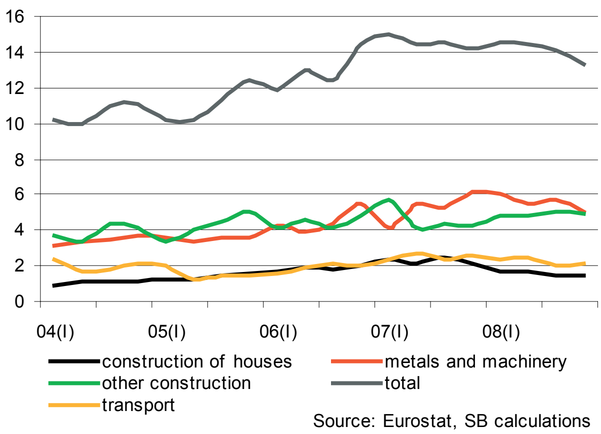
We expect **household consumption** to show an annual decline at least until the beginning of 2010, most likely to the middle of the year. It will be most of all affected by unemployment growth and pessimism, which cuts households' incomes and forces them to increase precautionary savings. In 2009, household consumption will be down 12-15% depending on the scenario.

Investments are expected to fall 20-30% depending on the scenario, and that includes a correction of inventories. The latter, however will take place largely in the beginning of 2009. The decline of investments could be deeper, if not with the EU funds[2], which will support spending in the public but also in the private sector. Infrastructure objects are expected to benefit most from EU-funded investments (some other areas like agriculture, R&D investments etc. will benefit as well). The co-financing of the projects will be solved with the help of borrowing and guarantees. The replacement of post-factum financing with operative financing will be an important factor for supporting EU-funded investments and the economy. Oth-

2 We have become a bit more pessimistic due to sluggish administrative process recently, but hope that the situation will improve at least in the 2nd half of 2009.

erwise, the fall in investments will be deeper, and the economic decline as well.

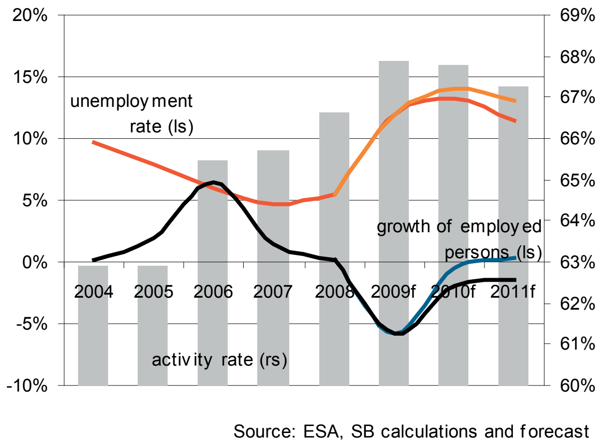
The recovery in investments will depend on the use of EU funds, enterprise confidence and the availability of external financing. Both domestic and external borrowing are possible sources for the latter, but also FDI. The use of external financing is currently limited, with low confidence and elevated risk margins. The factor, which will have positive effect on investments, is deflation, which makes investing cheaper and allows for making more investments than few years ago (and affects most of all EU funded investments).



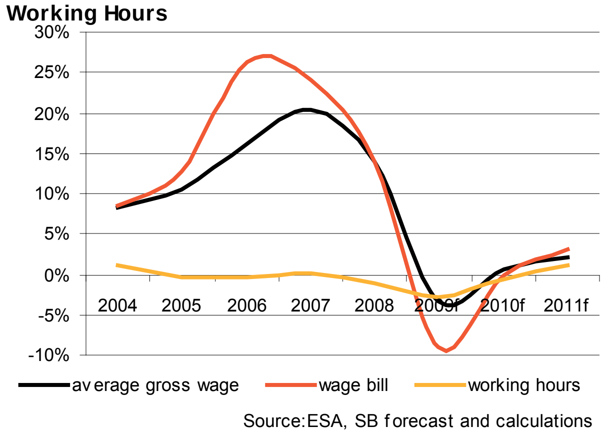
Government consumption is expected to fall in this and next year as government funds are limited and it tries to keep the budget deficit below 3% of GDP level. The government has reserves for covering the deficit, but loans will be used as well (for covering co-financing of EU funded investments).

3. Labour Market

We expect the average **unemployment** rate to soar over 12% this year and a decline to appear only in 2011. According to the pessimistic scenario, the unemployment level will exceed 13%, and risk scenarios point to even higher levels of unemployment. We expect that the number of **employed** persons will decline 5-6% in 2009 and 1-2% in 2010. The labour market will be affected by the declining number of working-age population (ca 0.6-0.7% p.a.), but also with sharply decreasing non-activity: the number of non-active persons will decline by 4-5%, most of all because people will list themselves as unemployed. This process was very intensive in the 2nd half of 2008 and in the beginning of 2009. The activity rates are expected to diminish in 2010 as many long-term unemployed will give up looking for a job, or will leave the country. This affects the Estonian unemployment rate: while currently we can see unemployed persons returning to Estonia, in the future we forecast **labour outflow** to increase, if the economic situation in the richer countries of the EU improves. The extent of future labour outflow depends on economic developments in Estonia: the higher the unemployment rate and the deeper the cuts in wages, the bigger the outflow will be. The labour outflow increases the risk that in ca 5 years Estonia will again have a period of very strong wage growth as a labour shortage will be extremely acute due to the falling number of working-age population.



We expect very sharp decline in **wage bill** in 2009 – it may happen that per worker an over 30% decline in wage income would not be a surprise – as besides cutting employment, wages and working hours would also be cut. It is estimated that, on average, bonus payments comprise ca 15% of total monetary compensation in Estonia. This part of wages are easy to cut, and we assume that it will happen (actually has already happened). Many companies have reached agreements with workers about cutting base wages (we estimate 10-15% of employed are affected), and/or working hours. The latter are cut due to a smaller number of orders and a temporary closure of factories. Cuts in working hours are affecting probably some 5-10% of companies during 2009 (but not all at the same time). Still, the average monthly wage decline will be smaller than the fall in total wage bill as the average wage is calculated on the assumption of full-time employment, and layoffs have so far affected mostly low qualified labour. Still, this tendency is about to end soon, as together with the deepening of the crisis, other categories of workers are affected.

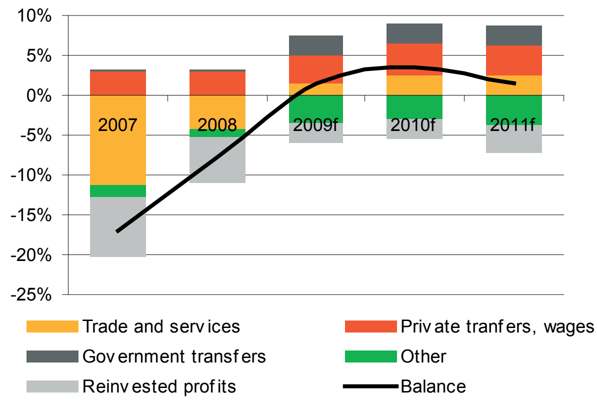


4. External Balances

We expect the Estonian **current and capital account** to be in surplus in 2009-11. The surplus will be 3% of GDP or even more, according to the base scenario in 2010, and over 5% according to the pessimistic scenario. The replacement of the deficit with a surplus will be the result of several processes.

1. Although exports are diminishing, the decline in imports has been and will be deeper until the economy finds a strong growth path. We forecast that the trade and services surplus will be 2-4% of GDP in 2010, if not more.
2. Difficult times have cut profits that foreign companies are earning in Estonia. The outflow of reinvested earnings (from FDI) has diminished substantially and we expect that process to continue in 2009. Stabilisation may come in 2010, but even then it will not bring a growth in outflow.
3. Depending on the intensity of the deleveraging process, we expect that the net interest payments growth will slow and then diminish. This process will be seen mostly in case the pessimistic scenario prevails in the economy.
4. Net inflow of transfers will increase. We expect a substantial increase of flows from the EU, but also from private sources. At the same time, the outflow will diminish as the Estonian EU payment will be smaller and the private sector will have fewer resources for supporting those abroad.

Current and Capital Account, % of GDP

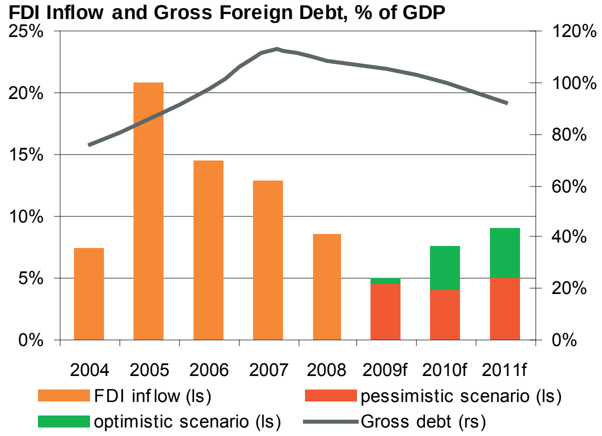


Source: EP; SB calculations and forecast

FDI inflow will be smaller than in the previous year, but will still be relatively strong (4-5% of GDP in 2009-10) as many foreign-owned companies remain profitable, and will usually keep their investments in Estonia (no profit disbursement). Depending on global developments and risk estimates, we can expect FDI inflows to Estonia, as investors look for cheap and attractive assets. This development is related to the M&A process. The factors affecting risk estimates are crucial also for other types of investments (first of all investments to stocks, loans to private sector). The outlook for Euro adoption could be a major trigger for an increase of capital flows to Estonia, and for lower risk estimates.

