

Update

Swedbank Economic Outlook

Swedbank Analyses the Swedish and Baltic Economies

January 14, 2010

Improved outlook – but growth will be sluggish

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Global development

- The outlook for global GDP growth has improved somewhat since our last outlook. We raise our forecast to 3.3% for 2010 and to 3.5% for 2011.
- Despite the improved prospects, risks are building up. The dependence on public stimulus packages is significant, and their rollback could create new strains on the real economy and financial markets.

Sweden

- Sweden's GDP growth has been revised upwards mainly due to the labour market performing better, resulting in a higher growth in household consumption. The already high debt ratio represents a risk as the Riksbank is expected to increase the repo rate to 3% by the end of 2011.
- Positive aspects of the Swedish economy are the good fiscal position, and the robust services sector. Negative aspects include the weak productivity growth and high cost increases, as well as the risk of more fundamental structural changes in Sweden's industrial sector. The strengthening of the krona may hurt exporters, although stronger global growth gives relief.

Estonia

- Joining the EMU is becoming increasingly more likely for Estonia. We anticipate that the budget criterion will be met for 2009, and that a decision to join the euro area will be made in June this year.
- Euro adoption is expected to spur investments in the Estonian economy. Already, improved global conditions are stimulating Estonian exports. The main risk is a postponement of the euro adoption.

Latvia

- Exports have started to recover, but challenges remain. Labour cost adjustment has improved competitiveness, but with deflation deepening, an increasingly important challenge becomes deleveraging.
- The main risk to the outlook is that domestic structural reforms stall. Insufficient progress in both the public and private sectors risks a post-recession stagnation. To make further competitiveness improvement less painful and ensure sustainable growth, lasting structural productivity gains are necessary.

Lithuania

- The rate of decline of economic activity in Lithuania appears to have slowed in late 2009. In particular, the export-driven manufacturing sector is doing better than expected.
- The Lithuanian economy faces significant challenges. A weak labour market undermines domestic demand and the decommissioning of Ignalina exerts further pressure on households and companies. Considerable uncertainties remain regarding public finance developments.

An improved outlook in the short term – but in the medium term risks are building up

Since September, when we published the previous Swedbank Economic Outlook, the conditions for global economic growth have improved somewhat. GDP growth has picked up in most parts of the world, especially in the emerging markets, but also in many of the OECD countries.

The signs of recovery are several: confidence among consumers and companies, as well as on financial markets, has strengthened. The industrial sector has seen the purchasing managers' indexes rising to levels that point to an improved outlook, and, in the services sector, activity has been rather robust despite the general downturn in many economies. In most countries, the deflation threat has diminished. We have raised our forecast for global GDP growth from 2.5% to 3.3% in 2010, and from 3% to 3.5% in 2011. Thus, export markets for Swedish and Baltic products are expected to expand somewhat faster than we projected in September.

Even if there are positive signs that point to higher growth, the reasons for the improved outlook still give cause for concern. The dependence on stimulus measures, in the form of both support to financial markets and fiscal expansion, is extensive. One risk to the outlook is the possible negative reaction to the provision of fewer new measures, and another risk is the subsequent withdrawal of stimulus, which will be felt already during 2010 and even more so during 2011 and beyond. The result could be increased volatility on financial markets, and also falling asset prices.

The stimulus measures also have negative side-effects. First, moral hazard could cause new financial crises at a later stage. Second, carry trade, such as the low interest rates in, for example, the US and Japan, cause an excessive flow of capital to many emerging markets, fueling bubbles in their asset markets. Third, the large budget deficits and increased public debt could cause uncertainty and

a higher cost of capital. This is already visible in some countries with a large dependence on foreign borrowing. Fourth, when economies start to recover more substantially in the medium term, there are risks of crowding out private investments, as well as of higher inflation. The overall concern is that excessive public debts tend to decrease economic growth.

In the short term, i.e., during 2010 and 2011, we are fairly positive about the possibility of maintaining decent growth rates globally, especially in Asia and, to a lesser extent, the US, Japan, and Europe. The stimulus measures continue to support economic activity, which is bouncing back from very low levels. The inventory cycle will also increase growth. During the forecast horizon, confidence may be affected negatively by the difficulties in finding the right balance between providing new stimulus and phasing out old stimulus; however, compared with the most acute phase of the crisis, the situation has improved.

Macro economic indicators, 2008- 2011

	2008	2009f	2010f	2011f
Real GDP growth, annual change in %				
Sweden (calendar adjusted)	-0.5	-4.2	2.0	2.6
Estonia	-3.6	-14.0	1.5	4.5
Latvia	-4.6	-18.0	-3.0	3.5
Lithuania	2.8	-16.0	-2.0	3.0
Unemployment rate, % of labour force				
Sweden	6.1	8.4	9.9	9.9
Estonia	5.5	13.5	14.0	12.0
Latvia	7.5	17.5	21.5	19.5
Lithuania	5.8	13.5	16.0	15.5
Consumer price index, annual change in %				
Sweden	3.4	-0.3	0.9	2.2
Estonia	10.4	-0.1	0.5	1.8
Latvia	15.4	3.5	-3.5	0.0
Lithuania	10.9	4.5	1.0	1.0
Current and capital account balance, % of GDP				
Sweden (current account)	9.6	7.2	6.7	7.0
Estonia	-8.4	6.0	6.5	6.0
Latvia	-9.8	12.2	14.0	10.0
Lithuania	-10.1	3.7	4.2	3.0

Sources: National statistics authorities and Swedbank

Sweden's calendar-adjusted GDP growth is expected to rise to 2% this year, compared with the 1.2% forecasted in September. Next year, GDP grows somewhat faster than the potential growth, rising by 2.6% (up from 2.3% in September). The most important reasons for the upward revisions are higher growth rates for exports and private consumption, spurred by the improved global climate and less negative labour market developments than projected earlier. The increase in Sweden's economic activity is mainly driven by domestic demand, as this is more positively affected by the monetary and fiscal stimulus measures.

Still, the forecast is cautious in the sense that growth picks up only moderately despite the great fall in activity during 2008-09. Sweden's economy is polarized between the negative developments in many parts of the industrial sector, which is heavily dependent on global investments, and the more robust services sector – supporting the greater cities – which has been less affected by the global slump. Structural changes are occurring in the industrial sector, but the impact is difficult to foresee. This is also the situation on the labour market, and, despite the forecast of lower open unemployment during 2010 and 2011 than in the previous Swedbank Economic Outlook, employment is not projected to increase much. Towards the end of 2011, when the Riksbank will have raised the repo rate to 3%, many indebted house-

holds will be less able to spend on consumption goods and services. Compared with last year, when consumer prices fell, households will also feel the effects of inflation normalising and reaching the inflation target of 2% during 2011, while wage developments will become more subdued. Therefore, households will only slowly reduce their high savings rate over the period.

In the Baltic region, the economies continue to be fragile, but the situation varies somewhat from country to country. In Estonia, prospects of joining the euro in 2011, when the Maastricht criteria are assumed to be fulfilled, is forecast to spur optimism starting after the decision is taken this spring. The growth engine is expected to be net exports this year, while domestic demand will take over during 2011. GDP is forecast to grow by 1.5% this year, and by 4.5% next year (up from 0% and 2%, respectively, in September). In Latvia and Lithuania, growth prospects look bleak, although a slow recovery is expected to start towards the summer. In the short term, export developments strengthen due to the improvements in the global climate. In the medium to long term, however, fiscal sustainability remains a significant problem, as well as deleveraging, with the two factors most likely contributing to an anaemic growth outlook for both countries. Latvia's GDP is forecast to fall by 3% this year (compared with a fall 2% in our September outlook), as imports

will fall less than previously expected, and next year the upward revision is marginal, from 3% to 4%. The unemployment rate is expected to worsen compared with the outlook in September; at the same time, cost adjustments are being made in order to improve competitiveness, although more will be needed. In Lithuania, the export sector will gain from faster global growth, thereby supporting a mild upward revision of GDP figures from -3% to -2.5% for 2010, and from 2.5% to 3% for 2011. The main risks are public finance and labour market developments.

Although economic prospects have improved somewhat during the last months, the policy challenges in all four countries remain large. Sweden has the advantage of having a relatively good fiscal position and has also so far gained because of a weaker krona and a loose monetary policy, but the structural changes in the economy raise demands for aggressive measures to improve competitiveness in the medium term. In the Baltic region, as currencies are fixed, the main policy tool is fiscal policy that can be used to address both short-term needs and medium- to long-term challenges. The crisis constitutes a window of opportunity for much-needed reforms, an opportunity that should not be missed!

Cecilia Hermansson

The global economy continues to strengthen

GDP forecast 2008 - 2011 (annual percentage change) ¹⁾

	2008	January			September		
		2009	2010	2011	2009	2010	2011
US	0.4	-2.4	2.2	2.5	-2.3	1.3	1.8
EMU countries	0.6	-4.0	1.1	1.6	-4.1	0.6	1.3
Of which:							
Germany	1.3	-5.0	1.5	1.8	-5.5	0.8	1.3
France	0.4	-2.3	1.6	2.0	-2.7	1.1	1.4
Italy	-1.0	-4.5	0.7	1.2	-4.0	0.3	1.0
Spain	0.9	-3.6	-0.1	1.3	-3.3	-0.1	1.3
UK	0.5	-4.3	1.0	1.9	-4.0	0.5	1.3
Japan	-1.2	-5.6	1.2	1.5	-6.0	1.0	1.4
China	9.6	8.0	8.5	7.8	7.5	8.0	7.5
India	7.3	6.3	7.0	7.5	4.8	6.0	6.5
Brazil	5.1	-0.5	3.5	4.5	-1.0	2.5	4.0
Russia	5.6	-8.9	4.3	4.5	-7.0	1.5	3.0
Global GDP	2.7	-1.1	3.3	3.5	-1.3	2.5	3.0

Sources: National statistical authorities and Swedbank

1) Countries representing around 70% of the global economy. The World Bank's weights from 2008 (purchasing power parity, PPP) have been used.

Since our last forecast in September, the global recession has ended and signals of a recovery in the US, Europe, and Japan have become more visible. In China and India, growth has picked up from already high rates. Important factors explaining the upturn are the stimulus effects from low interest rates, extensive liquidity provided to stabilise the banking sector, and fiscal expansion trying to counteract the large falls in demand. The return of risk appetite to financial and commodity markets, as well as improved consumer and business sentiment, has supported the recovery.

In annualised terms, GDP growth in the third quarter of 2009 reached double-digit rates in many of the emerging markets in Asia and Latin America, while the US growth rate (2.2%) was about double the ones in the euro area (1.5%) and Japan (1.3%). In Eastern and Central Europe, developments were divided between rather satisfactory performance in the Czech Republic and Poland, and continued weakening activity in Hungary.

Going forward, the outlook has brightened, at least in the short run (i.e., during our 2010-11 forecast horizon). Improved confidence and a continuation of expansionary economic policies have set the stage for a strengthening of global output. The inventory cycle will reverse and start contributing to growth. The bounceback is, however, from very low levels. This means that, even if growth rates are picking up, it will take the whole forecast period for most OECD countries to reach the GDP levels prevailing before the downturn started a little more than one year ago.

