Despite gearing down, the Baltic Sea region moves forward – rewarding business opportunities are there to be found!

- The Gross Domestic Product (GDP) of the Baltic Sea region is expected to grow by 3.6% this year, but a slowing global business cycle weakens the recovery and we expect growth rates of 2.6% in 2012 and 2.9% in 2013. Despite gearing down, the outlook is better than in other parts of Europe.

- Our structural index – The Baltic Sea Index – indicates that the region’s business climate and competitiveness remain strong again this year (7 out of 10). Education ranks high, but there is room for improvement, not least in the areas of entrepreneurship, labor market and taxes.

- Germany – the largest economy of the region – is expected to reach a GDP growth of 1.1% next year and 1.5% in 2013, which is a major slowdown compared to 2.9% this year. Labor market reforms have so far paid off. Structural policy is now focused on bank recapitalization and consolidation.

- Estonia shows the highest growth rate in the region, followed by Lithuania. The recovery in the Baltic countries is expected to continue, reaching growth rates of 3-4% per year. Although these countries are export dependent, earlier imbalances have been reduced and the resilience against global turmoil is greater. A slowdown will nevertheless complicate the reform process – in Latvia and Lithuania the goals are to reduce the budget deficit and inflation rate, and to enter EMU in 2014.

- Macroeconomic imbalances in Poland have increased in recent years, as suggested by higher inflation rates, and deficits in the fiscal and current accounts. Remedial policy action is reducing these imbalances, while economic growth is expected at respectable rates of 3-4%. Poland is not in a hurry to enter the EMU, but instead waits for the euro crisis to be resolved, and thus allows the fulfillment of the Maastricht criteria to take its time.

- GDP growth in Russia and Ukraine are expected to barely exceed 4%, and the dependence on high commodity prices is considerable. Reforms are pushed forward, and the vulnerability to global commodity markets is significant. The urgent need for reforms is reflected in the Baltic Sea index, which ranks the two economies at the bottom in the region.

- The Nordic countries are found at the high end of the Baltic Sea index with strong business climate. Also the economic outlook is relatively positive. Following a slowdown next year, GDP is expected to grow by about 2% in 2013. Real economic growth in Sweden is forecast at 1.1% in 2012 and at 2.2% in 2013. Should the fall in external demand deepen, the vulnerability of the business cycle and real estate developments are exaggerated by the elevated household debt ratios.
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Indicators</td>
<td>3</td>
</tr>
<tr>
<td>Important to maintain focus on the Baltic Sea region</td>
<td>4</td>
</tr>
<tr>
<td>Poland – reforms needed despite growth</td>
<td>17</td>
</tr>
<tr>
<td>Estonia – domestic demand is picking up</td>
<td>21</td>
</tr>
<tr>
<td>Latvia – export-led recovery, more balanced and resilient economy</td>
<td>25</td>
</tr>
<tr>
<td>Lithuania – improved competitiveness and more sustainable growth</td>
<td>29</td>
</tr>
<tr>
<td>Russia – a chance to modernise the economy after the election</td>
<td>33</td>
</tr>
<tr>
<td>Ukraine – lack of reforms and political uncertainty are eroding the business climate</td>
<td>38</td>
</tr>
<tr>
<td>Germany – benefiting from earlier labour reforms, but more needs to be done</td>
<td>42</td>
</tr>
<tr>
<td>Denmark – new government tries to kick-start growth</td>
<td>46</td>
</tr>
<tr>
<td>Norway – robust domestic demand but high household debt concerns</td>
<td>50</td>
</tr>
<tr>
<td>Finland – political challenges as the economy slows</td>
<td>54</td>
</tr>
<tr>
<td>Sweden – companies are preparing for an economic slowdown</td>
<td>58</td>
</tr>
<tr>
<td>Annex: Content, sources and developments of the Baltic Sea Index</td>
<td>62</td>
</tr>
</tbody>
</table>
# Economic conditions around the Baltic Sea

## October 2011

### Economic indicators

<table>
<thead>
<tr>
<th>GDP growth 2) (%)</th>
<th>Inflation (CPI, %)</th>
<th>Current account balance (% of GDP)</th>
<th>Fiscal balance (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland 3.8 3.7 3.0 3.4</td>
<td>2.6 4.0 3.0 2.8</td>
<td>-4.5 -5.0 -5.1 -4.5</td>
<td>-7.9 -5.5 -4.2 -2.9</td>
</tr>
<tr>
<td>Estonia 2.1 7.6 3.2 3.8</td>
<td>3.0 4.8 2.7 2.5</td>
<td>3.6 3.2 2.4 1.5</td>
<td>0.1 0.1 -1.0 0.0</td>
</tr>
<tr>
<td>Latvia -0.3 4.2 3.0 3.9</td>
<td>-1.1 4.5 2.4 2.5</td>
<td>3.0 -0.2 -0.7 -2.3</td>
<td>-8.3 -5.0 -2.8 -1.7</td>
</tr>
<tr>
<td>Lithuania 1.4 6.3 4.2 4.2</td>
<td>1.3 4.0 2.5 3.0</td>
<td>1.5 -2.0 -2.5 -2.7</td>
<td>-7.1 -5.2 -3.0 -2.0</td>
</tr>
<tr>
<td>Russia 4.0 4.5 4.2 4.5</td>
<td>6.9 8.7 7.5 6.9</td>
<td>4.0 4.0 3.0 3.5</td>
<td>-6.5 -3.0 -2.5 -2.5</td>
</tr>
<tr>
<td>Ukraine 4.3 4.2 4.0 4.2</td>
<td>9.4 9.3 8.8 8.5</td>
<td>-1.9 -3.0 -3.5 -3.7</td>
<td>-5.7 -3.5 -3.0 -3.0</td>
</tr>
<tr>
<td>Germany 3.7 2.9 1.1 1.5</td>
<td>1.2 2.3 1.9 2.0</td>
<td>5.7 5.3 4.9 4.7</td>
<td>-3.3 -1.7 -1.1 -0.5</td>
</tr>
<tr>
<td>Denmark 1.7 1.3 1.7 1.8</td>
<td>2.2 2.9 1.7 1.6</td>
<td>5.1 4.8 4.3 4.6</td>
<td>-2.8 -3.8 -4.0 -3.0</td>
</tr>
<tr>
<td>Norway 0.3 1.4 2.8 2.3</td>
<td>2.4 1.2 1.5 2.1</td>
<td>10.8 13.6 11.5 11.2</td>
<td>10.8 12.8 11.0 14.0</td>
</tr>
<tr>
<td>Finland 3.6 2.8 1.3 2.0</td>
<td>1.2 3.5 3.0 2.0</td>
<td>1.9 0.5 1.2 1.3</td>
<td>-2.8 -1.1 -0.8 -0.6</td>
</tr>
<tr>
<td>Sweden 5.6 3.9 1.1 2.2</td>
<td>1.2 3.1 2.3 2.4</td>
<td>6.2 6.6 6.3 5.8</td>
<td>-0.2 0.2 0.2 0.4</td>
</tr>
</tbody>
</table>