We forecast that the deleveraging process will bring down the Estonian **debt level**; however, this process cannot be rapid. We do not expect problems related to foreign loans. It is often assumed that the Estonian banking sector's short-term debt level is very high; however the figures allegedly indicating that are result of the particularities of statistics. Namely, all loans given by mother banks to their local subsidiaries are reported under line "cash and deposits", which are assumed to be short-term money, even if they actually are long-term (i.e. over 1-year) money[3].

FDI Inflow and Gross Foreign Debt, % of GDP



Source: EP, SB forecast and calculations

5. Prices and Competitiveness

Estonian **consumer price** growth has slowed rapidly and we expect a slight fall in the total price level this year. An annual decline of CPI is expected by the summer, and at the end of the year the decline may be rather significant (2-3% is most likely, a deeper fall is possible according to the pessimistic scenario). The pessimistic scenario foresees a ca 3% decline of CPI in 2010. The GDP deflator is expected to fall 2-3% this year.

Production prices are already falling, and we expect the decline to deepen in the 2nd half of this year. The sharpest decline will be in investment-related sectors and areas. The global fall in prices will be one reason for local price falls, but Estonian companies will make their own very intensive steps to improve their competitiveness which was lost during the boom in 2006-2007.

The exporting sector, where the overheating was relatively small, will be able to adjust with the help of cuts in labour costs and lower profit expectations. For exporters the major problem now is not price, but the demand. Our analysis points that although the currencies of several countries have depreciated

3 According to conservative estimates, approximately half of money reported under "cash and deposits" originates from mother banks.

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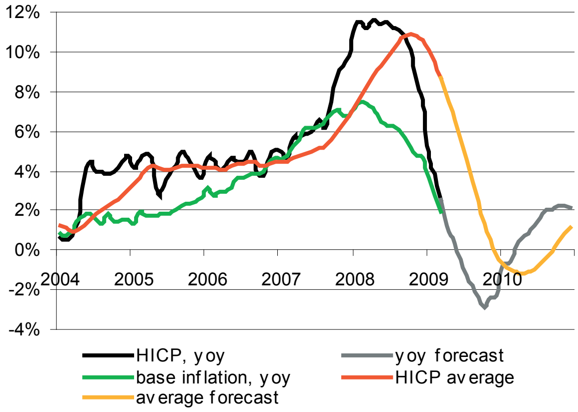
significantly (e.g. Sweden, Russia) this has not been a major reason for the decline in exports to those countries (although some companies might have suffered) as exports to those countries has not fallen the most (see chart).

Harmonized Index of Consumer Prices



Source: Eurostat, SB forecast

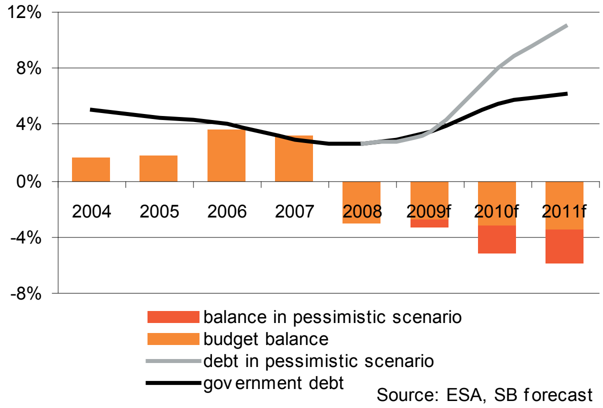
Estonian companies have made substantial **adjustments** in the 4th and 1st quarter by cutting labour costs, lowering profit expectations, lowering inventories, and rearranging their production processes (e.g. cutting other costs, increasing efficiency). This short-term response to the deterioration in demand should stabilize production and exports during the next quarters (i.e. we expect close to zero growth/decline mom and qoq rates). The increase in productivity through improvement and modernization of production requires additional funding and time, and is necessary for long-term development and for the Estonian economy to recover from the crisis. This, however, would require lower risk estimates and better access to capital, but also improved confidence and expectations.

6. Economic Policy

We are of the opinion that Estonia has a good chance of fulfilling **Maastricht criteria** in the autumn of 2009 or spring 2010, which makes it technically possible to adopt the Euro in mid-2010 or more likely in 2011. There are currently two problematic areas: inflation and budget deficit. The average growth of CPI will fall below the required level in October, or in September. The biggest hurdle is the fulfilling the budget deficit criterion (3% of GDP). According to the preliminary information, the Estonian budget deficit in 2008 was 2.97% of GDP and hence Estonia fulfilled the budget criteria. Still, the second updated release of the budget figures (on Sept. 30th) may change the result. There will also be a revision of GDP data in the beginning of September[4].

The Estonian government has to make cuts in the budget. This is not so much a question of regular assessment in spring 2010, but for the sustainability of the budget position. There is also a question of deficit financing.

Public Sector Budget Balance and Government Debt, % of GDP



Source: ESA, SB forecast

Our estimates suggest that if there will not be additional changes in the budget, the deficit will reach at least 3.4% of GDP, and that would not make it possible to join with the Euro zone, which means a further deterioration of confidence and a weaker economic outlook.

The budget sustainability is threatened by the inflexibility of budget spending: it is estimated that ca 72% of Estonian state budget spending is driven by entitlements and tax earmarks. Those spending items are hard to cut, which in the situation where incomes are falling or growing slowly, poses a serious threat for public finances. Therefore, there is a high need to make principal changes in revenues-spending linkages, increasing efficiency of public services and finding additional revenues. At the same time, the government cannot forget the immediate needs to support the economic changes (e.g. labour market, economic recovery).

Although the Estonian government has a relatively big amount of reserves (ca 6% of expected annual GDP at the end of March), they are not exhaustible – if the budget deficit is not limited to 3% of GDP and no additional sources are used, the reserves will be obsolete by the middle of 2010. Currently there is no good access for additional financing: besides a few suppliers, the cost of borrowing is high (the interest rate is estimated to be around 8-10%). The government has turned to the EIB for getting a 5-year loan for covering the co-financing needs of EU-funded investment projects. The funds will most likely be disbursed through commercial banks. It is possible that the government will take some other loans, but the lending cost will be looked at very closely.

In this situation, it is not surprising that the government has very few opprtunities for further economic stimuli. Still, we are of the opinion that some opportunities remain most of all in lowering administrative barriers and increasing flexibility in the use of funds (e.g. money from the EU social fund for the re-training of unemployed persons).

4 According Statistics Estonia, changes will increase GDP in current prices during the period of 2000-2005; of course there is a possibility that GDP for 2008 will be lowered.

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We are of the opinion that the government should make needed changes in 2009's budget as quickly as possible. The increase in unemployment insurance rates and freezing payments to the 2nd pension pillar[5] are those already decided. The unbinding of spending from revenues is one important step for reaching a better budget situation in 2010 and onwards. The changes in the social benefit system are required (to target those really in need), administrative and education reforms are highly needed[6]. Unfortunately, the approaching elections are seriously affecting decision-making in the government and irresponsible steps from some members of the opposition have been made. The government also has to look at ways to increase revenues.

We are of the opinion that Estonian authorities must make serious efforts to adopt the Euro in early 2011, as that would lower the risk margins currently applied to Estonia and increase investments and improve economic relations. The outlook of Euro adoption would have an immediate effect for Estonian risk estimations.

Maris Lauri

5 We are aware that this change is garnering some legal questions, and will undermine trust toward the pension system; however, we are also of the opinion that this step has a less adverse effect on the economy than cutting most of the other budget spending (e.g. investments, social benefits, etc).

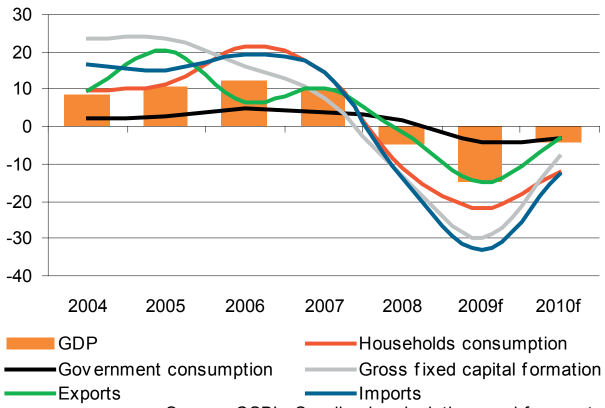
6 Administrative reform is not just merging municipalities, but also building a logical and effective system where responsibilities, commitments and resources (finances) are clear and bound together. Education reform should take into account the falling number of students, increase the quality of education and, most importantly, to shift the focus of professional and vocational education to the needs of the economy (e.g. increasing the intake of students into technical and natural science specialities).