We have revised global GDP growth upwards for 2010 by 0.8 percentage point to 3.3% and for 2011 by 0.5 percentage point to 3.5%. In addition, the fall of GDP in 2009 is expected to be somewhat less deep, at 1.1%, than previously forecast at 1.3%. The world economy is thus approaching trend growth of some 3.5 - 4% earlier than we expected in September. A relatively large upward revision has been made for the US, Germany, and France, as well as for the BRIC countries (Brazil, Russia, India, and China). Larger

effects from the stimulus measures are important for some countries, while higher commodity prices are pushing up growth for others (Brazil and Russia).

Although prospects have improved, large challenges remain in the global economy. The deleveraging in the financial and private sectors continues. Public sector debt is growing, as budgets show double-digit deficits in many OECD countries. In these, withdrawal of stimulus will start, giving negative effects mainly in 2011 and thereafter.

Unemployment, which has reached some 10% in the US (and in the euro area) brought more people into the ranks of the long-term unemployed, will start to diminish slowly, while labour markets are set to weaken further in many parts of Europe. In Germany, the "kurzarbeit" measures, by which the government subsidises employers keeping staff, has been extended until the end of 2011. So far, the programme involves some 1.5 million workers. Housing markets have started to stabilise in some countries (such as the US and United Kingdom)

while deterioration continues in Spain and Ireland.

Inflation is expected to return during 2010 and rise to some 2% in 2011 for most OECD countries, with the exception of Japan, where deflation will remain also during 2010 and parts of 2011. Our view of monetary policy has not been changed for 2010. The Federal Reserve, Bank of England, and the ECB will start hiking policy rates during this autumn. The Bank of Japan will wait to start normalizing rates until the end of 2011. Compared with our September forecast, policy rates will be somewhat higher at the end of the forecast horizon in Europe and the US. At that time, long-term bond rates will be marginally higher than previously expected, reaching slightly above 4.5%, and as growth and inflation in the US will outperform Europe, US bond rates will increase somewhat faster than the European ones.

The US dollar is still expected to strengthen against the euro. However, the appreciation is somewhat slower than projected in September, and this will improve the US growth prospects through higher net exports. We expect China's administration to accept a slow appreciation of the renminbi during

2011, as exports have become more robust and the threat to unemployment has abated. The Japanese authorities will be relieved by a weakening of the yen against the dollar as Fed rates move upwards.

Our assumptions on commodity prices are now a bit higher, with the Brent oil price increasing by US\$10 over the earlier forecast and reaching an average of US\$80 and US\$90 per barrel in 2010 and 2011, respectively. Stronger risk appetite and activity will also push up other commodity prices, like food and metal prices. The increase in 2010 and 2011 will not be as strong as during 2009, however, as the dollar's strengthening will hold back price increases and the effect of the bounceback will diminish.

The recovery of the global economy will continue during 2010 and 2011, but forecast risks are still on the downward side, as many challenges remain that, if unmet, could disturb the improvements in confidence and risk taking. Investments will remain weak as capacity utilization stays lower than normal. Industrial production and world trade will pick up, but from very depressed levels. The recovery continues to depend

on policymakers and stimulus measures, and, without these measures, the demand for shares, bonds, houses, cars, and commodities would look very different.

Three policy challenges are at the top of the list: implementing the exit strategies of monetary and fiscal policy; stabilising the financial sector, including the creation of a more effective regulatory framework; and combating the build-up of new asset price bubbles, especially in emerging markets, where capital inflows create instability. The concerns from a medium-term perspective of too-large budget deficits leading to higher public debt in most OECD countries could already create expectations during 2010 and 2011 that hold back optimism in the financial markets. The fiscal difficulties in Greece are just one example. Imbalances, such as the current account deficit and the private savings rate in the US, are subsiding at the moment, but in a few years the problems may return, creating new instability. The world economy is still fragile, and the risks beyond the forecast horizon are challenging. A double dip cannot yet be excluded. Hold on to your hat!

Cecilia Hermansson

Interest and exchange rate assumptions

	Outcome 12 jan 2010	Forecast 30 Jun 2010	--> 31 dec 2010	--> 30 Jun 2011	--> 31 dec 2011
Policy rates					
Federal Reserve, USA	0.25	0.25	1.00	2.00	3.00
ECB, Eurozone	1.00	1.00	1.00	1.75	2.75
Bank of England	0.50	0.50	0.75	1.50	2.50
Bank of Japan	0.10	0.10	0.10	0.10	0.50
Exchange rates					
EUR/USD	1.45	1.40	1.35	1.30	1.25
RMB/USD	6.83	6.83	6.83	6.70	6.50
USD/JPY	91	105	110	115	120

Sources: Reuters Ecowin and Swedbank

Sweden: Households contribute to higher growth

Key Economic Indicators, 2008 - 2011 ¹⁾

	2008	2009f	2010f	2011f
Real GDP (calendar adjusted)	-0.5	-4.2	2.0	2.6
Industrial production	3.3	-15.5	5.3	6.2
CPI index, average	3.4	-0.3	0.9	2.2
CPI, end-of period	0.9	0.9	1.3	2.5
CPIF, average ²⁾	2.7	1.9	1.3	1.4
CPIF, end-of period	1.6	2.7	0.9	1.7
Labour force	1.2	0.1	0.0	0.2
Unemployment rate, % of labor force	6.1	8.4	9.9	9.9
Employment	1.1	-2.3	-1.6	0.2
Nominal hourly wage whole economy, average	4.3	3.0	2.0	2.0
Nominal hourly wage industry, average	4.4	2.8	1.8	2.0
Savings ratio (households), %	11.8	14.1	13.5	12.6
Real disposable income (households)	3.7	2.5	1.5	1.3
Current account balance, % of GDP	9.6	7.2	6.7	7.0
General government budget balance, % of GDP ³⁾	2.5	-2.1	-2.9	-2.4
General government debt, % of GDP ⁴⁾	38.0	44.6	46.2	47.1

Sources: Statistics Sweden and Swedbank

1) Annual percentage growth, unless otherwise indicated

2) CPI with fixed interest rates

3) As measured by general government net lending

4) According to the Maastricht criteria

The outlook for the Swedish economy has improved from our September forecast, but even so we do not see a strong rebound of economic growth over the next couple of years. Global developments in the second half of 2009, with positive growth in Sweden's major trading partners, gave a small boost to export orders in the manufacturing sector, and confidence among producers and consumers has improved. The labour market outcome was not as severe as many had expected, including us, and the unemployment rate is estimated to have remained below 8½% on average, compared with our forecast of almost 9% open unemployment. Consumers showed resilience and continued to increase spending in the second half of the year and, thereby, reduced the magnitude of the economic downturn in 2009. The capacity utilization in the manufacturing sector started to increase and the rate of decline of investment fell. On the economic policy front, there were no major surprises.

The Riksbank confirmed its outlook on the economy and maintained the key

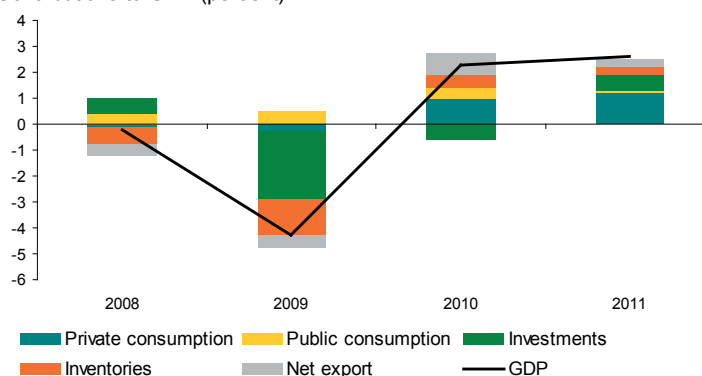
policy rate at record-low levels, while starting to unwind the fixed repo loans. The fiscal stance worsened, but less than expected, and it remains relatively strong, given the severity of the economic downturn.

For 2010 and 2011, we are raising our forecast. This year is likely to be affected by the full impact of economic stimulus packages launched globally. This will improve export performance in Sweden, while imports will tend to lag. Labour market conditions will continue to deteriorate but at a slower pace than

previously anticipated. Thus, we do not expect the rate of open unemployment to exceed 10% on average. Real disposable income is expected to continue to increase, underpinning real economic growth. Investment will fall before increasing in 2011, while inventory depletion will slow, reversing the impact on GDP.

We do not foresee any major revisions to economic policy. We expect that the Riksbank will start to increase the repo rate in the third quarter, which will by the end of 2011 reach 3%. The fiscal

Contributions to GDP (percent)



Sources: Statistics Sweden and Swedbank

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2008	2009f ¹⁾	2010f ¹⁾	2011f ¹⁾
Households consumption expenditure	-0.2	-0.6 (-0.9)	2.2 (1.7)	2.5 (2.2)
Government consumption expenditure	1.4	2.0 (1.5)	1.5 (1.3)	0.4 (0.4)
Gross fixed capital formation	2.6	-13.4 (-14.0)	-3.2 (-3.5)	3.5 (2.9)
- private, excl. housing	4.6	-16.1 (-17.1)	-5.9 (-5.6)	3.0 (2.0)
- public	4.0	7.6 (7.1)	3.0 (2.5)	1.7 (2.5)
- housing	-5.4	-22.5 (-21.4)	1.0 (-2.1)	8.0 (7.5)
Change in inventories ²⁾	-0.6	-1.4 (-1.1)	0.5 (0.3)	0.3 (0.3)
Exports, goods and services	1.8	-12.5 (-13.8)	4.6 (3.3)	6.0 (5.2)
Import, goods and services	3.0	-13.4 (-14.6)	3.5 (2.1)	6.2 (5.1)
GDP	-0.2	-4.3 (-4.6)	2.3 (1.5)	2.6 (2.3)
GDP, calender adjusted	-0.5	-4.2 (-4.5)	2.0 (1.2)	2.6 (2.3)
Domestic demand ²⁾	0.8	-2.6 (-2.8)	1.0 (0.5)	2.0 (1.6)
Net exports ²⁾	-0.4	-0.5 (-0.7)	0.8 (0.7)	0.4 (0.4)

Sources: Statistics Sweden and Swedbank

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

2) Contribution to GDP growth.

position will improve in 2011, after worsening in 2010, as economic growth picks up.

The main risks to our forecast are a sharp reversal of international growth and a reemergence of the turmoil in the international financial markets. Parts of the public stimulus packages will be withdrawn, and there is uncertainty to what extent the private sector will be in a position to take over as the main engine of growth. Domestically, the structural adjustment of the Swedish economy could be more abrupt than expected, with unemployment rising even higher and pushing down consumer confidence and the willingness to spend. Although most households will see their economic conditions improve, a significant share of the population, often concentrated in industrial regions, will see a sharp deterioration. On the other hand, the services sector could grow faster than anticipated, resulting in higher employment and private consumption.

Earlier recovery of foreign trade

The third quarter outcome for 2009 showed that the export volume of goods and services continued to fall but at a slower rate (12.5% annually) than previously. This development is expected to have continued in the fourth

quarter. Also, export orders to industry are estimated to have increased during the fourth quarter of 2009. However, the improvement is from low levels, and the volume of orders is still historically low. We expect that total export volume fell by 12.5% last year, which is the largest decline for a single year since World War II.

In our updated global outlook, we foresee growth of Swedish export markets of 3.5% in 2010 and nearly 5% in 2011, which is faster than we estimated in our September outlook. Market growth for Swedish companies, however, is still significantly lower than before the global recession started in the second part of 2008. The conditions for Swedish exporters will improve due to falling unit labour costs. The loss of market shares is

expected to end, and we anticipate some recovery in 2010 and 2011 despite an appreciation of the krona. Due to fierce global competition and the relatively slow recovery, Swedish exporters will be cautious in raising their export prices. We foresee that the total export volume will increase by 4.6% in 2010 and by 6% in 2011.