**GDP for Baltic Sea countries in total 3)**  
2010 2011 2012 2013  
3.7 (2.6) 3.6 (3.1) 2.6 2.9

1. The report also covers Norway and Ukraine.  
2. Not calendar-adjusted.  
3. Percentage increase using 2010 GDP weights (PPP). The figure from the June 2010 forecast is in parentheses.

Sources: National statistics and Swedbank’s own calculations.
Important to maintain focus on the Baltic Sea region

There are several reasons for writing this report on the Baltic Sea region, besides that we have done so every year in the last fifteen years for companies already active, or planning to be active, in the region.

The first is the region’s huge importance in terms of trade and investment to the countries we follow. For Swedish foreign trade it represents nearly 40% of exports and more than half of imports. For the Baltic countries the numbers are even higher, between 60 and 75%. Geographical and cultural proximity, specialisation, job sharing and outsourcing have all contributed to cross-border trade. Many companies have the region as their home market and see the jump to neighbouring countries as a natural first step when going abroad.

Secondly, regionalisation means more in times of globalisation. Being part of a strong region and contributing to its attraction is important, as the countries themselves have realized through the EU's Baltic Sea strategy work. Now they have to go beyond bureaucracies and institutions to create better drivers for the private sector to increase trade. One step would be to take the lead in the EU’s inner market and remove remaining restrictions on expanding within the region. It would also be beneficial to increase mobility in the labour market and encourage educational and R&D exchanges. It is positive that the Baltic Sea strategy can serve as an example for other European regions. Besides economic integration, the Baltic countries collaborate in terms of the environment, security and infrastructure – all important aspects of economic growth.

Thirdly, it is easy to lose focus locally when considering the euro zone’s escalating crisis, which now demands most of our time and attention. Although a worsening crisis would greatly impact the Baltic Sea region with its open, export-dependent economies, a number of the countries are in relatively good fiscal shape, have competitive businesses and are politically stable. Despite today's difficult conditions, many companies understand the long-term business opportunities and untapped potential. They are particularly aware of the growing demand from a prosperous middle class and are utilising more job sharing and specialisation in their production. This report helps to shift the focus back to more long-term development issues.

In the report we discuss the region’s markets, their prospects and structural issues such as market efficiency, competitiveness and long-term challenges. We have updated our Baltic Sea Index, which measures competitiveness and business climate in a number of areas. Many companies will find the updated information a welcome addition when having to decide on sales and production in the countries where they are active or plan to be. Another question is what strategies the Baltic countries should use in relation to the euro zone. Naturally this depends on whether you are talking about Germany, Russia or Latvia. Regardless of affiliation with the EU and EMU, the euro crisis is vital to strategies within the Baltic region in the years ahead.
Global growth slows – crisis in the euro zone worsens

A couple of months ago we published our forecast for the global economy and predicted slower growth, but that a new global recession could be averted. In our updated forecast we still see the “muddling through” scenario, but now with even weaker growth.

Most importantly, we do not expect the US to reach GDP growth of 2% this year or next. With weakness in its labour and housing markets, there is reason to expect lower growth of 1.6% this year and 1.9% in 2012. Worries about the euro crisis are hurting confidence, but even more important are the problems with the domestic economy, including the many hard-pressed small and medium-sized businesses that due to weak demand are putting off investments and hiring. Continued political unease is also creating uncertainty about taxes and regulations.