Latvia

	2003	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	7.2	8.7	10.6	12.2	10.0	-4.6	-15.0	-4.0
GDP, mln euros	9,978	11,176	13,012	16,047	21,111	23,115	18,273	17,015
GDP per capita, euro	4,302	4,846	5,671	7,034	9,296	10,223	8,132	7,623
Growth of GDP deflator, %	3.6	7.0	10.2	9.9	20.3	15.2	-7.0	-3.0
Growth of consumer prices, %	2.9	6.2	6.7	6.5	10.1	15.4	2.0	-4.0
Growth of harmonized consumer price index, %	2.9	6.2	6.9	6.6	10.1	15.3	2.0	-4.0
Growth of producer prices, %	3.2	8.6	7.8	10.3	16.1	11.5	na	na
Harmonised unemployment level, %	10.5	10.4	8.9	6.8	6.0	7.4	17.0	19.0
Real growth of average net monthly wage, %	7.8	2.4	9.7	15.6	19.9	6.1	-16.5	-5.0
Growth of exports of goods and services, %	14.3	21.4	31.4	15.3	24.1	10.4	-25.0	-4.0
Growth of imports of goods and services, %	19.5	27.0	27.4	31.3	23.5	-3.3	-35.0	-11.0
Balance of goods and services, % of GDP	-12.7	-15.8	-15.2	-22.2	-20.6	-13.0	-4.0	0.0
Current account balance, % of GDP	-8.2	-12.8	-12.5	-22.5	-22.5	-12.6	0.0	1.0
Current and capital account balance, % of GDP	-7.5	-11.8	-11.2	-21.3	-20.6	-9.8	1.5	3.0
Net FDI, % of GDP	2.3	3.8	3.6	7.5	6.7	3.3	2.0	3.0
Foreign gross debt, % of GDP	79.5	93.3	99.4	114.0	127.6	128.2	170.0	190.0
General government budget, % of GDP (ESA)	-1.6	-1.0	-0.4	-0.2	0.1	-4.0	-7.5	-6.0
General government debt, % of GDP	14.6	14.9	12.4	10.7	9.0	19.5	32.0	40.0

During 2008 GDP contraction accelerated from -0.5% yoy in 1Q to -10.3% in 4Q which was set off by a domestic demand contraction due to the real estate bust in 2Q 2007 and reinforced by an export contraction in 2H 2008 due to the deepening global recession. With falling economic activity and a worsening outlook, unemployment has been rapidly rising since late 2008. Remuneration packages are being cut aggressively, to offset the earlier excessive wage growth, as the private sector seeks to improve its external competitiveness and the public sector seeks to balance its books in an environment of falling revenues. Weakening confidence and a tightening credit market have undermined investment activity and consumption. On the positive side, falling imports have improved the current account faster than expected. CPI inflation has decelerated and monthly deflation is about to set in. The new government took office on March 12th, and while there is a shift

Real Growth of GDP by Expenditure, yoy, %



Source: CSBL; Swedbank calculations and forecast

in the agenda towards long-overdue structural reforms, solid results are yet to be delivered. The IMF postponed its second trench due in March 2009, as the obligations vis-à-vis budget cuts and structural reforms had not been met.

Compared to the previous Baltic Outlook, we expect the recession to be deeper. Key drivers for the forecast revision are: (i) a deeper global recession; and (ii) further worsening of the fiscal situation partly because of delays in implementing structural reforms. This will cut into foreign and domestic demand and result in higher unemployment levels, which we expect to peak at close to 20% in 2010. Nominal incomes will fall by close to 20% in 2009 and a period of annual consumer price deflation will set in this summer. We have pencilled in ca 15% real GDP contraction in 2009 and a further ca 4% in 2010 (-10% and -2% before, respectively) with the sharpest drop in activity in 1H 2009, followed by a gradual lessening in the speed of qoq contraction. We expect the recession to bottom out in mid 2010 with economic activity falling to the levels of 2003–2004, i.e. before credit-driven consumption boom period. As to the recovery we retain our earlier view that export-driven growth will commence in 2H 2010 and we will see modest positive GDP growth in 2011. We can point to some positive risks such as a swifter recovery in global trade, but the key risks to the forecast are strongly skewed to the negative side. Namely, the timing/depth of the global recession and the government's ability to access the IMF-supported funding programme. Last but not least, very high volatility in data series produce wide numerical forecast ranges with relatively minor input data changes. Our baseline scenario assumes that structural reforms are undertaken swiftly and external funding is obtained without significant delays.

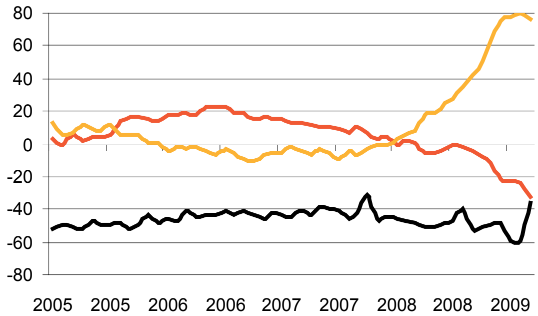
1. Domestic Demand

Real **household consumption** retreated during 2008 in an accelerated manner as its growth slid from -0.5% yoy in 1Q to -20.1% in 4Q. We expect this trend to ensue and consumption to shrink by more than 20% in 2009 and at least a further 10% in 2010. With the strongest income and employment reduction signals concentrated in early 2009, we expect the steepest qoq contraction in consumption to take place in 1H 2009, and then gradually subside. Deflation trends strengthening in 2H 2009 will support the purchasing power of households as their real incomes will not retreat as much as nominal ones.

This forecast presumes that the contraction in household consumption bottoms out in late 2010/early 2011 when consumption volume returns to its 2003 level, and its share in GDP shrinks to ca 55%, i.e. a temporary dip below its historic average of ca 60–64% (it was 72.4% at its peak in 2007). The key drivers of household consumption are expected to be the following:

- **Falling confidence.** Households see their financial situation worsening as unemployment is expected to grow; they plan to reduce major purchases over the next 12 months. Deposit volumes are falling, but according to our estimations on account of high-income large deposit holders, whereas low-income individuals increase their precautionary savings and thus reduce their consumption. According to the surveys only ca 20% of households expect to be able to increase their precautionary savings over next 12 months resulting in limited support to consumption as recession deepens.

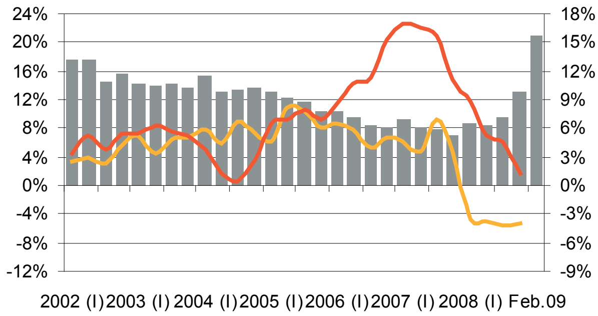
Consumer Confidence, s.a.



Source: Reuters EcoWin

- **Decline in employment.** In 4Q 2008 employment shrunk by 5.4% yoy, which was the first contraction in the number of employed since 2000. With the global recession escalating, businesses have finally understood that their already-depleted reserves will not last through this recession, and they must shed labour. The harmonised unemployment rate quickly shot up from 6.4% in 1H 2008 to 11.2% in December and 15.8% in February 2009[1]. Public sector restructuring and negative labour productivity pressures in the private sector from the continued fall in economic activity will continue to push up unemployment, which we forecast to reach ca 19% in the end of 2009 and peak at 20% in 2010. As the weakest companies go out of business, positive labour productivity growth will resume in 2010. With the economy gradually recovering, a job creation commencing in late 2010 or early 2011 and renewed emigration flows, unemployment is expected to decrease in 2011.

Labour Market Indicators



Source: CSBL, Eurostat; Swedbank calculations

- **Decline in incomes.** Dissipating employee bargaining power permits remuneration cuts as companies seek to improve their competitiveness, which was impaired by earlier excessive wage growth and recent weakening of trade partner currencies. Anecdotal evidence hints that 20–30% cuts are not unusual. In addition, employees are often being shifted to part-time positions thus amplifying the effect on consumption. The public sector is guided by the IMF Stand-By Arrangement (SBA), which targets the 2009 public sector wage bill at 30% below its 2008 level (incl. ca 5% employment drop). We anticipate most of the income cuts to be done in 2009; as restructuring continues they will also drag into 2010 but at a significantly smaller rate.

- **The credit squeeze** has intensified as interest rates have risen and new lending standards have tightened, which are unlikely to ease well into 2010 thus undermining consumption (see Monetary issues).

A necessity to balance its books will result in diminishing **government consumption** in 2009 and 2010. Due to worsening global and local outlooks and increasing tax evasion govern-

1 2009 data is preliminary and most likely will be revised downwards, but the unemployment rise is truly rapid since the registered unemployment has also shot up to 10.7% in March 2009 from 4.9% in 1H 2008.

