The Lithuanian Economy

Rising wages mask widening income inequality

- Rapid wage growth, but not for everyone
- Income inequality has picked up – action required
- Main culprits - weak social safety nets and changing economy

Rapid wage growth, but not for everyone
Average wage growth has been rapid, and wage inequality has declined over the past five years in Lithuania. However, public sector workers were among those who benefitted least from the economic recovery. Their wages have been growing less rapidly than those in the private sector for quite some time. There is plenty of room for bringing more efficiency to the public sector, which, in turn, would make more resources available for wage increases in that sector.

Income inequality has picked up – action required
The income of those at the top of the income distribution has been growing considerably more rapidly than that of those at the opposite end. As a result, the income inequality indicators have been trending upwards for the past few years. The Gini coefficient of disposable income is now at the highest level in the country’s history and one of the highest in all EU countries. The progress in bringing down poverty has stalled as well. The situation requires attention.

Main culprits - weak social safety nets and changing economy
One of the main factors contributing to high and rising income inequality is related to weak social safety nets, including for the elderly. The large employment gap between high- and low-to-medium-skilled workers is another important factor. The latter is an outcome of the ongoing structural transformation in the Lithuanian economy, which, given the technological development, is unlikely to be reversed anytime soon. Not only redistributive but also educational and regional policies need to be pursued to lower the inequality of income as well as the inequality of opportunity.

Share of national equalised income by quintile groups and S80/S20

Source: Eurostat

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Rising wages mask widening income inequality

Wage growth has been strong in recent years. However, not everyone has benefitted equally from the recovering economy and income inequality has thus picked up. Public sector workers, the low- and medium-skilled workers, and those depending on social security support have been among the most disadvantaged. However, redistribution alone will not help to reduce income inequality. This will require education reform, retraining and skill upgrading, and creative solutions to solve the problems related to regional inequality.

Strong wage growth, especially for low-income earners

Over the past five years, the average gross wage in Lithuania has increased by 30%. There are many reasons behind the strong wage growth - the rising minimum monthly wage, which has been raised by 64% since 2011, the need to restore the wage proportions between high- and low-skilled employees after minimum wage hikes, the declining scope of wages paid “under the table,” and the ever-more-pressing labour force shortages. Wage growth has been broad based, affecting low-, medium-, and high-wage earners.

Wage inequality has been on decline

Employees earning the lowest wages (the first quartile) have enjoyed the largest increase in their wages. Thanks largely to the hikes in the minimum monthly wage, their gross wages increased by 55% over the period 2011-2016. Although the high-wage earners saw the smallest increases in their wages, they could not complain either - their wages increased by almost 25% over the same five-year period. The median gross wage has been growing more rapidly than the average wage, but the median still remains around 18% below the average wage, signalling still-high inequalities in wage distribution. Nevertheless, the situation among low-income earners seems to be improving. The share of people earning the lowest wages has been declining steadily for the past few years – in 2010, more than 40% of all full-time employees earned less than EUR 400, while in 2016 only 15% earned less than that amount (see graph below).

Higher nontaxable income threshold has benefitted low-income earners

Last year, nominal growth of the average net wage even exceeded that of the gross wage. This was caused by the reduced tax burden for low-income earners and families with children. The maximum nontaxable income threshold was raised by 20% last year and again by 55% at the start of this year.1 This measure has raised incomes of low-wage earners. Families with children could also enjoy the extra cash provided through increases in

1 The nontaxable income threshold was raised to EUR 200 in 2016 and to EUR 310 in 2017. The additional nontaxable income threshold paid for each child and shared among both parents was raised to EUR 120 in 2016 and to EUR 200 in 2017.
additional non-taxable income threshold that applies to all families with children without any upper income limit. This measure doubled in 2016 and was raised by additional 67% in 2017. Thus, the net wage gap between high-wage earners and low-wage earners has been narrowed in recent years.

### Public sector employees benefitted least

Economic activities that tend to have the lowest wages, e.g., accommodations and food services, agriculture, lower-value-added manufacturing (of wood and paper products, textiles, clothing, food products, beverages, tobacco products, furniture), wholesale and retail trade, administrative and support activities, arts and entertainment activities, and construction, saw the largest wage increases since 2011. However, employees in some high-wage sectors, such as information and communication activities, as well as the manufacturing of computer, electronic and optical products have also enjoyed rapid wage growth. This is largely due to the rapid expansion of these sectors and to the increased demand for highly skilled ICT professionals and engineers and lagging supply of such high-skilled employees.