We still think the global economy can “muddle through”

We anticipate a recession in the PIIGS and have revised growth downward in the US and euro zone

### Global GDP growth (annual change in %)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>3.0</td>
<td>1.6</td>
<td>1.9</td>
<td>2.4</td>
<td>2.1</td>
<td>2.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Euro zone:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.8</td>
<td>1.6</td>
<td>0.8</td>
<td>1.2</td>
<td>1.7</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>France</td>
<td>3.6</td>
<td>2.9</td>
<td>1.1</td>
<td>1.5</td>
<td>2.9</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Italy</td>
<td>1.4</td>
<td>1.4</td>
<td>1.2</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.1</td>
<td>0.6</td>
<td>0.4</td>
<td>1.0</td>
<td>0.6</td>
<td>0.8</td>
<td>1.2</td>
</tr>
<tr>
<td>UK</td>
<td>1.3</td>
<td>1.1</td>
<td>1.2</td>
<td>1.7</td>
<td>1.3</td>
<td>1.6</td>
<td>1.8</td>
</tr>
<tr>
<td>Japan</td>
<td>4.0</td>
<td>-0.2</td>
<td>2.5</td>
<td>1.2</td>
<td>-0.2</td>
<td>2.8</td>
<td>1.4</td>
</tr>
<tr>
<td>China</td>
<td>10.3</td>
<td>9.0</td>
<td>8.4</td>
<td>8.0</td>
<td>9.0</td>
<td>8.4</td>
<td>8.0</td>
</tr>
<tr>
<td>India</td>
<td>10.4</td>
<td>7.7</td>
<td>7.5</td>
<td>7.5</td>
<td>7.8</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>7.5</td>
<td>3.7</td>
<td>4.0</td>
<td>4.3</td>
<td>3.8</td>
<td>4.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Russia</td>
<td>4.0</td>
<td>4.5</td>
<td>4.2</td>
<td>4.5</td>
<td>4.5</td>
<td>4.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Global GDP in PPP</td>
<td>5.0</td>
<td>3.6</td>
<td>3.6</td>
<td>3.7</td>
<td>3.8</td>
<td>3.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Global GDP in US dollars</td>
<td>4.1</td>
<td>2.7</td>
<td>2.8</td>
<td>2.9</td>
<td>2.9</td>
<td>3.1</td>
<td>3.1</td>
</tr>
</tbody>
</table>

The most precarious position in the global economy is occupied by the euro zone. Back in August we predicted that the region would develop weakly, but in light of the increased difficulties faced by the financial sector and widespread concerns that have sapped confidence among businesses and households, it is likely that GDP growth will be even weaker, lower than 1% next year.

Several PIIGS countries can expect recessionary conditions in the next two quarters, but in the core countries and northern Europe, i.e., Germany, France, the Netherlands, Austria and Finland, we anticipate slight growth, especially in relation to trade with the emerging countries.

We reiterate our forecast from August that the euro zone will be able to handle the current political crisis, but don’t expect it to happen until the last minute, not least because euro zone politicians are deeply
concerned about moral hazards. As a result, they have delayed aid payments while demanding reforms that are tough enough to prevent similar crises in a few years’ time due to a similar lack of fiscal discipline. The process of strengthening the euro zone’s institutions continues, but with great difficulty and at a slow pace. Even more impatient financial markets are dubious about investing in countries in crisis, which makes it reasonable to expect a good bit of turbulence to arise now and again in the years ahead.

We have not revised our outlook for emerging countries to the same extent as we have for Western countries. Of course, slower growth in their most important export markets will have some effect, since they have been unable to reduce their reliance on the West. China’s exports, for example, are now increasingly headed toward Europe instead of the US. China continues to be the biggest global growth engine, but with the overheating risks that still exist, the global economy won’t get the same big stimulus if a new recession arises. This, along with the fact that Western countries have few economic tools at their disposal, is stoking fears of a new recession.

The fears themselves are enough to cause a worse outcome than we predicted in our main scenario. The risk of a new recession has risen slightly from our previous probability of around 30%, and it is hard to see the positive scenario (10% in our August forecast) happening during the forecast period, since it assumes that many of the current political knots will be untangled.

We still believe that the world can avoid a new global recession like one following the Lehman Brothers bankruptcy, since so much more is known about the potential impact, but we do see a recession in several crisis countries due to negative growth between quarters. Global economic growth has been revised downward by a couple of tenths of a percent to 3.6% in 2011 and 2012, and to 3.7% in 2013.

Oil, metal and food prices are all expected to be slightly lower than in the August forecast, but are holding up better than other sectors of the financial market. Our view on fiscal and monetary policy hasn’t changed, and the real economy will not be stimulated in the years ahead – rather austerity is in the pipeline. Calls for other measures, such as higher inflation and protectionism, are likely to become louder and more frequent despite that they would be counterproductive.

Growth is slowing – but the recovery continues

In our most recent Baltic Sea Region report (June 2010), we predicted that the region’s GDP would grow by 2.6% for that year, after which growth would strengthen to 3.1% in 2011.

Current data show that the result was much stronger for 2010 at 3.7%. Estimated GDP growth of 3.6% this year would also exceed our earlier forecast. Given that the region’s most important export market – the euro zone – will develop slower in 2012 and 2013, we
see GDP growth in the Baltic Sea region dropping to 2.6% in 2012 before rebounding slightly to 2.9% in 2013.

**GDP growth in the Baltic Sea region (annual change in %)**

![](image)


There are three main reasons why the Baltic Sea region was particularly hard hit by the global financial crisis and recession in 2008-2009:

1. Many countries, including in the Nordic and Baltic regions as well as Germany, are highly dependent on foreign trade, so their GDP fell more than countries where domestic demand plays a greater role. Poland, the only country in the region to avert a recession, is less dependent on exports at the same time that the zloty weakened and economic policies benefitted growth.

2. There were major external and internal imbalances in the Baltic countries. Adjusting them while the global economy was decelerating made the situation considerably worse.

3. Russia and Ukraine are reliant on the commodity markets. When energy, metal and prices fell, an already unstable financial sector couldn't put up much resistance, and GDP declined substantially.

Looking ahead there are new challenges in the form of the debt crisis and slackening demand in the Baltic Sea region’s key European export markets. The recovery so far could become derailed if the euro crisis worsens.

Several factors suggest that a new recession would be milder in the Baltic region, Russia and Ukraine in the event of any other major European and global crisis, but probably harder in the Nordic region, Germany and Poland.
Introduction

Why milder in the Baltic region, Russia and Ukraine?

