

Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

September 29, 2009

The Sharp Decline is Over

Table of Content:

Introduction: The global rebound creates conditions for recovery – but more reforms are needed to sustain growth	2
Global Outlook: The global economy bounces back but watch out for setbacks	4
Sweden: Signs of recovery – challenges remain	6
Estonia: Slow recovery	14
Latvia: Recovery path largely depends on government action	22
Lithuania: The free fall slows – but fundamental restructuring is necessary	29

Global development

- The global economy is in for a rebound, but the risks for setbacks are large. Economic growth is boosted by policy stimuli that later will be phased out and balance sheets still need correction.
- We expect that global growth falls to a negative 1.3% in 2009, to return to growth of 2.5% in 2010 and 3% in 2011. This is still below potential.

Sweden

- The Swedish export sector has been hit hard by the global recession, while households so far have been cushioned by tax cuts and low interest rates. We project that GDP will fall by 4.5% in this year, but increase in 2010 to 1.2% and 2.3% in 2011, respectively. Private consumption will be the main growth engine.
- Economic policy is expected to be expansionary over the forecast period. The main risks include a global downturn, increased vulnerability of Swedish households, and demanding structural adjustment in the industrial sector.

Estonia

- The economic downturn in Estonia has ended and a slow recovery has started. After stabilising during 2010, the economy is set to grow by 2 % in 2011. EU funds drive investments, which are increasing from a low level.
- The main forecast risks include the global economy, but the adjustment process in the public sector also poses a clear risk.

Latvia

- The speed of contraction slows and most of the fall in GDP is over. While domestic demand contraction will continue at a slowing pace, exports are bottoming out and will lead to positive quarterly GDP growth in mid 2010.
- Labour market adjustment deepens as businesses cut costs and improve external competitiveness via deflation and productivity growth. The depth of recession and recovery path depends on government action.

Lithuania

- The free fall of the economy observed in the first half has stabilized, however, the economy will continue to face challenges for some time to come. Most of the adjustment is driven by a fall in domestic demand. We expect stabilization of the economy next year.
- Downside risks to our forecast scenario include slower than expected recovery in Lithuania's main trade partners in the old EU and a higher unemployment level.

The global rebound creates conditions for recovery – but more reforms are needed to sustain growth

During the summer and early autumn, the world economy has shown signs of bottoming out and starting a recovery. As Sweden's and the Baltic countries' most important export markets are coming out of the recession, the conditions for growth will slowly improve. A better functioning of the financial sector, increased demand for Swedish and Baltic products, and higher confidence among households, companies, and financial actors, will support a recovery. There is still a dependence on stimulus measures from central banks and governments worldwide: Without these measures, the recovery in Sweden would come to a halt and the bottoming out of the Baltic economies expected within the next year would most likely be postponed.

Despite a decent bounce-back of the world economy, the recovery in a medium- or longer-term perspective will still be slow and bumpy. Balance-sheet corrections in the private sector will hold back growth. In less than a year's time, central banks' policy rates will have increased from the current near-zero levels, and many governments have started to plan for budget consolidation, with tax increases and expenditure cuts to be executed in 2011/2012.

Sweden's GDP is expected to shrink 4.5% this year, and to grow modestly by 1.2%, in calendar-adjusted terms. In 2011, we foresee Sweden's GDP growth coming back to potential, i.e., around 2.3%. At the outset, households will be the main growth engine. Supported by tax cuts, and by low interest rates and inflation, real disposable income will increase throughout the forecast period (2009-2011). Swedish exports will grow, but a lingering low demand for investment goods, together with a somewhat stronger exchange rate, holds back the upturn. As industrial capacity utilization is at an historic low, investments will not start to grow until late 2010. Stimulus measures continue to support the economy, albeit declining in importance. By the end of 2011, the Riksbank is expected to have increased its policy rate to 3%, a level that will start to strain the most interest-rate-sensitive households. As only one-third of the government's most recent budget measures were temporary, fiscal policy will be expansive also in 2010 and 2011.

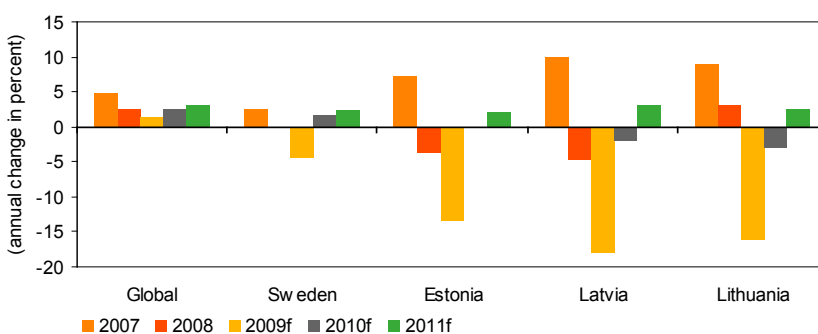
The Baltic countries are still a long way from showing robust economic growth, although the pace of deterioration is slowing. GDP will shrink by 13-18%

this year. In Lithuania and Latvia, GDP will fall even further during 2010, while Estonia is set to stabilize. During 2011, growth rates of 2-3% are foreseen. Domestic demand will be subdued because of the large austerity measures and weak external demand, as disposable incomes fall and companies adjust to slower activity by reducing staff and capital spending. Unemployment is set to increase to 14-20% in 2010. Estonia will lead the recovery, reaching the bottom earlier than Latvia and Lithuania. Fiscal tightening and external support are expected to allow the pegs to the euro to remain in place and will also enhance the likelihood of Estonia's joining the European Monetary Union, which we foresee occurring in 2011 at the earliest. Other factors of importance for adopting the euro, such as inflation, government debt, interest rates, and to a less strict extent, current accounts, are not problematic, like the budget deficit criterion. Today, all three Baltic countries show surpluses in their current accounts, although this is mainly a consequence of deflationary developments.

Thus, in 2011, all four countries are expected to show economic growth of some 2-3%. Sweden will then start closing its GDP gap. Growth in the Baltic countries, however, will still be lower than their potential growth rates, which are assumed to be lower than the last five years' average. Therefore, it will take time before unemployment declines significantly in these countries.

The major risk for Sweden is that of the unemployment worsening more than the 11-12% we forecast. With parts of the industrial sector undergoing structural adjustment, labour income developments remain highly uncertain. The household

Economic growth



Source: National Statistics and Swedbank

sector, which is raising its debt ratio as interest rates are lower than normal and house prices continue to increase, will be taking a risk in the medium to long term when interest rates and unemployment will be higher.

In the Baltic countries, the austerity measures risk creating a more long-lasting anaemic economic climate. In the near term, there is a risk that the internal political challenges of negotiating large budget cuts will hurt Latvia's relations with the international community and jeopardise further disbursements of the loan package. There are also uncertainties regarding Lithuania's possible need

for external support, although so far the fiscal corrections made seem sufficient. The restructuring of all three economies also poses an upside risk, not least in a longer-term perspective, as a substantial improvement in competitiveness may attract more foreign direct investments when global capital flows return.

One of the lessons learnt from Sweden's financial and property crisis in the 1990's is the importance of a sound macroeconomic framework to counteract imbalances. After the crisis, economic policy became focused on macroeconomic stability. Thus, Sweden has entered the current crisis equipped with sound

public finances and well-functioning financial regulations. Another lesson learnt was to quicken the pace of the reforms after the crisis, i.e., to deregulate product markets, reform pensions, etc. Productivity grew substantially as a result. Upon exiting the current crisis, which could take a number of years, the Baltic countries are likely to have better internal and external balances than upon entering the crisis. Restructuring the economies as a result of the crisis will be painful, but in a few years' time the payoff may be substantial.

Cecilia Hermansson

The global economy bounces back – but watch out for setbacks

GDP forecast (annual percentage change)

		September				June	
		2008	2009	2010	2011	2009	2010
US		0.4	-2.3	1.3	1.8	-2.7	1.2
EMU		0.7	-4.1	0.6	1.3	-4.5	0.1
Of which:	Germany	1.3	-5.5	0.8	1.3	-6.0	0.2
	France	0.3	-2.7	1.1	1.4	-3.5	0.3
	Italy	-1.0	-4.0	0.3	1.0	-4.0	0.2
	Spain	1.2	-3.3	-0.1	1.3	-3.5	-0.3
UK		0.8	-4.0	0.5	1.3	-4.0	0.2
Japan		0.7	-6.0	1.0	1.4	-6.5	0.4
China		9.0	7.5	8.0	7.5	6.5	7.5
India		7.5	4.8	6.0	6.5	5.0	6.0
Brazil		5.3	-1.0	2.5	4.0	-1.0	2.0
Russia		5.6	-7.0	1.0	4.0	-6.0	1.0
Global GDP		2.7	-1.3	2.5	3.0	-1.6	2.2

Sources: National Statistics and Swedbank

In recent months, conditions in the financial sector have improved, several economies have reported growth, and confidence among households, businesses, and the financial market has risen. The purchasing managers' index (PMI) is signalling growth in the manufacturing sector in Asia, the US, and parts of Europe. The global economy seems to have bottomed out, and a recovery is expected in the second half of the year.

In the short term, the recovery should thus be fairly decent. In the medium term, though, there is an increasing risk of setbacks. The reasons for a slow, bumpy recovery are still there: growth is being supported by stimulus measures, balance sheets need to be corrected – which implies extensive deleveraging – and there is little incentive to add capacity. When stimulus is unwound, growth is likely to weaken.

According to our forecast, global GDP will fall by 1.3% this year, but rise by 2.5% and 3% in 2010 and 2011, respectively. This means GDP growth will be below the figures of some 5% prior to the financial and economic crises,

and also below the average growth of the last 20 years of 3.5%, which could serve as a best guess for global potential growth.

Major OECD countries face a period of weak growth, but BRIC countries will be faster to reach the growth figures experienced before the crisis started. Especially in Asia, the room for stimulus is rather large, and internal imbalances are small. On the other hand, for the US, UK, Spain, and Ireland – countries where households are correcting their balance sheets and fiscal balances are worsening – the economic, social, and political impact of the crisis will be larger. The wealth gap between East and West is shrinking.

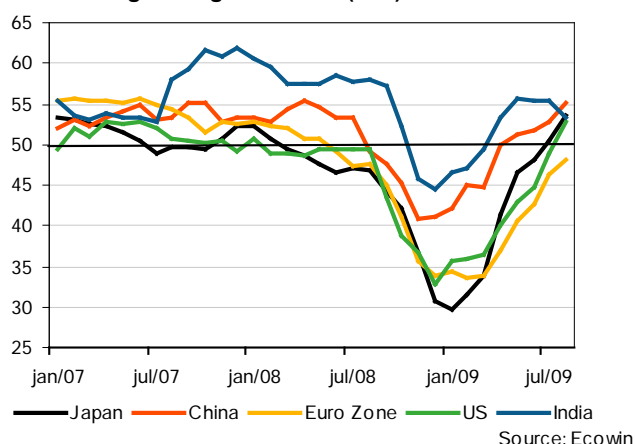
The assumptions for the global forecast include the political situation, sentiment among various actors, and the timetable for the withdrawal of fiscal and monetary stimulus measures, as well as the outlook for commodity, property, and financial markets. Even if exit strategies are being discussed, budget consolidation will not start before 2011. Public debt is expected to increase by 40 percentage points in G20 countries

between 2007 and 2014, with several countries reaching public debt of more than 100% of GDP. Especially in the US and the UK, the process of unwinding fiscal stimulus will be difficult as debt has increased quickly, and the central banks have taken on government debt on their balance sheets.

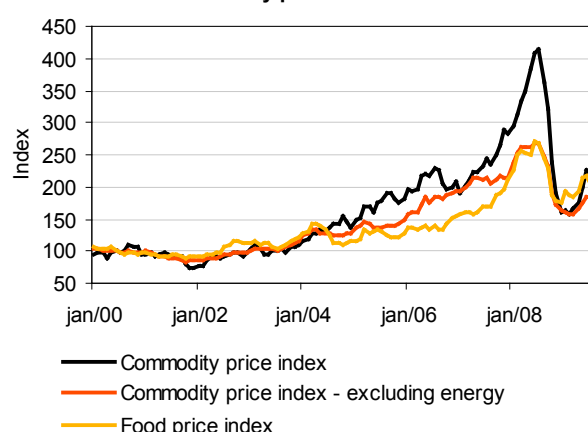
The deflation threat has diminished, and focus is being transferred to lowering the risk of uncomfortably high inflation in the medium term. In the short term, output gaps are large in most countries and unemployment will hold back inflation pressures. Further on, it is important to avoid undermining the confidence of central banks' commitment to maintaining price stability. There is thus a trade-off for central banks between, on the one hand, supporting economic activity and fiscal balances by keeping debt on their balance sheets and holding interest rates low, and, on the other, raising interest rates in time to prevent inflation expectations from rising.

We assume that the Federal Reserve and the Bank of England will start raising the policy rates in the second half of

Purchasing Managers' Index (s.a.)



World market commodity prices



2010, while the ECB follows suit in the beginning of 2011. The pace of interest rate hikes will most likely be gradual and somewhat slow in order to avoid risks of the recovery coming to a halt. The average policy rate will be 2-2.5% at the end of 2011. Higher economic growth and inflation will push the US 10-year bond rate up to an average of 4.5% during 2011, with a somewhat slower increase in Europe than in the US.

The US dollar is expected to weaken against the euro during 2009 in line with monetary and fiscal policy, but will strengthen during 2010 and 2011, with prospects of higher interest rates and growth in the US than in the euro zone. A dollar collapse is not part of our main scenario, as we expect confidence in the ability of US monetary policy to deliver price stability to remain in place.

We expect the oil price to reach an average of 60 US dollars per barrel this year, before rising to 70 dollars in 2010 and 80 dollars in 2011. With the current level of the oil price around 70 dollars, this means that the speed of the upturn, i.e., the doubling of the oil price from the end of 2008, will slow. Metal prices are also rising from relatively depressed levels, while food prices are more stable than at the beginning of this year and are assumed to increase at a slower rate. House prices increased in June in the US for the first time in 35 months, but it is too early to establish if an upward trend is starting. There could be further corrections in some European countries, like the UK and Spain. For countries that have largely avoided major price declines, corrections could come later, after the period of very low interest rates has ended. The major risks for the hous-

ing market are unemployment, interest rates, and confidence.

All in all, the recovery in the real economy, in the financial sector, and on various asset markets is dependent on stimulus measures remaining in place. At the same time, the risks for new bubbles on asset markets are increasing with the vast liquidity that is being provided. Therefore, it is important that reforms to increase financial stability alongside price stability be implemented in central banks in order to make policies macro prudential, and that financial sector regulation become less procyclical. With a fast recovery, the momentum of reforms may be lost, but with a slower recovery ahead – which is our main scenario – the likelihood of changing unsustainable policies increases.

Cecilia Hermansson

Interest and exchange rate assumptions

	Outcome 28 Sep 2009	Forecast 31 Dec 2009	--> 30 Jun 2010	--> 31 dec 2010	--> 30 Jun 2011	--> 31 dec 2011
Policy rates						
Federal Reserve, USA	0.25	0.25	0.25	1.00	1.50	2.50
Bank of Japan	0.10	0.10	0.10	0.10	0.50	0.75
ECB, Eurozone	1.00	1.00	1.00	1.00	1.75	2.50
Bank of England	0.50	0.50	0.50	0.75	1.50	2.25
Exchange rates						
EUR/USD	1.47	1.48	1.40	1.32	1.28	1.22
RMB/USD	6.83	6.83	6.83	6.83	6.70	6.50

Source: Swedbank

Sweden: Signs of recovery – challenges remain

Key Economic Indicators, 2007 - 2011

	2007	2008	2009f	2010f	2011f
Real GDP, % change	2.7	-0.4	-4.5	1.2	2.3
Industrial production, % change	2.3	3.3	-13.2	3.5	5.5
Consumer price index, average, % change	2.2	3.5	-0.2	1.0	1.9
Consumer price index, end-of period, % change	3.5	0.9	0.7	1.4	2.0
CPIF, average, %change	1.5	2.7	2.0	1.3	1.2
CPIF, dec-dec, %change	2.4	1.6	2.4	1.0	1.3
Labour force, %	1.6	1.2	0.2	-0.4	0.2
Unemployment rate, % of labor force	6.1	6.2	8.9	10.7	11.6
Employment, % change	2.6	1.1	-2.7	-2.4	-0.8
Nominal hourly wage whole economy, average % change	3.3	4.3	3.0	2.0	2.0
Nominal hourly wage industry, average % change	3.7	4.4	2.8	1.8	2.0
Savings ratio (households), %	9.1	11.8	13.3	12.8	12.3
Real disposable income (households), annual % change	3.7	3.7	0.5	1.2	1.6
Current account balance, % of GDP	9.0	8.3	7.1	6.7	7.2
General government budget balance, % of GDP	3.8	2.5	-2.3	-3.2	-2.8
General government debt, % of GDP	40.6	38.0	45.2	47.7	49.4

Sources: Statistics Sweden and Swedbank

The Swedish economy is at the moment characterized by a polarization between the industrial sector, which is in a sharp downturn and households' relatively positive situation due to low interest rates and tax cuts. Our estimate is that the economic situation in Sweden in the remaining part of 2009 will improve. In particular, the impact of net export and household consumption outweighs the substantial fall in investments seen in the first half of the year. We also raise our forecasts of economic growth for 2010 to 1.2%. We foresee that economic activity will continue to expand in 2011 at a rate of 2.3%, although GDP will not reach the same level as before the crisis. Net exports should start to contribute positively to growth already in 2010 on the back of stronger world demand, but export growth is still expected to remain below previous years' growth rates.