**Strongest wage growth in industries where low wages prevail**

Unfortunately, the economic recovery has not been very generous to people working in industries with a large public sector presence, such as education, government, defence and social security, health care, as well as in electricity, gas, and steam supply. Wage increases in these economic activities were among the lowest in the country.

**Slowest wage growth among public sector workers**

Private sector employees have been enjoying more rapid wage growth than those in the public sector throughout the whole economic recovery period. Since 2011, the average gross wage in the private sector has increased by 36%, while that in the public sector has grown by only 22%. The wages of teachers and doctors have been growing even more timidly than the public sector average – last year, the average gross monthly wage of teachers and doctors was only 0.7% and 4.7% above their peak 2009 levels, respectively.

Public sector wages require systemic reviews

There are two main reasons why wage growth is slower in the public sector than in the private sector. First, supply-demand-related wage-setting principles are largely non-existent in the public sector. Second, there has been no major revision of public sector employee wages in years, except for the hikes in the minimum monthly wage and some ad-hoc wage increases, as the ones seen for health care and education workers in the second half of last year. Public sector wage reviews require a more systemic approach.

Otherwise, this could lead to undesired consequences

If the situation does not improve, the continued decline in wages in the public sector, relative to the country average, could generate undesired consequences. It may become increasingly difficult to attract highly qualified and motivated employees to the public sector, which, in turn, may result in a deteriorating quality of public services. In addition, this could also lead to a spike in corruption, which would lower the trust in the public sector and the respect for its employees. As the wages in the private sector continue to grow, the pressure on politicians to raise wages of the public sector employees will continue to build.
Leaner public sector could lead to higher wages

There is plenty of room for bringing more efficiency to the public sector, which would, in turn, make more resources available for wage increases in the public sector. Last year, public sector employment stood at 28.2% of total employment and at 26% of the labour force. These numbers are comparable to those found in the Scandinavian countries, which tend to have high-quality institutions, but they are unaffordable in Lithuania. Bringing the size of the public sector closer to the OECD average could lead to a more efficient allocation of resources. According to our estimates, if the number of public sector employees were to be cut by 20%, the saved funds could be used to raise wages of the remaining public sector employees by around 25%.

High income inequality and prevalent poverty

However, wage data do not reveal the full picture of the well-being of different groups in society, especially those outside the labour market. There are dependents such as retirees, as well as those living on social benefits such as the disabled, the unemployed, and those who have dropped out of the labour force because they no longer expect to find a job. Neither do the data say anything about those who receive nonwage income. Moreover, the still-large shadow economy and the wages paid under the table make the official wage data less reliable. Thus, the disposable income data, obtained via surveys, might be a more reliable source of information.

Income growth was uneven

In fact, the disposable income data yield a somewhat different picture than the wage data and indicate that the economic recovery has not been equally generous to all groups in society. Even though official wages are growing most rapidly for low-income earners, the average disposable income per one household member of those at the bottom 20% of the income distribution (those in the first income quintile group) has been growing rather sluggishly in recent years - in 2015, their incomes were only around 5% above those in 2012 (see graph above). Looking at the incomes of equivalent adults (after accounting for the differences in household size and composition) yields a somewhat brighter picture for the

*incl. benefits in kind

Source: Statistics Lithuania

* Source: Eurostat and Swedbank
The Lithuanian Economy

Most rapid income growth for those at the top of the income distribution

The higher the income, the faster the income growth had been over the 2012-2015 period. The average disposable income per one household member of those at the top 20% of the income distribution (those in the fifth income quintile group) was up by 42% in 2015, compared with 2012. Income growth was even more rapid for the 1% of adults with the highest income in the country. The equalised disposable incomes of those at the 99th percentile of the income distribution had doubled over the 2012-2015 period. However, the spike in their income in 2015 could have been a one-off resulting from the introduction of the euro, receipt of dividends or other events, including polling inaccuracy, as the data are based on surveys.

Income inequality has picked up

These trends have resulted in a growing share of national income received by the people with the highest income (the highest fifth) and a shrinking share of national income received by the rest. As a result, the income inequality indicators, such as the income quintile share ratio (S80/S20) and the Gini coefficient, have been trending upwards since 2013. In 2015, both of these indicators increased to the highest level in the country’s history and the highest level in the EU countries.