- Although the Baltic countries are dependent on exports, they have implemented major austerity programmes and largely corrected their imbalances while becoming more competitive. The financial sector is stronger now than after the last crisis. Rating agencies have raised their credit ratings.

- Commodity prices will retreat in the event of a major recession, but could hold up to some degree due to continued demand from emerging economies. This benefits Russia and Ukraine, which haven’t actively reduced their vulnerability to a new crisis, instead relying on the continued high commodity prices.

Why more severe in the Nordic region, Germany and Poland?

- The Nordic region is highly dependent on exports, and this time it will be harder to overcome a recession with the help of households in Norway, Denmark, Sweden and Finland, where debt is already high in relation to disposable income. There is also a risk of a major correction in housing prices and balance sheets, which would increase the severity of another slowdown.

- Germany is at risk of being dragged down by the PIIGS countries through its banks, demands for new aid contributions and even the possibility of a credit downgrade. Moreover, like its Nordic neighbours Germany is highly dependent on exports.

- Poland managed well in 2008-2010, but since then imbalances have built up. Inflation is high, though falling. The same goes for its budget and current account deficits. It is not as easy to stimulate the economy, although the zloty’s depreciation does provide some support to exporters. Slightly more than half of mortgages are denominated in Swiss franc, which is putting pressure on the banking sector and reducing access to liquidity.

We expect the recovery in the Baltic Sea region to continue, but at a slower pace in the next two years. The imbalances that still remain or have recently arisen have to be alleviated, however, for the region to withstand another economic slowdown.

Inflation has risen faster than expected in several countries, including in the Baltic region, Russia and Ukraine. Strong price gains in global commodity markets are part of the reason, but domestic factors come into play as well, e.g., weak competition in several product markets and tax increases. Higher inflation is due to more than just commodity prices
Inflation (annual change in consumer prices, %)

There is also a risk that wage growth will accelerate faster than productivity growth, since there is a labour shortage in competitive sectors. Reforms that make product and labour markets more efficient are therefore essential to reduce the risk of excessive inflation. We expect inflation to slow, especially since monetary policy has been tightened in Poland, for example, and commodity prices have begun to taper off.

Current account balance, % of GDP

Current accounts were clearly showing signs of imbalance prior to the crisis and since 2009 have rebounded to the plus side in the Baltic region. This is primarily due to the recession, where imports fell more than exports. Going forward there is a growing risk that current account deficits will rise and won't be covered by capital inflows from foreign direct investment (FDI) if the crisis worsens. Competition for...
FDI is likely to grow, which will require more reforms in order to attract it. In Poland, the current account deficit has risen and could become harder to finance with new loans in a European credit crunch.

It is also worth noting that although public debt in the Baltic countries is small as a share of GDP, total foreign debt is relatively high at 145% in Latvia, 95% in Estonia and 80% in Lithuania. The corresponding percentages in Poland and Ukraine are 65% and 75%.

In the Nordic region, it is important to focus on household debt and implement reforms that slow credit growth, e.g., amortization requirements and, when the business cycle allows, reduced interest deductions. In addition, the housing shortage has to be eased to keep real estate prices in check.

What can the PIIGS countries learn from the Baltic countries?

Since 2008-2009 the Baltic countries have implemented extensive structural changes by reducing nominal wages and tightening public finances. Currency regimes remained unchanged and a major banking crisis was averted. Many experts have compared what has happened and the policies adopted with the challenges faced by the PIIGS countries. Could they take the same tough action?

First, we don't know yet whether the strategies used in the Baltic region will be successful from a long-term competitiveness standpoint. Will we again see large current account deficits? Will inflation be a bigger problem? Will institutions change so that there are permanent shifts in competitiveness? It is too early to say whether “internal devaluation” has worked, although greater instability in the financial sector was averted, along with the impact it probably would have had on the real economy.

Secondly, we have to remember that there are major differences between the three countries. Estonia has now become a member of EMU, while Latvia and Lithuania are still hoping to join. There are also differences in terms of the business sector, trade patterns and public administration.

Thirdly, there are significant differences between the Baltic countries and southern Europe. The Baltic countries made changes in order to join the EMU, while the PIIGS countries are already members. And their crises have arisen in different ways. In the Baltic countries, there was too much optimism about the convergence process, which led to excessive credit growth and domestic demand. The countries in southern Europe have faced internal and external imbalances for many years, which have sapped their competitive strength and led to a fiscally unsustainable situation with high debt ratios as well as a loss of confidence in public institutions. The latter countries have previously been able to resort to the devaluation weapon, but no longer. Since they freed themselves from the former Soviet Union in the 1990s, the Baltic countries maintained their currency pegs (before Es-
tonia entered the EMU in 2011). There is and has been a common goal to keep the small nations together and build them up after their independence, which has facilitated the necessary adjustments. There are still some things that can be learned, however, from the structural changes made by Baltic countries:

- The countries with the biggest imbalances have been the hardest hit. In the same way, the countries that were slowest to respond to the crisis have fared worse. Lithuania’s imbalances were a little smaller. Estonia began slightly earlier to try to repair the damage. Latvia has been affected most by the crisis.

- Low public debt, currency board regimes and ample access to credit through Nordic banks have helped to hide the underlying problems with high debt levels throughout the private sector as well as insufficiently tight fiscal policy. The problems with current account deficits were swept aside by foreign direct investment, but in connection with the global crisis, when capital inflows reversed, the imbalances have risen to the surface. It is important to track several parameters that may warn of imbalances.