Domestic demand will be the main driver of growth with, in particular, household consumption making a come back. Confidence indicators have improved and real disposable income increases as a result of fiscal measures and low inflation. Household savings will fall gradually

from a high level. Investments, however, will continue to hold back the recovery.

The large production falls at the end of 2008 and during the first two quarters of 2009 has led to a record low capacity utilization rate in the manufacturing sector, which will delay new investments. At the end of the forecast period, we see a modest return, in particular of housing investments.

We expect the expansive economic policies to remain in place for most of the forecast period. Budget deficits are growing during 2009-10 as a result of not only contracting activity in the economy but also increasing discretionary spending. Although the deficits are likely to cause fiscal policy to deviate from the long-term goals, there is, on current policies, no serious threat to fiscal sustainability, and public debt is not expected to exceed 50% of GDP. We also expect monetary policy to remain expansive over the next two years and a gradual tightening of monetary policy to start only in the latter half of 2010. At the end of the forecast period, the repo rate will have reached 3%.

The risk of deflation has diminished, but inflation pressures will remain subdued over the period. Unemployment continues to rise and will peak in 2011, when the unemployment rate is expected to reach 11.6%. Swedish competitiveness is expected to improve over the period, with increasing productivity and falling labour costs, despite a marginally stronger trade-weighted exchange rate. However, the composition of world market demand is likely to shift, and the resulting period of adjustment of Swedish production will slow the recovery. For Sweden, the effects of global developments are considered to be the main downward risk, but, in addition, increasing unemployment rates and eroding household confidence could undermine consumption as the main pillar of domestic demand.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2007	2008	2009f ¹⁾	2010f ¹⁾	2011f
Households consumption expenditure	3.0	-0.2	-0.9 (-1.6)	1.7 (0.6)	2.2
Government consumption expenditure	0.4	1.5	1.5 (1.5)	1.3 (0.5)	0.4
Gross fixed capital formation	7.5	2.7	-14.0 (-12.3)	-3.5 (-4.3)	2.9
- private, excl. housing	8.4	4.6	-17.1 (-14.5)	-5.6 (-8.0)	2.0
- public	2.4	4.0	7.1 (-7.7)	2.5 (5.9)	2.5
- housing	8.7	-5.4	-21.4 (-22.3)	-2.1 (-0.8)	7.5
Change in inventories ²⁾	0.8	-0.6	-1.1 (-0.8)	0.3 (0.3)	0.3
Exports, goods and services	5.8	1.9	-13.8 (-14.0)	3.3 (2.5)	5.2
Import, goods and services	9.4	3.0	-14.6 (-13.8)	2.1 (1.0)	5.1
GDP	2.6	-0.2	-4.6 (-4.6)	1.5 (0.7)	2.3
GDP, calender adjusted	2.7	-0.4	-4.5 (-4.7)	1.2 (0.4)	2.3
Domestic demand ²⁾	3.2	0.9	3.0 (-2.7)	0.6 (-0.4)	1.8
Net exports ²⁾	-1.3	-0.4	-0.7 (-1.1)	0.7 (0.8)	0.4

1) The figures from our forecast in June are given in brackets.

2) Contribution to GDP growth.

Sources: Statistics Sweden and Swedbank

Consumers drive the economic recovery

We expect a slightly better outlook for the remaining part of 2009, given the positive economic developments during the summer. In particular, household consumption is providing a bottom to the fall in economic activity; moreover, the negative impact of net exports is smaller than previously forecasted. We expect economic growth to recover, but relatively slowly, and remain below potential. Weak external demand, as well as the adjustment of the Swedish economic structure, will limit the rebound.

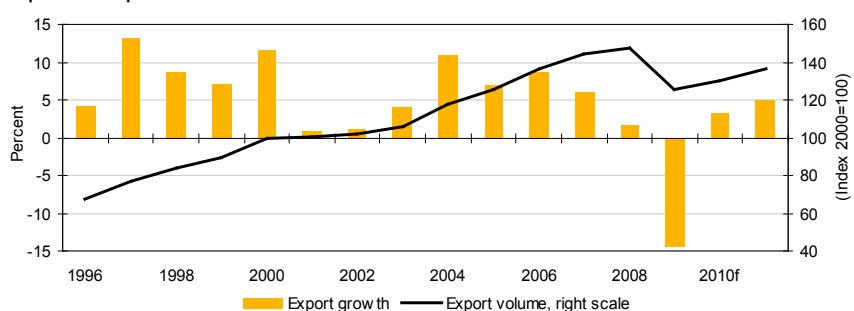
Modest improvement in foreign trade

Exports of goods and services have decreased sharply due to the global recession and an unfavourable Swedish export composition. During the first half of 2009, total export volume fell by nearly 20% over the same period last year. The collapse in global demand has led to falling export volumes for a majority of the Swedish export industries despite a weaker krona. However, the development has not been evenly distributed: Some branches have been more affected than others. The exports of vehicles show the largest drop, a fall of more than 50% during the first two quarters of 2009, and this sector's share

of merchandise exports shrank to 8% from 13% last year.

There has been an improvement in the firms' order books during the summer, according to Swedbank's and SILF's PMI figures, and production plans for the coming six month have been revised upwards. Even if there is a recovery in the pipeline, it is expected to be relatively weak and slow. Based on a global outlook, the world market growth for Swedish firms is projected to be below trend. Overcapacity in several industries due to the sharp drop in industrial production will limit the demand for investment goods. In 2011, when the utilisation rate is higher and global demand is growing faster, the need for investment and intermediate goods is expected to strengthen.

Export developments



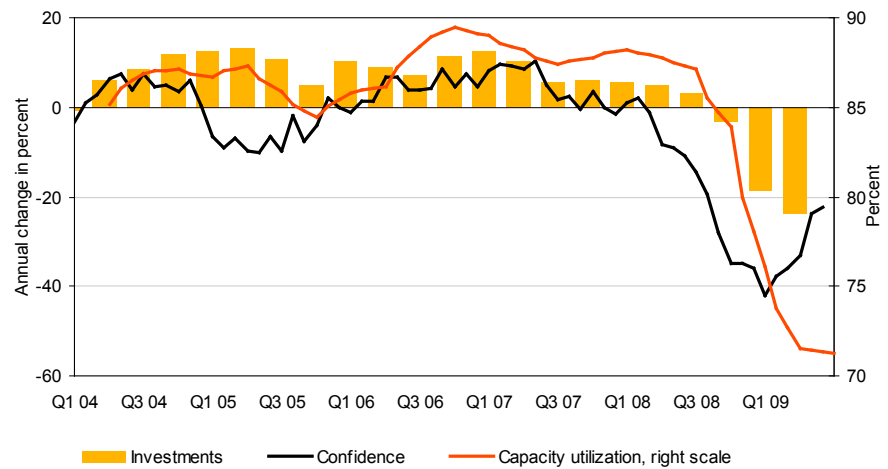
Sources: Statistics Sweden and Swedbank

The competitiveness of the Swedish industry is set to improve during 2010 and 2011, as higher productivity growth and lower nominal wage increases will lead to falling unit labour costs. In our forecast we anticipate a moderate appreciation of the krona as the growth outlook improves and risk appetite in the financial markets increases. We expect a total export growth of 3.3% during 2010 after a fall of roughly 14% this year. For 2011, we anticipate an increase of 5%. This forecast implies that the

export volume at the end of 2011 will be lower than the pre-crisis level of 2008. A gradual recovery in the global economy is expected to raise Swedish exports of raw materials and intermediate goods, particularly when industrial production is growing and the restocking process starts. However, the outlook for investment goods is different. Overcapacity and relatively weak global demand will hold back the investments and we do not foresee stronger exports of investment goods until 2011 at the earliest. Exports of services, which account for nearly one-third of total Swedish exports, are expected to be driven by a stronger demand for business services and tourism.

During the first half of 2009, the total import volume of goods and services fell by 17% over the same period last year. The slowdown was mainly driven by sharply falling business investments, large destocking in the industry due to shrinking production levels, and lower private consumption. In 2010, we foresee a modest import growth of 2% after a fall of nearly 15% during 2009. The recovery next year will be due to a gradual growth in manufacturing production as the destocking process ends. Further falls in private investments limit the imports of goods. For 2011, when domestic demand in the Swedish economy improves, imports of goods and services are expected to grow by 5%. Stronger import demand at the end of the forecast period will gradually lead to lower net export contributions to GDP growth. Despite weak global demand and limited export possibilities, the impact on the current account balance will be relatively small. For 2009, we expect a surplus of 7% of GDP compared with 8.3% last year. A less favourable price development due to the stronger krona and growing price competition will further reduce the surplus in the current account balance to 6.7% of GDP in 2010; this figure is still large, also compared with other countries. When export demand strengthens during 2011, we foresee a growing surplus in foreign trade.

Investments, capacity utilization and business confidence (netbalance, sa)



Source: Statistics Sweden and NIER

Protracted investments slump

The sharp decline of investments continued in the second quarter of 2009. In particular, investment by the private sector (excluding housing) contracted by an estimated 23% on an annualized basis, compared with 17% in the first quarter. The steepest decline was seen in machinery investments. Housing investments fell by the same rate as in the first quarter, roughly 26%, public sector investments gained momentum and increased by more than 7%.

The slow recovery of investment will limit domestic demand and growth for the next couple of years. Record-low capacity utilisation in the manufacturing sector delays the need to reinvest. Furthermore, the relative slow recovery of global growth, and thus demand for Swedish exports, will also hold back growth. Domestically, there is no strong evidence of a financing constraint, and the decline in lending to the private sector is mainly the result of the recession. Surveys also show fewer companies claiming that the lack of lending is a binding constraint on their investment decisions. Moreover, business confidence in the manufacturing industry remains very weak despite an uptick in recent months.

We expect overall investment in 2009 to decline by almost 14% over 2008, albeit at a slowing rate. In particular, the manufacturing sector has been hard hit by the global slump, and the contraction is expected to be led by further decreases in machinery investments. Despite more new orders, there is still plenty of spare capacity, and we do not expect investment to pick up in a more sustainable manner until 2011, when export growth rebounds more significantly. We also expect an inventory correction following the large declines over the last three quarters.

Housing investments are more difficult to assess. The boom in recent years has led to a rapid growth in housing. With the drop in prices last year and the significant slowdown in market activity; the number of house sales was down approximately 25% in the last three quarters. Indeed, the number of permits for housing starts has decreased steadily during 2009. However, low interest rates have led to increased risk appetite on housing markets, which could support housing investments with a lag. Lower costs and an increased demand should lead to a bottoming out of housing investments during 2010. A survey of the construction industry shows that the share of companies that think the

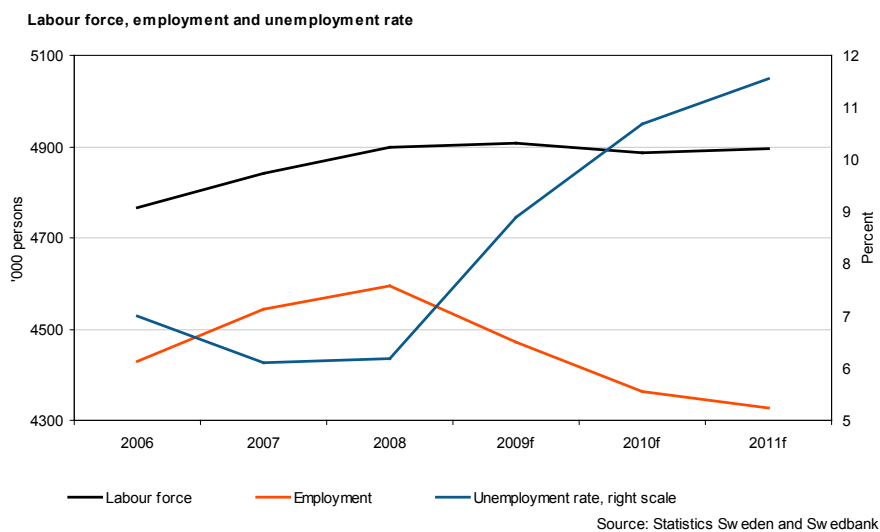
market will better in 2010 than in 2009 has increased from 5% to 26% in the last 6 months. In 2011, we expect a recovery in housing investments that will begin to correct for the low investment levels in previous years.

After strong growth in public investment in recent years and in 2009, we expect the growth rate to slow in 2010, when many local governments will be facing tightening budget constraints. Given the pressure to reduce unemployment and decreasing costs, we expect a continued growth of public investments in 2011, but at a slower rate than in recent years. In light of increased risk appetite and better confidence, we believe that the risks of the forecast of housing investments are mainly on the upside, although it may be too early to exclude setbacks.

The public sector might also launch some large public investment projects, taking advantage of decreasing costs, both for labour and financing, in order to suppress unemployment rates over the medium term. There are, however, also downside risks, especially regarding machinery investments, stemming mainly from a slower-than-expected global recovery and adjustment needs in the manufacturing sector.

High unemployment lowers consumer price pressures

The labour market in Sweden has been worsening, but by less than we expected in June. In the first half of the year, employment fell by nearly 2% from last year. Temporary jobs account for the larger part of the job decreases – a development that is to be expected at the beginning of an economic slowdown. The decline in employment, which started to fall at the end of 2008, has gradually increased during 2009, and we assume this trend will continue in the second half of this year. Due to a less negative employment growth at the beginning of 2009, we revised the forecast to



-2.7% from -3% in the June forecast. This implies a total decrease in the number of employed of 124 000 people during 2009.

Several industries in the private sector have introduced a shorter work week, characterized by unchanged hourly earnings. This is a one-year agreement between unions and employers and will be in effect until the end of March 2010. Working-time reductions and a sharp slowdown in total production have led to larger fall in the number of working hours than in the number of people employed. For this year, we expect the total working hours in the total economy to fall by 4% on average.

Despite a return to growth of the Swedish economy, the impact on the labour market will be limited. A low utilisation rate in the private sector is expected to postpone a recovery in the labour market. We anticipate two additional years of falling employment and a resulting accumulated employment decrease of 260 000, or nearly 6% since 2008. In the recession at the beginning of the 1990's, the employment decrease was more severe: 500 000 job losses from the employment peak of 1990. However, the current implications for the labour market will still be large, and it will take several years for employment to return

to the pre-crisis level of 2008. For 2010, we anticipate a smaller fall in working hours (2%) and a turnaround in 2011, when firms will be using the available labour force before they start recruiting again..

The open unemployment rate in August was 8% and we expect a continued increase in the second half of 2009. On average, we forecast an open unemployment rate at around 9% this year, compared with 6.2% last year. We foresee further increases during 2010 and 2011 due to a weak demand for labour. A labour supply that is more or less stable during the forecast period is another reason for projecting the unemployment rate to exceed 11% and not to decrease until after 2011. Structural reforms in the labour market and less favourable social insurance benefits have been implemented since 2006 to stimulate a higher labour participation. Both short- and long-term sickness rates have been falling sharply in recent years. Also, the incentives to search for jobs have been increased.

The labour market programmes have also changed and are to a greater extent focused on helping people to find jobs through training, job guarantees for youth, and job coaching. Only a smaller fraction of these are subsidized public employment programs, which were more

common during the 1970's and 1980's. To limit unemployment growth, the government has increased expenditures on labour market programmes. More than 250 000 people (4-5% of the labour force) are now expected to be in labour market programmes during 2010 and 2011. This means that more than 15-16% of the labour force are unemployed or in different types of labour market programmes.

Wage increases have gradually diminished since the labour market started to deteriorate last year, but the adjustment has so far been limited by the central wage agreements established in 2007. At the beginning of next year, a new, extensive round of wage negotiation will start, including more than 3 million employees. Compared with the negotiations in 2007 when the Swedish labour market was tightening and the lack of labour became more pronounced, the conditions for next year's wage negotiations are different. We expect nominal wage increases of 2% per year for the whole economy during 2010 and 2011, due to lower wage agreements and wage drifts being limited because the demand for labour is shrinking.

After three consecutive years of negative productivity growth, we foresee a shift in productivity, with the production level gradually increasing and further cuts in employment expected. We antici-

pate productivity growth above 3% in 2010 and somewhat lower (2%) in 2011. This will have implications not only for a firm's competitiveness but also for its profit margins. Unit labour costs, which have increased strongly during 2008 and 2009, are expected to fall during the next year by nearly 2% and will be more or less, unchanged in 2011.

The continued prospects for low inflation remain strong. In our June forecast, consumer prices were expected to fall by 0.4% in 2009 and increase by 1.1% in 2010. The picture has not changed substantially. The forecast has been revised upwards to negative 0.2% for 2009, and downwards to 1.0 % for 2010. Gasoline prices have increased faster than previously expected, and the housing component gives a more negative contribution due to lower interest rates. Consumer prices are projected to rise by 1.9% in 2011. Hence, the consumer price index (CPI) will stay below the inflation target until the end of 2011 as resource utilisation is subdued. The possibility for companies to raise prices will gradually increase during the period, but will stay weaker than normal.