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ment revenues have been weaker than planned. The depth of government consumption contraction will depend on a trade off between price and real volume adjustments. To lessen the depth of real contraction and thus the subsequent negative effect on the employment, price elasticity should be raised (i.e. making prices easier to adjust downwards) via the public sector restructuring and a price transparency increase.

According to our estimates, in order to achieve the currently planned budget deficit of LVL 746m (as stated in SBA), it would be necessary to cut about LVL 1bn in expenditures (ca 16% of total). To diminish over-sized public expenditures, several measures have been undertaken, e.g. non-indexation of pensions, cuts in wages, a temporal cut in the share of social tax payments going to the 2nd Pillar pension scheme from 8% to 2%. However, current expenditures have still been rising in 1Q 2009 by 11% yoy. There has been a shift in economic policy from linear across-the-board cuts in expenditures to long-overdue structural reforms, but in our opinion the government is still lagging in its response to developments in the economy and a considerably more pro-active down-to-fundamentals revision of functions and activities is necessary. The government should set clear long term priorities where further systemic cuts are possible. Discussions are very often considering the issues on how to cut cost in the current system and make the current system more efficient, while in many cases changing the system itself would be a more efficient solution (e.g. in education, health care and public administration). Required **sustainable** cuts in expenditures can only be achieved via structural reform. Main items of the structural reform should involve: (i) a reduction of oversized public administration[2] and a restructuring of inefficient state sector (e.g. education and health care), and (ii) an enhancement of business environment (i.e. reducing administrative barriers to entrepreneurial activity and supporting the economy through the government guarantees etc.). Deviations from the budget target (but not far from 5%) will be addressed only when structural reforms are clear; however, even a higher budget deficit of 7.5% of GDP will still require about a LVL 0.7bn cut in expenditures (ca. 11% of total currently planned expenditures).

The implementation of reforms is urgent; if the reduction in expenditures is delayed, it will carry over into 2010-2011 and jeopardize introduction of euro in 2012. Given that Latvia has not accomplished several important tasks so far (e.g. the supplementary budget should have been approved until March) the EUR 200m instalment from the IMF that was supposed to be paid in March was postponed. Uncertainty remains how the government will proceed and what the specific measures to be executed will be. Failing to draft and implement sustainable cuts puts the availability of external funding at risk, as well as intensifies and prolongs the recession. The supplementary budget for this year is planned to be approved by the end of June. The IMF technical mission will be in Riga in late April to discuss the progress. Conditional on sufficient progress in reforms, the next instalment of about EUR 400m from the IMF3 and EUR 1.2bn from EC would be available in June/July. However, if the IMF decides not to disburse the money due to poor reform implementation process, given that this is a joint programme, it is extremely unlikely that other lenders will step in.

General Budget, Annual Growth Rates %

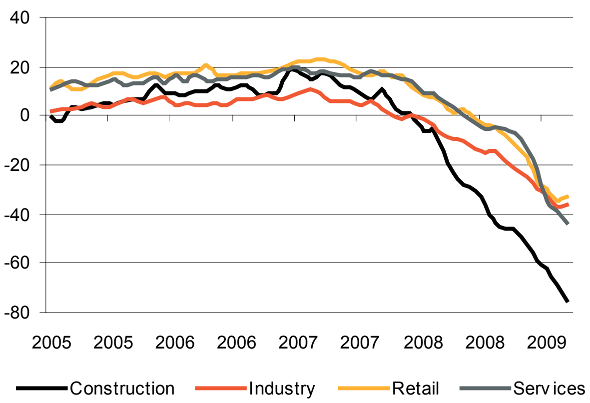
	2006	2007	2008	1Q 2009	1Q of 1Q plan
Net revenues	25.7	33.5	6.4	-10.4	-
Tax revenues	30.3	34.4	11.9	-14.7	98.1
Personal income tax	29.1	35.1	15.2	-15.8	106.4
Social tax	28.1	37.7	21.1	-8.1	112.0
Corporate income tax	40.5	57.5	25.9	-10.2	138.3
VAT	37.4	29.3	-7.1	-28.6	74.6
Excises	16.6	22.3	20.7	0.0	87.2
Customs	7.6	34.4	-5.2	-28.6	132.5
Non-tax revenues	13.1	21.7	8.6	-26.8	85.2
Net expenditures	24.4	28.0	18.4	9.4	-
Current expenditures	23.3	27.5	23.6	11.1	-
Capital expenditures	39.3	40.6	-1.8	7.1	-
Budget balance, % of GDP	-0.2	0.1	-4.0	-1.1	-

Source: State Treasury, State Revenue Service; Swedbank calculations

We leave our investments forecast unchanged at -30% in 2009 (excl. inventories). The contraction is expected to be mostly on account of investment for domestic demand purposes, while the recovery in late 2010 will be mostly driven by investments for export purposes. Export-oriented sector is anticipated to be the earliest to recuperate and provide incentives for investing. Overall, we expect gross fixed capital formation to return to 2004 levels. The factors that will drive investments down are:

- Investments in construction works, which is the most vulnerable position, comprise approximately half of the total. Real estate prices continue to drop (down by

Business Confidence, s.a.



Source: Reuters EcoWin

2 E.g. according to the State Chancellery, 14% of employed persons in Latvia work in public administration and this figure should be reduced to ca 8-10%.

3 Of which EUR 200m is the postponed instalment for 1Q and EUR 200m is the 2Q instalment.

more than 60% from their peak in May 2007) thus undermining construction industry developments.

- Businesses are not willing to invest as there is high uncertainty about both future global developments and domestic economic outlook.

- Businesses have fewer resources to invest because their profitability deteriorates and banks have become more careful in credit issue as credit risks have increased. Deflation makes the deleveraging process deeper for companies as their liabilities rise and credit risk increases (see Monetary issues).

- Slow insolvency and bankruptcy processes according to current law make it time consuming for companies to acquire bankrupt businesses.

On the positive side, investments will be supported by EU funds inflows and public sector procurements, as well as by foreign direct investments that might take advantage of low asset prices (albeit negative reinvested earning will drive FDI down). In addition, prices are expected to go down thus making investments less expensive.

As the recession gradually bottoms out, we shall see a fall in inventories. Inventories should decrease both due to smaller purchases, as well as asset revaluation due to deflation. So far inventories have been growing (albeit the growth has decelerated), indicating that the recession is still to deepen further.

2. External Balance

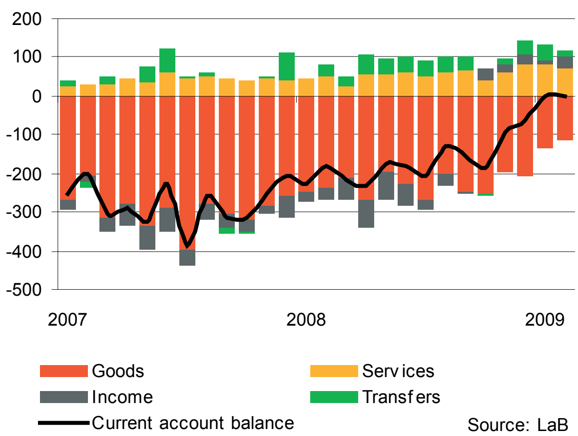
The current account deficit decreased throughout 2008 and there was an unexpected marginal surplus in 2m 2009. We forecast current account to be roughly balanced in 2009, with deficit or surplus likely not to exceed few percent of GDP. The factors that will improve current account in 2009–2010 are:

- Key adjustments will come through the **trade account**. The necessity to improve the current account, i.e. drying up of funding, puts downward pressure on imports. The stronger is the fall in exports due to global recession, the more imports should be reduced. Although the gap between exports and imports has continued to diminish rapidly, it was still about 10% in February 2009 (35% in Feb 2008).

- **The income account** is expected to contribute positively, as interest payments are not expected to increase substantially due to falling world interest rates. Negative reinvested earnings will statistically result in an income account improvement.

- **Current transfers** are expected to be relatively stable, supported by the acquirement of EU funds for the new budgeting period.

Current Account, LVLm



Source: LaB

We expect nominal **exports** to fall by ca 25% in 2009, with a downside risk due to global uncertainty. Sharply deteriorating world demand significantly hit goods exports – the most vulnerable are wood and metals industries, both owing to unfavourable price developments and the construction downturn in the world. The forecast drivers are the following:

- Export prices are expected to diminish in 2009 both because of necessary cuts in exporters' costs to improve competitiveness, and decreasing world prices (especially wood, metals, food).

- The decline in goods exports volumes is mostly influenced by the fall in external demand, which is supported by the rise in the protectionism.

- Services exports are expected to remain relatively stable – travel from neighbouring countries is likely to remain steady (substituting for expensive distant trips); the demand for business services (e.g. financial or IT services) probably will not disappear.

With the world economy recovery expected in 2010, businesses will see the opportunities for profits in exporting industries. Export recuperation in late 2010 is anticipated to be the factor driving the Latvian economy out of recession.