The poorest did not fare well, and progress in reducing poverty stalled

Society may be fine with growing income inequality as long as it is merit based and “as long as growing incomes increase the prosperity of the society [as a whole] and reduce the poverty of the lower percentiles.” This actually was the case during the post-crisis period, but the situation has changed recently. In 2015, the spike in the Gini coefficient was accompanied by stagnant equalised disposable income of the poorest 20%, as well as by an uptick in poverty indicators. Not only the at-risk-of-poverty rate went up, but also the progress in reducing the rate of severe material deprivation stalled and the share of people living in low-work-intensity households increased somewhat. As the recent events in some developed Western countries show, the continuation of these developments may not be received favourably by society and could lead to unfavourable political and economic consequences. But choosing the remedies first requires identifying the causes of the illness.

Weak social safety nets

One of the main factors contributing to high and rising income inequality is related to the weak social safety nets, including for the elderly. The Gini coefficient before social transfers, including pensions, in Lithuania is similar to that found for other countries, e.g., Sweden, but the less supportive social security is unable to bring income inequality down as much as in other countries (see graph above).

Social policy has been unable to bring more equality to income distribution

2 The ratio of total equalized disposable income received by the 20% of the population with the highest income (top quintile) to that received by the 20% of the population with lowest income (bottom quintile)

The Lithuanian Economy

Weak protection against poverty

Moreover, the Lithuanian social safety net provides weak protection against poverty for those not fully or actively enrolled in the labour market, such as the unemployed, disabled, and elderly, as indicated by the highest at-risk-of-poverty-or-social-exclusion (AROPE) rates among these groups. The gaps in AROPE rates for those depending on social benefits and pensions, such as the unemployed, retirees, and people with disabilities, and their counterparts, are among the largest in the EU (see graph below).

Social benefits have not kept up with economic growth

Expenditures on social benefits in Lithuania are relatively small and have not kept pace with the economic growth and rising average income in the country. This situation has resulted in a large and increasing income gap between those who depend on the state and those fully participating in the labour market. For example, the average old-age pension has been trending slightly upwards since 2011, but it (and other types of pensions) has not kept up with the average wage growth; thus, the average pension relative to the average net wage, as well as expenditure on pensions relative to GDP, has been trending downwards in recent years (see graph above). Although an increase in pensions of more than 7% this year has stabilised the situation somewhat, this is insufficient to narrow the income gap.

Social safety net strengthened somewhat recently, but the unemployed remain very vulnerable

Since the start of this year, the social security net has strengthened. In addition to the raised pensions, more support for families with children, as well as more flexibility to work for those receiving social benefits, has been introduced, and the income threshold for receiving social housing has been lowered. However, the state-supported income, which is used as a base for social benefits in cash, including unemployment benefits, has been left unchanged, at EUR 102, since 2008. On one hand, the unemployment benefits should not be too large, in order to ensure that the unemployed remain motivated to get into employment, but, on the other, unemployment benefits that remain stuck at low levels may lead not only to rising income inequality, but also to high poverty rates, social problems (e.g., widespread alcoholism), and rising inequality of opportunity and lower social mobility among children of disadvantaged families.

Structural shifts in employment

The large employment gap between high- and low-to-medium-skilled workers is another important factor behind the high income inequality in the country. The employment rates of low- and medium-skilled workers are considerably lower than those of high-skilled ones. Moreover, they are lower than those in the EU on average and still below the pre-crisis peak. Meanwhile, the employment rate of high-skilled workers in Lithuania is one of the highest in the EU and already exceeds the pre-crisis peak. The unemployment data yield a similar picture. Despite the economy’s operating at full speed (the output gap has been more or less closed by now), the unemployment rates among low- and medium-skilled workers remain elevated and are considerably higher than the unemployment rate among the high skilled.4

4 In 2016 the unemployment rate among high skilled was at 2.9%, and that among low and medium skilled was at 24.5% and 10.4%, respectively.
This is an outcome of an ongoing structural transformation in the Lithuanian economy (and other developed countries) that has been unfavourable to those at the lower end of the income distribution. A decline in the relative importance of certain low-value-added sectors, such as agriculture and low-value-added manufacturing, and the emergence of the service sector has shifted in employment away from low- and medium-skilled occupations towards high-skilled ones, and this has contributed to rising income inequality.