Weak domestic demand and falling industrial production has led to a significantly slowdown of Swedish imports. For 2010 and 2011, we foresee that the import volume will grow by 3.5% and 6.2%, respectively, as industrial production recovers and domestic demand strengthens. The growth contribution to GDP from net exports will gradually diminish from 0.8 percentage point in 2010 to 0.4 percentage point in 2011.

Export indicators



Sources: Statistics Sweden and NIER

Investments continue to lag

The decline in investments continued during the autumn but at a slower-than-anticipated rate. In the third quarter, overall private sector investments fell at an annual rate of an estimated 16.1%, compared with a decline of 21.0% in the second quarter. Not surprisingly, public investment continued to expand, while investments in housing remained at a low level. Companies continued to deplete inventories, but to a smaller extent.

The outlook for investments remains subdued, but marginally less so than envisaged in September. The private sector revised downward their plans in the October investment survey. However, global demand is expected to grow somewhat faster than previously expected; this will exert a larger pull on Swedish export companies. Also, housing will benefit from increasing demand and higher prices, although the risks here are significant. A larger fiscal space in 2010 will increase the room for further expansion of public investments, and a reversal of the inventory depletion will have positive effects. In the end, however, the still-low capacity utilization, together with sluggish global growth, will drag out the investment rebound.

Less negative labour market and low price pressures

The deterioration in the Swedish labour market has been smaller than we expected, despite a substantial drop in production. After a significant increase

in the number of layoffs at the end of 2008 and the beginning of 2009, labour market developments were less negative during the autumn. The slowdown in the number of vacancies decelerated. Due to a more moderate adjustment in the labour force, productivity growth in the Swedish economy was more negative than we expected. Companies did not reduce labour to the same extent as the significant fall in production. In 2009, the unit labour cost (ULC) rose by more than 4% for the whole economy, marking the third consecutive year of increasing labour cost. This dampened the profitability of the business sector.

Total employment is estimated to decrease by a cumulative 170, 000 over 2009-11, compared with the reduction of some 270, 000 we anticipated earlier. In 2010, we foresee a further fall in total employment as the business sector continues to adjust the size of the labour force but not to the same extent as in our September outlook. Employment will shrink by 1.6%, or 70,000 employees, compared with 2009. A modest employment increase is now also expected during 2011, mainly driven by the private service sector, while the demand for labour in industry will be constrained.

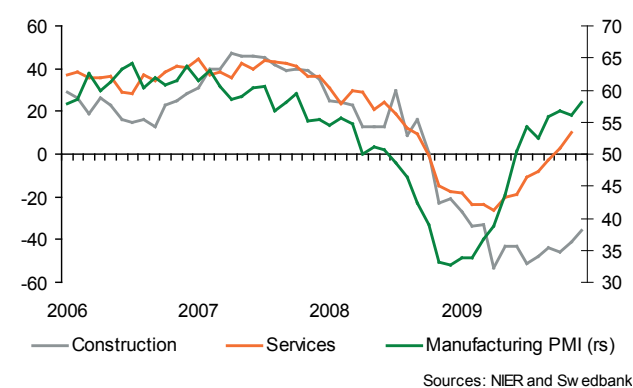
Structural reforms in the labour market and less favourable social insurance benefits to stimulate labour participation have led to a growing labour supply, despite weak labour market conditions. Both short- and long-term sickness

rates have been falling in recent years, and this development will continue. As a result, the labour force will not decrease during 2010-11, as it did during previous recessions when labour markets were weak. The unemployment rate is expected to increase to just below 10% in 2010 and then stabilise in 2011. When labour market programs are included, the total unemployment rate will still be worrisomely high, at about 15% of the labour force, in 2011.

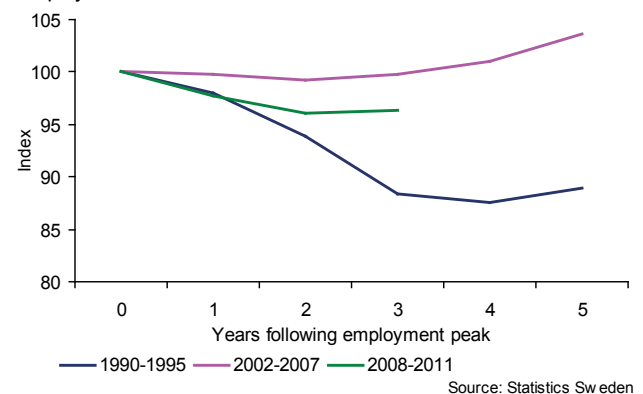
Although we foresee a less negative outlook for the labour market, the nominal wage increases will be modest during the whole forecast period. An extremely low capacity utilisation rate gives room for a strong growth in productivity. A higher production growth and further reductions in the number of working hours, although at a lower rate, will generate labour productivity growth (of 4% in 2010, compared with -1.4% 2009). Next year, when employment is expected to pick up, productivity growth will slow to 2%.

Due to the higher productivity growth, the unit labour costs for the business sector will decrease during 2010-11. The downside risks on the labour market are mostly connected to a weaker recovery and an underestimation of the labour adjustments required in the business sector by increased global competition and structural changes.

Confidence Indicators



Employment



During 2009, Sweden's consumer prices fell in annual terms by 0.3 %. Although price developments could be characterized as deflationary, the main reason was the decrease in interest rates. In terms of the consumer price index (CPI) with constant interest rates, the increase during 2009 was 1.9%. Going forward, the most important index to look at would be the one in which interest rates are kept constant, as the swing from lower interest rates will be reversed when the Riksbank starts raising interest rates during 2010.

Comparing this forecast with the one in September, there are expectations of slightly higher inflation during 2011. As interest rates are raised, the CPI will increase above the inflation target of 2.0% and reach 2.2% in 2011. Still, the average of the CPI with constant interest rates of 1.4% (up from 1.2% in September) suggests low underlying inflation pressures. Higher commodity prices, affecting Sweden's domestic market, support the upward revision despite a stronger krona. Overall, the ample spare capacity in the economy, leading to low wage increases, as well as higher productivity growth, will dampen inflationary pressures over the forecast period.

Higher consumption growth

Despite improvements in Swedish households' purchasing power over the first three quarters of 2009, private consumption fell in annual terms and precautionary savings skyrocketed. The main adjustment to a worsened outlook took place at the beginning of 2009, after which higher asset prices, continued low interest rates, and media reports of a brighter outlook improved household confidence. Thus, consumer spending seems to have stabilised towards the end of the year in annual terms.

Going forward, real disposable income will continue to grow, although not as quickly as during 2009. The impact from economy policy will weaken, and labour

income is not expected to increase until 2011, after two years of falling number of hours worked. The main reasons for revising private consumption upwards for 2010 and 2011 to 2.2% and 2.5%, respectively, are the improved confidence and increased risk appetite, as well as the smaller deterioration of the labour market than in our previous forecast. Credit growth to households has continued to increase rapidly. House prices, although fluctuating, have almost returned to the high levels noted before the crisis. Activity in the services sectors has held up well, which means better prospects for households in the larger cities. Quarter-on-quarter private consumption has become positive, and this is expected to continue.

Although the outlook has brightened – and households can remain an important engine for economic growth – the risks to the forecast are plentiful. Labour markets could turn out both better or worse compared with our view, and confidence could weaken due to global developments that dampen optimism on financial markets. In the medium term, there is a risk that the present household debt ratio of some 160% will rise and hamper growth when interest rates move higher.

Economic policy stance remains expansive

The Swedish Riksbank has maintained its most important policy rate – the repo rate – at 0.25% since July 2009, and has

signaled its intention to keep the rate unchanged until the autumn of 2010. After three fixed repo loans of close to a total of SEK 300 billion, that facility has been considered needless – a sign that the situation in the financial sector has improved. The repo path has not been changed by the Riksbank despite a stronger growth outlook. One reason is the downward revision of the inflation outlook. Another reason could be an aversion to creating expectations of higher interest rates, which would weaken the effect of today's expansionary policy.

We maintain our view that the Riksbank will start normalising the repo rate in the third quarter of 2010. The large output gap will not start closing until 2011. Inflationary pressures will continue to be weak, and the recovery in the industrial sector will proceed slowly. At the end of 2011, the repo rate will have reached 3%, i.e., the same level we had envisaged in our September forecast.

At that point and thereafter, some of the highly indebted households with flexible interest rates will face difficulties with their mortgages. Overall, we do not expect households will create major problems for banks; rather, the risks are geared towards slower consumption growth and falling asset prices. The Riksbank will continue to focus on the inflation target and, together with other institutions, deal with the risk that low interest rates could create a new bubble in the Swedish housing market as house

Interest rate and currency outlook

	Outcome	Forecast	-->	-->	-->
	2009 12 jan	2010 30 jun	2010 31 dec	2011 30 jun	2011 31 dec
Interest rates					
Policy rate	0.25	0.25	1.25	2.00	3.00
10 yr Gov. bond	3.41	3.40	3.70	3.90	4.10
Exchange rates					
EUR/SEK	10.2	9.8	9.5	9.3	9.3
USD/SEK	7.1	7.0	7.1	7.2	7.3
TCW (SEK)	135	131	127	127	127

Sources: Reuters Ecowin and Swedbank

prices increase and households' debt ratios, despite the weakening of labour markets, rise.

The Swedish krona strengthened during 2009 but remains weaker than our assumption in September, both against the dollar and the euro. For the upcoming two years, we assume a stronger krona than in our previous forecast. The trade-weighted index (TCW) will reach 127 at the end of 2011, compared with 129 assumed earlier. This is mainly because Sweden's growth performance is projected to be better than many of the euro countries'.

The fiscal balance is showing some improvement from our September forecast. During the autumn of 2009, revenue collection exceeded our expectations, and we have revised our estimate

upwards for the end-year fiscal balance (as measured by general government net lending) from -2.3% of GDP to -2.1% of GDP. The improvement stems mainly from a better performance by taxes on labour and consumption, depending respectively, on the labour market not deteriorating as much and consumption picking up. This, together with a smaller contraction of GDP, also led to a smaller increase in public sector debt.

We expect fiscal balances for 2010 and 2011 to improve from our September forecast, based mainly on our more positive outlook on economic activity over the next couple of years. We do not include any spending or tax initiatives over the period additional to the September forecast. The upward revision of real growth and the more positive outlook on labour and consumption are

thus expected to narrow the fiscal deficits to 2.9% of GDP in 2010 and 2.4% of GDP in 2011 compared to our previous forecasts. Our path for government debt has been revised downwards. Partly, this is the result of higher growth and better fiscal performance. Partly, some of the expected debt transactions—specifically, support to the financial sector—have been scaled down. Furthermore, significant valuation gains due to exchange rate fluctuations will reduce the debt expressed in krona. At end-2011, we expect debt as a share of GDP to rise to around 47%, still significantly below the Maastricht criterion of 60% of GDP, and below the debt ratios of most EU members.