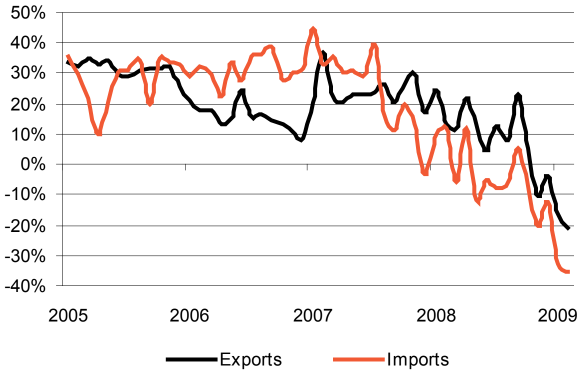
We forecast nominal **imports** to decrease by ca 30% in 2009. The sharp domestic demand contraction resulted in a rapid decline in goods imports mostly due to cuts in private consumption, particularly in luxury goods, cars, durables, etc. The forecast drivers are the following:

- With lower incomes and increasing unemployment, households revise their consumption, and such goods as cars and household durables are the first to be given up. Also imports of mineral products (oil, etc.) will suffer due to fewer cars, lower production. With investments retreating there will be less demand for investment goods, e.g. machinery and equipment. Service imports (both passenger and freight) are to decline as well, albeit to a lesser extent.

- The effect of decreasing prices is less pronounced than that of exports, but still import prices are to decline due to global deflationary pressures and devaluations in trade partner countries[4].

The contraction in imports will continue into 2010, albeit at a lesser speed than in 2009, due to a milder contraction in domestic demand. The main risk to the forecast is a sharper than expected decline in private consumption which would restrain imports.

Nominal Growth of Exports and Imports of Goods and Services, yoy



Source: LaB; Swedbank calculations

3. Monetary Issues

Our **consumer price inflation** forecast for 2009 is ca 2%. Although monthly price inflation resumed in January–March mainly due to tax changes and increases in administratively regulated prices[5], annual CPI growth rates have continued to decelerate to 8.2% in March. We anticipate monthly deflation to resume in April and annual deflation to set in by late summer, reaching ca -4% in December. The forecast drivers are the following:

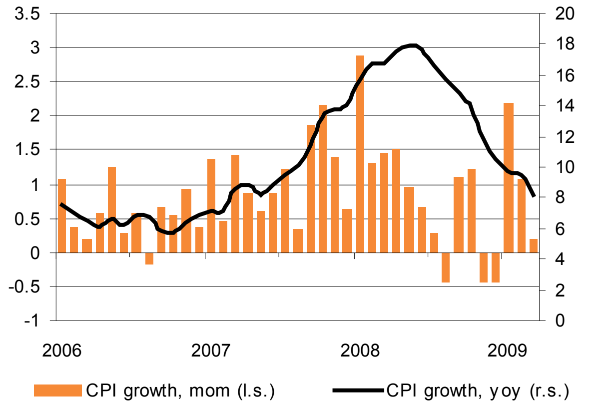
- Although there are planned declines in natural gas and heating tariffs (due to world price developments) and some transport tariffs, administrative decisions overall will increase CPI inflation (e.g. rise in VAT and excise tax , health services' prices).
- The main downward price pressure comes from moderation of private spending. This will be particularly noticeable in prices of durables, clothing, recreation services, etc.
- According to our estimates the positive output gap turned to negative in 2008, meaning that GDP growth is now under its potential level. The increase in spare capacity will push prices downwards (e.g. capacity utilization in manufacturing started to decline in early 2008).

4 E.g. ca 25% in Russia, ca 10% in UK, ca 20% in Sweden.

5 There was a substantial rise in patient payments in hospitals and in out-patient treatment in March (2.7 times more in some cases).

In 2010 average CPI change is expected to reach at least -4% but this is fully the result of the base effect (i.e. prices remaining stable in 2010). Due to delays in structural adjustment deflation might carry on into 1H 2010, and thus price decrease in 2010 might be significantly deeper. There is also a risk of a debt-deflation process, which is likely to strengthen deflation pressure in 2010[6].

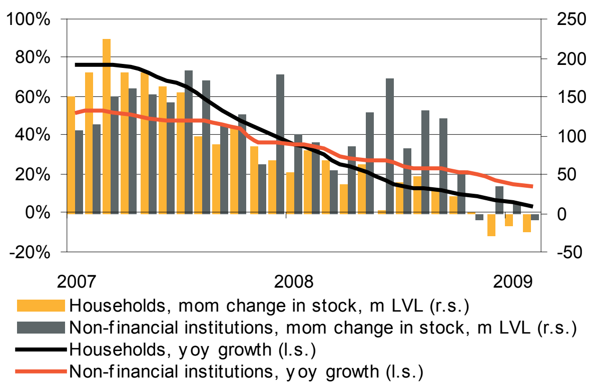
Consumer Price Inflation, %



Source: CSBL

LVL credit **interest rates** continue to increase both due to growing risk margins and rising RIGIBOR. Although EURIBOR has decreased substantially, EUR credit interest rates in the local market are relatively stable due to rising risk margins. This together with tightening standards intensifies the credit squeeze for new lending. Household credit stock has been shrinking for the third consecutive month and weak demand suggests that it will continue to do so as the recession deepens. The worsening economic outlook precludes both credit supply and demand thus largely making it impossible to flood significant amounts of credit into the market and undermining private consumption and investments. The credit squeeze is likely to last into 2010 as credit quality deteriorates and bank

Loans to Resident Households and Non-financial Institutions

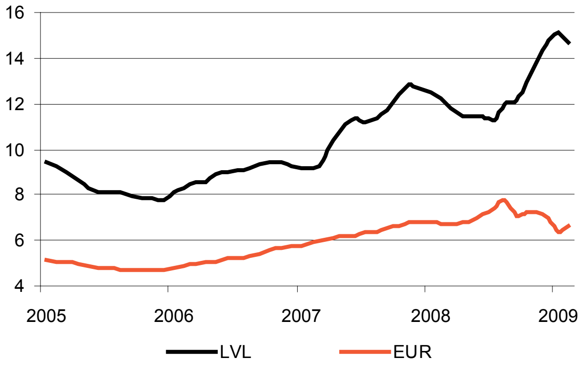


Source: LaB; Swedbank calculations

6 I.e. borrowers in attempt to reduce their burden of debt engage in distress selling to have money to repay their debt; massive repayment of debt causes a monetary contraction and thus falling prices; deflation reinforces indebtedness as debt volume is specified in current prices and the vicious circle appears.

profitability worsens – loan provisions were about 3.4% of bank lending portfolio in 1Q 2009, while loan overdues of more than 90 days rose to 7.1% in 1Q 09, from 3.6% in 4Q 08, and are expected to increase further.

Weighted Average Credit Interest Rates (LVL and EUR)



Source: LaB; Swedbank calculations

Pressure on the lats eased in January, but resumed in late February–March, and the lats exchange rate is still close to the upper band. Cumulative interventions by the Bank of Latvia to support the exchange rate were LVL 250m in 2009. International reserves of LaB comprised ca 5 months of imports in March, and this indicator had been relatively stable. LaB continued to ease monetary policy and reduced the refinancing rate to 5% (from 6%) and the marginal deposit facility rate with the LaB to 1% (from 2%) as of 24th March.

4. Summary and Policy Implications

We expect a deep recession with a through in 2010 and economic activity returning to its 2003–2004 levels (i.e. before the EU accession). As the CAD financing gap is likely to be by and large closed in 2009, the depth of the recession will depend on how fast domestic imbalances are corrected. The economic structure will change with the share of domestic demand declining and that of exports rising. Structural changes such as lower consumption will reduce employment and this reduction in several sectors (e.g. construction, car retail) will be long-lasting. It takes time to create new jobs, and the success of it will predominantly depend on structural adjustments driven by the government. Failing to swiftly deliver on structural reforms would put at risk the availability of external funding, intensify and prolong the recession, and increase financial market volatility. Clear communication of measures undertaken by the government is important to reduce social pressures. Social ownership of the restructuring package should be strengthened and success of recovery ensured.