We do not foresee inflation returning until December of this year. During 2010 and 2011, relatively weak demand, although slowly increasing, will ease price pressures. For example, wage demand will be subdued and are thus

not expected to contribute to inflation. The Swedish krona is also expected to strengthen somewhat during the forecast period, thus holding back inflation pressures.

The CPIF, i.e., the consumer price index using constant interest rates, will stay just above 1% during 2010-2011. Thus, this index is more stable than the CPI because the latter, to a large extent, is affected by base effects from changes in interest rates. Although inflation expectations have already started to grow, they are still indicating weak price increases. The risk of deflation has faded, but the risk of uncomfortably high inflation is perceived as rather low by the financial market, the trade unions, and the public.

Households - the main engine for growth

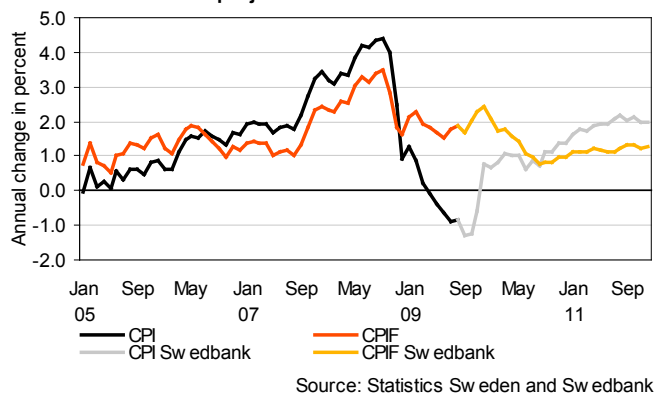
Swedish households have been quick to adjust their consumption to a markedly worsened economic outlook during the past year. Private consumption fell in the second quarter by 1.8% in annual terms.

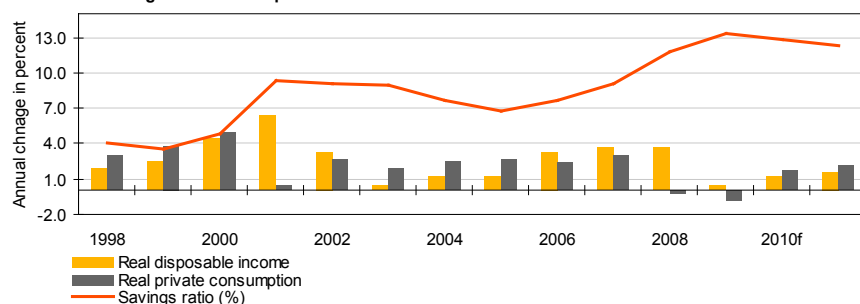
More negative sentiments about the future in general, and prospects for higher unemployment, in particular, have led to a rapid increase in household savings. The savings ratio in the second quarter reached 15%, a high figure in historical terms.

Productivity and unit labour cost



Inflation and inflation projections



Household savings and consumption

Source: Statistics Sweden and Swedbank

Looking forward, consumers – at least in relative terms – will become an important engine for economic growth. Household sentiments, on both the general and the personal economic situation, have improved as the recession has faded. Other important reasons for increased confidence are the fiscal and monetary stimulus measures that have been taken. Lower interest rates and tax cuts have strengthened the economic situation for householders who still have their jobs.

Even if the unemployment rate is increasing and real disposable income will grow weakly during 2009 and 2010, households are expected to increase their consumption and thus lower savings. The total labour income for the household sector is falling – for the first time since 1993 – but fiscal measures and low inflation have triggered growth in real disposable income. After falling by 0.9% in 2009, private consumption is set to grow by 1.7% in 2010 and 2.2% in 2011 as confidence strengthens and the situation in the labour market stabilises. In line with stronger confidence among consumers regarding the Swedish economy, the consumption of capital or durable goods will increase. Purchases of cars have decreased markedly during 2008 and 2009, but will approach moderate growth rates in 2010 and 2011.

Risk appetite is returning to the Swedish household sector. Activity on the stock exchange is increasing, and mutual funds are showing record inflows. The low

interest rates are also contributing to higher credit growth for the household sector. Mortgages increased by 8.1% in August in annual terms, which means that the annual growth rate is again rising

Prices on houses and condominiums are again increasing in monthly and quarterly terms. The great fall in house prices expected in August 2008 was due to the high interest rates at the time, and as interest rates fell, the housing market held up better than assumed. Housing affordability had by last autumn decreased to levels where households could no longer afford to buy a house without great strains on their personal finances. As interest rates have reached exceptionally low levels (the repo rate is at 0.25%), housing affordability has again improved. Households now have an income margin of 42% when buying a house. On the other hand, when tests are made for more normal interest rates (taking an average of the last 10 years which gives a result of 4.6% for mortgage rates, compared with the current 2.4%), the income margin shrinks to just 8%.

Households are taking on more debt (debt in relation to disposable income has reached 160%). Interest rates chosen are flexible and will rise to more normal levels within 2-3 years. Within a 5-year period, a major correction of housing prices could thus be expected as households are very sensitive to changes in interest rates.

In the short term, household consumption will start picking up. In the medium term, as the stimulus is withdrawn slowly, private consumption will come back to more normal growth rates of 2-2¼%. In a somewhat longer perspective, i.e., in 3-5 years, however, consumption could become a drag on economic growth if asset prices fall and balance sheets must be corrected.

The main downside risks during the forecast period are the labour market, the risks of higher interest rates, and the possible shock from falling share prices or real estate prices. Another risk to consumption is the swine flu, which could offset growth in consumption as the population becomes sick or just more hesitant to shop. On the other hand, there are also upside risks, of which the labour market's developing more favourably is the most important.

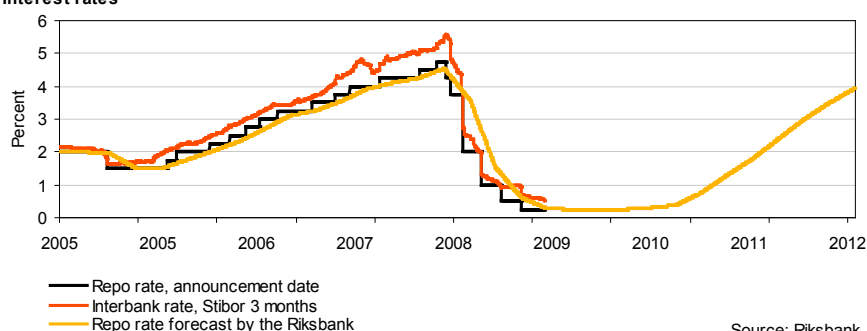
Policy expansion remains in place

Policymakers are continuing to provide substantial stimulus to limit the economic downturn and prevent a relapse into negative economic growth. In the most recent meeting of the board of the Riksbank, not only did it maintain the record low policy rate but it also signalled its commitment to maintain that rate well into 2010. Also, the government, with its budget proposal for the election year 2010, will maintain an expansionary fiscal stance. The budget includes both tax cuts and increased expenditures. We do not expect any policy tightening over the 2009-2011 forecast period.

Monetary policy – on hold for now

The Swedish Riksbank cut its most important policy rate – the repo rate – to 0.25% in July 2009. This means that this rate has been lowered by 4.50 percentage points since September 2008, when the financial crisis escalated and Sweden faced a recession. This expansive policy is intended to ease the situation in the

Interest rates



credit market and support economic activity by, inter alia, relieving the pressures on borrowers.

In addition to the repo rate cuts, a number of measures have been implemented to strengthen national and regional financial stability, such as lending in dollars, changing the collateral requirements for credits, authorizing contributions of liquidity to stressed financial companies, and granting loans to neighbouring countries.

The Riksbank has also supplemented monetary policy measures to make sure they had the intended effects by offering loans to banks on a fixed interest rate (July and September) with a maturity of 12 months. In September, most banks signalled they did not need the loans, but the Riksbank sees this measure as part of monetary policy, i.e., to create confidence for the interest rate path and to signal that the repo rate will be at the prevailing low level for approximately another year.

However, the financial markets do not

believe in the Riksbank's forecast and assume the first rate increase will already be made by next spring. According to our forecast, the Riksbank will not start normalising the repo rate until the third quarter of next year, but will be raising this rate somewhat faster than the Riksbank's forecast implies today. At the end of 2011, the repo rate will reach 3%, instead of 2.4%. During the second half of 2011, the Swedish economy will be growing above its potential, and the output gap will be starting to close. As the labour market situation stabilises during 2012 and inflation pressures start to resume, the interest rate will be increased to its natural or neutral rate of some 3% by the end of 2011. This means that we foresee monetary policy to start being contractionary after the forecast period.

In line with the higher repo rates and increased economic activity in Sweden and elsewhere, Swedish long-term bond rates are gradually picking up from the current level of 3.3%. Towards the end of 2011, the 10-year bond rate will have reached 4.0%.

The Swedish krona is expected to strengthen further during 2009, but to weaken again during 2010 as the US dollar strengthens against the euro and the krona in line with somewhat higher interest rates and greater economic activity in the US than in the euro zone. The strengthening of the Swedish krona against the euro is an effect of stronger Swedish exports, a normalisation of the functioning of financial markets, and decreased pressures on the krona from the alleviation of the economic crisis in the Baltic countries.

During the forecast period, a relatively low but slowly higher repo rate will raise risks that housing prices will increase faster than fundamentals (nominal growth, disposable income, etc.) would imply. We have assumed that the Riksbank will focus on the inflation target and the output gap rather than on implementing monetary policy to foster an uncomfortably high growth rate in housing prices and/or credits. Instead, other measures will be implemented to focus on financial stability, such as capital requirements in banks, and these measures will be coordinated with other central banks and financial supervision institutions in Europe.

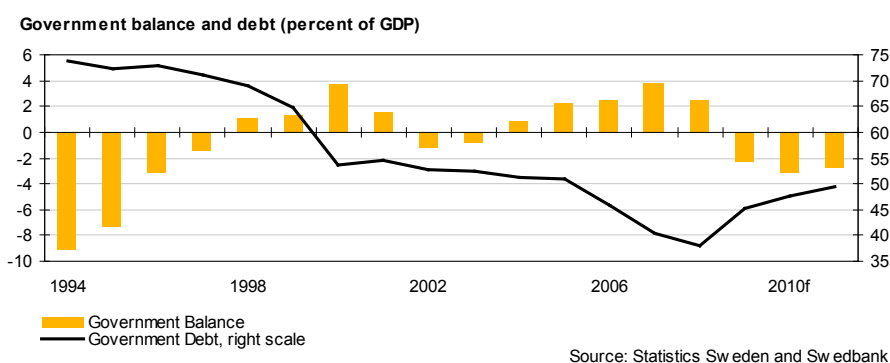
Large fiscal deficits but still under control

The fiscal outcome for 2009 is likely to be slightly better than forecasted in June. Revenue collection in the first half of the year is exceeding expectations, supported by the bounce back of the financial

Interest and exchange rate assumptions

	Outcome 25 Sep 2009	Forecast 31 Dec 2009	--> 30 Jun 2010	--> 31 dec 2010	--> 30 Jun 2011	--> 31 dec 2011
Interest rates						
Policy rate	0.25	0.25	0.25	1.25	2.00	3.00
10 yr Gvt bond	3.40	3.50	3.50	3.80	3.90	4.00
Exchange rates						
EUR/SEK	10.19	9.85	9.80	10.00	9.80	9.50
USD/SEK	6.93	6.66	7.00	7.58	7.66	7.79
TCW (SEK)	133	129	131	134	132	129

Sources: Swedbank and Ecwin



markets and strong growth of retail trade and accompanying tax collection. On the expenditure side, the government has approved on an extra transfer of SEK 1 billion to cover the costs associated with the flu vaccination. We expect the fiscal balance for 2009 to improve by 0.2 percentage points of GDP compared to our previous forecast.

The government's budget for 2010, proposes continued expansion of the fiscal stimulus measures. The bill contains additional transfers to local government amounting to SEK 10 billion to compensate for falling revenues and increased spending relating to, in particular, growing social assistance costs. These transfers are expected to limit the numbers of layoffs in the local governments. Funding for labour market programs is further expanded compared to the Spring Policy Bill, including measures to assist the increasing number of people that will become ineligible for continued sick leave. On the revenue side, the government is proposing to implement the fourth phase of the tax cut on labour income. This is expected to lower tax

revenues by an additional SEK 10 billion per year. Compensation for the pensioners is estimated at SEK 3.5 billion. Put together, the cost of these new proposals, of about SEK 32 billion, is approximately of the size we predicted in our June forecast. In addition, we expect additional spending initiative to be launched in the 2010 Spring Fiscal Policy Bill, ahead of the election in September, amounting to some SEK 10 billion. The upward revision of GDP growth for 2010, compared to our June forecast, is expected to improve the fiscal balance, and our forecasted fiscal deficit for 2010 is 3.2 % of GDP.

For 2011, we do not expect any significant consolidation efforts of the budget deficit. Most of the measures that the government has taken on the revenue side are permanent, although some of extra spending announced this year is phased out, and spending pressures relating to labour market programmes are likely to remain high as the unemployment rates continues to increase. The increasing GDP growth, however, is expected to improve the fiscal balance mainly through better revenue perform-

ance, and we forecast a deficit of 2.8 % of GDP in 2011. We have also revised the projected path of public debt, and we expect the consolidated gross debt (Maastricht) to reach almost 50% of GDP in 2011. We do not expect any significant change in the overall balance should the elections result in a change of government. In that event, however, the composition of the fiscal policy might change toward higher spending on labour market programmes coupled with increased tax rates.

Still, the rules based fiscal policy framework will be tested and the debate on whether to further increase spending and lower taxes will intensify in the run up to the elections next year. We foresee that the target of 1% surplus over the business cycle will be breached. In addition, the Stability and Growth Pact deficit limit of 3% of GDP will also, on current projections, be exceeded, and local governments will struggle to balance their budgets in 2010 and 2011. However, even though the Swedish fiscal position is worsening as an effect of the financial crisis and the recession, the situation is not yet alarming, and it is substantially better than in many other EU countries.

Cecilia Hermansson

Jörgen Kennemar

Magnus Alveusson

Estonia – Slow Recovery

Key Economic Indicators, 2007 - 2011

	2007	2008	2009f	2010f	2011f
Economic growth, %	7.2	-3.6	-13.5	0.0	2.0
GDP, mln euro	15,627	16,073	13,400	13,300	14,000
Average growth of consumer prices,%	6.6	10.4	-0.3	-1.0	1.4
Unemployment level, %	4.7	5.5	13.5	14.2	12.5
Real growth of gross monthly wage, %	13.0	3.2	-5.5	-5.0	1.0
Exports of goods and services, %	7.0	6.9	-20.0	1.5	3.5
Imports of goods and services, %	8.0	-2.8	-30.5	-1.0	3.2
Trade and services balance, % of GDP	-11.7	-4.3	5.5	7.0	7.0
Current and capital account, % of GDP	-16.8	-8.4	4.5	6.0	5.5
FDI inflow, % of GDP	12.8	8.2	5.0	4.0	6.5
Gross foreign debt, % of GDP	111.0	118.5	130.0	128.0	120.0
General government budget, % of GDP	2.6	-2.9	-2.8	-2.8	-1.5
General government debt, % of GDP	3.4	4.7	5.0	5.5	6.0

Sources: National statistics and Swedbank

The Estonian economy reached the bottom of the current cycle in the summer and has started a slow recovery in the second half of 2009. Growth in 2010 will be marginally above zero and 2% growth is expected in 2011. The process will take long –at least 5 years to reach pre-crisis levels, depending on developments in the global economy and in Estonia. The major negative impact comes from domestic demand –the estimated cumulative decline during 2008 - 2010 will be over 30%. Net export will contribute positively to GDP growth.

Weak domestic demand will squeeze imports, but exports have already started a slow recovery in the second half of 2009 as global demand improves. Hence, the current account surplus will increase this year and next, with probable stabilisation in 2011 and decline afterwards. Growing savings, low investments, and overcapacity in companies mean that both domestic and foreign debt levels will decline.

We are cautiously optimistic regarding the government's capacity to adjust budget spending to revenues. Despite

several minefields, there is a possibility that Estonia will fulfil the Maastricht budget criterion and will be able to adopt the euro in 2011.

There are several positive risks in our forecast (mentioned below, but difficult to estimate as of now due to uncertainty about the turning point in the economy¹), which we have not taken into account in our main scenario. The major downside (but also upside) risk is the global economy, but the adjustment process in the public sector also poses a clear risk.

1 It is always difficult to make forecast at times when trends are changing, especially taking account that release of statistics always lags economic processes. We see that Estonia is currently (i.e. in September 2009) in that position.

Swedbank's GDP Forecast - Estonia*

	2007	2008	2009f	2010f	2011f
Household consumption, %	9.0	-4.7	-21.0	-9.0	3.5
Government consumption, %	3.7	4.1	0.0	0.0	0.0
Investments, %	8.2	-16.6	-38.0	13.0	8.0
Domestic demand, %	7.5	-7.4	-24.0	-1.0	4.0
Exports, %	0.0	-0.7	-10.0	1.0	3.0
Imports, %	4.7	-8.7	-30.0	-1.0	3.0
Net exports, contribution to GDP growth, %	-5.2	8.7	18.5	1.0	-2.0
GDP, %	7.2	-3.6	-13.5	0.0	2.0

* These are averages of the forecast ranges.