- Rapid access to external financing through the IMF, EU and the Nordic countries was important for Latvia to create confidence and implement reforms.

- By fully committing to austerity programmes, governments created confidence. So did the fact that the opposition and large segments of the population supported the need for austerity. Of course, these countries are small compared with Italy and Spain, for example, so it can be easier to build political consensus.

- Maintaining currency regimes was a goal of all three countries, so adjustments have to be made through wages and lower public spending (and to a lesser extent through higher taxes).

- Stress tests showing that Nordic banks would be able to handle a crisis in the Baltic region helped confidence by reducing concern over devaluations. That the Nordic banks announced their long-term commitment was also important.

- Plans for Estonia’s euro accession and Lithuania’s mobilisation of financing on international capital markets strengthened confidence that all three countries would be able to handle the adjustments. It was important that there also were quick delivery of the plans, so that confidence would remain.

- The three Baltic countries have been highly adaptable and flexible in their labour markets and public sector, which other countries might find hard to copy.

- Countries that have built up strong institutions are better able to handle crises. This refers to political alliances, the crisis management capabilities of the central bank and financial supervisory authority, and institutions that look after those most in need in society.
Except in Estonia, the recovery has been fairly slow so far, and there is still a big output gap, especially in Latvia. Unemployment is high, as are the social costs. The challenges are great considering that the global economy is again slowing. The Baltic countries in particular have to work harder to be competitive in the long term. Reforms have to remain high on the agenda.

Compared with Greece, they are a step ahead. In Greece, the change process has to be intensified and the challenges are probably greater. Still, it would pay to learn from the Baltic crisis – i.e., that you can use nominal wages and public finances to adjust the economy, but that it requires political courage and patience.

Relationship between the Baltic Sea countries and the EU and EMU

The countries in the Baltic region have a range of relationships with the EU and EMU:

1. Germany, Finland and Estonia – members of EU and EMU
2. Denmark, Latvia and Lithuania – members of EU and ERM2
3. Sweden and Poland – members of EU
4. Norway – member of EFTA and EES
5. Russia – negotiations on a partnership agreement with EU are underway
6. Ukraine – the framework for the relationship with the EU is a Partnership and Cooperation Agreement (PCA), but negotiations are being held on an Association Agreement to replace the PCA within the framework of the Eastern Partnership

Among the Baltic Sea countries, the focus is on whether Latvia and Lithuania will be able to take the step and become members of the EMU in 2014, when Poland will decide to join ERM2 before becoming a member of the EMU, and whether Denmark and Sweden are interested in joining the EMU (Sweden – just like Poland – would first have to be a member of ERM2 for two years).

For Latvia and Lithuania, EMU membership has been an important driver for the adjustment process during the crisis. The countries have maintained fixed exchange rate regimes for many years, have small currencies and do not intend to introduce an alternative exchange rate regime. In both cases, EMU membership is understandable. There are two factors that could hurt Latvia’s and Lithuania’s opportunities to join the currency union. One is the euro zone’s problems, which could force it to wait before adding more members – and prospective members to want to wait to see how the euro zone’s problems are resolved. The second factor is the ability of the countries to meet the Maastricht criteria. This applies to inflation, which may not be 1.5 pp higher than the average for the three EU countries with the lowest inflation in the year before evaluation. Budget deficits may not exceed 3% of GDP, which could be hard for Latvia to achieve, and maybe even more so Lithuania, which has to reach this level during
an election year. If there is a recession in the euro zone, it would be even harder for Lithuania and Latvia to consolidate their budgets.

Instead of 2014, which is not impossible but appears to be getting harder, 2015 or 2016 would be more likely for accession. Since the road to membership is just as important as reaching the finish line, it can give the countries more time to institute reforms that strengthen key institutions prior to membership.

Poland, which has benefitted from a flexible nominal exchange rate during the crisis, isn't in as much rush to become a member of either ERM2 or EMU. Earlier ERM2 had been planned in 2013 and membership in 2015, but we now expect it to take one or two years longer before Poland joins the currency union. It will take even longer to work off its large budget deficit, and inflation is too high as well. The euro crisis is also affecting Poland’s decision. Poland, a large country with relatively good experience with a floating exchange rate, and greater impact on the euro zone, doesn't have to be in as much rush considering that its convergence process hasn't been completed.

Neither Sweden nor Denmark is planning to join the currency union in the immediate future. The euro crisis makes joining less appealing, and the issue has been put off to a future time. Norway has recently shown slightly more interest in EU membership, but unlike Iceland, which is an official candidate country, it hasn't applied.

Several challenges face the region: Our Baltic Sea Index signals the need for reform

Even if the Baltic Sea region has managed the crisis relatively well, the adjustment during the crisis has been painful, especially for the Baltic countries. The slowdown in the real economy has been significant in the region as a whole, unemployment has risen and – except in the Baltic countries – many reforms that could have an impact in the long term have been put off due to the crisis.

The focus is still on competitiveness, and even if internal devaluations and nominal currency depreciation have made the region more competitive, there is still more that can be done to compete with the euro zone, for example. In the diagram below we show real effective exchange rates from BIS deflated by relative consumer prices. The higher they rise, the less competitive the country. Russia is now in a worse position than during the crisis. The Baltic countries have become competitively stronger since the start of 2009, and even though the cost levels are lower than in the eurozone, there is more to do.
Long-term challenges include how the region will strengthen and maintain its attractiveness. At the very least, it has to cooperate in research & development, the commercialisation of ideas, and infrastructure to link labour market regions and clusters. For the labour market in the region, education is the key. There are many positive effects of exchanges between countries among students and workers. Demographic trends will make it more difficult to find competent labour going forward. Consequently, opening up the economies to other regions around the world is vital.