Lija Strašuna
Dainis Stikuts
Mārtiņš Kazāks
Ivonna Slapiņa

Lithuania

	2003	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	10.2	7.4	7.8	7.8	8.9	3.0	-13.0	-3.0
GDP, mln euros	16,452	18,159	20,870	23,978	28,423	32,292	28,235	27,525
GDP per capita, euros	4,763	5,285	6,113	7,065	8,420	9,612	8,442	8,263
Growth of industrial sales, %	16.1	10.8	7.1	7.3	4.0	2.7	-15.0	-4.0
Growth of GDP deflator, %	-0.8	2.5	6.6	6.5	8.8	10.3	0.5	0.5
Growth of consumer prices, %	-1.1	1.2	2.7	3.7	5.7	10.9	5.0	2.0
Growth of harmonized consumer price index, %	-1.1	1.2	2.7	3.8	5.8	11.1	5.0	2.0
Growth of producer prices, %	-0.5	6.0	11.5	7.4	7.0	18.2	-13.0	3.0
Harmonized unemployment level, %	12.4	11.4	8.3	5.6	4.3	5.8	14.5	16.0
Growth of real net wage, %	9.3	4.9	6.8	14.9	17.7	11.2	-10.0	-5.0
Growth of exports of goods and services, %	6.2	12.0	27.0	17.9	9.2	25.4	-20.0	-2.0
Growth of imports of goods and services, %	6.9	14.2	26.1	23.1	15.9	18.3	-28.1	-1.0
Balance of goods and services, % of GDP	-5.7	-7.0	-7.2	-10.3	-13.4	-10.5	-3.0	-3.6
Current account, % of GDP	-6.8	-7.7	-7.1	-10.6	-14.6	-11.6	-3.0	-3.5
Current and capital account, % of GDP	-6.4	-6.4	-5.8	-9.5	-12.8	-9.7	-1.0	-0.5
FDI inflow, % of GDP	1.0	3.4	4.0	6.0	5.2	3.8	1.0	1.0
Foreign gross debt, % of GDP	40.5	42.4	50.7	60.2	72.3	71.4	76.7	76.0
General government budget position, % of GDP	-1.3	-1.5	-0.5	-0.4	-1.2	-3.2	-4.0	-4.0
General government debt, % of GDP	21.1	19.4	18.4	18.0	17.0	15.6	19.5	20.0

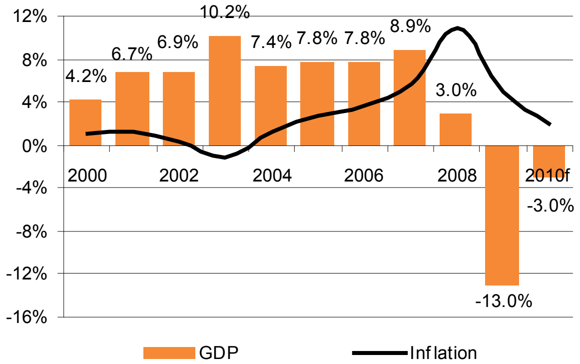
The turn of the Lithuanian economy into recession has been abrupt. After slowing down gradually in the first three quarters of last year, the economy dived into recession in the fourth quarter, contracting by 2.2% yoy. Investments took the steepest plunge, declining by 17.9% and private consumption fell by 2.9%. The fall of GDP in the first quarter of this year, according to the preliminary data, reached a staggering 12.6% yoy. The deterioration of the economic situation has been clearly visible in labour market developments already in the 4Q 2008 as well. Unemployment started to rise rapidly, reaching 7.9% and the previously rapid wage growth was halted (real wage growth in 4Q was flat compared to the previous quarter). On the positive side, external imbalances are improving swiftly. During Jan-Feb, due to the sharp fall in imports, the foreign trade deficit was practically eliminated. Inflation, after an initial jump at the beginning of the year, is also easing (annual CPI growth in March slipped to 7.7%).

1. Highlights of the Forecast

We have revised our forecast as the situation in the economy is deteriorating faster and the fall into an outright recession was more severe than anticipated before. We downgraded our GDP forecast, and expect a ca 13% fall instead of 6% for this year due to a sharp fall of investments and larger than anticipated before contraction in household consumption and government spending. As global environment (especially in the key export markets) adds plenty of a negative effect, the recession in Lithuania will be deeper than we had forecasted before. We retain our GDP growth forecast for next year and expect the economy to decline by 3%.

Given recent developments in the labour market -- strong growth of unemployment and a halt in the growth of salaries -- we cut the real net wage growth forecast to -10% for 2009 and to -5% for next year. The weaker economic situation will diminish wage demands in the private sector, while difficulties in the state budget will result in the reduction of public sector wages. Unemployment will reach higher levels than previously anticipated: 14.5% instead of 9.5% forecasted before in 2009 and 16% instead of 10% in 2010. We maintain that consumer price inflation will reach 5% this year and have downgraded our expectation to 2% (instead of 3% anticipated before) for 2010.

Economic Growth and Inflation



Source: LDS, Swedbank forecast

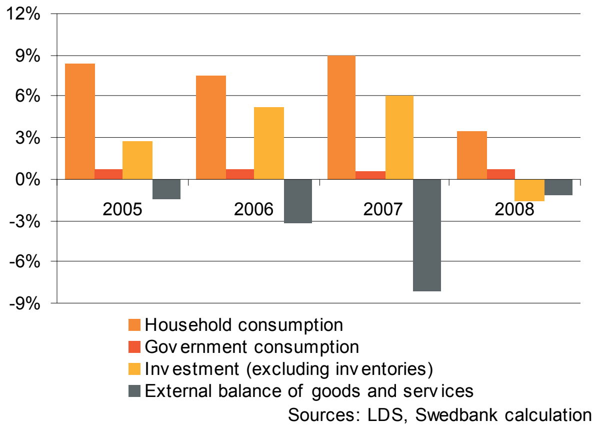
Although the global downturn will affect our exports, a fall in imports will be sharper due the steep decline in domestic demand. This will result in an improvement of the current account deficit from 11.6% in 2008 to 3-4% in 2009–2010.

2. Economic Growth

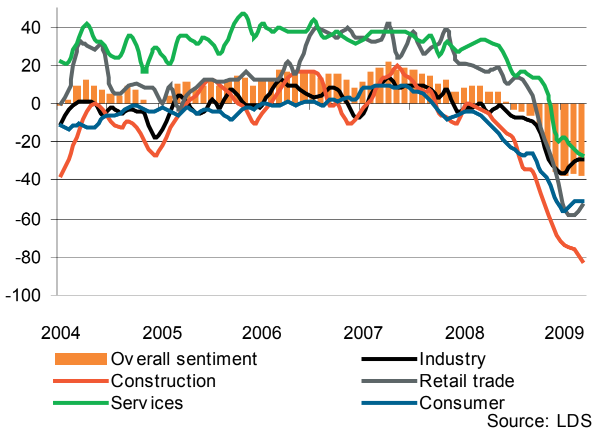
We estimate the fall in GDP to reach ca 13% in 2009 (instead of 6% as predicted before) with a risk of the fall being steeper due to the higher 2008 base and stronger than expected global downside risks. We expect the economy to contract by a further ~3% next year. Declining demand in local markets and faltering external demand will undermine companies' investment plans. Household consumption will be impaired by lower incomes and unemployment fears. Local financial institutions have become extremely cautious and have cut lending heavily, thus deepening the drop in consumption and investments even more. Net exports will contribute positively to GDP growth - even though exports are expected to decline due to the recession in major export markets, the fall of imports will be deeper. The influence of Mazeikiu Nafta oil refinery will diminish this year (the company showed impressive results last year due to the lower comparable base in 2007).

Economic sentiment fell rapidly at the end of last year, and, although the free fall appears to have stabilized, confidence

Contributions to GDP Growth



Confidence Indicators



is unlikely to rebound soon. Currently the key risk to economic growth is that of excessive pessimism, which may induce a sharp cut in investments and consumer spending triggering a downward spiral of pessimism and growth contraction.

2.1. Domestic Demand

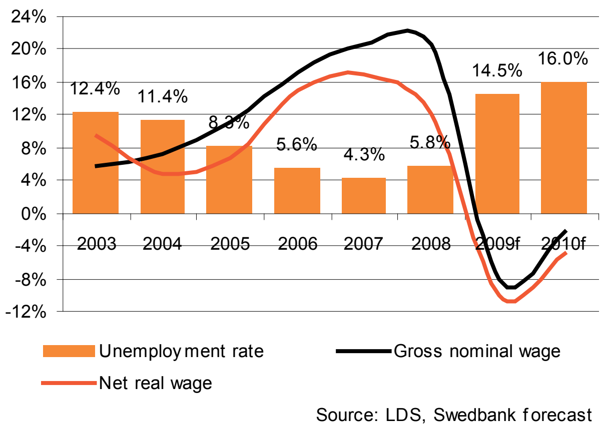
Domestic demand is expected to retreat drastically due to the drop in household consumption and falling investments. We expect domestic demand to shrink ~15% in 2009 and to contract further by ~5% in 2010. Negative growth rates will be observed in all components of the domestic demand.