Cecilia Hermansson
Jörgen Kennemar
Magnus Alvesson

Estonia: Towards euro adoption

Key Economic Indicators, 2008 - 2011 ¹⁾

	2008	2009f	2010f	2011f
Economic growth	-3.6	-14.0	1.5	4.5
GDP, mln euro	16 073	13 800	13 800	14 500
Average growth of consumer prices	10.4	-0.1	0.5	1.8
Unemployment level, % of labour force	5.5	13.5	14.0	12.0
Real growth of gross monthly wage	3.2	-5.2	-6.0	0.6
Exports of goods and services (nominal)	6.9	-19.0	7.0	6.5
Imports of goods and services (nominal)	-2.8	-29.5	7.2	7.8
Trade and services balance, % of GDP	-4.3	5.3	5.5	4.5
Current and capital account, % of GDP	-8.4	6.0	6.5	6.0
FDI inflow, % of GDP	8.2	5.0	5.0	8.0
Gross foreign debt, % of GDP	118.5	125.0	121.0	117.0
General government budget, % of GDP	-2.7	-2.7	-2.2	-0.5
General government debt, % of GDP	4.6	6.4	7.5	7.0

Sources: Statistics Estonia and Swedbank

1) Annual percentage growth, unless otherwise indicated

The decline of Estonian real GDP diminished in the third quarter of 2009 to 15.6% annually (from 16.1% in the second quarter), and we estimate a seasonally adjusted quarterly decline of 1.9%.¹ We have lowered the growth outlook for 2009, expecting a 14% decline (13.5% previously) due to a deeper-than-expected correction in inventories. But we have increased the growth outlook for 2010 and 2011 due to the improved global outlook, better performance of investments and household consumption, and decline of risk estimates in recent months. We expect the Estonian economy to grow by 1.5% in 2010 and by 4.5% in 2011.

The major factor affecting Estonian economic developments in 2010-11 is the expected adoption of the euro in 2011 – this is our main scenario. We forecast a decline of risk estimates, which would bring cheaper and bigger capital inflows, make investments more attractive, and, hence, contribute strongly to growth, which will mostly

manifest itself in 2011. The failure to fulfil the Maastricht budget criterion would have a major negative impact on economic developments as risk estimates would increase, thus making investments more expensive. Other risks to the Estonian economy are related to global economic developments – demand and price growth, mainly – but there is also a possibility that Estonian households will continue to keep saving levels high despite the improving economic situation.

Export- supported recovery, household spending weak

We estimate the Estonian economy to have declined by 14% in 2009, but expect it to grow by 1.5% in 2010 and 4.5% in 2011. Exports have been the driving force behind economic growth since the second quarter of 2009, and investments started to contribute positively in the third quarter of 2009 (6.4% quarterly growth), due to a substantially lower inventory correction than in the second quarter. We estimate domestic demand to have begun growing in the fourth quarter of 2009 as gross capital formation increased. Household

consumption will start to grow in the second half of 2010, to be followed by government spending in the last quarter of 2010 at the earliest. The positive contribution of net exports to real GDP in 2009 will continue in 2010, but strong investment growth will trigger the growth of imports; hence, we expect a slight negative contribution of net exports in 2011. The expected adoption of the euro will have an encouraging effect on consumption and investments at the end of 2010 and in early 2011.

Export growth associated with growth of global economy

In 2009, exports and imports are estimated to have shown deep declines (close to 20% and 30%, respectively, in nominal terms), but their growth will resume in 2010. We forecast exports to grow in 2010 by 7% and by 6% in 2011 – which is more than we expected in the autumn – due to increased trade activity. Import growth will be somewhat stronger than export growth in 2010 and the difference will widen in 2011, owing to recovering domestic demand. In volume terms (i.e., excluding the price effect), exports started to grow already in

¹ This is not the official figure. No detailed seasonally adjusted data have been published yet. We used the Census X12 method for getting detailed, seasonally adjusted GDP data.

Swedbank's GDP Forecast - Estonia

Changes in volume, %	2008	2009f ¹⁾	2010f ¹⁾	2011f ¹⁾
Household consumption	-4.7	-18.5 (-21)	-6.0 (-9.0)	2.0 (3.5)
Government consumption	4.1	-0.8 (0.0)	-1.8 (0.0)	1.0 (0.0)
Investments	-16.6	-45.0 (-38)	13.0 (13.0)	20.0 (8.0)
gross capital formation	-12.1	-32.0 (-27)	4.0 (4.0)	10.0 (5.5)
changes of inventories/GDP (current prices)	0.4	-3.0 (-3.5)	0.2 (-0.2)	0.7 (0.5)
Domestic demand	-7.4	-25.0 (-24)	-0.5 (-1.0)	6.5 (4.0)
Exports	-0.7	-10.5 (-10)	8.0 (1.0)	5.5 (3.0)
Imports	-8.7	-27.0 (-30)	4.0 (-1.0)	6.0 (3.0)
Net exports, contribution to GDP growth	8.7	18.5 (-18.5)	3.5 (1.0)	-0.5 (-2.0)
GDP	-3.6	-14 (-13.5)	1.5 (0.0)	4.5 (2.0)

Sources: Statistics Estonia and Swedbank

1) These are averages of the forecast ranges, which are ca 2 percentage points wide. The figures from our forecast in September are given in brackets.

the second quarter of 2009, and imports in the third.

We changed our export and import forecast mostly due to heavier mediated (transit) flows and increased subcontracting work. In both ways, the trade volumes will increase, but their effect on the trade balance will be relatively small, albeit more pronounced in services exports. In addition, we expect a stronger growth of global prices, which will affect imports more than exports due to Estonia's negative balance of fuels trade. We are also more optimistic regarding domestic demand in 2010, and particularly 2011, which will mean more imports.

Although Estonia's main trading partners will show rather modest recoveries in 2010, we still see good growth possibilities for exports due to the substantial improvement of competitiveness in Estonian companies through cost cutting. This improvement occurred mostly in the first half of 2009 but continued into the second half of 2009 and should do so in 2010 as well. Investment growth in 2010-11 will improve the competitiveness of companies even more, as we expect substantial investments will be made to increase efficiency and change production towards more value-added products.

We expect export growth to Germany and other euro zone countries to be

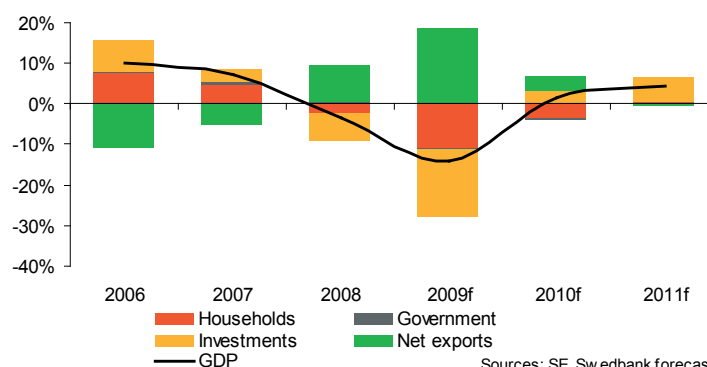
strong, particularly after Estonia joins the euro zone. The weakest markets are Latvia and Lithuania, as well as Sweden due to problems in the machinery and car industry for which Estonian companies did subcontracting work. Exports to Finland are challenging. For subcontracting companies, the situation looks difficult as Finnish companies, to which Estonian companies subcontract, are experiencing trouble in finding global markets. Cost advantages should support at least tourism revenues, and perhaps also other services. We are of the opinion that the invitation to Estonia to join the euro zone in the second quarter of 2010 will start to make business contacts easier, particularly with respect to trade with Finland.

Exports of food, mineral, chemical, and timber products are relatively good, and we forecast continued improvement in

sectors producing these goods. Exports of metal products, as well as machinery and equipment, will not recover rapidly because excess capacities in most countries in the world are reducing demand for investment goods.

Exports of services will remain distressed in early 2010, but we expect some improvement in the second half of 2010 and an acceleration in 2011. There was a delayed impact on exports of services from the crisis; and we are of the opinion that the recovery will also be somewhat delayed compared with overall economic developments. We forecast that marine passenger transport, marine and railway cargo transport, and transport-related services like cargo handling, logistics etc., will perform well in 2009-10. Travel services will grow in 2010-11, mostly due to increased tourist flows from Finland and Russia.

Contributions to GDP Growth



External surpluses to remain

After showing an estimated surplus of 6% of GDP in 2009, Estonia will continue to run current and capital account surpluses in 2010 and 2011 as well. The trade and services balance will also be in surplus over this period, generating the biggest part of the current and capital account surpluses.

The trade deficit was smallest in 2009 – we estimate it to be about 4% of GDP – and will start to widen in 2010, as imports begin growing after the recovery of domestic demand. We foresee imports of investment goods (machinery and equipment) as the first to grow, while consumer goods imports will remain distressed for some time. This means that products with lower prices will be preferred by consumers. However, price developments, particularly if oil prices increase more than now assumed, will affect imports and the trade balance more strongly than currently expected.

The services surplus will be biggest in 2010, most likely in the middle of the year, when export of services—but not yet imports—will have begun to grow. Households will keep down their spending on travelling, and companies will try to buy fewer services, particularly expensive ones from abroad.

The income account deficit will continue to diminish during the forecast period. There are several reasons for this decline: (1) growing workers' re-

mittances; (2) modestly growing profits in Estonia; (3) the weak performance of Latvian and Lithuanian economies, the source of most Estonian income earnings; and (4) low interest rates. However, at the end of the period, we forecast the deficit to begin to grow slowly. Transfers surpluses of 2009 will continue to increase in 2010, before stabilizing in 2011. This growth is mostly a result of increased transfers from EU and other funds.

The current and capital account surpluses mean that the financial account will show a deficit in 2010, as in 2009, but probably not in 2011, due to increased FDI inflows. Although inflows of FDI in Estonia in 2009 were substantially smaller than in 2008 due to a decline in reinvested earnings, they were still relatively high – close to 5% of GDP. The sale of state shares in Estonian Telekom increased new FDI in the fourth quarter of 2009. Reinvested earnings will grow in 2010-11, and new FDI will begin to be stimulated in the second half of 2010 by the prospect of euro zone membership.

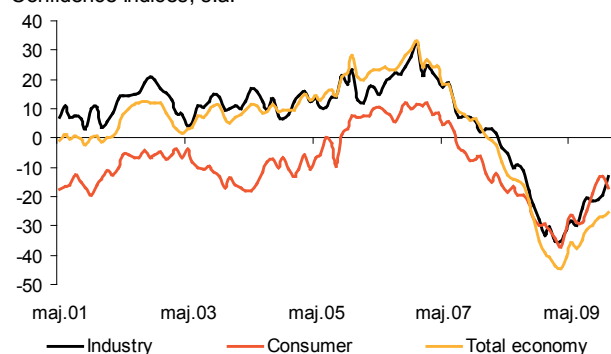
Other investments will show net outflows due to the deleveraging process. While in 2009, as in 2008, Estonia's assets abroad declined, in 2010-11 foreign assets are expected to grow as households resume saving for pensions. The decline in foreign liabilities in 2009 will continue in 2010, but they will grow in 2011, as access to foreign capital will improve after euro adoption.

Investments supported by EU funding

Our estimates suggest that investment (including inventories) increased by 6.4% quarter-on-quarter (s.a.) in the third quarter; however, this increase was primarily the result of a substantially smaller inventory decline than in the second quarter. Gross fixed capital formation continued to decline, but significantly less than in the first quarter (-4.6% vs. -20.6%). The most encouraging outcome was the growth of investments in machinery and metal products of 9.3% (quarter-on-quarter, s.a) in the third quarter.