Especially the Baltic countries and Poland remain in transition between emerging and more developed economies. For the last 20 years the business model these countries have used has involved integrating a cheap but well-educated labour force into the European economy. Competition is now growing from emerging countries in Asia, Latin America and Africa. Far too few resources have been invested in research and development. Poland – both public and private – invests 0.6% of GDP, and of the 50 000 patents awarded annually in the OECD, Poland accounts for only 10 to 20. Continuing to educate engineers and maintaining the entire educational system at a high level is critical. It is positive that the ICT sector is in good shape in both Poland and Russia.

There are drivers of innovation and foreign direct investment (FDI). The transition from coal to more environmentally friendly energy will attract FDI and increase innovation in the region. In Poland, where 90% of electricity still comes from coal, the EU’s penalties are accel-
erating the process. The country’s first nuclear power plant is now planned with the help of foreign investment. Other types of energy are also a priority. In Gdansk, a transition is under way from the shipping industry to wind power production.

Some structural problems that were previously hidden by high but unsustainable growth have risen to the surface due to the crisis. For example, structural unemployment is now rising, which requires a more active labour market policy. At the same time there is a growing shortage of competent labour. How well the public sector works is also critical. For example, there are still problems with a large informal sector in the Baltic countries, Poland, Russia and Ukraine. They also face problems with tax evasion, corruption and bureaucracy. In the Nordic region, better priorities have to be set in health care and social care, so that their welfare systems can be maintained.

In our previous report we published for the first time a Baltic Sea Index to measure competitiveness and business climate. The eleven countries are ranked in relation to each other and the rest of the world. Keep in mind that even if every country in the world improves and the Baltic Sea countries keep pace, our index won’t change, since it measures progress compared with others.

The Baltic Sea Index is composed of several indexes from various sources, which are then converted into a ranking for these countries. We have chosen nine areas as the basis for the overall index. Each category consists of several underlying factors. The list is not complete, but should serve as a good indicator of progress in the business climate relative to other countries. Read more about the method at the end of the report.

1. Entrepreneurship
2. Labour market
3. Tax policy
4. Financial market
5. Foreign trade
6. Education
7. Governance
8. Infrastructure
9. Innovation

In summary, Denmark and Finland rank the highest, followed by the other Nordic countries, Estonia and Germany. Just below the average we find Latvia and Lithuania, followed by Poland. The need for structural reform is greatest in Russia and Ukraine.

Denmark (8.7), which shares first place with Finland, has not changed from three years ago, but has slipped compared with the last two years. The same is true of Sweden (8.6), while Finland has improved in each of the last three years. This is also the case for Poland (6.4), which remains farther down the ranking. Norway (8.5) has lost ground slightly, but maintains a high position. The Baltic countries have im-
proved from the previous year, but only Estonia (7.9) has strengthened in relation to the period before the crisis, while Latvia (6.7) and Lithuania (6.6) have even more structural work to do. Russia and Ukraine are both trending lower each year and ranked last at 4.0, compared with an average of 7.0.

The Baltic Sea Index – ranking compared with the rest of the world
(10 highest ranking, 0 lowest)


The Baltic Sea region ranks relatively well with an average of 7.0. Interest in investing in the region remains high and could increase due to growing uncertainty about other developed countries in the eurozone as well as the US. For small and medium-sized companies, the region is attractive because it fares well in our ranking but also because of its untapped potential in form of sales markets and production.

If we look at the categories, we see that Baltic Sea region’s strengths are in education (8.5) and innovation (7.9). On the other hand, we are weakly positioned in terms of taxes (5.3). With regard to the financial sector (6.4) and entrepreneurship (6.6), major reforms are needed. In the financial sector, Russia, Ukraine and Lithuania are dragging down the regional average, while the challenges are more similar with respect to entrepreneurship. In the tax area, it’s the Nordic region and Germany that are dragging down the average.

It is clear that the countries in the Baltic Sea region need structural reform to increase foreign investment, manpower and ideas. We can see above that the areas of taxes and entrepreneurship require change and new laws and regulations, as do the financial sector and labour market. It pays to climb up to the ranking – and since it takes a while for the results to become evident, there is no time to lose!

Cecilia Hermansson

The region needs improvement in several areas – the Baltic Sea index shows where!
Poland – reforms needed despite growth

Population: 38.2 million
GDP per capita (PPP) 2010: USD 19 747
Government: Liberal conservative
Prime Minister: Donald Tusk
President: Bronislaw Komorowski
Next parliamentary election: 2015
Next presidential election: 2015
Average GDP growth in last five years: 4.7%
Average inflation rate in last five years: 3.1%
Average unemployment in last five years: 9.7%

Summary

- We expect GDP growth to decline from 3.7% this year to 3.0% next year and then strengthen to 3.4% in 2013. This is higher than many other EU countries. Even if consumption growth is slowed by the budget consolidation and weaker labour market, retail sales should continue their relatively good growth.

- The Poles re-elected the coalition government on October 9, which paves the way for further modernisation and good relations with the EU. The reform process should continue – Poland’s Baltic Sea Index could be higher. Euro accession is still the goal, but we expect it to take time due to the crisis in the euro zone and difficulties meeting the convergence criteria. This isn't the right time to peg the zloty to the euro in ERM2.

Consequences for businesses

- The Polish consumer market continues to grow, and investment, while slightly weaker, is also growing fairly well. Infrastructure in the form of properties, transportation and energy require investment. The Euro 2012 Championship in Poland and Ukraine will bring with it major investments, not least in the construction industry.