Sources: National statistics and Swedbank

Economic downturn has ended

We forecast Estonian economy to decline 13-15% this year as domestic demand will contract approximately 25%. The economy will stabilize in 2010, and show around 2% growth in 2011. Domestic demand will contribute negatively this year and next, while the impact of net exports will be positive. As domestic demand strengthens, imports will pick up, and, consequently, the impact of net exports should turn negative at the latest at the end of 2011.

The slowness of the recovery is a result of several factors. Low domestic confidence: we are of the opinion that the improvement of confidence, which started in April, is still mostly a reflection of overly pessimistic views in October to February, although some of the improvement is definitely also a result of real improvement in businesses (particularly

in manufacturing). The huge scope of adjustments: although the private sector has gone through the largest part of the process for now, this process has not yet ended, and the public sector continues to struggle with the changed environment.

External demand – already picking up

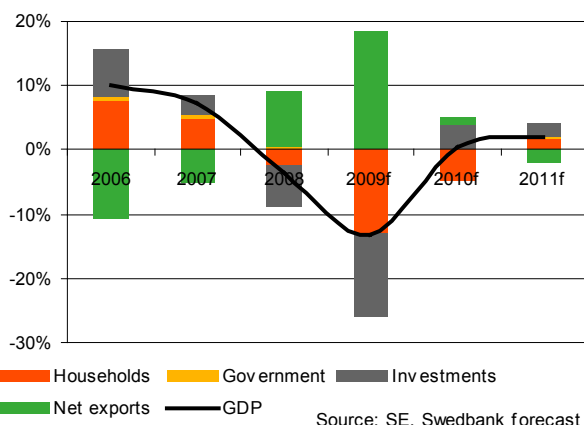
We forecast that the recovery from the collapse of exports (the cumulative decline from September's peak to April's low point was 35%) will be slow, albeit merchandise exports have recovered already by 13% (July vs. April). We expect that merchandise exports will reach 2008's level at best in 2013, while services are expected to perform better. Our expectations are based on following reasoning.

Estonia's exports of goods is heavily dominated by cyclical products – both intermediate and own-produced inputs for production of capital goods – hence,

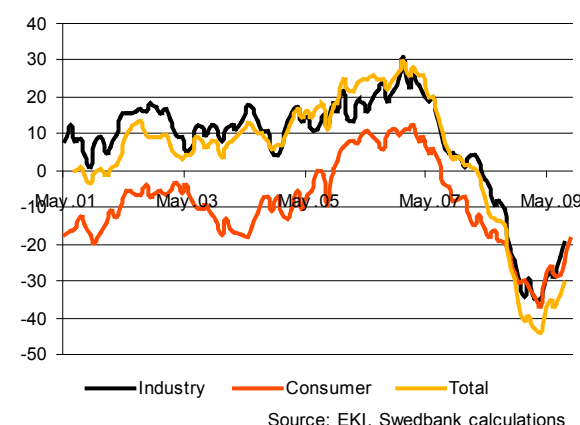
the effect of the crisis on the trade volumes is strong, and the recovery of those exports will take time. The situation does not look promising, taking into account the fact that Estonian manufacturing companies are subcontracting mostly for Finnish and Swedish producers, which are among those suffering the most from the international collapse in demand. In addition, Estonian exports to Russia, Latvia, and Lithuania included large shares of intermediate capital goods, like machinery, equipment and vehicles, which are unlikely to recover soon (probably only in 2011). Although this means lower imports as well, Estonia loses from services related to this process.

The Estonian economy is benefitting from transit-type trade – importing mineral products from Russia and raising their value added (adding some components) and selling them mostly to countries outside the EU. This type of business produces rather substantial

Contributions to GDP Growth



Confidence Indices, s.a.



trade flows, but the processing itself generates relatively little value added.

Estonia will increase exports of electricity to Latvia and Lithuania after Lithuania closes the Ignalina nuclear power station, but exact volumes are hard to determine, as they depend heavily on the decision making in a few companies. Hence, our expectations may fall short of actual results.

In intra-Baltic trade (and related production), Estonia most likely will continue to lose ground in 2009 and early 2010 due to the cost advantage its southern neighbours have – this will affect primarily the food industry (and related businesses), but also metalworking (for export orders) and other specific sectors/products. This situation will not last long due to the small size of the market and heavy competition. But for some time it will exert a very strong pressure on domestic food industries and agricultural prices. The latter are also subject to pan-EU decision making, which we consider as neutral for our forecast.

Wood, timber, paper, and furniture industries are performing relatively well as lower prices of timber and increased supply make it possible to produce competitive products. However, the increase will remain relatively modest in 2009 and in the beginning of 2010, as export markets will remain weak. In following periods, we expect a rather good performance due to favourable mix of cost, price, and competition.

Cost competitiveness has improved significantly during the last 12 months, and we expect this to continue in 2009 and early 2010. Cost and inventory cutting in enterprises has brought these elements down to the level of early 2007 or late 2006, according to second quarter data. Because of cost adjustments, companies will continue to improve efficiency, making them also more profitable even in the challenged demand environment.

We were cautious in projecting strong revenues from services. Due to the fall in global trade and the distressed domestic demand in neighbouring countries, particularly Finland, we do not expect strong growth to appear soon. Still, the low prices may attract Finnish and international customers, providing us with one possible positive risk in our forecast. The outlook for 2011 is better as the global economy improves, but this will also increase imports of different type of services.

Estonia is about to benefit from production transfers from Finland and other Western EU countries, but the process might be not very intensive in 2009, as the expectations of a devaluation of the kroon are affecting many decision makers. The clear prospect of the adoption of the euro would significantly speed up the process of production transfer, as well as related export and economic recovery.

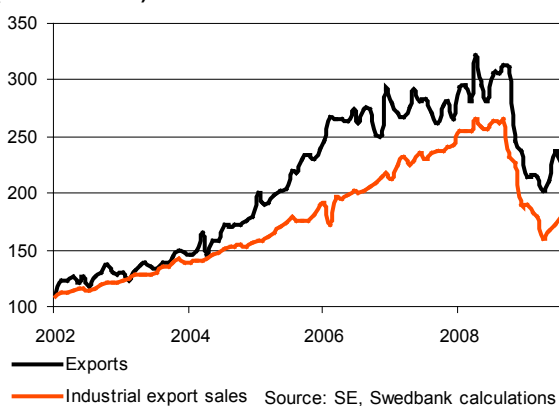
Current account in surplus, debt down

We expect the Estonian current and capital account balance to be in increasing surplus in 2009 and 2010. Stabilisation is expected in 2011, after which the surplus will start to decline gradually.

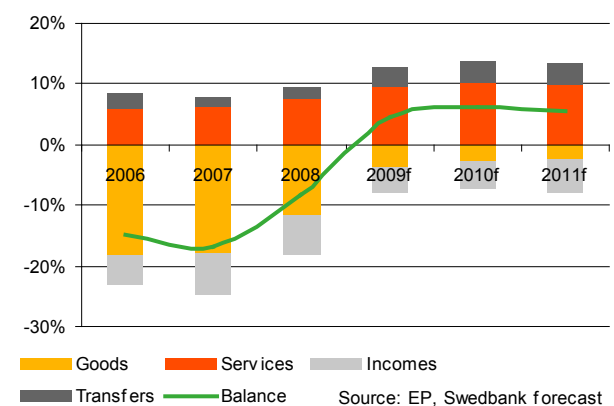
As domestic demand has fallen very sharply, the decline in imports has been much stronger than that of exports (e.g., in the second quarter, imports declined by 34.7% and exports by 22.5%, compared to a year ago). Consequently, the trade and services balance swung into a large surplus (8.1% of GDP in the second quarter). We forecast that the trade and services balance will remain in surplus during the forecast period, but this does not take into account (1) the possible increase of electricity exports, and (2) imports of investment goods for special investment projects in the energy sector (see below).

The income account, which generated substantial deficits in previous years on account of reinvested profits, is now reporting a significantly smaller deficit. We do not expect a surplus in the income account, as (1) workers' remittances will remain small, even if they will increase in 2010-2011, (2) the profitability of foreign direct investments (FDI) in Estonia will remain relatively good, which is not the case with Estonian investments abroad (mostly in Latvia and Lithuania), and (3) net payments of interest rates are modest due to low rates and relati-

**Index of Export Volumes, s.a.
(Jan.2000=100)**



**Current and Capital Account Balance,
% of GDP**



vely low levels of debt.²

We forecast an increase of governmental current and capital transfers as the government is trying to use as much EU funds as possible (and there are more available). However, private sector transfers will be relatively low in 2009 but grow in 2010 and onwards.

The current account surplus and sharply fallen foreign financing has pushed the financial account into deficit, but these developments do not necessarily mean problems. The level of new FDI has been surprisingly strong in the first half of 2009 (over 3% of GDP), but reinvested profits are low as losses increase and FDI loans are highly negative. Estonian FDI abroad is also very big (5.5% of GDP). However, with other investments, Estonian residents reduce their assets abroad (particularly the government), and decrease their liabilities (particularly banks).

We expect those processes to continue in 2009 and probably into the first half of 2010, but some quarterly fluctuations are possible. A sharp increase of FDI is expected at the end of 2009 as Telia Sonera most likely will take over the Estonian Telekom. Estonian gross foreign debt will decline. The overall deleveraging process will, however, continue far

² Estonia earns relatively good income from loans given to other countries (mostly in Central and Eastern Europe). The net interest payment is close to balance despite the fact that Estonian gross debt is higher than its gross lending.

beyond our forecast range.

We do not expect the net foreign financing of Estonian banking sector to increase as demand for loans will remain low and domestic deposits will continue to increase. We also expect that the Estonian financial sector will resume investments abroad as the second pension pillar will partly start to work in 2010 (we expect that 50% households will resume of their contributions; the payments were stopped in June).

EU funds drives investments

We forecast gross investments to plummet by about 38% this year after declining by 16.6% in 2008. However, this very sharp decline will be followed by over 10% growth in 2010 due to the very small comparison base. In following years, investments will grow by 4-8% per annum. The decline of fixed capital formation (i.e., investments excluding inventories) will be substantially smaller than the decline of gross investment – “only” about 25% - but the recovery in 2010 will be also very minimal, at 2-3%. Our projection of investments is very uncertain, as the data available about past investments are poor and difficult to use for numerical forecasts.

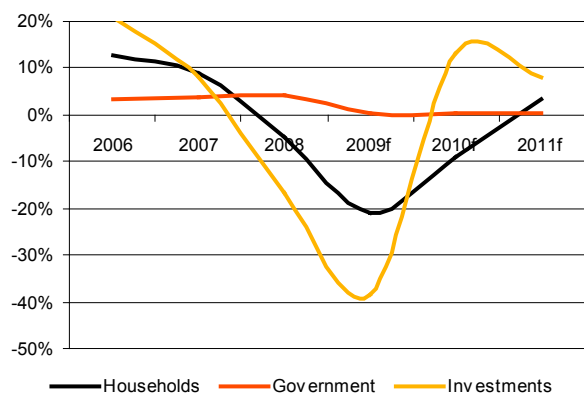
We are extremely pessimistic regarding real estate investments, both in residential and non-residential areas. The oversupply of residential office and retail

space is significant and demand prospects are poor. Hence, growth in these areas can at best not be expected until the end of 2010, but more likely in 2011. Even then, the recovery will be rather small and confined to selected areas. Due to the low comparison level, the growth rates might, however, be relatively strong at first.

The same effect – low absolute levels – might bring relatively vivid growth rates in other investment areas as well. Our forecast is not taking into account large possible investments in some companies (e.g., the renovation of the Narva power stations and the building of Estlink2 by Eesti Energia), which will most likely take place during 2010-15, as the timing and cost are not clear. These large investment projects may substantially affect Estonian investment levels, imports, and future exports, and are thus positive risks for our scenario.

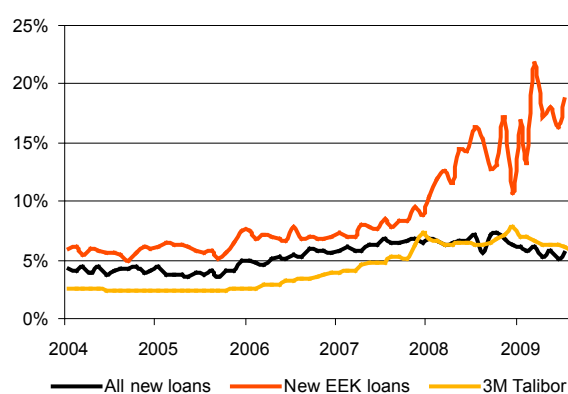
We are not very optimistic regarding machinery and equipment investments in the short-term, as well as purchases of transport vehicles (excl. possible big purchases of major companies, which are not taken account in our forecast) due to high overcapacity (in the second quarter capacity utilization rate in the manufacturing sector was about 59%; long-term average being 68%) and low demand. However, we expect that in 2010, particularly at the end of the year, growth will resume. The euro prospects and production transfer might increase

Domestic Demand Components, yoy



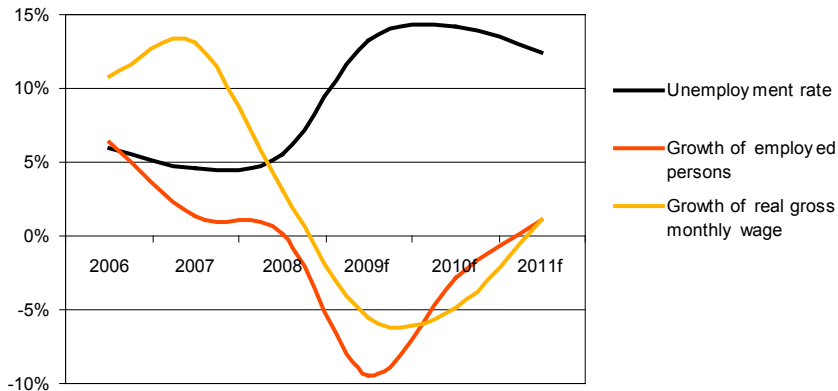
Source: SE, Swedbank forecast

Loan Interest Rates



Sources: EP, ReutersEcoWin, Swedbank calculations

Labour Market



Source: SE, Swedbank forecast

the machinery and equipment investments in 2010 and 2011 more than our main scenario predicts.

The only area of investments where we are optimistic is that of EU-funded investments, which mostly go to infrastructure (e.g., road-building, environment, and energy efficiency). However, some investment also goes into important social areas (e.g., health care and education). The reasons for our optimism are the following: first, the substantial increase in funds available for Estonia from the EU budget; and, second, the keen interest of the government to use all available funds.

One positive factor for investment prospects is the low price of capital, investment goods and services. This affects positively EU-funded investments and households' small investments (renovations), and has recently engendered slight optimism on the real estate market. However, as the number of potential buyers is relatively low, and most of them have taken a wait-and-see position, we cannot expect a vivid recovery in the real estate market. If it comes, the secondary market (particularly soviet-era cheap apartments) is the most likely area of higher activity.

Inventories will contract by 4-6 percentage points of GDP during the years 2008-2009. While last year the contraction affected mostly unfinished buildings, during 2009 companies are diminishing their inventories of products

(inputs, final and for sale). Although the majority of inventory cutting might be over for now, we cannot expect a vibrant recovery until domestic demand starts to grow, and we see this happening only in mid-2010.

Labour market – situation continues to worsen

We expect both the number of employed persons and the average gross wage to contract by 10-12% during the crisis; and the unemployment rate will exceed 14% in 2010 (over 15% in some quarters). This forecast is based on several processes that affect the Estonian labour market.

The major long-term factor is the decline and ageing of the total and working-age (from 15 to 74 years' old) population. The recent peak of the working-age population was in 2006 (1,049 thousand people), and for 2012 the number will decline below 1,020 thousand (about 3%). Hence, the potential supply of labour will continue to fall.

The activity rate reached 67.7% in the fourth quarter of 2008 (the average of the last ten years is 64%) as most of people who are able to work listed themselves on labour boards to get state allowances and/or services in the case of need. Hence, the number of unemployed and the unemployment rate grew much faster than the number of layoffs. The activity rate started to decline after-

wards, but we do not expect a sharp correction of this level.

The number of job seekers is up also on account of those who were working abroad. Although many (probably most--we do not have figures on people working abroad) have remained in their host country even in cases where they have lost their job, because of the higher unemployment benefits there. However, a very substantial number of Estonian residents are working abroad (mostly in Finland) on a contract basis while maintaining their residences in Estonia. Those people register for unemployment positions in Estonia.

We expect labour outflow (mostly contract based) to increase in the future; however, this depends on the economic situation in the host country, which in Estonia's case is usually Finland. Even Finland may not offer many possibilities as unemployment grows there. We also see that Estonians are less demanding (e.g., concerning wage and location) and more competitive in specific geographical and professional areas; hence, the labour outflow will definitely increase. The biggest outflow will probably appear only in 2011 or even later, when Western EU countries are growing, while Estonia's economic situation may not yet be as good and the unemployment rate still high.

Most of unemployment is now short term, but it lengthens as fewer jobs are created than cut. This means that unemployment-related social costs and problems have only started to increase. We project the most troubled time to appear in winter 2009-2010.