Employment in commercial services, excluding trade and transport, increased by one-fifth over the past eight years (see graph below), with the largest increases in professional services, e.g. administrative and support activities, professional, scientific and technical activities, information and communication technology, and others. Meanwhile, employment across the remaining economic activities in the country, except for the public sector, still remains below 2008 levels. These trends are supported by the findings of Skills Panorama, a project conducted by the European Commission, according to which ICT professionals, engineers, and managers are in the shortest supply.

These trends will become even more pronounced in the future. As the economy develops and moves up the value chain, the demand for high-skilled professionals (e.g., in ICT, professional services, biotech, and other types of high-technology manufacturing and knowledge-intensive services) will continue to grow, while the employment prospects of the less skilled in traditional sectors may become increasingly gloomy, especially if the technological revolution picks up speed. According to Skills Panorama, by 2025 the Lithuania job market will witness the most rapid employment growth among the high skilled, while employment among the less skilled, such as the elementary occupations, plant and machine operators, is expected to decline (see graph below). These developments may further widen income inequality.

Employment growth in services has been strongest

The continued structural transformation may continue to affect inequality negatively

Employment by economic activity, 2008=100

Future employment growth in Lithuania (2015–2025), % change

Still significant skills mismatch and geographical misalignment in the labour market

However, despite these structural shifts and the high rates of unemployment among low- and medium-skilled workforce, The Lithuanian Labour Exchange reports that companies are having a hard time filling certain vacancies requiring low or medium skills. According to the agency, the demand for truck drivers exceeds their supply by almost 9 times and that of cashiers by almost 9 times. There may be a few reasons for this. The reluctance to take such jobs could be partly related to unattractive working conditions, low work morale, and the large unemployment trap, which increased from 61.5% in 2014 to 81.6% in 2015 and

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9 The unemployment trap measures what percentage of the gross earnings (after moving into employment) is “taxed away” by the combined effects of the withdrawal of benefits and higher tax and social security contributions.
The Lithuanian Economy was above the EU average. However, this problem is most likely related to a skills mismatch between those required in the market and those that the prospective employees hold, as well as a geographical misalignment between the vacancies and the availability of the workforce.

The latter phenomenon—geographical misalignment—is supported by the wide and growing employment gaps between Vilnius (the capital city) district and other ones (see graph below). There are also large differences in unemployment rates between Vilnius and other districts, which can be as big as 10 percentage points. This was again resulted by the trends described above, i.e., the structural shift towards high-skilled occupations, which are being increasingly concentrated in the largest cities, mostly in Vilnius and, only recently, in Kaunas. A lack of jobs in the regions that have been left behind has led to large outflows of people; this, in turn, has reduced the aggregate demand in those regions and the size of the workforce, which has made attracting investment into the district an ever harder task.

Breaking the vicious cycle is very important for fighting high income inequality, but this is easier said than done. Due to technological development and urbanization, these trends are becoming more pronounced, also globally, which may stoke further rising inequality.

There is a growing regional inequality

Employment rate (15-64) difference between Vilnius district and respective district (pp)

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<th>District</th>
<th>2016</th>
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Source: Statistics Lithuania and Swedbank

Is income inequality bad, and what can we do about it?

The answer to the question whether income inequality is necessarily a harmful phenomenon that needs to be addressed is far from straightforward. Some degree of income inequality may be useful to society, as it creates incentives for people to learn, compete, save, and invest, in order to move up the social ladder. It is sometimes argued that inequality does not pose any problems as long as the incomes of those at the bottom of the income distribution are growing and the wealth of the society as a whole is rising.

But the growing consensus among economists and international organizations, such as the OECD and the IMF, is that high and widening income inequality may have "significant implications for growth and macroeconomic stability; it can concentrate political and decision making power in the hands of a few, lead to suboptimal use of human resources, cause investment-reducing political and economic instability, and raise crisis risk" (IMF, 2015). Income inequality in Lithuania is currently clearly above a desirable level. It is possibly having a negative effect on the economy and the political environment and thus needs to be addressed. Unfortunately, there is no single solution to the complex problem, but a combination of different measures could yield an improvement.

Some degree of income inequality may be useful...

...but it is above desirable levels in Lithuania

10 Most likely the unemployment trap declined in 2016 and 2017 due to raised nontaxable income threshold
11 In 2016 the unemployment rate in Vilnius stood at 3.7% and in Utena district it was at 13.7%.
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Stronger social safety nets are needed...

Strengthening of the social safety net is one of the necessary tools for lowering income inequality in Lithuania. It is often feared that greater social transfers, especially higher unemployment benefits, would reduce the motivation to work. However, an adequate and properly built support of the unemployed may allow for proper job search, especially if accompanied by well-functioning retraining programs and counselling. Raising pensions for the old and the disabled are also important in bringing down income inequality.