- Placing production in Poland offers closer access to the growing markets of Central and Eastern Europe. Labour costs are still lower than the EU average and education levels are high.

- Direct investment in recent years has benefitted the ICT sector, where local programming skills attract foreign companies. Poland also faces a major energy transformation, since 90% of its electricity comes from coal. Although the retail sector has already attracted foreign companies, the growing consumer market, primarily in metropolitan areas, still offers potential for new companies. The service market is also a sector that is developing strongly.

- Poland’s EMU accession will be delayed. Currency fluctuations continue to affect earnings for many companies. The central bank appears to have halted the zloty's recent rapid depreciation, but if financial worries were to worsen, there are fears of another wave of depreciation, which would also complicate interest rate cuts.
Government is re-elected – yes to euro, but accession will be delayed

The Civic Platform’s Donald Tusk, has been re-elected to lead the government for a second term as the first head of state after the fall of Communism in 1989. Together with the smaller Polish People’s Party, it received just over 51% of the seats in parliament (just under 48% of the votes) and was able to continue the government coalition. The main opposition party, Law and Justice, received just under 30% of the votes. Despite gains late in the campaign, it wasn’t able to gain power. The new liberal party, Palikot’s Movement, received 10% of the votes, mainly from young urbanites attracted to the party’s message of free abortions, support for HBT issues and deregulation. The government’s re-election clears the way for a more modern Poland, closer relations with the EU and a continued budget consolidation. To date reform efforts have been cautious, and changes will probably remain gradual in the political arena. Many Poles are impatient and want to see a faster pace of reform, especially when it comes to infrastructure.

The election is a feather in the cap of the government, which currently holds the EU's rotating presidency. Its goal this half-year has been to invest more in the inner market, strengthen EU relations to the south and east, and continue the EU's expansion (Croatia is expected to become a member in 2013).

Another goal of its presidency is to strengthen crisis management in the euro zone, but since Poland isn’t a member of the EMU, the government can’t expect to have much say. Unlike the Law and Justice Party, however, the Civic Platform is positive to joining the euro zone; 2013 had previously been mentioned as a possibility, but because of the euro crisis and Poland’s own difficulties meeting the Maastricht criteria, accession has been delayed, probably until after 2015. Since a two-year period within ERM2 is required before joining and since there is a certain degree of vulnerability associated with this period, Poland isn’t in a rush in such turbulent times to peg the zloty to the euro. Moreover, it’s often said that the focus should be just as much on meeting the qualifications for membership as joining EMU itself, and that this should be reflected in Poland’s reform efforts.

A country as big as Poland impacts the euro zone to a greater extent than small countries and may want to influence the design of the euro zone’s institutions in the years ahead despite not being a member. It would probably also be in the euro zone’s interests to confer on the reform of the currency union with such an important future member as Poland.

Good growth – but slight slowdown on the horizon

In the second quarter of this year Poland’s GDP grew by 4.3% at an annual rate and private consumption rose by 3.5%. Two of the reasons for the positive growth are exports to Germany, which have risen of late, and major transfers from the EU, which have led to rela-
tively high investment growth. Euro 2012 in Poland and Ukraine is also contributing to major infrastructure investment.

As growth in the euro zone now slows, Poland’s export prospects are expected to diminish as well. The focus, therefore, is shifting to domestic demand. At the same time there are signs that companies are delaying investments and hirings in the wake of the euro crisis, and that unemployment is no longer shrinking. Retail sales are not growing at the same high rate as last year.

Economic growth will still remain higher in Poland than most other EU countries in the years ahead. We expect GDP growth to decrease from 3.7% this year to 3.0% in 2012, before rising to 3.4% in 2013. A weaker zloty will give a slight boost to exports in an otherwise sluggish market. The budget consolidation continues, and in combination with a cooler job market means that households may become more cautious than during the previous recession. The fact that many homeowners have mortgages in Swiss franc could be an issue if the zloty weakens, although few borrowers have fallen behind in their payments yet for that reason. Many young Poles who grew up after the baby boom in the early 1980s are now starting families. Urbanites with decent wage growth will continue to see their standard of living rise, though not quite as quickly as before.

Applying the gas and brakes to economic policy

Inflation has lately exceeded the central bank’s target of 2.5% (+/- 1 pp). After peaking at 5% in May, it fell to 3.9% in September. Besides high commodity prices, a weaker zloty is one reason for inflation. Wages have risen as well, and in June the average gross salary was 3 526 zloty, or 4.6% more than a year ago.

The recent drop in inflation is the result of slightly lower commodity prices and the central bank’s rate hike. Since the start of the year the benchmark rate has been raised four times, from 3.5% to 4.5%. Expectations are that rates could be cut after year-end. At the same time the central bank has wanted to teach the currency market a lesson by intervening to stop the zloty’s rapid decline. So far this year it has lost some 10% against the euro, but before the interventions the loss was 14%. The current account deficit has risen after certain statistical inaccuracies such as EU transfers and auto imports were corrected. Since the deficit is now 4.5% of GDP and there is a risk that foreign direct investment will decline in the wake of the financial crisis, we will have to keep an eye on Poland’s current account balance.

The budget deficit was allowed to swell during the crisis years, 2008-2010, and last year reached 7.9% of GDP. It was positive that Poland was able to let automatic stabilisers have their full effect, but negative that its debt ratio is nearing the limit at which the constitution requires measures to be taken, i.e., 55% of GDP. The government has to cut the budget deficit to 3% of GDP next year. The goal is to meet the convergence criteria and avoid facing sanctions for failing the excessive budget deficit procedure. Since GDP growth is likely to be about a percentage point lower than the government has forecast, addi-
tional measures may be needed to meet the target. The government has already taken action, including freezing public sector wages, increasing the VAT by a percentage point to 23% and reducing transfers to the pension system’s second pillar. More still needs to be done, and considering that about 70% of spending in the government budget is fixed and that interest expenses may rise in the wake of the financial crisis, it will be even more difficult to cut the deficit by more than half in the next year. We expect the budget deficit to shrink at the best to 4% of GDP.