The significant layoffs have arisen in most of the troubled sectors – construction, notably – and companies. However, companies ended also their overstaffing, which was widespread during recent boom years when companies, because it was very difficult to find new workers, kept people on board in case they needed

more workers. The labour shortage created also a fall in productivity, as new workers were in average less productive than the old ones. Therefore, the current cost cutting is also raising the productivity level.

Many companies used part-time jobs and wage cutting in different ways to adjust with the drop in sales last winter and spring. Layoffs intensified afterwards as companies became aware that the crisis was not about to end soon and because the labour law limits the possibility of forced part-time jobs or unpaid vacations.³

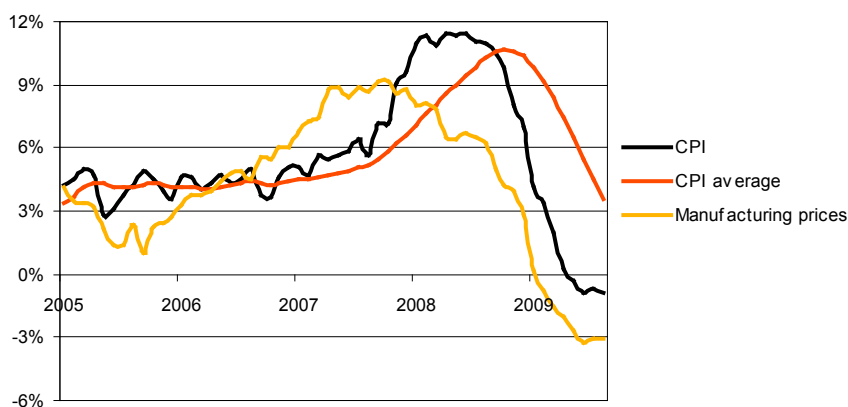
The new labour law, which increases the flexibility of the labour market, took force in July. This has led to an increase in the number of layoffs in August; however, this process is also a result of the increasing number of bankruptcies.⁴ The number of officially unemployed is growing substantially more slowly than last winter (about 130 persons per day vs. over 400 then). This level has been stable for 3-4 months, as the number of ended jobless claims is growing (i.e., people are moving to work, or back to non-active status).

The unemployment rate may start to accelerate in autumn as seasonal works end, but we should not expect sharp increases in unemployment anymore. One reason is that the companies have already made most of the adjustments. Another reason, speculative –we admit, is that the public sector will make the labour cost cutting mostly through wage cuts, and to a lesser extent through job slashing. We forecast that the public sector will primarily choose wage cuts, and then go on to cutting working hours (either through part-time jobs or unpaid vacations). The reason for expecting this

³ There is more room in the case employers and employees find the agreement for cutting working hours, but it is extremely difficult to expect to happen in bigger companies. Estonian trade unions are generally weak (except in some areas) and the use of collective agreements is very low.

⁴ Bankruptcies do not start at the beginning of a crisis, but later.

Major Price Indices, yoy



Source: SE, Swedbank calculations

is the need to continue providing public services, although in smaller volumes. The public sector's cuts in labour costs will affect the economy mostly in 2010.

The gross average monthly wage has fallen in 2009 as private sector has continued and as public sector has started with wage cuts. Seasonally adjusted data suggest that the wage decline started at the end of 2008 and that the cumulative cut has been so far about 6%. This figure, however, does not reflect the part time jobs and increased tax burden. Our estimates suggest that payrolls may decline over 20% during this crisis.

Household consumption – no extra spending planned

We forecast that household consumption may plummet by over 20% this year and an additional 8-10% in 2010; following a decline of 4.7% in 2008. Consequently, households will slash their spending about 30% during the crisis. The recovery of consumption will be relatively good, although well below levels of previous years, i.e., 3-5% per annum.

The major factor that affects household spending is the decline of incomes. We forecast about a 22% decline of net wage income, as the tax burden increases (the unemployment insurance rate was increased in June and August), this year. An additional loss of net incomes comes from sickness payments, which starting in July were shifted for the most part onto the companies; these

payments will remain uncompensated for a longer period (3 days vs. 1 day before) and their level was lowered.

We do not expect a pension increase in 2010-11, or a pension cut (due to political reasons), although that could be one way to cut the budget deficit – this is one negative risk for our forecast. The incomes from allowances will start to decline in the winter as (i) a growing number of unemployed will lose their relatively high unemployment insurance payments and have to rely on very low state unemployment benefits (if they are eligible), and (ii) most of the other social allowances will be squeezed. The only two probable areas in which we could expect higher spending are social support for low-income families (covering minor basic needs), due to the increasing number of those families, and maternity/paternity leave payments, which will be increased.⁵

We also expect a decline of remittances from people working and living abroad, although already in the next year these amounts probably will start to grow.

Consequently, household incomes will fall rather substantially. Our estimated disposable income is forecast to fall next year to the level of mid-2006. As a response to falling incomes, households will squeeze spending and try to increase savings (as they have done so already). It is possible that the savings will continue

⁵ The political will may change, however we see that unlikely in the current coalition.

to increase. However, it is very unlikely to happen in the first half of 2010 as housing costs (mostly heating) will take a big chunk of spending, and incomes will be the worst during the crisis at that time.

Although consumer confidence has recently strengthened, and most of all on the basis of well improved expectations, we see that the actual situation is deteriorating gradually and are of the opinion that this improvement of moods is in substantial part an overreaction to the overly pessimistic mood of last winter. It might be that households have adjusted their everyday lives to the changed environment, and accept that the recent boom years were abnormal (the 2006 spending level was not bad at all).⁶

Falling prices are a factor that definitely makes households' financial situation stronger – we expect that consumer prices will fall this year 0.4-0.1% on average and by about 1% in the next year. It is, however, somewhat complicated to make good estimates of the CPI as the consumer basket has probably changed very substantially during the year. The spending on durable goods has fallen sharply, and the same applies to many services. People have shifted to cheaper products, have increased the use of own products (e.g., food and leisure services) and secondhand goods are very popular (this is the only area where retail sales are growing). These environmentally friendly and sustainable developments have, however, a rather negative impact on economic growth. The consumption deflator suggests that the price decline has been deeper for households than the fixed-basket CPI decline (in the second quarter, on an annual basis -0.5% vs. -0.3%).

Economic policy – budget gets all the attention

The possible changes in economic policy are crucial for our forecast; however,

⁶ This means that a shift has taken place in peoples' expectations and valuations, like that around 2005, but now in the opposite direction.

they are hard to predict in the current political situation (a minority government and local elections on October 18th). We are hardly in the camp of pessimists but also not among the optimists in that aspect. We are of the opinion that the government will continue its efforts to keep the budget deficit within the Maastricht criterion (i.e., below 3% of GDP), and aim for membership of the EMU in 2011. We see that it is possible that Estonia will meet this criterion in 2009 and will be accepted as a new member of the euro zone in 2011 (acceptance expected in late spring or early summer of 2010). However, we also see the possibility that Estonia marginally misses the target, as there could always be political turbulence and indecision.⁷

Although we do not expect that possible shifts and changes in the government would mean a principal change of the government policy, it could bring short-term delays in the adjustment process that would be enough to thwart fulfilment of the budget criterion. However, we are also of the opinion that the financial markets will not significantly punish⁸ Estonia for missing the budget target, if that overshooting is small. In any case, this requires that the Estonian economy show clear advancement at that time (in April-May 2010).

We do not expect changes in monetary

⁷ A very big uncertainty comes from the measurement of GDP (particularly deflators) and its revisions afterwards (in last four quarters GDP growth rates have been revised up, the most drastic being the first quarter of 2009 when annual decline was improved from 15.6% to 14.2%). The government has made its budget calculations based on a pessimistic view of the economy (i.e., 14.5% decline of real GDP and 0.9% of GDP deflator in 2009) to maintain a large safe margin.

⁸ This opinion is based on the fact that market consensus does not expect the fulfilment of the budget criterion. Short-term increase of interest rate margins is, however, very likely. Estonia has managed to distinguish itself from its southern neighbours (look on interest margins), but regional view weights heavily on general public opinion, hence we cannot be sure about the reactions. Unfortunate regional or/and global timing could end up with totally different result.

policy ahead of euro zone membership Euro adoption would make the economic recovery easier as it should finish the speculations about a kroon devaluation and bring more and cheaper investments. It would also mean that Estonian companies could expand their businesses and export sales, as the low confidence exhibited in Estonia is quite often a big obstacle for business.

In the fiscal policy area, we do not expect substantial increase of taxes in the future, although smaller adjustments are likely. Political parties, which could initiate a larger tax increase (first of all, through income tax), lack the needed support in parliament. The current government has opposed any change – except for freezing the planned income tax rate lowering – in the current income tax law (applies both to persons and companies). Nevertheless, there are many different proposals from different parties, analysts, and think tanks (mostly regarding corporate taxation). We do not expect any major changes, but we would also not be surprised if something is decided after the elections or in case of a government reshuffle.

Taking into account the rather high level of labour taxation, we do not expect a further increase in this area, but rather a decrease in 2011 or, more likely, after that (e.g., lowering the unemployment insurance rate back to 3%,⁹ and setting an upper limit for the social tax). The most likely areas of further increase are consumer and environmental taxes; although they were increased only a few months ago (an increase of the tobacco excise in January is currently the only one stipulated in the law, increase of alcohol excise was confirmed by the government recently). An increase of VAT rates after July's raise from 18% to 20% looks unlikely as of now.

The government is trying to increase nontax revenues and cut spending. It

⁹ It was increased to 4.2% combined for employers and employees in August.

is planning to increase dividend payments from state companies (from Eesti Energia, Tallinna Sadam, and Estonian Telekom), sell state property (including forests), improve the collection of unpaid fines, etc. Our forecast does not expect that the state will sell any of its ownership in major companies, except the recently decided sale of shares in Estonian Telekom. The government has made an initial proposal to cut spending across the board by 9% in 2010; however, this requires making some difficult political choices, which is difficult to do ahead of elections.

The cofinancing of EU funded projects is one major area where the government has not made meaningful cuts. While all borrowing by local governments has been frozen, they can take loans for cofinancing purposes (on approval of the Ministry of Finance). As the EU funds are

now practically the cheapest way to get funding for investments and their effect on investments and future economic growth is rather substantial, it is unlikely that these would be cut; on the contrary, many efforts have been made to increase the use of EU funds.

This is practically the only way the government can support the economy – public sector investments are sharply up as a share of GDP – although some other efforts are being undertaken (e.g., extending the export guarantee programme) and several proposals are being prepared by ministries. Still, the implementation of these programmes may need time due to budget constraints, as the government's most important goal is to keep the budget deficit below 3% of GDP.

Estonia's public sector finances are in relatively good shape as substantial

reserves were built up during the boom years. These reserves have allowed the government to avoid the need to borrow extensively; however, they are not limitless, and are often meant for specific purposes. Besides the central government, municipalities and public institutions (e.g., hospitals) have collected reserves and are now using them. Setting limits for the use of these reserves is politically very challenging and legally difficult, so the burden of adjustment has shifted significantly to the state budget. The public sector budget will remain in deficit for several years, but after the sale of Estonian Telekom there is no urgent need to borrow for covering the budget deficit, as reserves amount to some 8% of GDP. If the government decides to borrow it will carefully consider the cost of borrowing (the current interest rate of existing loans is around 4.7% and most of these loans were taken in the 1990's).

Maris Lauri

Latvia: Recovery path largely depends on government action

Key Economic Indicators, 2007 - 2011

	2007	2008	2009f	2010f	2011f
Economic growth, %	10.0	-4.6	-18.0	-2.0	3.0
GDP, mln euro	19,936	21,910	17,966	16,375	16,697
Average growth of consumer prices, %	10.1	15.4	3.5	-4.0*	0.0
Harmonised unemployment level, %	6.0	7.4	17.0	20.0	18.5
Real growth of average net monthly wage, %	19.9	6.1	-8.0	-2.0	2.0
Growth of exports of goods and services, %	24.1	10.4	-21.0	4.0	8.0
Growth of imports of goods and services, %	23.5	-3.3	-38.0	-14.0	7.0
Balance of goods and services, % of GDP	-20.6	-13.0	-1.0	6.5	7.5
Current account balance, % of GDP	-22.5	-12.6	10.0	9.0	7.5
Current and capital account balance, % of GDP	-20.6	-9.8	12.0	11.0	9.5
Net FDI, % of GDP	6.7	3.3	1.0	3.0	3.5
Foreign gross debt, % of GDP	127.6	128.2	145.0	150.0	140.0
General government budget, % of GDP	0.1	-3.3	-8.5	-7.5	-5.0
General government debt, % of GDP	9.0	19.5	40.0	55.0	60.0

* If VAT is not increased

Sources: National statistics and Swedbank

The largest fall in GDP is over; however, contraction will continue and the trough in the Latvian economic cycle is expected in mid-2010. Although the global economy seems to be bottoming out faster than expected, its recovery is likely to be slow and bumpy. Consistent positive growth in Latvian exports is thus not expected earlier than the beginning of 2010. Renewed agreements with international lenders (the IMF, the EC, the World Bank, etc.) allow Latvia to finance its budget deficits and carry out the necessary restructuring.

We expect that the cumulative Latvian real GDP fall from the peak to the trough will be about 25%, thus returning to 2004 levels. As annual figures are extremely sensitive to timing (e.g., in which quarter a larger decline occurs), the forecast ranges are quite wide.

We maintain our view that the largest fall in GDP will be in 2009, reaching 17-19% followed by stabilization in 2010 (-3% to 0%) and a slow growth in 2011 (2-5%). The job seekers' rate will reach its maximum in the first half of 2010 (20-21%), before starting to diminish in 2011 by a few percentage points due to rising employment and emigration. Because of tax rises earlier in the year, 2009 will still show average annual inflation of 3-3.5%. The largest consumer price deflation is expected in 2010 (2-4%), while prices will stabilize in 2011. Although exports and imports are by and large already balanced, there will still be a small trade account deficit in 2009 (0-2% of GDP), which will turn into notable surpluses in 2010-2011 (4-8% of GDP), with slowly recovering exports exceeding weak imports driven by falling domestic demand.

Our base forecast is built on the assumption that government action will remain reactive, as it is now. The speed of the recovery will be largely determined by the 2010 government budget. So far, the economic activity has been falling due to both domestic demand and export contraction, but the dynamics are changing. While the domestic demand fall will continue (albeit slower), exports are bottoming out, thus changing the economic structure. The economy is muddling through, but the risk factor is government action, which might create uncertainty and distort motivation for recovery.

Swedbank's GDP Forecast - Latvia*

	2005	2006	2007	2008	2009	2010	2011
GDP	11%	12%	10%	-5%	-18%	-2%	3%
Household consumption	11%	21%	15%	-11%	-20%	-12%	0%
General government consumption	3%	5%	4%	2%	-8%	-8%	-4%
Gross fixed capital formation	24%	16%	8%	-13%	-30%	-17%	1%
Export of goods and services	20%	7%	10%	-1%	-16%	2%	5%
Import of goods and services	15%	19%	15%	-14%	-35%	-15%	5%
Net export contribution to GDP	-0%	-9%	-5%	8%	14%	8%	0%

Source: Swedbank

* These are averages of the forecast ranges, which are as wide as 2 percentage points.

Most of GDP contraction is over

Latvia has been in a recession for 6 quarters now. GDP has fallen to the 2005 level, with a cumulative decline of 21% from the peak in the fourth quarter of 2007. After a seasonally adjusted GDP fall of 11% in the first quarter of 2009, the speed of contraction decelerated to 0.8% in the second quarter, and we believe that the largest quarterly fall has now passed. Due to, e.g., government spending cuts and their effect on domestic demand, the declines in the second half of the year are anticipated to be larger than those of the second quarter; however, a drop of 11% will definitely not be repeated. Recovering exports, significantly smaller declines in inventories, and further falling imports will support GDP in 2010, and slow quarterly economic growth might resume in the middle of the year. Investments will join the positive growth trend in late 2010 and private consumption in 2011.

External sector is largely balanced

We believe that export volumes will bottom out in the second half of 2009 and start growing in early 2010. Real exports are now back to their 2005 level, being about 21% down from the peak in 2007 (i.e., in line with GDP contraction). A fall in real imports continues; however, it will decelerate in the second half of the year. Since early 2007, real imports have diminished by 46% and we believe that their cumulative fall will reach 55% by mid-2010. By the second quarter of 2009, export volumes were nearly the same as imports in real terms.

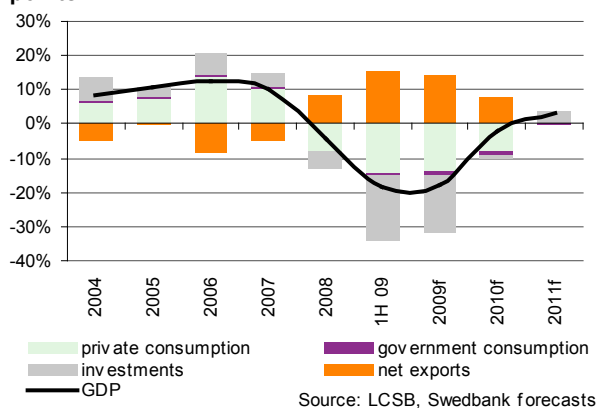
Foreign trade forecasts are subject to the high uncertainty of export/import deflators. They are influenced not only by global price developments, but also by other business costs, as well as the change in the product mix.¹ Therefore,

1 For instance, wood industry temporarily shifted to lower value added products, as their demand had declined less than for more advanced products.