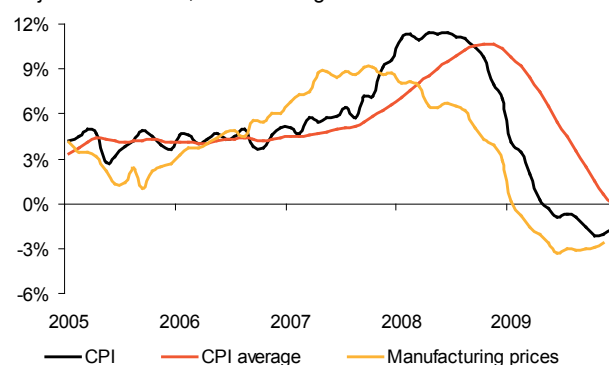
We estimate that gross fixed investments grew in seasonally adjusted terms in the fourth quarter of 2009, most of all due to growing machinery and non-residential construction investments. These investments are supported mostly by growing EU-funded investments. Big investments are being and will be made in infrastructure (road and energy) and the social sector (hospitals) in 2009 and afterwards. However, companies are also increasingly using EU funds, e.g., for renovation and R&D purposes. Households have mostly been focusing on renovating and improving housing energy efficiency (there is a special programme with funding for apartment buildings) in 2009-10. Residential construction will start to grow only in the second half of 2010, and even then only very slowly.

Confidence Indices, s.a.



Sources: EKI, Swedbank calculations

Major Price Indices, annual change



Sources: SE, Swedbank

Inventories continued to decline throughout 2009; some companies, however, started to increase these already in autumn 2009. One reason for the general decline is the continuing weak household demand, which is forcing retailers to sell inventories and avoid new purchases (e.g., passenger cars). We expect inventories to start to grow in the spring of 2010.

Price growth to resume in 2010

We have revised our consumer price inflation forecast for 2010 in the expectation that prices will grow by 0.5% this year and by 1.8% in 2011. Several reasons underlie this revision. First, global price growth has been stronger than previously assumed, particularly regarding fuels, which affect the Estonian market directly. Second, the government and some municipalities have planned to make several tax increases in the first half of 2010 (hikes in fuel, tobacco, and electricity excises, introduction of a sales tax, etc). Although the VAT increase in July 2009 affected mostly corporate profits and had only a short-term effect on price levels, we are not so optimistic now about its limited effect, as the rise in the tax rate affects mostly monopolistic or oligopolistic markets. Hence, there will be a stronger immediate upside effect on the price level and a downside effect on consumption, and a delayed, somewhat muted, downside effect on prices. Third, the fact that a group of prices (mostly services, but also some goods) have declined very modestly or not at all--although sales are falling rapidly-- suggests that there might be problems with competition.

Production, retail, services, and export prices will continue to decline in annual terms; however, in some areas monthly growth has already resumed, beginning in mid-2009. Sharply falling prices are the reason why we expect exports to perform well; however, the growth of global prices will affect Estonian price levels as well. Still, we expect this to be seen mostly in the second half of 2010

and afterwards.

Labour market to improve from spring 2010

We forecast that the average unemployment rate, estimated at 13.5% in 2009, will be 14% in 2010, and 12% in 2011. However, the unemployment rate will peak at the beginning of 2010 when it exceeds 14%. We expect employment to begin to grow in the spring of 2010 (s.a. comparison); however, growth will be very slow at first. Still, the number of working hours already began to increase during 2009, as forced part-time jobs continued to decline after a pickup in the second quarter. In the winter of 2009/10, unemployment will increase, due to layoffs mostly in domestically oriented companies, but also in the public sector, which has been forced to make spending cuts.

The average gross wage declined by 5.3% in 2009 and will fall by 5.5% in 2010; however, we expect growth of approximately 2.4% in 2011. The decline of incomes was deeper than that of the average wage because of fewer working hours in 2009. However, we forecast somewhat stronger wage growth in 2010 as underemployment will diminish and employment will grow.

Private spending remains distressed

Private consumption in the third quarter declined slightly less than we expected; hence, we estimate a somewhat smaller

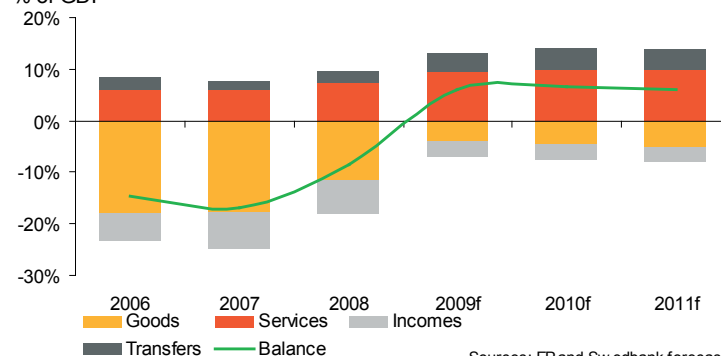
decline than previously projected in 2009 (18.5% vs. 21%). We also foresee a smaller decline in 2010 (6% vs. 9%), but we are less optimistic regarding growth in 2011 (2% vs. 3.5%). The high unemployment rate is one reason behind this-- long-term unemployment could remain relatively high for several years. However, we have also seen that households are more inclined to save and are taking fewer loans than was forecast in the autumn. There are few reasons to expect better consumption performance, as unemployment will remain high, public sector spending was cut substantially, and price growth will be stronger than we assumed before.

Households may increase spending more at the end of 2010, as it is commonly believed that prices will increase with euro adoption. However, we should then see in early 2011 a short-term setback in consumption.

Economic policy concentrated on euro adoption

We have made the assumption that Estonia will fulfil the Maastricht criteria and will join the euro zone in 2011. The most challenging is the budget deficit criterion – 3% of GDP – but we estimate that this criterion was fulfilled in 2009 (as it was in 2008, and will be in 2010 and 2011). The government has made strong efforts to keep the budget in line with the 3% target, and the same approach will affect the government's policy choices in 2010 as well. We expect

Current and Capital Account Balance,
% of GDP



that the government will reduce the deficit for reaching the budget balance in 2012 or 2013.

We estimate that the Estonian public sector budget deficit in 2009 was approximately 2.7% of GDP, as in the second half of the year central government showed a strong surplus (the third quarter result was 2.7% of GDP, and the fourth quarter even higher). However, not only municipalities, but also social funds were in deficit. Still, we expect that the deficit in those sectors also declined as substantial spending cuts were

made in the third and fourth quarters of 2009.

The public sector deficit data will be released in late March by Estonian Statistics and in April by Eurostat. Following an evaluation by the European Commission, the report will be published, probably in May. Final approval is expected in June. We are of the opinion that the data release is the most crucial point in the process – if the deficit as a share of GDP is below 3%, we can expect that Estonia will be accepted as a new member of the euro zone.

Euro zone membership would mean substantially smaller risk margins and a lower minimum reserve requirement in the central bank (currently 15%, vs. 2% in the euro zone). We also expect a pickup of optimism among consumers, companies, and investors. Hence, euro zone membership should give additional impetus to economic growth through increased lending, capital inflows, investments, and consumption. This has been included in the forecast.

Maris Lauri

Latvia: Recovery of exports has started

Key Economic Indicators, 2008 - 2011 ¹⁾

	2008	2009f	2010f	2011f
Economic growth	-4.6	-18.0	-3.0	4.0
GDP, mln euro	21 952	18 067	16 361	16 775
Average growth of consumer prices	15.4	3.5*	-3.5	0.0
Harmonised unemployment level, % of labour force	7.5	17.5	21.5	19.5
Real growth of average net monthly wage	6.3	-6.3	-4.0	1.0
Growth of exports of goods and services (nominal)	10.4	-17.2	10.0	13.0
Growth of imports of goods and services (nominal)	-3.3	-36.3	1.5	12.0
Balance of goods and services, % of GDP	-12.9	-0.4	3.7	4.5
Current account, % of GDP	-12.6	9.8	10.0	8.0
Current and capital account, % of GDP	-9.8	12.4	14.0	11.0
Net FDI, % of GDP	3.3	0.3	0.4	0.8
External gross debt, % of GDP	128	153	165	155
General government budget (accrual basis), % of GDP	-4.1	-10.0	-8.5	-6.0
General government debt, % of GDP	19.5	35.0	57.0	60.0

Sources: CSBL and Swedbank

1) Annual percentage growth, unless otherwise indicated

The general economic outlook is broadly unchanged since September. However, the emphasis has shifted on some of the issues. We see earlier improvements in exports, which also supports imports. Approval of the 2010 government budget has reduced the short-term uncertainty about the economy, but longer-term fiscal sustainability problems remain – more consolidation is to come, the tax system to be modified, and structural reforms improving public sector efficiency and business environment to be continued. Deleveraging is becoming the increasingly important challenge for 2010-11 as deflation deepens.

While positive quarterly GDP growth is expected to resume in mid-2010, a contraction in GDP of about 2-4% is now forecast for the whole year (0-3% before) due to a smaller decline in imports. Economic activity is then anticipated to grow by about 2-5% in 2011. The average job seekers' rate is estimated to have been about 17.5% in 2009, and it is still forecast to reach its maximum in mid-2010 (albeit at a somewhat higher level, about 23%) and start to diminish gradually afterwards, first due to emigration and rising inactivity, and then due to slow job creation. Deflation is in full

swing – the annual consumer price index (CPI) inflation of 9.8% in January 2009 turned into 1.5% annual deflation in December 2009. Deflation will continue into 2010 and early 2011, with averages for those years of 3-4% and 0%, respectively. The marginal deficit in trade of goods and services in 2009 will turn into surpluses in 2010-2011 of 3-6% of GDP, driven by exports; however, these surpluses will be somewhat lower than previously anticipated due to faster import recovery.

The negative risk to the base forecast is insufficient structural adjustment locally, as well as a fallback via a W-type recovery globally. Insufficient progress on structural reforms in both the public and private sectors runs a risk of post-recession stagnation, with very weak convergence in living standards to the rest of the EU (like, e.g., Portugal's experience after joining the euro). A faster-than-expected global recovery in 2010 would result in larger Latvian exports in the short term; however, this may put at risk the timely completion of reforms and, later, when global monetary and fiscal stimuli are withdrawn and the world economy slows, the same structural problems may still be undermining

Latvia's competitiveness and exports. On the other hand, an upgrade of Latvia's sovereign credit ratings' outlook (or even a rating itself if political stability and long-term fiscal strategy is clearly manifested) would improve the availability of financial resources and support faster recovery via, e.g., foreign investments.

Export recovery is beginning to counteract the fall in domestic demand

The cumulative fall in real GDP from its peak in late 2007 to the third quarter of 2009 reached 24%. The quarterly decline in economic activity accelerated in the third quarter, partly due to fiscal consolidation. The seasonally adjusted GDP fall was 4% quarter-on-quarter, due to harsh declines in private consumption and gross fixed capital formation (9% and 14%, respectively). On the positive side, exports were growing by 1%, reflecting stronger global demand and improved competitiveness. Real imports continued to decline (by 1.9%), but much slower than before.