2.1.1. Household Consumption

Household consumption – the former main driver of the economy – is contracting rapidly and will continue to do so. We expect the fall in consumption to be deeper and longer than previously anticipated. Household consumption grew by 4.7% in 2008, but is expected to contract by ca 15% this year and ca 5% in 2010. As main growth drivers ran out of steam, household consumption fell already in 4Q 2008. The major factors that will discourage consumption further are the following:

- **Rapidly rising unemployment**. We expect unemployment to continue to surge to double-digit levels, reaching ca 14.5% on average this year and peaking at 16% in 2010. This means ca 165,000 new unemployed in the next two years. The effect on consumption may be larger as some workers may become discouraged and decide to exit the labour market. We have already witnessed unemployment growth starting this summer and the process is expected to intensify as an increasing number of troubled companies continue to make layoffs. The fall in companies' profits to very low levels will also result in a decline in vacancies. This process will go on further as companies are facing a decline in productivity and are anxious to cut expenses, such as labour costs. Moreover, the deteriorating budgetary situation will also cause layoffs in public institutions. A sharp rise in unemployment will put a direct downward pressure on wages and consumption, thus creating a risk of a further increase in

Labour market



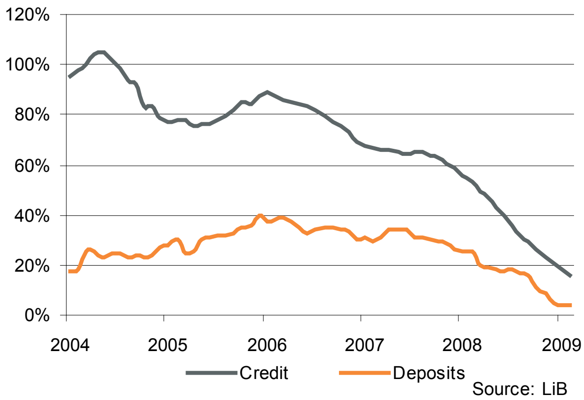
Please see important disclosures on last page

unemployment, i.e., a downward spiral in internal demand sectors.

- **Wage contraction.** We expect the real average net wages to decrease by ca 10% this year, despite the positive effect of personal income tax cut that came into effect starting January this year. In 2010 nominal wage is estimated to deteriorate by 3.5% (i.e. ca 5% in real terms). As the bargaining power of employees (for the majority of those of those who have retained their jobs) has diminished, wage and bonus cuts have become possible. Another factor, which will affect the decrease in aggregate wage payments is the decline in working hours. Businesses have just started to adapt to the changing environment by cutting expenses, so this year the adjustment process will be in full swing and will affect the larger part of the working population. Furthermore, the public sector is aiming to cut wages substantially. Therefore, we expect productivity to grow faster than the real wage.

- **Credit squeeze.** Loan stock growth started to fall already last year and will definitely continue to do so in 2009-2010 driven by pessimism, tighter loan conditions and high risk premiums. In the face of economic recession, household demand for loans has diminished rapidly, putting a strong downward pressure on consumption. At the same time banks are more cautious about the earnings prospects of their clients. During February the amount of new loans to households was negative (EUR 63m) for the first time since 2001, which signals the start of the deleveraging process.

Household Credit and Deposits Growth, yoy



Source: LiB

- **Pessimism.** The consumer confidence index hit the lowest level due to lower consumers' expectations of financial standing in their households, economic developments, and a sharp increase in the number of jobless.

- **Fewer transfers from emigrants.** The global downturn means that emigrants are unable to support their families as generously as during previous years. This particularly applies to Lithuanians employed in the stagnating key destinations – Ireland and the UK. We do not expect large-scale emigration due to declining employment opportunities in Lithuania, since it will be much more difficult to find jobs in Western Europe as well.

2.1.2. Government Spending and Policy

Last year's expansionary fiscal policy is set to tighten in 2009 and 2010. Thus, we expect general government consumption to diminish this and next year. There is an obvious risk that the economic recession will put the planned general budget deficit under pressure, as the government is about to feel the squeeze from tax revenues unless public sector efficiency is considerably improved.

Weak economic developments have had an impact on the state of Lithuania's public finances: in spite of a quickly-pushed tax reform package and austerity budget adopted at the end of last year, the government was faced with a more severe than anticipated shortfall in revenues at the beginning of this year. According to preliminary data, the revenues of Lithuania's state budget (excluding EU support) declined by ~15% yoy during the 1Q 2009, thus missing the revenue target by EUR 200m (15%). Tax revenues are expected to continue to decline as VAT (40% of total state budget revenues) and excise collection will dry out due to the weakening consumption. Moreover, we are of the opinion that higher excise tax duties are unlikely to bring the anticipated revenues to the budget. We also expect social tax and income tax revenues to be less than currently forecasted, as wage growth is slowing down, unemployment is increasing, and company profits are falling rapidly.

Given weak tax collection the Lithuanian government was forced to adopt an additional austerity package in April, further **reducing government expenditures** by ca EUR 1bn (3% of GDP). The government is likely to make further cuts in June (additional ca 2% of GDP). The cuts are spread throughout all areas, such as investments, public sector wages and a reduction of the size of the government. The revenue target of Lithuania's 2009 central government budget has also been reduced by ca EUR 1bn, compared to the amount planned in 2009's budget law last December. This supplementary budget proposal is yet to be reviewed by the Parliament. We are of the opinion that crisis years are the best time for making adjustments in the public sector itself: during previous boom years inefficiency (mostly through additional employment and unjustified wage increases) was increased in almost every field of activity in the public sector. In our opinion, budget cuts will be made so that they improve the efficiency of public services, and spending will be increased in areas important for sustainable economic growth (e.g. granting the use of EU funds, labour market activities, education, etc.).

The government seeks to have the **general public sector budget deficit** within the 3% of GDP limit this year. In our opinion, this fiscal target, however, will be difficult to achieve.

Lithuania received **EUR 340m from the European Investment Bank** (EIB) in March, a third of the total agreed loan of EUR 1.132bn. The second instalment of the EIB loan is expected to be released in October this year. The money will be used for the co-funding of 2004-2013 projects supported by the EU. The EIB will contribute to the co-financing of projects worth up to EUR 9.564bn in the following sectors: infrastructure, transport, water, sewerage, health and education. It is expected that this amount set forth in the economic stimulus plan will be absorbed this year, and banks will be encouraged to provide loans.

The Government has prepared an **Economic stimulus plan** worth up to EUR 2.4bn (~8% of GDP). Besides loans from EIB, commercial banks are expected to contribute some 30% of the financing needs, with the rest of the money coming from EU funds and the state budget. The plan is aiming to help small- and medium-sized enterprises to obtain the needed credits, improve the country's economic environment, ease market regulation, increase the energetic effectiveness of buildings, and speeds up the use of EU structural assistance as well as encourages exports and investment. The funds to be allocated are substantial and we hope they will mitigate the credit problems for some companies, and therefore smooth the recession in the Lithuanian economy. The full effect of the plan depends on how quickly the funds reach companies, and it is to be fully visible only later in the year. There is a risk that the part of the plan aimed at energy-saving measures of the Soviet-era housing stock might be delayed, and so will not mitigate the downturn in the construction sector as hoped.

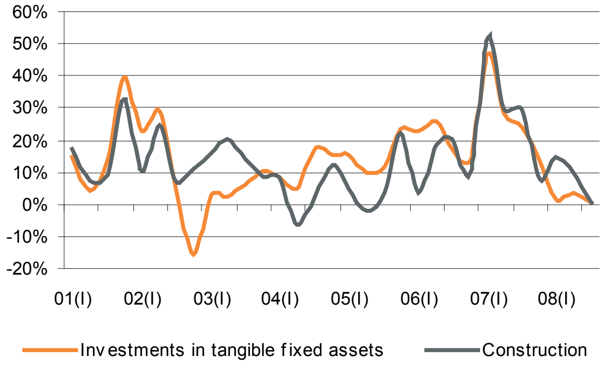
2.1.3. Investments

Investments (excl. inventories) started to decline in yearly terms already in 2Q 2008, while in the 4Q the fall of investments reached 17.9%. The contraction of investments (excl. inventories) is expected to accelerate in 2009 and reach ca 25% driven by high uncertainty, excessive pessimism, tighter lending conditions, rapidly declining profits and the continued correction in the real estate market. We forecast investments to fall by less, ca 5%, in 2010. Investments as a share of GDP, after having peaked at 28% of GDP in 2007, will reach more sustainable levels in the next few years - 19-20% of the projected GDP. The main source of investments during the upcoming few years will come from EU structural funds.

In 2009 and in 2010 the fall in investments will be mostly apparent in domestically-oriented sectors. Investments in the export-oriented sectors should begin to pick up slightly next year following the recovery in the key trade partners. A possible source for investment is also external financing, namely, an increase in M&A activity driven by reasonable asset prices. Such investments, however, are so far being prevented by high uncertainty regarding economic developments in the Baltic countries. In an attempt to stimulate business, the government has launched a stimulus plan aiming to increase availability of lending to exporters and small and medium sized enterprises, accelerate the implementation of EU funds, as well as targeting the construction sector (i.e., aiming to improve energy efficiency in the Soviet-era housing stock). Although the first results of the plan will be visible only later in the year, we are hopeful that the plan will have a substantial mediating effect and prevent a steeper fall in investments next year.

The ongoing correction in the real estate market and related sectors is one of the main reasons for the pessimistic outlook for investments. The correction in the real estate sector is continuing, while falling real estate prices are fuelling expectations for further declines. Activity in the sector has declined markedly – house purchase transactions during the first two months of the year fell about 60% yoy – and is expected to remain extremely weak in the upcoming few years. In order to finish their projects, developers had continued to build aggressively during the last quarter, which, although being the last such spurt, will add to the already high stock of new homes compared to sales. The excessive supply might also be increased by the rise in foreclosures. Due to the weak economic sentiment overall, high housing stock and omnipresent expectations for further price falls, the Lithuanian property market is unlikely to show signs of stabilization for quite some time. We do not expect the sector to stabilize earlier than late 2010.