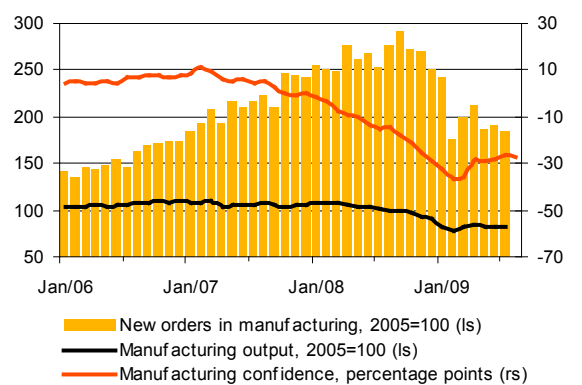
the figures are likely to be revised afterwards, resulting in smaller fall in real exports and imports.

We forecast nominal exports to decline by 19-24% in 2009. Slow growth will start in 2010 (2-5%) and accelerate in 2011 (6-10%). This forecast is based on the view that manufacturing has basically bottomed out and fragile growth is already observed in, e.g., wood processing. Export volumes of food products, chemicals, and plastics seem also to have levelled out and started growing slowly (although industrial output in these industries is not yet rising). New orders in manufacturing are not growing notably so far, but are quite stable, as is also industrial confidence. Cost competitiveness has started to improve slowly (see the section on labour market adjustment), while globally lower commodity prices are allowing Latvian exporters to increase their market shares. The positive risk is a shift in the product mix back to higher-value-added products

Contribution to GDP growth, percentage points



Industry indicators, s.a.



when global demand recovers. Although currently exports to CIS countries are declining somewhat slower than to the EU15, the short term export possibilities to EU15 countries are more favourable as they are expected to recover faster (e.g., Germany, France, and Sweden already showed positive quarterly growth in the second quarter of 2009).

Nominal goods imports have been largely stable since May, and the imports' fall will decelerate in the second half of 2009. External imbalances have for the most part vanished, and with the trade account (goods and services) nearly balanced; the current account has therefore also improved. While in 2009 overall the trade balance will still be negative, it will improve substantially in 2010-2011, reaching a surplus of 4-8% of GDP. The trade surplus will be supported by negative import growth in 2010 (9-14%, with nearly one-third of it being a negative carryover effect), as private consumption and investments will still be falling. Driven by stabilization in domestic demand and export growth, imports will start to grow gradually (5-7%) in 2011. The import growth will be supported by increasing demand for the imported capital and intermediate goods necessary to produce exports and restocking. However, the import growth will still be smaller than that of exports as private consumption and investment growth will still be marginal.

The current account surplus that

emerged so quickly in 2009 is also very much due to the income account surplus, which is driven by FDI losses (the virtual accounting effect). The current account surplus reached 14.2% of quarterly GDP in the second quarter. Such a large surplus is clearly temporary. With FDI losses disappearing in 2010-2011 (e.g., part of the loan provisions of the banks will not materialize in actual losses), the income account surplus will decline notably. We believe that interest rate payments will not increase substantially in 2010-2011 (the interest rates on the IMF and EC loans are low and private debt is expected to decline). Therefore, the current account balance might reach a surplus of about 10% of GDP in 2009, but diminish to 6-9% of GDP in 2010-2011 and will mostly likely be caused by the positive trade account balance.

External debt volumes in lats are not expected to change significantly over the next few years; however, the composition of debt will change. Currently private sector liabilities comprise 90% of total external debt. In the near term, government debt will increase, while the private sector liabilities will diminish due to weak demand for new loans and the gradual amortization of the existing credit stock. However, as nominal GDP will decrease more rapidly, the ratio of external debt to GDP is likely to rise to 160% of GDP in 2010 and diminish to 150% in 2011, when GDP recovers).

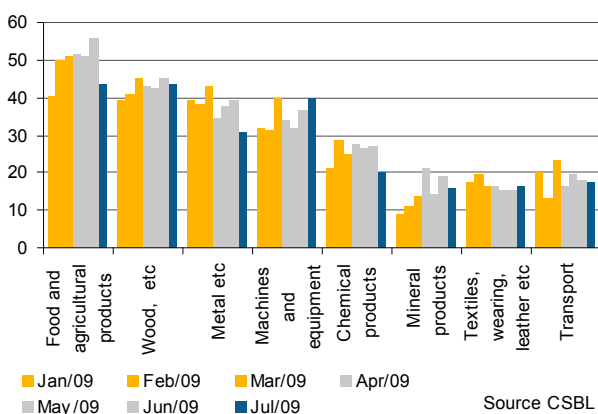
Investments activity to remain weak

The rapid fall in investments (excluding inventories) continued in the second quarter of 2009, and we believe that it will proceed also in the second half of the year, declining 30-32% in 2009 overall. Currently investments (excluding inventories) are back to 2004 levels, with a cumulative decline of 41%, but the most rapid quarterly declines are most likely to be over.

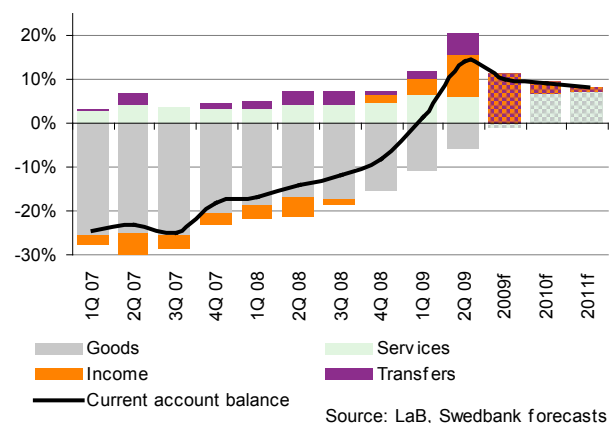
We believe that investments will fall by about 50% until the trough has been reached. Uncertainty remains high as tax changes have not yet been decided, the country ratings have been cut, financing are more expensive and more difficult to obtain, and business profitability has deteriorated dramatically. There is also substantial spare capacity in the economy –for instance, the capacity utilisation rate in manufacturing was 54% in the third quarter of 2009, compared with 72% in 2007. Therefore, despite the stabilisation of business sentiments, not much investment activity is expected. Government capital spending, which has been supporting investments in the first half of the year, is also being reduced in order to contain the budget deficit.

Investments are expected to bottom out in the second half of 2010. Stabilisation will be supported by low asset prices, necessity to increase equity capital due to deleveraging, as well as by the approved 2010 government budget (and, thus,

Exports by products, LVL m



Current Account, % of GDP



known tax changes) and the clearer global situation. We forecast investments (excluding inventories) to decline further by 15-18% in 2010 (however, nearly half of it is a negative carryover effect from 2009) and to begin to recover slowly in late 2010, with 0-2% growth in 2011.

The recovery will be based on investments in exporting sectors (e.g. manufacturing and transport), while the residential real estate market will probably not see significant capital inflows for several years. For instance, companies manufacturing wood products (e.g., panels for houses) currently invest in factories with a large capacity, so as to be ready to export when global construction markets recover from the crisis.

The least certain factor –yet the one that influences GDP by several percentage points –is inventories. The data are extremely unreliable as they are calculated as a residual (which includes errors and omissions). The fall in inventories in the first half of 2009 was substantial (about 9% of GDP); however, balance-sheet analysis suggests that many businesses still have large inventories. Therefore, destocking will continue, as businesses face weak demand, resulting in declining turnover and the need to deleverage at the same time. The largest adjustment is expected in 2009; declines in inventories will continue into early 2010 and will gradually start to rise somewhat before investments' recovery.

Labour market adjustment to deepen

Labour market adjustment is on its way. Private enterprises and public institutions continue to reduce their labour costs. In the private sector, this adjustment has been done predominantly on account of decreasing working hours and layoffs, while in the public sector it has been effected predominantly through wage cuts (especially in public administration and education). The total wage bill in the private sector decreased by 27% in the second quarter of 2009 compared to the same period last year, while in the public sector it was down by 13%. A decline in the total wage bill in the economy is in line with our expectations; however, average wages are decreasing slower than we have anticipated, because we underestimated the opportunities of businesses to reduce costs through cuts of working hours² (shift to part-time jobs, eliminating overtime, etc.). As long as at least about 20% of employees receive an official minimum wage (while probably receiving additional bonuses in "envelopes"), the official part of the income cannot be significantly reduced. The reduction in working hours is especially pronounced in services sectors (trade, restaurants, hotels, and support services), while in manufacturing, construction, transport, and real estate services the adjustment is mostly being

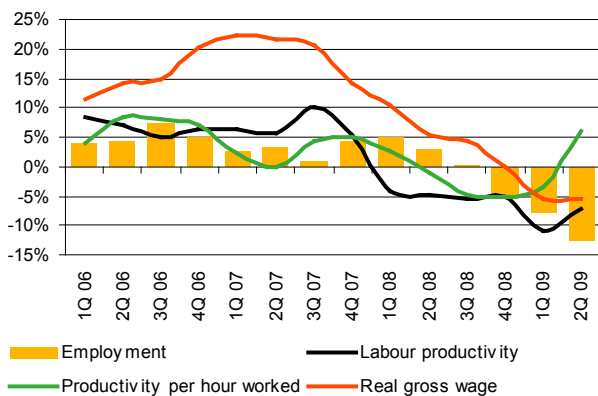
² Average wage is calculated as total wage bill divided by a number of employed in full-time equivalents

made through layoffs. Consequently, we have revised our 2009 forecast for average nominal net monthly wages to a decline of 3-6%. Similar decreases are expected also for 2010 (perhaps a few percentage points larger due to a negative carryover effect), with wages stabilizing in late 2010 - early 2011 and starting to grow marginally in 2011 as economic activity recovers.

Employment has decreased dramatically, returning to 2002/2003 levels (while GDP is at the 2005 level). Average labour productivity (i.e., GDP per employed) was still diminishing by about 7% in the second quarter of 2009 compared to the same period last year. In turn, productivity per one hour worked has started to grow already, reaching 5.9% growth in the same period. This means that cost competitiveness is starting to improve (see also below). The positive news is that productivity gains in manufacturing tend to be larger on average than in the economy, and thus the competitiveness of exporters is improving more rapidly.

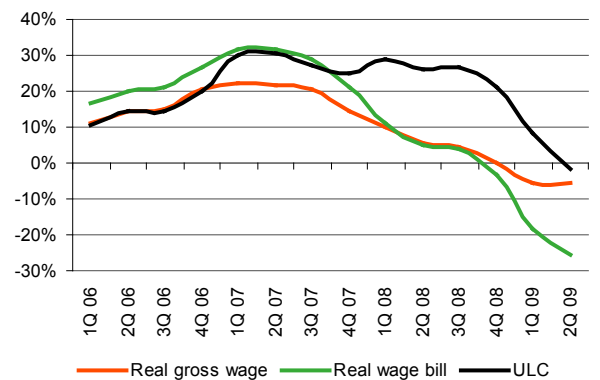
Further productivity improvements are still required, however. If productivity growth is insufficient, the downward pressure on wages and employment remains. The harmonised unemployment rate reached 16.7% in the second quarter of 2009. We forecast it to peak in early 2010 (likely to marginally exceed 20%) and diminish to 17-19% in 2011. Declining income and difficulties in

Wages, productivity and employment, yoy



Source: CSBL

Wages and labour costs, yoy



Source: CSBL

finding a job will increase emigration flows. The decline in employment is also influenced by the gradually decreasing activity rate (e.g., the rise in number of pensioners,³ discouraged job seekers, etc.), which is expected to continue also in 2010.

Deflation improves external competitiveness

Diminishing purchasing power due to decreasing incomes and rising unemployment is the key driver of consumer price deflation. Currently, diminishing prices for all kind of consumer durables and household equipment are largely driven by businesses' selling off their inventories. These are mostly imported goods, and the global prices for them will most likely not decline further, although a further reduction in distributor margins is possible. Global commodities prices started to increase faster than expected this year, pushing up, e.g., fuel prices in Latvia. Energy prices are expected to rise in 2010-2011. The recessions in Estonia and Lithuania have put downward pressure on import prices. We believe that CPI deflation in 2010 will be driven mostly by cheaper locally produced goods and services, supported by substantial spare capacity in the economy. Annual average deflation in 2010 might reach 3-4%, partly as a carryover effect (due to prices rising in early 2009, the annual decline

in early 2010 will be larger), with prices stabilizing in 2011. The risks of more prolonged deflation are non-trivial, however, especially if productivity growth is weak and competitiveness needs to be supported via lower prices.

Deflation depth might be diminished by possible tax increases, for instance, a rise in the VAT from 21% to 23% in early 2010. If the VAT is raised in January 2010, annual average deflation will be less by 1-1.5 percentage points. As weak domestic demand does not allow a full pass-through of the increase to consumers, businesses will be forced to decrease their margins and take up some of the price increase. Deflation for businesses is thus deeper (also due to the shift of consumers to cheaper products, thus diminishing the corporate turnover) and the deleveraging process will be more difficult.

Because local prices are diminishing faster than in Latvia's trading partners, Latvian external competitiveness is gradually improving. For instance, in July 2009 the real effective exchange rate (CPI-based) was down by 3.5% from its peak in March 2009. Unit labour costs also started to fall and were down by 1.5% in the second quarter of 2009, compared to the second quarter of 2008. However, the adjustment is clearly insufficient so far. Further reductions in factor and product prices are necessary, and larger productivity gains are required.

Household consumption the last to recover

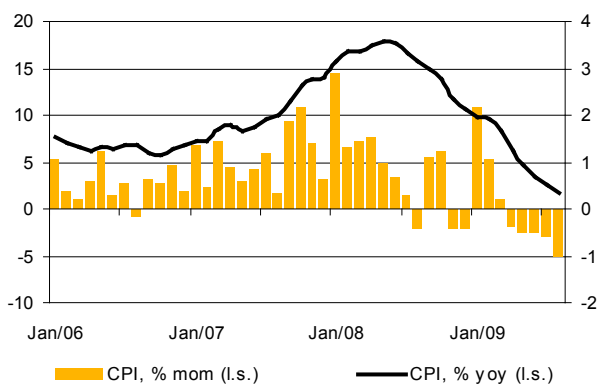
From its peak in the third quarter of 2007, household consumption has declined by 30% and is back to the 2005 level. We believe that the cumulative fall will reach 40% by the end of 2010, thus returning to the levels of 2003/2004. The fall of household consumption accelerated in the second quarter of 2009, which is somewhat contradictory to the improvement of consumer confidence and retail trade turnover stabilization during this period. This could indicate data problems and possible revisions afterwards.

The decrease in incomes (including also expiration of unemployment benefits⁴) and increasing unemployment and unemployment expectations continue to undermine private consumption, and recovery is not expected until 2011. The government and municipalities are now introducing different public works programmes; however, the number of positions is limited and the remuneration is very low. Low employment (980 thousand, compared to an elevated 1.13 million in 2007) means a lower wage bill and thus also lower consumption. We thus forecast household consumption to decline by 19-22% in 2009 and 10-15% in 2010 (nearly two-thirds of this being a negative carryover effect). In mid-2011, the slow growth is expected to resume, but it will still be nearly

⁴ State unemployment benefits are available for 9 months.

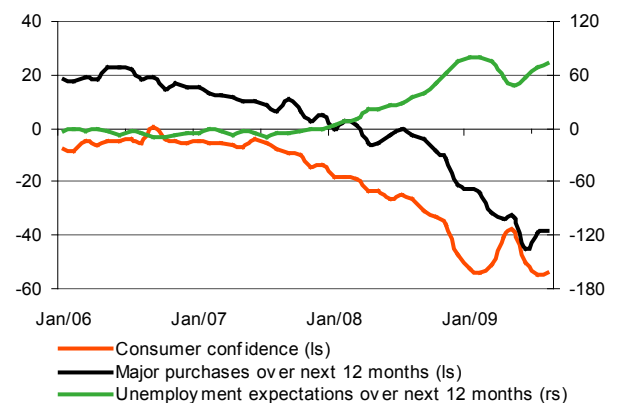
³ As of July 2009, the pension for working pensioners was cut by 70%. Many working pensioners (e.g. teachers) thus retired.