Import recovery to start earlier than expected

Export developments among industries have varied widely. The wood

Swedbank's GDP Forecast - Latvia

Changes in volume, %	2008	2009f ¹⁾	2010f ¹⁾	2011f ¹⁾
GDP	-4.6	-18.0 (-18.0)	-3.0 (-2.0)	4.0 (3.0)
Household consumption	-5.5	-23.5 (-20.0)	-12.0 (-12.0)	1.5 (0.0)
General government consumption	1.5	-8.0 (-8.0)	-3.0 (-8.0)	-2.0 (-4.0)
Gross fixed capital formation	-15.6	-36.0 (-30.0)	-17.0 (-17.0)	5.0 (1.0)
Export of goods and services	-1.3	-15.0 (-16.0)	5.0 (2.0)	7.0 (5.0)
Import of goods and services	-13.6	-34.0 (-35.0)	-7.0 (-15.0)	6.0 (5.0)
Net export contribution to GDP growth	8.5	13.8 (14.0)	5.6 (8.0)	0.6 (0.0)

Sources: CSBL and Swedbank

1) These are averages of the forecast ranges, which are ca 2 percentage points wide. The figures from our forecast in September are given in brackets.

and chemical industries have been the most successful in adapting to the deteriorating economic situation by increasing the shares of exports in their turnover and expanding their output. For instance, the output of the wood industry in November 2009 was 49% higher than its lowest point, reached in January 2009. Positive developments are also seen in the food, machinery and equipment, electronics, and paper industries – although output in these sectors is recovering very slowly (food manufacturing is still falling); these businesses have increased their sales in export markets. Positive developments in these industries are expected also in 2010-11. On the other hand, exports of, e.g., metals, nonmetallic minerals, and textiles are still far behind last year's levels. Services exports were falling much less than goods exports, especially sea transportation and travel. However, in 2010-11 transit flows (especially freight) might be somewhat undermined by increasing competition among Baltic ports. Prospects for tourism are brighter; this branch has also shown quite good results in 2009.

Since early 2009, export market shares of Latvian companies in foreign markets have gradually been rising (especially in Estonia and Russia). There is a risk of rising protectionism in Russia, though, which might undermine Latvian exports. In the EU27 overall, Latvian export market shares have been stable, and this will continue to be a main export market for Latvian goods and services. Taking

into account the somewhat faster global recovery, significantly reduced local costs, and growing industry confidence, nominal exports are now expected to grow by 9-11% in 2010 and 12-14% in 2011.

Import contraction, spurred by weak private consumption, low investments, and destocking, has shown much less variation across commodity groups. Imports fell more sharply than domestic demand in late 2008–early 2009, and the liquidity squeeze throughout 2009 forced many companies to run down their stocks instead of importing. Given the earlier contraction in imports, we are of the opinion that imports are close to bottoming out – while domestic demand will continue to retreat, import dependency for both intermediate and capital goods (including exporting sectors, where we expect stronger growth) is high. Import recovery is thus likely to begin earlier than previously anticipated.

Rising prices of imports, especially those of energy (which comprise nearly one fifth of goods imports) will support nominal imports in 2010-11. Consequently, nominal imports may even grow marginally in 2010 (our forecast is 0-2%). Growth will become stronger in 2011 (11-13%) with the recovery of domestic demand.

So far, current account surpluses have been mostly due to FDI losses (including the banking sector provisions for bad debts), while trade in goods and services

became balanced in the second quarter of 2009. Expected surpluses in 2010-11 (9-11% and 7-9%, respectively) will be mostly driven by positive balances in the trade account, while income account surpluses will diminish.

Investment recovery to start in second half of 2010

Investment activity remains weak, although several large investment projects have been announced in industry (e.g., in wood and metals manufacturing, and in the energy sector) and transit services (ports).¹ Although the investment climate has improved somewhat (e.g., a somewhat clearer tax policy for 2010), a more long-term fiscal strategy is required. Spare capacity in manufacturing is still high (about 45% vs. 27% in 2005-07), albeit somewhat lower in the two largest manufacturing sectors, the food and wood industries. High credit interest rates, the necessary deleveraging, and low country ratings are also undermining investments. Support will come from EU funds, which might comprise about 6% of GDP in 2010 (with cofinancing²) and 5-6% in 2011.

Revised data show a deeper than expected contraction in investments in 2008-09. As we do not anticipate significant improvement in investment

1 E.g. reconstruction of one of the co-generation plants (LVL 300 million for 5 years), deepening of Liepāja port (LVL 20 million), millions of lats worth of projects in the wood sector, etc.

2 Authorities claimed that resources thought for EU fund co-financing will not be cut; also, the share of necessary co-financing in the projects has been diminished

environment in 2010 (gross fixed capital formation to fall by 16-18% largely due to carryover effects), we forecast a sharper rebound in 2011 to rebalance the earlier undershooting (growth of about 3-6%). An important negative risk is that improved confidence in Estonia in case of its acceptance to the euro zone in 2011 might divert some of investment away from Latvia.

A significant numerical risk to the forecast is inventories (shifting GDP by 1-2 percentage points in each direction). Destocking is certainly expected to continue in 2010, but there is high uncertainty regarding its statistical measurement. Anecdotal evidence suggests that current inventories might be overvalued and thus actual destocking has been deeper in 2009.

Adjustment in labour costs has been rapid

Labour costs have been reduced sharply – in the third quarter of 2009, they had fallen by 30% since the fourth quarter of 2008. The largest adjustment came through job destruction and the decrease in working hours. Overall, unit labour costs (ULC) have already diminished by 13.5% year-on-year, showing that adjustment in costs is more rapid than decline in output. While average productivity per employed continued to decrease in the third quarter of 2009, productivity per a full-time equivalent improved for the second quarter in a row,

reflecting grown part-time employment. Nevertheless, structural productivity gains are still weak, especially in the public sector, and adjustment should continue.

Unemployment growth was somewhat steeper than we expected in the autumn of 2009, and the job seekers' rate reached 21.7% in November. This rate is expected to peak at about 23% in mid-2010 and start to diminish slowly afterwards. The main reason for lower unemployment in 2011 (coming down to about 17% at the end of the year) will be emigration and increasing inactivity, while job creation most likely will remain weak.

Until the third quarter of 2009, average gross wage cuts were sizable in the public sector (-18.1% since the fourth quarter of 2008), but not so much in the private sector (-3.6%), where wage cuts are often taken as a last resort. Therefore, while employment adjustment will largely be completed in the first half of 2010, incomes will continue to decrease before starting to recover slowly in the second half of 2011. We expect real average net wages to fall by 3-5% in 2010 and expect them to grow by 0-2% in 2011, with the economic outlook improving.

Deflation deepens, making deleveraging difficult

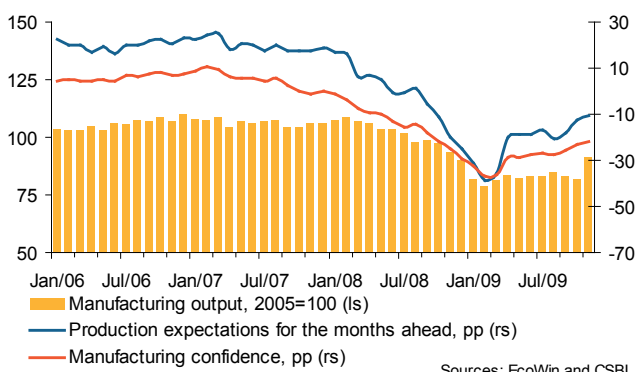
Falling purchasing power continues to

drive prices down. Deflation is in full swing, and consumer prices have been declining in annual terms since October 2009 (in December, they had fallen by 4.5% from their peak in March 2009). External competitiveness is improving – according to our estimations, some 20-30% of the real effective exchange rate (REER) appreciation during 2006-08 has already bounced back (depending on whether the consumer or producer price index, or the ULC deflated REER is used).

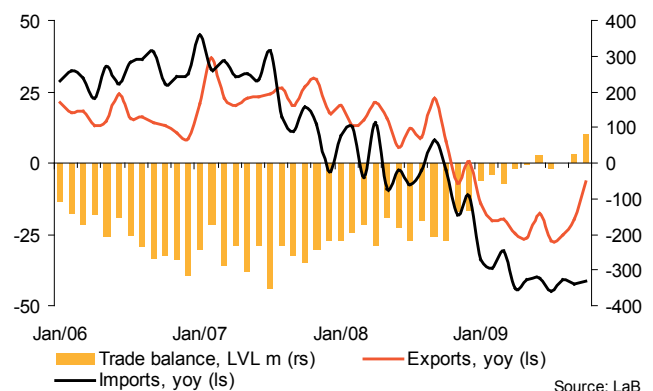
At the same time, an increasingly important challenge – that of deleveraging – is looming. The number of bankruptcies has increased, as has that of credit overdues. The fact that local prices are falling more quickly than those of imported inputs makes deleveraging particularly difficult for the companies selling in the domestic market. To improve competitiveness in a less painful way and make the gains sustainable, further output-enhancing measures are necessary (e.g., new products and markets, cost efficiency). If productivity growth remains slow, cost and price adjustment will need to be deeper, making deleveraging even more difficult.

The downward trend in the CPI will continue into 2011. Upward pressure in the first half of 2010 will come from alcohol and tobacco (due to excise rises), as well as more expensive public transport in Riga. On the opposite side, housing costs will continue to decrease in the first half

Industry indicators, s.a.



Trade in goods and services



of the year due to lower gas and heating tariffs, but a rebound is expected in the second half of 2010, due to both a rise in global prices of energy resources and the introduction of an excise tax for natural gas. We are maintaining our forecast of 3-4% deflation for 2010 and about 0% for 2011 (but a fall in local prices is likely to continue also in 2011).

Household spending to remain weak

While households are adapting to the economic situation and confidence slowly recovers, the decline in household consumption has been accelerating. Increasing unemployment, falling incomes, and the need to service their loans will continue to induce households to reduce their spending. The factor that is somewhat supporting consumption is pensions – despite a 10% decrease in July (70% for working pensioners), the average pension size increased by nearly 30% year on year in the first nine months of 2009.³ In addition, the Constitutional Court's decision that the pension cuts have been illegitimate implies larger pensions in 2010.⁴ While the average pension size is still small (EUR 242 per month), it is a certain and regular income, and the number of pensioners is nearly half that of the number employed in the economy.

Household consumption is expected to

³ Mostly due to indexation in late 2008, but also due to larger pensions for new pensioners.

⁴ Planned to start paying larger pensions as of February 1st.

continue decreasing at a slowing rate into 2010. It is thus anticipated to fall by about 12% in 2010, largely due to negative carryover effects. Growth is forecast to reemerge in 2011 (of about 0-2%), supported by increasing employment and stabilized incomes.

Budget target to be met, but more consolidation necessary

The general government deficit is expected to hit 10% of GDP on an accrual basis in 2009 (i.e., the European Commission target). The central government budget deficit has been higher than committed to in the supplementary budget as of June 16 2009, indicating that fiscal discipline still needs to be improved. In addition, because pension cuts, as noted above, have been ruled illegitimate by the Constitutional Court, about LVL 60 million will need to be paid back for the second half of 2009, adding about 0.4% of GDP to the deficit on an accrual basis.

The approved 2010 budget reduced short-term uncertainty. The general government deficit was planned to be at about 7.5% of GDP; however, the Constitutional Court's decision resulted in a further LVL 120 million shortfall (about 1% of GDP). While the government claims that it is still possible to meet the 8.5% EC target, including increased spending on pensions, we are of the opinion that additional fiscal consolidation will be necessary to meet this goal, as the current revenue forecast by the

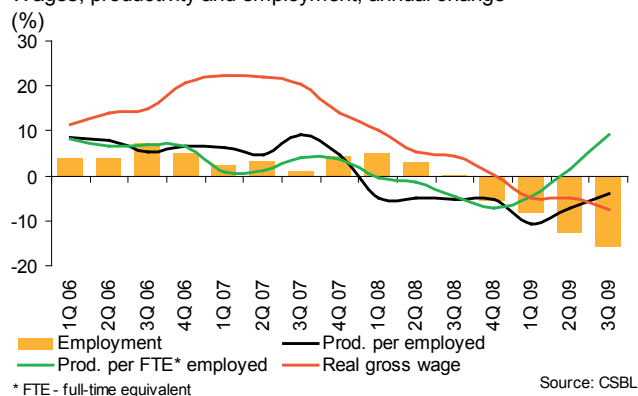
Ministry of Finance is somewhat optimistic. The IMF program is on track, but due to changes in the procedure of parliamentary approval the agreements with the IMF and the EC is now necessary. This may slow down the third review and thus the disbursements for 2010. It, should not, however, cause problems as State Treasury has sufficient funds to accommodate such delays.