...but limited resources are available

However, increasing social protection spending is tricky due to the limited resources that are available to the state. This would require additional revenues to the government budget from improved collection of taxes, changes in taxation, and/or more efficient use of available resources. Improvements in all of these areas could bear positive results.

There is still plenty of room for higher efficiency and improved tax administration...

Even though revenues to the state budget exceeded expectations in recent years, revenues from value-added tax (VAT) have been constantly missing the target. VAT compliance remains poor largely due to fraud, evasion, and tax avoidance. According to the EC calculations, Lithuania has one of the largest VAT gaps in the EU (see graph below). Improved tax administration and measures to curb the shadow economy could lead to better tax compliance and, thus, increased tax revenues. Moreover, there is still plenty of room to increase the efficiency of spending via improved procurement procedures and more efficient use of state property, including real estate and state-owned enterprises.

![VAT gap (%) 2014](image)

Source: European Commission

...but it is also important to bring more horizontal equity and rebalance away from labour taxes

It is also important to bring more horizontal equity to the tax system by equalising the rates for individuals with similar incomes. This requires eliminating loopholes and tax exemptions that currently apply (e.g., the plentiful tax exemptions that apply to farmers, the reduced income tax rates applying to certain forms of activity, etc.). This could raise tax revenues even without any major overhauls to the tax system. Nevertheless, the rebalancing of the tax system away from labour taxes towards less distortionary ones, such as wealth taxes, could improve income distribution. Lithuania is one of the few EU countries that does not have a full-scale real estate tax (it applies only to a very narrow base), nor any form of private passenger car taxation.

Social spending should not be the sole measure

However, increases in social spending cannot be the sole measure taken to raise the incomes of the poor. It is crucial to improve the employability of labour by upgrading the skills of the unemployed, as well as of those who are at high risk of unemployment (the low and medium skilled); this requires better functioning of the retraining programs and the education system as a whole.

Crucial to address regional inequalities

However, major changes in employability are unlikely if regional inequalities are not addressed. But finding answers to the problem of regional inequalities is easier said than done. Clustering and the concentration of businesses and jobs in the largest cities are a global trend that is unlikely to be reversed soon, and policymakers all over the world are looking for ways to address the issues related to declining former industrial and rural areas.

13 Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report, CASE and Institute for advanced studies on behalf of Directorate General Taxation and Customs Union (EC).

14 A measure of VAT compliance and enforcement, defined as the difference between the amount of VAT collected and the VAT total tax liability.
The investment funded by the EU structural funds have made the disadvantaged regions prettier, but seem to have had limited positive effect in putting those economies back on their feet. This raises doubt about the effectiveness of such measures for future use. Some areas have learned to benefit from the thriving cities and tourists from neighbouring countries by focussing on recreational services, but there is limited scope for further expansion of this model to other areas. One of the possible solutions is related to the facilitation of the movement of people from declining places to thriving ones by improving the transportation network. However, Enrico Moretti, a professor of the University of California, Berkeley, goes beyond that and argues that introducing reallocation vouchers (temporary financial support) to the unemployed who decide to move to thriving areas could solve the problem. Since there is a lack of alternative ideas, this one may be worth considering.

Meanwhile, the use of the minimum monthly wage in raising the incomes of low-wage earners has been largely exhausted. The minimum wage already stands at around 50% of the average wage in Lithuania, which is one of the highest figures in the EU. Further increases in the minimum monthly wage may have a negative effect on the cost competitiveness of Lithuanian companies. A further reduction in taxes for low-wage earners is the way forward. It would not only raise the incomes of low-wage earners but would also make employment more attractive to the unemployed. This is what is expected from the new technocratic government, and some proposals have already been made. However, it still remains unclear whether this will not lead to increases in the income tax rates on other types of income, which could have a negative effect on investment.

A longer-run approach to raising wages in the country should be related to higher productivity growth, which requires bringing the Lithuanian economy up the value chain. To lower income inequality is also crucial to ensure more equity in opportunity by improving the quality of education. For this, even more complex solutions, as well as unpopular structural reforms, are needed. So, is it any wonder we are hearing only about the popular solution, namely, the redistribution of income?

Laura Galdikienė

15 Read more: The New Geography of Jobs, Enrico Moretti, 2013
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