Consumer price developments, %



Source: CSBL

Consumer confidence, percentage points



Source: DG ECFIN

General government budget, yoy (%)

	2007	2008	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09	Jul 09	Aug 09
Revenues, net	33.5	6.4	-24.2	-6.2	-0.7	-23.8	-24.7	-22.5	-6.9	-26.1	-17.6
Tax income	34.4	11.9	-6.3	-8.9	-16.2	-19.4	-25.9	-29.9	-29.9	-29.6	-32.6
Personal income tax	35.1	15.2	-0.5	-5.9	-20.2	-21.1	-24.5	-27.1	-30.1	-34.0	-33.6
Social tax	37.7	21.1	6.4	1.0	-13.5	-10.9	-8.6	-18.6	-18.9	-22.9	-26.6
Corporate tax	57.5	25.9	17.2	9.9	-1.5	-34.5	-84.9	-70.9	-89.8	-84.7	-72.7
VAT	29.3	-7.1	-39.0	-25.5	-35.5	-25.4	-26.9	-27.0	-31.0	-22.7	-30.6
Excise	22.3	20.7	10.3	-4.6	19.4	-15.1	-23.7	0.6	-6.2	-6.7	-7.8
Customs tax	34.4	-5.2	-6.7	-15.4	-33.3	-37.1	-37.0	-56.2	-55.1	-55.2	-36.6
Non-tax revenues	21.7	8.6	9.1	-23.3	-25.5	-31.2	-12.2	44.7	4.1	308.3	-32.4
Expenditures, net	28.0	18.4	-9.1	1.7	14.3	10.6	15.9	1.2	-9.1	-34.4	-17.5
Current expenditure*	27.5	23.6	-0.1	4.1	12.1	15.7	19.2	-18.7	3.6	-21.3	-12.0
Capital expenditures*	40.6	-1.8	-30.4	-27.8	-21.0	73.4	113.5	-58.5	-30.3	-52.6	-45.7
Budget balance, % of GDP [†]	0.6	-3.6	-3.6	0.5	0.1	-1.1	-2.6	-2.6	-3.3	-3.4	-3.1

Source: State Treasury, Swedbank calculations

* non-consolidated central government and municipalities budgets, i.e. the sum of these expenditures is not equal to consolidated general government net expenditures

[†]GDP - Swedbank forecast for 2009

zero for the whole year. The recovery will be supported by a slow decline in the unemployment rate, wage growth, increasing confidence, and the slowing of the deleveraging process.

Besides the labour market influence, the necessity to reduce the excessive liabilities is the main factor that drives household consumption down. Household credit stock is declining – an annual fall was first observed in May, while monthly declines began in December 2008. The RIGIBOR is still in double digits, leading to increasing lat lending rates and reducing willingness to take on new consumer loans. Despite decreasing EURIBOR, euro lending rates are quite stable on account of increasing margins. Deposit volumes are falling as, with diminishing incomes, households are using up their savings to repay debts and/or support consumption. Weak demand for credit and high interest rates will also influence household consumption further. Deflation (especially for food and housing tariffs) helps households to cope with the deterioration of their financial situation, but the deleveraging process reduces consumption further.

Signs of stabilization in financial sector

The pressure on the lat's exchange rate has eased, although volatility in financial markets is most likely to increase again later this year due to possible delays in the 2010 government budgeting process. The Bank of Latvia's international reserves remain at healthy levels (more than 6 months of imports), propped up by EC and IMF disbursements (EUR 1.2 billion in July and EUR 190.4 million in late August). International reserves were also increased due to additional liquidity support by the IMF to all its members (EUR 102.9 million for Latvia).

Fiscal policy to determine the recovery path

The government's fiscal situation has improved somewhat as tax revenues have stabilized since April as the economic contraction has slowed and expenditure cuts have become deeper following the municipal elections in June. Although tax revenues are expected to fall further along with economic downturn, the largest contraction in tax revenues seems to be over. General government deficit reached LVL 417 in 8 months or just above 3% of annual forecast GDP.

Under the existing budget plan, we expect the general government budget

deficit to reach ca 8-9% of GDP (ESA basis), i.e. significantly below the 10% target.

The discussions with the IMF in July produced an updated Letter of Intent⁵ (signed on July 27, made public in September) and the IMF tranche of EUR 190.4 million was received in late August. In the Letter of Intent, Latvia committed to implement LVL 500 million (ca 4% of GDP) in targeted expenditure cuts and tax measures to cap 2010 general government deficit at 8.5% of GDP (ESA basis). The key measures to be effective as of 2010 are:

- Broaden the tax base of the Personal Income Tax (PIT) including capital income. Most tax exemptions will be reduced or removed.
- Unify the income tax regime of the self-employed with the standard personal income tax system (i.e. use a rate of 23% instead of 15%).
- Expand the base of the real estate tax, including all residential properties, on the basis of the updated cadastral values.
- Stop pension indexation, pending the pension reform.

5 See <http://www.imf.org/External/NP/LQI/2009/lva/072709.pdf> for details

- Implement structural reforms in many areas (e.g., public administration consolidation, culture, defence, transport, and social benefits).

We believe these measures are well-balanced. However, the early discussions on 2010 budget show that fiscal consolidation is difficult and some good ideas are shelved due to lack of political consensus (e.g., the reduction of the number of ministries). As a result of incoherent views in the ruling coalition, the issue of real estate tax for residential properties (the option was a flat rate of 0.2% of cadastral value) was held off in Parliament. This delays the budgeting process as the Parliament will need to return to this question as Latvia committed to introducing such a tax in the Letter of Intent (which was signed by all coalition parties).

In case the above described measures are insufficient to keep the budget deficit below 8.5% of GDP in 2010, the agreement with the IMF outlines additional fiscal consolidation measures:

- A progressive PIT rate to raise the average effective tax rate to about 25% for those earning more than LVL 500 per month, effective from January 1, 2010.
- An increase the VAT rate from 21% to 23%, effective from January 1, 2010.
- And securement of an additional 1.5% of GDP in expenditure cuts during the budget process, including fundamen-

tal revisions of the ministries' budgets.

In our view, the benefit of such additional steps would not outweigh the costs. The taxes are distortive and the effectiveness in raising revenues could be undermined by tax evasion. We see that the committed fiscal consolidation amounting about LVL 500 million against the budget base of the second half of 2009 should be sufficient to reach the targeted budget deficit of 8.5% of GDP. We believe that the government can accomplish this through expenditure cuts and committed revenue raising measures, which would effectively cancel any necessity to raise PIT and/or VAT rates.

If such prudent approach for 2010 budget is followed, we see a possibility that there will be only minor, if any, expenditure cuts necessary to squeeze below the 6% budget deficit cap in 2011. Yet, further consolidation will most likely be necessary to complete structural reforms and reduce public debt as our estimates show that in 2011 it may rise close to 60% of GDP, which is one of Maastricht criteria in order to introduce the euro. Hence for 2011, we pencil in budget deficit at about 5%.

Although we see that the government is moving in the right direction, its action is still slow and not consistent between the coalition partners and ministers, and public communication is still very poor. There is progress on structural reforms –for instance, the network of

schools and hospitals is being rationalized, measures to support start-ups by e.g. reducing minimum fixed capital requirements are about to be introduced, and budget expenditures are reviewed by functions to avoid across the board linear expenditure cuts. The upcoming parliamentary elections in the autumn of 2010 put at risk timely, well thought-through and well communicated budget expenditure cuts.

Reforms continue to lag behind schedules and policy intentions are often badly communicated, thereby increasing social tensions. Measures are often only enforced partially, which makes restructuring more costly.

The 2010 budget adoption is lagging by about a month (now to be submitted to Parliament in November), which may cause additional volatility in financial markets later this year (as happened in May-June) and, thus, deter investments and increase unemployment. The adjustment in the private sector has, so far, often took place despite the government's action, rather than with its support. In order to ensure smooth and lasting recovery, improvement in overall business environment is crucial. In the short-term, a timely approval of 2010 budget by reaching a consensus among the main partners is extremely important, both to receive further funding and to be able to carry out restructuring.

Mārtiņš Kazāks

Lija Strašuna

Lithuania: The free fall slows – but fundamental restructuring is necessary

Key Economic Indicators, 2007 - 2011

	2007	2008	2009f	2010f	2011f
Economic growth, %	8.9	3.0	-16.0	-3.0	2.5
GDP, mln euros	28 423	32 292	27 261	26 311	27 508
Growth of consumer prices, %	5.7	10.9	5.0	1.0	1.0
Unemployment level, %	4.3	5.8	14.5	16.0	15.5
Growth of real net wage, %	17.7	11.2	-10.0	-5.0	0.0
Growth of exports of goods and services, %	9.2	25.4	-27.0	-2.0	8.0
Growth of imports of goods and services, %	15.9	18.3	-37.6	-1.3	7.4
Balance of goods and services, % of GDP	-13.4	-10.5	-0.3	1.0	1.3
Current account, % of GDP	-14.6	-11.6	1.0	1.0	1.0
Current and capital account, % of GDP	-12.8	-9.7	3.0	3.0	3.0
FDI inflow, % of GDP	5.2	3.8	1.0	1.0	1.5
Foreign gross debt, % of GDP	72.3	71.4	78.0	76.0	75.0
General government budget position, % of GDP	-1.2	-3.2	-8.0	-7.0	-3.0
General government debt, % of GDP	17.0	15.6	30.0	40.0	50.0

Sources: National Statistics and Swedbank

The Lithuanian economy moved into a severe recession during the first half of 2009, with the rate of decline accelerating even further in the second quarter of 2009. GDP fell by 20.2% in the second quarter of 2009 and 17% in the first half overall, compared to the same periods 2008, with the largest drop recorded in investment spending and household consumption. Meanwhile, the contribution of net trade to the overall GDP growth was positive.

Despite recent positive news, such as green shoots of recovery observed in the major economies, a marginal upturn in consumer and business confidence, and moderation in the steep declines in manufacturing, we are a long way from the

first signs of a fully sustainable economic recovery. The period of deterioration has not run to its full course yet. Given the rising unemployment rate, which reached 13.6% in the second quarter of 2009, it can be questioned how long the current improvement in the confidence levels will last (confidence levels are fragile and will likely plummet again towards the end of the year). The housing market has not yet reached its bottom, and with the worsening situation in the labour market, further price falls are expected.

We have emphasised previously that risks to our growth scenario are weighted significantly to the downside. With the recent tentative signs of some economic stabilisation, most of all in the

main trade partners, this is no longer clearly the case. The key downside risks nevertheless include a slow and inconsistent recovery in the EU countries stretching until the end of 2010, which would hold back export growth more than currently is forecasted. More rapid than expected rises in unemployment are contributing to further declines in consumer confidence and spending, with negative feedback effects on business revenues, investment, and employment. Also, a higher-than-expected increase in commodity prices in 2010 could lead to a larger than currently calculated rise in household energy bills and more losses for companies.

Swedbank's GDP Forecast- Lithuania*

	2005	2006	2007	2008	2009	2010	2011
GDP	8%	8%	9%	3%	-16%	-3%	3%
Household consumption	12%	11%	12%	5%	-18%	-6%	1%
General government consumption	3%	4%	3%	4%	-5%	-5%	-3%
Gross fixed capital formation	11%	19%	21%	-6%	-42%	-5%	7%
Export of goods and services	18%	12%	4%	11%	-21%	-4%	6%
Import of goods and services	16%	14%	12%	10%	-28%	-9%	4%
Net exports contribution to GDP growth	-0%	-2%	-6%	-0%	4%	2%	1%

Sources: LDS and Swedbank

* These are averages of the forecast ranges, which are as wide as 2 percentage points.

Stabilization expected next year

We forecast that economy will contract by 16% overall this year. We would expect some stabilization in 2010, with GDP falling by 3% despite the closure of the Ignalina nuclear power plant. For 2011, we see an economic recovery, with GDP growth reaching 2.5%. The contraction is driven by domestic demand, especially investments and household consumption, while the contribution of net exports to overall GDP growth will remain positive in the forecast period.

Adjustment will occur via a decline of prices and wages, as well as an overall restructuring of the economy. Credit supply in Lithuania has been cut quite abruptly, starting at the beginning of this year, and we expect the deleveraging process to deepen for the rest of 2009 and into 2010. The recovery of the economy will depend on Lithuania's main trade partners - if growth in global economic activity does not revive as expected, the recession will last longer.

Net trade supports GDP

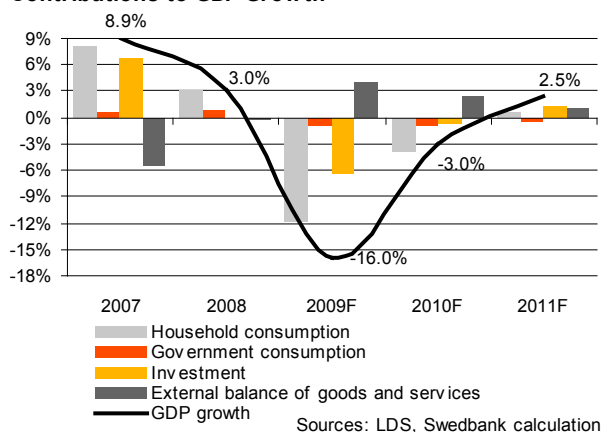
Net exports are projected to make a positive contribution to GDP growth in 2009 and 2010 due to a sharp fall in imports rather than strong growth in exports. Nominal exports of goods fell by 32.2% over the first half of 2009, but the free fall observed in the first quarter appears to have been halted. With major trade partners in the old EU already showing some signs of recovery, we anticipate further improvement in exports starting in late 2009-2010; this is key for the economy to come out of the recession.

We would expect some export-oriented industry sectors (namely, machinery and equipment, the chemical industry, and metalworking) to pick up as soon as global demand bounces back. The currency depreciation in neighbouring countries, which undermined the competitiveness of Lithuanian exports in the first quarter, has stopped and should also contribute to a less negative export outlook. The fall in service exports is the main part of the worsening of the trade balance, however.

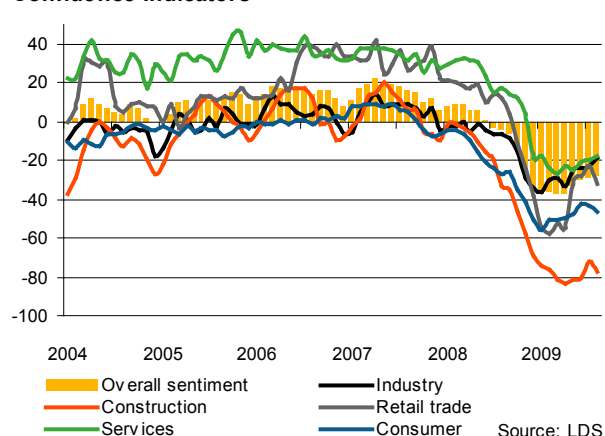
According to preliminary estimates, exports of services declined by 19% during the first half of this year, with transport services leading the fall. The transport services sector, particularly road transport, is facing many problems due to an unsustainably rapid expansion (and, consequently, an unsustainably large fleet of trucks acquired) and, until last year, competition coming from Polish, Latvian, Bulgarian and Romanian companies, together with enhanced risk perception by commercial banks. We project exports of both goods and services to fall by 21% this year overall and to further decline by 4% next year, with positive growth of 6% expected for 2011.

After increasing by 18.7% last year, overall imports of goods plummeted by 43.7% over first half of this year in nominal terms. The fall, though, has stabilized somewhat, with marginal monthly positive growth rates recorded in the last few months. The share of investment goods began to plunge already last year, and the negative growth stood at

Contributions to GDP Growth



Confidence Indicators



as high as 63.5% in the first half of this year. We expect imports of goods and services to fall by 28% in real terms this year due to the sharp fall in consumer purchasing power and the ongoing curtailment of companies' investment plans. Although domestic demand for both investment and final consumption goods will remain anaemic next year, an increase in gas imports after the closure of the Ignalina nuclear plant will limit the fall of imports to 8-9% in real terms over 2010 as a whole. Imports will slowly recover and grow by 2-3% in 2011 overall.

After reaching a deficit of 11.6% of GDP in 2008, the current account balance has shown a small, though consistent, surplus since the start of the year. We forecast the current account surplus to reach 2% of GDP over this year as a whole. The salient factor, similar to last year, is the improvement in the foreign trade balance. For the rest of the year, the trend in the deficit remains relatively flat, with exports reviving slightly towards the end of the year and imports remaining weak. Another significant factor pushing the current account balance to the positive side is the reduction of the income balance deficit, which last year declined about 10%, and further improved by 75% in the first half of this year compared with the same period a year ago (this is mainly a result of the decline in reinvested profits from FDI). The services account will remain one noteworthy factor pulling the current account balance to the negative side,

as the demand for transport services continues to decline. More generous and faster implementation of EU funds is adding to the capital account surplus, which rose significantly last year, while FDI flows will remain meagre. FDI inflows to Lithuania have been notoriously low even in the previous boom years, with the share of FDI in the manufacturing sector declining in the last few years. FDI flows can be expected to pick up only after the overall improvement in macroeconomic conditions, signals of a more stable taxation and fiscal policy, and a more positive outlook of external investors on the potential of the region.

Weak investment developments

Investments are undergoing a severe adjustment this year as tight lending conditions, a sharp plunge in domestic demand, and uncertainty about global market demand are causing companies to cancel or delay their investment plans. Total investment in fixed capital contracted by an estimated 39.8% in the second quarter of 2009 compared with the same period last year, following a very similar drop in the first quarter of 2009. Companies started adjusting their investment plans already in the middle of 2008: The second quarter of this year was the fifth consecutive quarter of declining investment, which followed a period of strong growth, averaging 17.1% over 2005-2007.

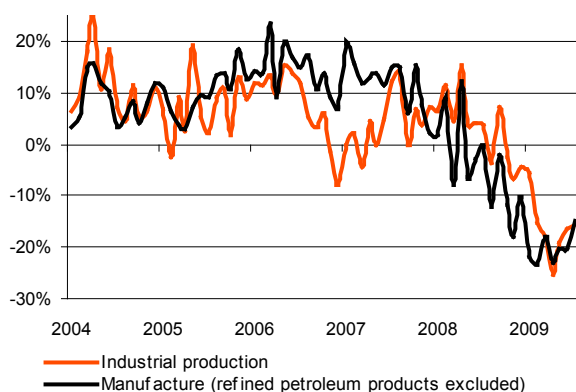
Going forward, investments are expected

to remain weak, and exhibit similar year-on-year declines for the second half of the year. Consequently, investments are expected to contract by around 42% in 2009, with a further 5% fall in 2010. Given the depressed domestic economic growth prospects, combined with continued constrained credit availability, the fall in investments will take time to reverse. Recovery is expected, however - most of all in the exporting sectors, at the end 2010 at the earliest.