Clear fiscal strategy and policy targets should be set

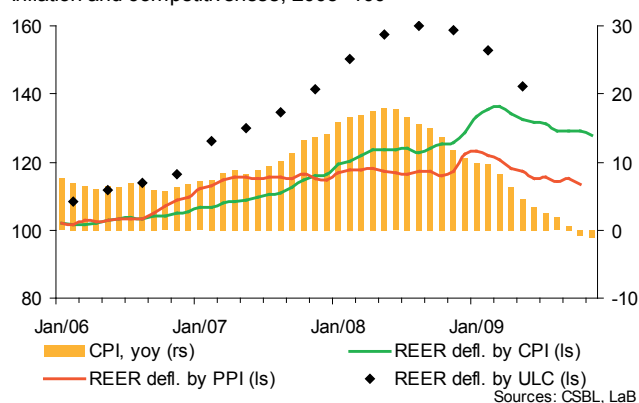
Challenges remain with respect to fiscal sustainability. In our opinion, the 2010 budget does not solve many of the long-term structural problems of the Latvian economy.⁵ On the revenue side, we believe that the measures to address tax evasion are clearly inadequate and the tax burden is still skewed towards low- and medium-income inhabitants. For the tax system to be put on a sustainable footing, the tax burden should be shifted from labour to property and consumption. On the expenditure side, the progress in structural reforms is still insufficient. In many cases, the process has been postponed due to a lack of consensus (e.g., in the higher education sector, it still cannot be decided what changes are needed) or due to a widespread "wait-and-see" approach (e.g., on reducing the number of ministries). Delays in restructuring have, of course,

⁵ For more details see Swedbank Analysis on fiscal stance in Latvia, <<http://www.swedbank.lv/eng/docs/materiali.php?nmid=0&naid=3>>

Wages, productivity and employment, annual change



Inflation and competitiveness, 2005=100



also partly been influenced by the elections in 2010.

Short-term problems should be addressed in the context of a long-term outlook to ensure a sustainable solution. Our policy suggestion is to set a clear agenda for 2010-11 with a specific action plan and a time frame to ensure that the targets set are fulfilled. For

instance, in the first quarter of 2010, a cheap, simple, and quick bankruptcy procedure should be introduced; in the second quarter, a tax system should be developed that supports the sustainability and efficiency of the economy. Structural reforms should continue (both raising the effectiveness of the public sector and improving the business environment), as otherwise productivity

gains might be insufficient and deeper deflation would be necessary to improve competitiveness; the latter would complicate the deleveraging process and make the labour market adjustment even more painful.

Mārtiņš Kazāks
Lija Strašuna
Dainis Stikuts

Lithuania: A slow and fragile recovery awaits

Key Economic Indicators, 2008 - 2011 ¹⁾

	2008	2009f	2010f	2011f
Economic growth	2.8	-16.0	-2.0	3.0
GDP, mln euros	32 203	27 186	26 509	27 577
Growth of consumer prices	10.9	4.5	1.0	1.0
Unemployment level, % of labour force	5.8	13.5	16.0	15.5
Growth of real net wage	11.2	-10.0	-5.0	0.0
Growth of exports of goods and services (nominal)	25.5	-27.0	-0.6	8.7
Growth of imports of goods and services (nominal)	18.9	-37.6	-1.3	7.8
Balance of goods and services, % of GDP	-10.9	-0.5	-0.1	0.2
Current account, % of GDP	-11.9	1.0	1.2	-0.3
Current and capital account, % of GDP	-10.1	3.7	4.2	3.0
FDI inflow, % of GDP	3.9	2.0	1.0	1.5
Foreign gross debt, % of GDP	71.6	85.0	88.0	86.0
General government budget position, % of GDP	-3.2	-9.5	-9.5	-7.0
General government debt, % of GDP	15.6	30.0	40.0	50.0

Sources: LDS and Swedbank

1) Annual percentage growth, unless otherwise indicated

The annual GDP decline in the third quarter decelerated in comparison to that of the first half of 2009. After contracting by 16.5% in the first half of the year, real GDP fell by 14.2% year on year in the third quarter (and grew by 6.1% quarter on quarter, seasonally adjusted) mainly due to better-than-expected results of the export-driven manufacturing sector. The rise in unemployment also appears to have slowed, and leading indicators for the fourth quarter of 2009 support the assumption that industrial production results continued to improve.

Even though some developments in the second half of 2009 were slightly better than we anticipated, it is nevertheless too early to speak about a sustainable economic recovery. GDP results in the third quarter of 2009 confirmed the dire situation in all domestic demand components. Public finances also continued to be under strain. The Lithuanian economy will thus be subjected to a severe test in 2010, as household consumption remains anaemic, given falling wages, increasing unemployment, and rising electricity prices following the

decommissioning of the Ignalina nuclear power plant. Public sector consolidation measures will further exacerbate the fall in household purchasing power.

We retain our September forecast and estimate the economy to have contracted by 16% in 2009. We forecast real GDP to decline slightly less – by approximately 2% rather than 3% as anticipated in September- in 2010 due to an improved global demand outlook. The economy is expected to start a somewhat more pronounced recovery under the impact of the international cycle in the second half of this year. The Ignalina nuclear plant closure is estimated to have a negative -0.8-1 percentage point impact on GDP growth in 2010. We forecast real GDP to grow by around 3% in 2011. A recovery in exports, which will lead to a smaller decline in both gross fixed capital formation and private consumption in 2010 will support positive growth rates for domestic demand components in 2011. The net export contribution will be positive throughout the forecast horizon. Risks to the forecast remain relatively balanced at this time. On the positive side, a stronger-than-expected export performance might have an earlier and

larger positive impact on the economy. On the negative side, there remain considerable uncertainties regarding public finances and labour market developments for 2010.

Exports are recovering slowly

After a sharp contraction in the beginning of 2009, exports of goods showed signs of stabilization in the second half of the year and improved somewhat towards the end. Textile, timber, furniture, and machinery and equipment exports improved the most, while chemical and food product exports also started to recover mildly towards the end of last year. Exports will continue their recovery in 2010 due to a more favourable outlook for Lithuania's main trade partners (most importantly Germany, but also Poland, the United Kingdom, and the Benelux countries), which appear to be getting back on their feet and resuming consumption of Lithuanian manufacturing products. The somewhat stronger economic growth projected for the Nordics, particularly Denmark and Sweden, allows us to expect further improvements in textile, timber, furniture, machinery and equipment exports, while a faster revival for the Russian economy should

Swedbank's GDP Forecast - Lithuania

Changes in volume, %	2008	2009f ¹⁾	2010f ¹⁾	2011f ¹⁾
GDP	2.8	-16.0 (-16.0)	-2.0 (-3.0)	3.0 (2.5)
Household consumption	3.6	-18.0 (-18.0)	-5.0 (-5.0)	1.0 (1.0)
General government consumption	7.9	-5.0 (-5.0)	-5.0 (-5.0)	-2.0 (-2.0)
Gross fixed capital formation	-6.5	-42.0 (-42.0)	-4.0 (-5.0)	8.0 (7.0)
Export of goods and services	12.2	-18.0 (-18.0)	1.1 (-0.5)	6.8 (5.9)
Import of goods and services	10.5	-27.0 (-27.0)	-4.2 (-4.2)	4.0 (4.0)
Net exports contribution to GDP growth	-0.5	8.8 (8.8)	2.9 (1.9)	1.4 (1.0)

Sources: LDS and Swedbank

1) These are averages of the forecast ranges, which are ca 2 percentage points wide. The figures from our forecast in September are given in brackets.

help boost Lithuanian food, machinery and equipment exports.¹ Our outlook for services exports, especially transport, has improved somewhat as well since September, given the more favourable outlook for the Russian economy. Nevertheless, we remain cautious regarding our forecasts and foresee that exports of goods and services in nominal terms should remain stagnant or fall marginally in 2010 before rebounding more strongly -- by almost 8.5-9%-- in 2011.

We have not changed significantly our forecast for import growth -- after a drastic plunge of nearly 40% in 2009, imports will decline by 1.3% in nominal terms in 2010 and rebound by 7.8% in 2011. Without the increase in gas imports to compensate for the shutdown of Ignalina, the fall in imports would be considerably larger, given the weak household consumption and dire investment prospects. The contribution of net exports to the GDP growth will be positive both in 2010 and to a lesser extent in 2011, as the contraction in imports outpaces that of exports.

Current account developments are in line with our expectations - after a small 0.2% of GDP deficit in the second quarter, the current account reached a surplus equivalent to 2.9% of GDP in the third quarter of 2009.² While the trade

¹ For some food products, however, the outlook remains uncertain because of customs duty increases and some other possible adverse political developments.

² Such a significant improvement was primarily due to the increase of losses reported by the foreign capital companies during the month of September, which further narrowed the income account deficit.

balance is expected to have improved only marginally, the surplus is likely to have been maintained in the fourth quarter due to a small deficit maintained in the income account, resulting in a current account surplus of 1.2% of the GDP for 2009 overall. During 2010, the current account should remain in positive territory as well, reaching 1% of GDP due to the same factors, namely, trade and income balances, that caused external imbalances to disappear completely last year. The current transfer account will add to the correction of imbalances to a larger extent in 2010 due to the accelerated usage of EU assistance. As the economy begins to recover, we expect the current account to revert to a slight deficit of -0.3% of GDP in 2011.

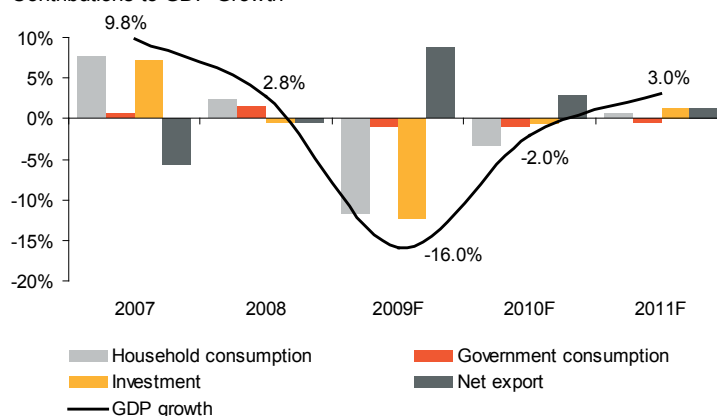
No quick turnaround in investments expected

As expected, investments (excluding inventories) continued to fall markedly

Meanwhile, the trade balance improved marginally compared with the first half of 2009.

in the second half of 2009, contracting by 41.4% year on year in the third quarter. No significant improvement is expected this year as well, and we retained our forecast of a 4-5% contraction of investments (excluding inventories) for 2010. The only significant source of investments will be the EU funds (the government also accelerated the adoption such funding in 2010). We must also acknowledge that the government economic stimulus plan, adopted at the end of 2008, has not delivered the hoped-for results. Although some funds supporting exporting companies and small and medium-sized enterprises (SMEs) were allocated in the second half of last year, it will be possible to assess the actual impact during 2010. The programme, aimed at increasing energy efficiency in old Soviet-era buildings and thus mitigating the downturn in the construction sector, not only has not started but also faces administrative hurdles moving forward. We are hopeful that, as the global economy recovers and

Contributions to GDP Growth



Sources: LDS, Sw edbank calculation

the Lithuanian economy regains some of its competitiveness due to the fall in factor prices, we will see some increase in foreign investment activity towards the end of 2010. The lowering of the corporate profit tax rate from 20% to 15% and 5% for small and medium-sized enterprises improves perhaps initially only expectations, but it might also encourage investments in the second half of the year and in 2011.