Real Growth of Investments and Construction

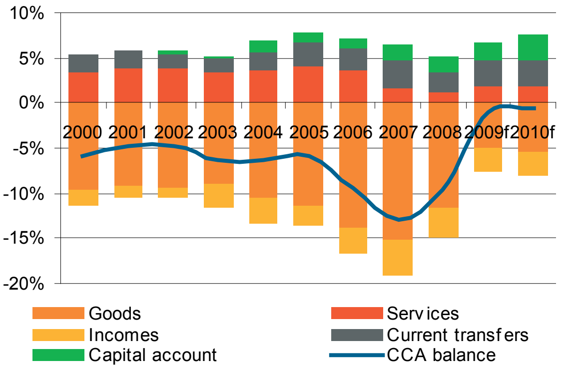


Source: LDS

2.2. External Balance

Large external imbalances are rapidly unwinding. The current account deficit reached 11.6% of GDP in 2008, however, the CAD started to narrow already in July 2008, and improved even more rapidly during 4Q reaching 3.8% of GDP. During Jan-Feb of this year, exports fell by 21.8% yoy and imports by a surprising 41% yoy, resulting in an 87.3% yoy narrowing of the trade deficit. We expect that a continuing contraction in domestic demand will improve the trade deficit considerably, which will be the main factor behind the narrowing of the CAD to ca 3% of GDP this year. Since lower profitability of companies and high dividend income tax (increased from 15% to 26% at the beginning of this year) will halt payments to non-residents, income account deficit is set narrow, which will add to the improvement of the CAD. The current transfers account should stay in surplus due to substantial inflows of the EU funds. Even though exports will decline by less during 2010 following the pick up in the economic activity in the Euro zone markets, a further narrowing of the current account deficit in 2010 will be prevented by a significant increase in natural gas imports due to the Ignalina nuclear power plan closure. We forecast CAD to reach ca 3.5% of projected GDP in 2010.

Current and Capital Account (CCA), % of GDP

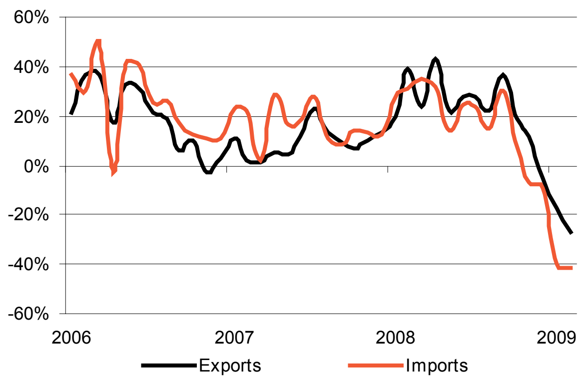


Source: LiB, Swedbank calculations and forecast

The outlook for Lithuanian exports has deteriorated further since the publication of our last Baltic Outlook in January. We expect this year to be very challenging. The decline of exports, however, might be limited to 20% in 2009 since major Lithuanian exporters possess a diversified client base (for instance, mineral product exporters); we anticipate gloomy, though slightly better, developments for next year. Export growth reached 28.4% over 2008, however, during first two months of this year, fell dramatically by 21.8% (excluding refined mineral products – 22.9%). The decline in the beginning of this year affected all commodity groups and key trade partners, though the magnitude of the fall of Lithuanian exports is comparable to the ones registered in the other Baltic economies. All export-oriented sectors will continue to be hurt this year by a downturn in major trade partners. The situation is further exacerbated by currency depreciation in Russia, Poland, Belarus and Ukraine.

We expect the decline in imports to outweigh that of exports in 2009 due to a sharp contraction in domestic demand. The

Growth of Exports and Imports of Goods and Services, current prices, yoy



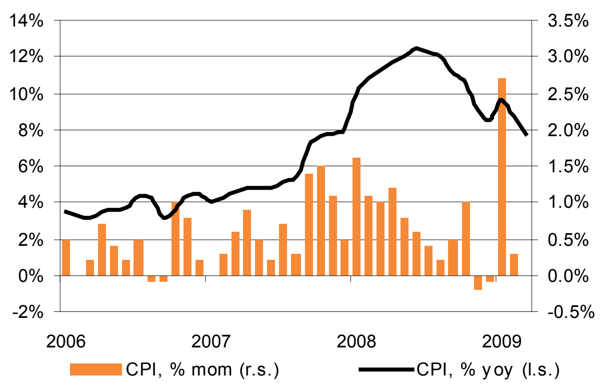
Source: LiB, Swedbank calculations

41% yoy fall in imports in the first two months of the year was driven by a decline in imports of durable and investment goods, the worsening of the credit crunch, as well as a decline in the possibilities for re-exports. Such trends are to continue throughout the year. We forecast that imports will fall by ca 25-30% this year, although the decline might be steeper if the contraction of domestic demand is larger than currently forecasted.

3. Monetary Issues

Average consumer price inflation stood at 10.9% in 2008, but will mediate to ca 5% this year. The principal downward push to the price growth will come from a sharp contraction in household consumption. Consumer price growth jumped in January reflecting the higher value-added tax rate, the abolition of most VAT exemptions, and higher administratively established prices, though such a spurt was the last one to be observed this year. During March, zero monthly inflation was registered, while annual price growth slipped to 7.7%. We expect monthly deflation to occur in the 2Q and 3Q, while price growth will accelerate slightly in autumn due to higher VAT (an increase from 5% to 19%) for central heating. Nevertheless, the effect of heating prices on CPI could be lower than anticipated currently if energy price laws, requiring the revision of prices more than once a year, are adopted1. Given stronger domestic demand pressures and global price developments, especially for natural gas, which will result in lower than expected electricity prices next year, we lowered our forecast for average CPI growth from 3% to 2% for 2010.

Consumer Price Inflation

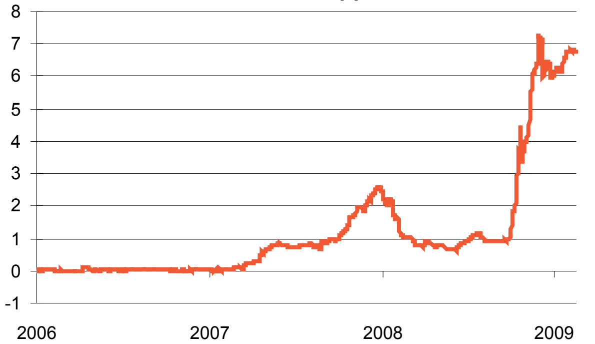


Source: LDS

The demand for loans has been falling due to excessive pessimism, tighter lending conditions and expectations of a continued correction in the real estate market. Over 2008 loan portfolio increased by 18.9%, however, credit growth has

1 Lithuanian gas utility company, "Lithuanian gas" also issued a statement saying that gas prices to private households might be lowered by 15% this coming autumn, reflecting the international price decline

Interbank Borrowing Rates: Spread Between 6-month VILIBOR and EURIBOR, pp



Source: LiB, Bloomberg, Swedbank calculations

been slowing gradually since the beginning of last year. At the end of February overall credit portfolio growth declined to 13.6% yoy. Even though a more marked drop in credit growth is not yet visible, we expect the decline in credit growth to accelerate and the loan portfolio over the entire 2009 to decline slightly compared to 2008. We anticipate, however, that the sharper decrease in credit will be partly compensated by new loans that will be used to co-finance EU structural projects, especially infrastructure ones. As deposit growth due to favourable conditions for time deposits has been stable so far, the gap between loans and deposit growth might be eliminated - this may even temporarily remove additional liquidity needs from foreign banks.

Lithuanian money market interest rates remain high. After having fluctuated around 9-10% at the end of last year/beginning of this year, 6-month money market interest rates (VILIBOR) decreased to ~8.35% at the end of April. Shrinking external imbalances, wage flexibility and other ongoing adjustments in the Lithuanian economy appear to be gradually reducing the pressure on the national currency; moreover, a stable currency regime is strongly supported by politicians, central bank and major business groups in Lithuania. The economy is rapidly adjusting via cost reduction, which suggests that the pressure on the national currency will diminish and influence positively the direction of interest rates (we do not reject, however, the possibility of one-time movements induced by ad hoc currency devaluation fears).

4. Conclusion

The **recovery of the** Lithuanian economy is highly dependent on the global environment. Economic activity will revive when the advanced EU economies start to recover from their recessions. We saw that firms can react quickly to the changes in the environment, which makes us hopeful that they will be able to do this again. Recovery will be export-driven as the contraction in domestic demand is expected to be deeper and more prolonged.

The intended exit strategy is **Euro accession** by 2012, made possible by rapid elimination of inflationary pressures; however, this will require a strict budget policy under extraordinarily difficult circumstances.

Significant **downside risks** for our forecast scenario include excessive pessimism, which could drag domestic demand unnecessary low as well as an inability of our exporters to compete in the international arena.

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