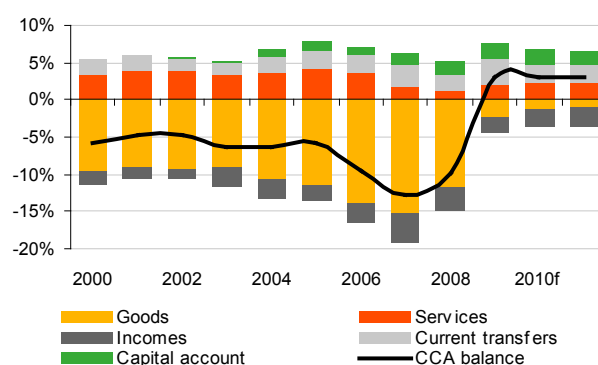
Construction (both residential and nonresidential) continues to occupy the largest share of investments, while investments in productive capital goods, which are crucial for the competitiveness of the economy, account for a much smaller share. It is noteworthy that the latter indicator has been steadily declining since 2004, while the share of investments in buildings has been growing accordingly. Real estate operations continued to attract the largest share of total capital investments; there is no doubt, however, that the indicator for this sector will fall sharply this year since the real estate market has come to a halt, while manufacturing industry will increase its share of total investments.

The situation in investments is partly remedied by the projects (infrastructure, public buildings, etc.) cofinanced by the EU structural funds. The rules of the usage of the funds, which were simplified at the beginning of the year, and a firm determination to fully exploit all the

Industry, yoy



Current and Capital Account (CCA), % of GDP

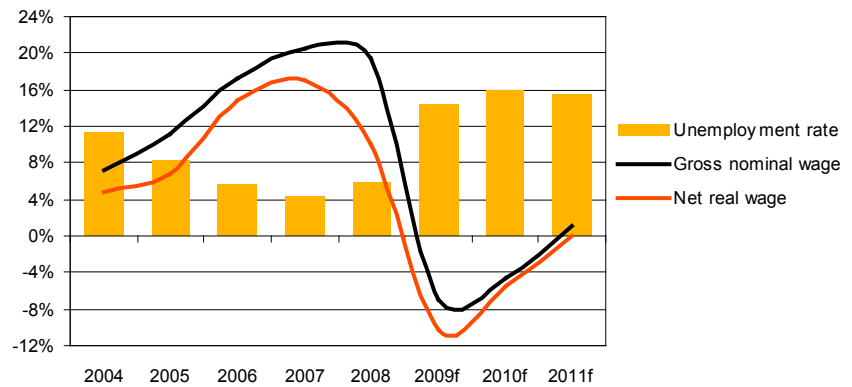


possibilities offered by the EU assistance, will accelerate the adoption of the funds. As part of its stimulus plan, the government is placing a lot of emphasis on increasing energy efficiency in apartment houses, as well as improving public buildings; these actions should mitigate the impact of the downturn for construction companies to some extent.

The worst of the decline in the activity of the housing sector is certainly not over. The market still remains weak, with a potential for further falls in prices ahead as oversupply is unlikely to be eliminated soon and the labour market situation is expected to worsen further. It is estimated that Lithuanian house prices have fallen by about 25-30% compared with last year, with the steepest decline seen in the prices of new apartment buildings. Housing transaction levels are very low – while last year a decline of 32% compared with 2007 was registered, according to preliminary estimates, the number of contracts fell by another nearly 60% in the first half of 2009 compared with last year. The housing transaction levels will worsen well into 2010, with a continuing slackening in the labour markets, and plummeting incomes. House building is expected to remain subdued (it is likely that almost no new housing projects will be carried out in the country for the next 2 years), partly exhibiting attempts by property developers to constrain supply. The oversupply of flats, however, is unlikely to be eliminated soon – even though the number of completed buildings fell by 56.7% in the second quarter of 2009, compared to the same period in 2008, the inertia of housing market processes still drove the supply of new flats up by 27% in 2008.

We would expect activity in the real estate market to pick up again in the middle or at the end of 2011. Recovery in house prices is likely to be modest at first, although prices could recover again as supply shortages arise anew, credit conditions return to normal, and negative memories of the current housing bust fade.

Labour Market



Source: LDS, Swedbank forecast

Inventories have plummeted sharply so far during 2009 and are expected to exert a negative effect on GDP over 2009 as a whole. Given the rapid fall observed, stockbuilding might pick up in 2010. Inventory estimates are often subject to later revision, so too much should not be read into these figures at this stage. The rapid reduction of inventories during the first half of the year, however, is likely lead to an earlier rebound in quarterly GDP growth.

Inflation, labour market, wages and productivity

Lithuania's unemployment rate went up to 13.6% in second quarter of 2009, reaching the levels recorded in the first quarter of 2003. We forecast unemployment to continue to surge and reach 14.5% on average this year, and to peak at 16% in 2010. A sharp rise in unemployment will put direct downward pressure on wages and consumption. We would expect employment to decline by 9% and 3% this and next year, respectively. At the peak of the crisis, the number of employed will fall to the levels recorded in 2001-2002 (i.e., about 1.35 million). Job creation will commence at the earliest at the end of next year or perhaps not even until early 2011. The unemployment rate is projected to decrease slightly to 15.5% for 2011 as a whole.

The labour market continues to be affected by the economic recession and

enterprise bankruptcies. Worsening expectations have led to a decline in domestic demand, which consequently is feeding into business revenues and employment. The private sector was the first to adjust to the changes in the environment while it was facing negative labour productivity pressures, which pushed the unemployment rate upwards. Although the cuts in employment were significant, it is evident that they are not nearly enough, and another wave of employment cuts is about to come. The public sector, however, is only beginning its restructuring, which will further increase the current unemployment level.

Since the recovery of Western European economies and the US will start earlier than in Lithuania, the situation in the labour markets will differ substantially. We would project, therefore, a second wave of emigration and brain drain, which could reach levels similar to those observed after Lithuania became a member of the EU. After the economy recovers, Lithuania might encounter labour supply problems once again. In the long term, this could dampen potential growth and worsen the situation in the social insurance system, and, thus, create fiscal pressures.

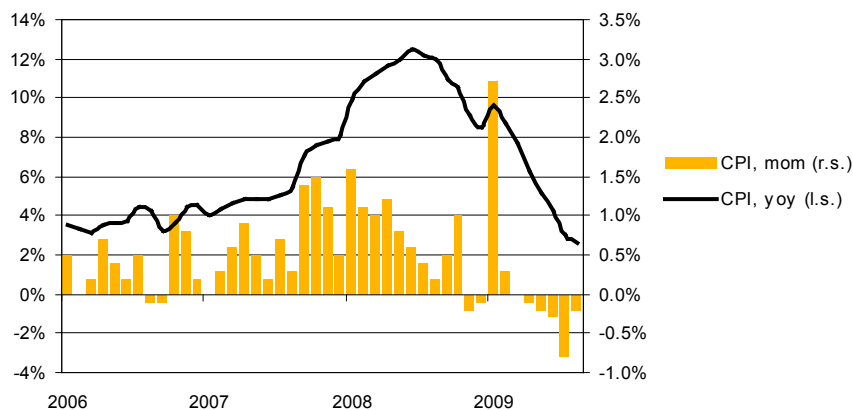
The correction in wages comes on the back of soaring unemployment. We forecast that wages will fall by at least 10% this year and about 5% next year. In 2011, we expect some stabilization - average wages will stay at a similar level

during the year. Businesses started to adapt to the changes in business environment by cutting expenses at the end of last year. This year, the adjustment process is in full swing and is affecting the larger part of the working population. We forecast an even more extensive decline in wage bills. Working hours would also be cut due to the smaller number of orders, besides the layoffs and cutting of wages. We predict an over 20% decline in the wage bill for this year and a decline of about 8-10% for the next year. This tendency will change at the end of next year, together with the revival in the overall economic activity.

The average gross salaries in Lithuania's economy (excluding self-employed) fell by 2.9% in the second quarter of 2009 compared to the second quarter 2008. Wage cuts have so far been extensive in the private sector but relatively modest in the public sector. Average net salaries grew by 1.5%, while real net wages declined by 6.4% in the second quarter of 2009 over the same period in 2008. Soaring unemployment rates are eroding the bargaining power of employees. The official wage statistics, however, only reflect a limited part of the situation, as the unreported part of income is expected to decline more extensively.

In the second half of the year, the drop of public sector wages will be more pronounced as the official base for calculating salaries for public sector officers is reduced by 5%. At the same time, the coefficient for calculating salaries was raised for those getting lower salaries, while for the highest-grade civil servants the coefficient was lowered. As a consequence of these changes, the net monthly wage will decrease by 10% on average, mainly due to a decline of salaries by 15-20% of the highest-grade public officials. For instance, the net monthly wages of chief specialists will decline by 5%, while the wage for the lower-grade servants will increase. The lower wages will remain until the end of 2010, and are then expected to be brought back to the previous level.

Consumer Prices



Source: LDS

The adjustments in the economy are expected to narrow the gap between productivity and wage growth. Last year's labour productivity growth of 3.5% was meagre, considerably below real wage growth (10.1%), and it varied between different sectors of the economy. For instance, productivity growth in manufacturing (the principal exporter of goods) was 2.4%, while it reached 12.4% in the transport, storage, and communication sectors (the principal exporter of services); productivity, however, in wholesale and retail trade shrank by 2%.

We forecast the wage-productivity gap to reverse this year and the next as the wage decrease is expected to be more pronounced than the decline in productivity. Companies are being forced to undertake strict measures - if they appear to be insufficient, we expect additional layoffs and wage cuts. We also anticipate an increase in the number of bankruptcies for those who are unable to make more adjustments. As the weakest companies go out of business, positive labour productivity growth will resume in 2011. We anticipate productivity (real GDP per employed person) will drop this year by about 8%, remain unchanged in 2010, and increase by about 2.3% in 2011. In connection to this, productivity improvements during the current crisis will be based on cuts in employment, not on investment or innovation.

A decline in the numbers of employed allows significant negative productivity

changes to be avoided and lays the foundation for a more rapid pace of the growth in the long run. An increase in labour supply and weak wage pressures will help to intensify the restructuring process, which could foster the recovery of the economy. Unlike previous years, when economic growth was mostly based on increasing the number of workers, productivity may again become the main contributor to growth.

The competitiveness of companies has been hurt in recent years by excessive wage growth and the weakening of currencies of trading partners. A decline in employees' bargaining power has enabled companies to cut wage costs. The real effective exchange rate, which increased sharply at the end of last year and early this year, has started to diminish gradually in the last few months. The largest adjustments and improvements in competitiveness are expected in 2009-2010 as a result of reductions in costs and prices. Productivity growth will be lower than would be needed to strengthen competitiveness as wages stabilize in 2011. In a longer perspective, starting from 2011, increasing productivity is necessary for sustained economic growth.

CPI inflation fell to an annual rate of 2.6% in August from its relatively high level of over 9.6% in January. Monthly deflation was registered for the fifth consecutive month in a row. Domestic demand pressures since late 2008 have played an important role here, and earlier

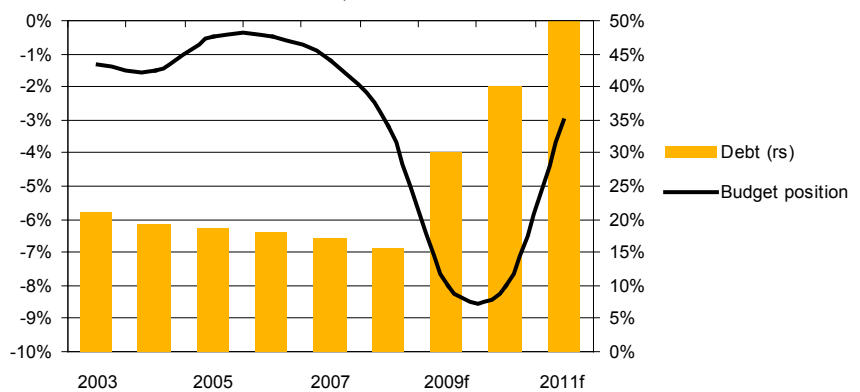
food and overall energy price rises have also started to fall out of the 12-month inflation calculation. Some administered measures (VAT increases, excise tax hikes, etc.) adopted at the beginning of the year prevented further disinflation; however, administered electricity and gas prices were lowered this summer, which added to the deflationary tendencies.

We expect the monthly price fall to continue this year, with average inflation reaching close to 5% for the year as a whole. The fall in prices in September might be partly halted by the VAT increase of 2 percentage points (19% to 21%). We are of the opinion, however, that not all of the increase is likely to be passed onto consumers due to the sharp decline in consumer purchasing power. We would expect inflation to reach 1% during 2010 as domestic demand pressures remain weak, although there will be an upward push from the increase in electricity prices after the closure of the Ignalina nuclear power plant. It has been estimated by the National Control Commission for Prices and Energy that regulated electricity prices to consumers would increase by approximately 28% [in 2010?]. Electricity price increases for businesses are harder to predict, as these will depend on imported electricity, and negotiated gas prices, which will determine the costs of the local generators. Consumer price developments will also depend heavily on trends in world commodity prices, which are expected to begin slowly reviving next year.

Large contraction of household consumption

Real household consumption contracted in an accelerated manner this year, dropping by 15.7% in the first quarter and falling by 19.4% in the second quarter, compared to the same period last year. We expect that the annual drop will not go much deeper in the second half of this year – household consumption as a result will contract by about 18% on average in 2009 and at least a further 6% in 2010. By that time, the household

General Government Finances, % of GDP



Source: Lithuanian MoF, Swedbank calculation

consumption will have returned to the level of 2005. We expect household consumption to show annual declines at least until the middle of 2010, most likely to the end of the year; we predict 1% growth in 2011. Household consumption will be negatively influenced by a rise in unemployment, negative growth of real wages, and pessimism. We also predict fewer transfers from emigrants as in the global downturn emigrants are unable to support their families as generously as during previous years.

The consumer confidence index is still low compared with historical levels, although it improved slightly from the beginning of this year. It appears that society is starting to get used to the changes in the environment, while signs of stabilization in the global economy also help people to feel more comfortable and expect some improvements in the country. Household finances will be very tight – according to the confidence survey, only 20% of household expect to increase savings. There will be no support to consumption from borrowing, as the deleveraging process is currently in full swing.

Weak household consumption will remain harmful to all domestic demand-driven industries and importers. For instance, retail sales, which are an indicator of household spending, dropped by 28.5% (in real terms) in the first seven months of this year. The retail sales drop has stabilised lately, suggesting that

households may have already gone through most of the necessary adjustment.

No stimulus provided by the tight fiscal policy

The expansionary fiscal policy observed in the previous years is set to tighten in the forecast period. The economic recession placed the general budget deficit under pressure, and the squeeze from tax revenues and expenditures will not decrease substantially unless public sector efficiency is considerably improved. In order to keep the budget deficit from escalating to unsustainable levels, substantial cuts in government spending and some efforts to increase revenues have been made. The inability to borrow at reasonable rates, as well as the determination to achieve the Maastricht budget criterion target in two years, forces fiscal policy to become more restrictive.

Even after the spending cuts, the budget deficit is likely to be close to 8% of GDP in 2009. We expect next year's budget deficit to improve slightly; however, a tight fiscal policy and better revenue collection due to a recovery in activities could reduce the 2011 budget deficit to the Maastricht level of 3% of GDP. This target, however, might be difficult to achieve, and additional deficit reduction in 2011 could be needed. At the same time, cutting expenditures that are important for long-term growth (like the cofinancing of EU funds and export stimuli)

must be avoided.

In the first half of this year, the Lithuanian central government sector's deficit amounted to about 5% of GDP. The Lithuanian state budget revenues are strongly dependent on cyclical taxes, VAT and excises, which account for about half of total revenues. The outlook for the near future is pessimistic as an increase in unemployment, a fall in incomes and weak consumption will weaken tax revenues to a larger extent. The VAT rate was raised from 19% to 21% in September this year – however, the increase will have only a temporary effect in raising revenues. In the first half of this

year, the Lithuanian general government debt increased by 41.6%, and we project it will reach 29% of GDP this year.

The Ministry of Finance signed an agreement with the Council of the European Development Bank regarding an EUR 130 million long-term (15 years) loan. It will be used to cofinance government investments in social infrastructure development projects. The loan will be provided in annuities and each time with different interest rates. This year, Lithuania will receive EUR 20 million of the loan with 4.7% interest rates. Moreover, in the first seven months of this year, the government has already borrowed EUR

693 million domestically.

Since Lithuania experienced a sharp plunge in its tax revenues in early 2009, the government has been forced to implement a fiscal savings package of around 7.5% of GDP that combined tax increases and spending cuts. Government consumption is expected to decrease by about 5% this year and next, and further decline by about 3% in 2011.

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