The rise in unemployment slows while wages decline

The ongoing correction in the economy is weighing heavily on employment, which is set to fall by 10% from the end of 2008 to the end of 2011. As a result, the unemployment rate will remain high in the forecast period, reaching 16% and 15.5% in 2010 and 2011, respectively. After an alarming pace of deterioration in the first half of 2009, the worsening of labour market indicators appears to have already slowed in the second half of that year. The unemployment rate rose only marginally, by 0.2% in the third quarter of 2009 from 13.6% in the second quarter. We are of the opinion that the third quarter 2009 reading sends a signal that the most drastic adjustments are nearly over; jobs, however, will continue to be shed slowly, but persistently, throughout 2010 as many companies will continue to face challenges, particularly in the first half of the year. We base our forecast for 2010 on the layoffs expected both in the private and public sectors: in the National Agreement signed with business groups and trade unions on October 28, 2009, the government pledged to reduce the number of civil servants by 10% in 2010.

Although the rate of increase in unemployment numbers lessened in the second half of 2009, the average duration of unemployment and the share of unemployed with low levels of education are on the rise. The youth unemployment rate reached an alarming 33% in the third quarter of 2009 (more than dou-

bling the rate of a year earlier), thereby further raising the risk of another large emigration wave over the forecast period. Admittedly, an increase in emigration will be a significant offsetting factor for the unemployment statistics in 2010 and 2011. The risk, however, of a further worsening of the investment and growth prospects in Lithuania is far greater.

One of the reasons for the better-than-expected unemployment numbers could be the rapid adjustment in wages last year, especially in the private sector. Real net wages will have fallen by about 10% in 2009; unit labour costs declined by 7.2% year on year during the third quarter of 2009. Real net wages are expected to continue declining in 2010 by 5%, driven also by a further reduction in public sector salaries starting at the beginning of the year, and are anticipated to stagnate in 2011.

Marginal CPI inflation due to electricity prices

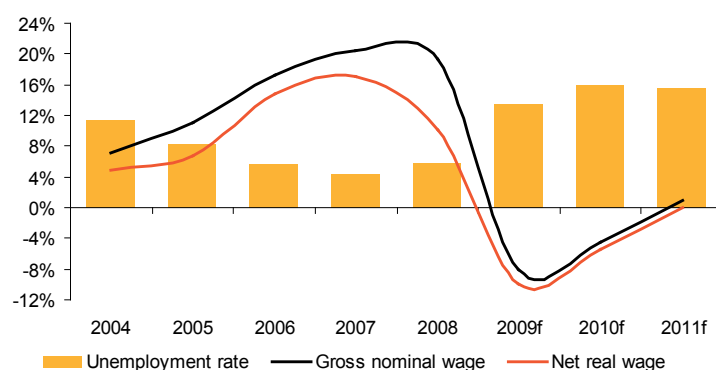
Consumer price inflation (CPI) slowed markedly over 2009, reaching 4.5% on average, and is projected to remain low over the forecast horizon. The most significant source of inflation this year will come from a rise in electricity prices, following the decommissioning of Ignalina. For households, electricity tariffs were hiked by 29% at the start of 2010 compared to December, 2009. Meanwhile, prices for industrial consum-

ers are harder to predict and will likely fluctuate throughout the year in line with commodity price developments; the increase in electricity prices for industrial consumers will nevertheless be lower than for households as they will be able to buy imported electricity in the open market, which, given higher local generation costs, will likely be cheaper than locally produced electricity.³ It has been estimated that the rise in prices for industrial consumers could reach 20% overall this year, resulting in a seemingly low increase of average costs for companies of about 5%.⁴ Together with second-round effects, the increase in electricity prices is estimated to have an overall effect of 1.1 -1.4 percentage points on annual CPI. The prices of oil, gas, and other commodities in international markets are likely to become sources of inflationary pressures as well, as the global recovery gains momentum. These cost increases, however, could be quite hard to pass onto consumers both in Lithuania and abroad (in the first half of the year), thus the competitiveness of some Lithuanian industry sectors is likely to suffer significantly in the short term.

³ Local electricity generation costs are to increase from about 6.5 ct/kWh on average in 2009 to approximately 17 ct/kWh starting in 2010 (The electricity generation cost for the largest thermoelectric power plant, Lietuvos Eletrine, which de facto "replaces" the Ignalina nuclear power plant, stands at 29.31 ct/kWh, compared with 6.4 ct/kWh for the Ignalina nuclear power plant).

⁴ The share of electricity in their cost structure is higher, for instance, for some construction, paper, textile, and plastics companies and stands at 8-10% of all costs.

Labour Market



Source: LDS, Swedbank forecast

On the other hand, clear deflationary tendencies are likely to prevail due to downward pressures of domestic demand, particularly in the first half of this year. We retained our forecast that consumer price inflation will reach 1% in 2010 and 2011; due to the stronger deflationary pressures that became evident in the last months, we do not exclude the possibility of average CPI being lower this year.

Household consumption to remain weak

In line with our expectations, the contraction of household consumption did not slow in the third quarter of 2009, and we estimate a similar year-on-year reading for the fourth quarter of 2009 as well. Any noticeable improvement in household consumption is unlikely this year, given the alarming unemployment numbers and lack of upswing in earnings, as well as the electricity price increases and likely continuation of tight credit conditions. The strong overall deflationary pressures will encourage those few who will not be budget constrained to postpone their purchases as well. We anticipate a further 5% contraction in household consumption this year. Given the electricity and other commodity price increases⁵, and rising unemployment, the first half of the

⁵ It has been estimated that the electricity bill for an average household will increase by only LTL 20 per month (the average electricity bill currently stands at LTL 60.74 per month, or approximately 3% of total household expenses).

year will be especially challenging. We anticipate that export-driven economic recovery will lead to a marginal rebound of household consumption only in 2011.

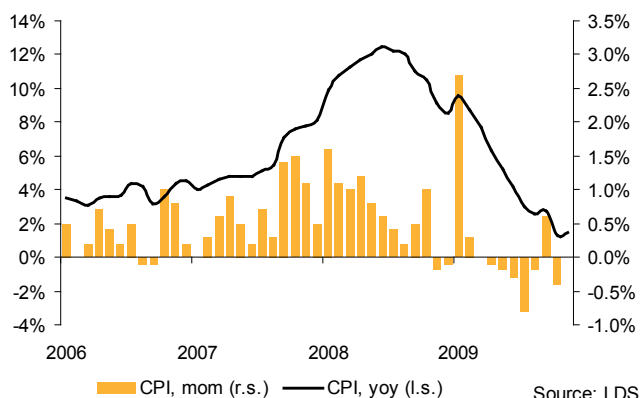
Public finances remain under strain

The budget for 2010 adopted at the end of 2009 promises decisive and harsh, but not at all surprising measures, as the downturn took a heavy toll on public finances in 2009, necessitating implementation of a further set of consolidation measures. Funding for the vast majority of social benefit programmes (including pensions and parental leave benefits) was reduced, and the wage bill for civil and other public servants was cut by approximately one-third. The trimming of public sector wages and the reduction of social benefit programmes, together with other measures aimed at reducing expenditures, will likely reduce the deficit by more than EUR 0.58 billion, or 2.5% of GDP. Combined, the budget consolidation measures of 2009 and 2010 will reach approximately 12% of Lithuania's GDP. Although we might criticize the government for not adopting some of the measures earlier last year, especially the one regarding the reduction of the public sector wage bill, we must acknowledge that such proposals would have encountered considerable difficulties and might have been impossible to pass through the parliament.

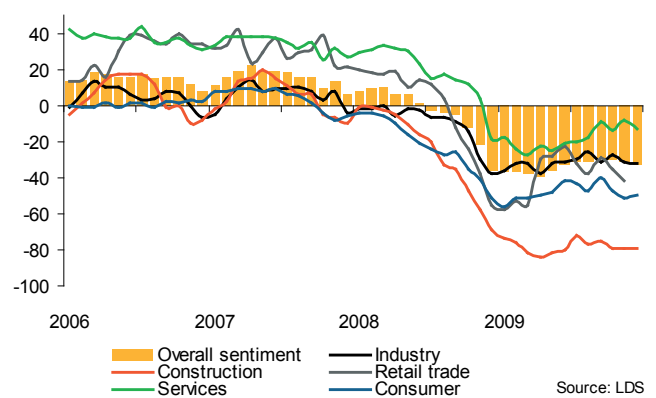
At the same time the government pledged to significantly accelerate the adoption of EU funding, which is a primary factor behind the projected overall increase of 2% in government expenditures; together with government funding, this will be directed to investments projects (infrastructure, energy efficiency, and research and development). The corporate profit tax rate was brought back from the 20% rate of 2009 to the 2008 level of 15% (the corporate profit tax rate was lowered to 5% for SMEs, down from 13% in 2009). We are of the opinion that the government still needs to signal clearly its firm intention to maintain a stable corporate tax policy; however, even though the new rates are likely to have some adverse effects on tax receipts in the short term, the tax changes are a step in the right direction.

Despite the consolidation measures, the adopted budget targets an alarmingly high deficit. We raised our forecasts and expect the general government deficit to stand close to 10% in 2009 and 2010, with public debt as a result quickly escalating to 40% at the end of this year. Borrowing overall, mainly in the international markets, will reach approximately EUR 3.8 billion in 2010. It is unlikely that the Lithuanian government will be able to keep on borrowing in 2010 on the rather favourable (though still expensive) terms it enjoyed in 2009, which will put further pressure on the fragile situation in public finances and

Consumer Prices



Confidence Indicators



also raise difficult questions about fiscal sustainability. We do not anticipate further significant corrections to the adopted budget in 2010 -- at least not to the extent that occurred last year. The government has a good chance of achieving the revenue targets set; it is very unlikely that revenue projections will be revised upwards -- and if they are, all funds will be used to finance the fiscal deficit.

Export-driven recovery, which is ex-

pected to start in the second half of this year, is likely to lead to higher revenues only in 2011. At the same time, most of the expenditures are cyclical and cannot be easily reduced. Given also that 2011 is an election year for municipalities, we foresee only a gradual decline of the fiscal deficit to about 7% of GDP. The government has also set no clear official target year for reducing the budget deficit below 3% of GDP, as required by the Maastricht criterion. We are of the opinion that an increase in revenues could

reduce the deficit to below 3% of GDP in 2012; however, there might be difficulties in achieving the target in 2012 as well, as this is a parliamentary election year. The budget criterion is most likely to be met in 2013 at the earliest, with acceptance into the euro zone following in 2014. However, the Maastricht criterion on public debt will also have to be monitored closely.

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