Privatisations continue to generate revenue that will reduce debt. In its campaign, the Civic Platform has pledged to sell the airline LOT. Because of the financial market’s concerns, however, the revenue from any privatisations is likely to be significantly lower than planned. We expect the debt ratio to stay just below the 55% limit.

Despite growth – long-term challenges require reforms

Poland ranks below the Baltic Sea Index average at 6.4, ahead of only Russia and Ukraine. The main areas in need of reform are entrepreneurship (starting and running businesses, lawsuits) and foreign trade. Taxes and the labour market also need improvement. For example, Poland is simultaneously facing a labour shortage and unemployment, which indicates the need for improvements in continued education and a better match between educational offerings and occupational skill requirements. Education is otherwise an area where Poland ranks high. PISA surveys point to improvements in recent years, although there are still concerns about the quality of the education system, especially at the university level.

Poland has to move up the value-added chain. This makes it even more important to invest in R&D. The current level, 0.6% of GDP, is too low to create the dynamic energy needed to attract new ideas, foreign direct investment and labour. The fact that only 10-20 patents have been awarded in the country, compared with 50 000 in the OECD in the last year, is a clear signal of the need for improvement.

Cecilia Hermansson
Estonia – domestic demand is picking up

Population: 1.3 million  
GDP per capita (PPP) 2010: USD 20,033  
Government: Right-wing liberal and conservative coalition  
Prime Minister: Andrus Ansip  
President: Toomas Hendrik Ilves  
Next presidential election: 2016  
Next parliament election: 2015  
Average GDP-growth in last five years: 0.4%  
Average inflation rate in last five years: 4.9%  
Average unemployment rate in last five years: 9.4%

Summary

- Economic growth will slow down considerably in 2012 to 3.2% from 7.6%, as the global economy slows as well. Growth will pick up again in 2013, reaching 3.8%. Growth is supported by growth in exports and investments. Private consumption growth will stay modest in 2011, but is estimated to accelerate in 2012-2013.

- No significant changes are expected to economic policy in next two years as the government coalition did not change during the latest parliamentary elections in March. This means the continuation of policies of a limited government, low tax rates, balanced budget principles, and exceptionally low public debt.

- Estonia ranks relatively high on our Baltic Sea index (BSI) – at 7.9 just above the region’s average – and has a positive track record with regard to trade, infrastructure and the innovation climate. The largest improvements are needed in entrepreneurship and in financial market.

Consequences for companies

- Economic activity among sectors still differs as the private consumption recovery has been modest. As a member of the EMU, Estonia will be less vulnerable to the global turmoil, supported by the increasing trade flows with euro area, which in turn are endowed by stable interest rates; it is no longer open to currency risk. Nevertheless, the current situation in Europe will increase its obligations in terms of solidarity and commitment conditions.

- The Estonian demographic situation has been worsening and the structural problems in the labour market might increase the risk for the long-term growth of enterprises. At the same time, the labour market has proved to be rather flexible and the labour costs while growing are still comparatively low.

Political stability to continue

Estonia has a majority centre-right government, consisting of the Pro Patria and Res Publica Union and the Reform Party. The coalition

No radical change in economic policies
has agreed on the following tax measures so far. Labour and capital taxation will ease, with some compensation from consumption taxes. The flat personal income tax system will be maintained, and the income tax rate will be lowered to 20% from the current 21% for both businesses and individuals starting in 2015. Retained profits of companies will continue to be tax-free. As the unemployment fund is running surpluses the unemployment insurance tax will be cut, estimably in 2013.

In 2014, a ceiling will be put on the pension insurance part of social security contributions for salaries over €4,000 per month. This is in accordance with government policies to promote the creation of more high-value-added jobs in Estonia. Excise taxes on alcohol and tobacco are also scheduled to continue to increase.

The government has clearly articulated the goal of achieving a public budget surplus as soon as possible. A temporary deficit (0.8% of GDP according to our forecast) is still planned for 2012 for one-off reasons, but public debt is forecast to decline steadily and remain under 6% of GDP, by far the lowest in the EU. Liquid financial assets of the central government exceed the debt by a large margin.

The parliament has voted for joining the European Financial Stability Facility (EFSF) to express solidarity and commitment to the common currency. This means that Estonia has taken an obligation to guarantee the principles and interest payments of loans granted by the EFSF up to EUR 2.5 billion. The direct impact of that decision is that the of public debt will grow by a negligible 0.28% of GDP, which is the Estonian share according to participation rules.

Export-driven growth about to slow

After the downturns, the Estonian economy has recovered by strongly – positive annual growth rates were already present in 2010 and growth picked up even more in the first half of 2011, when the economy grew by 8.9% on average. The growth has been mainly export driven – exports of goods and services were up by 35.6% during the same period. Overall, we expect the economy to grow by 7.6% this year. Our estimations have been revised compared with the August Swedbank Economic Outlook due to data revisions and to somewhat worsened global (especially Europe’s) economic outlook. We revised this year’s growth rate upwards from 6.7% to 7.6%, as the base year’s (2010) annual growth was revised downwards (from 3.1% to 2.1%), which, in turn, increased growth rates for this year. Next year’s growth revision from 4.2% to 3.2% is based on new data and the worsened overall economic environment. For 2013, we expect growth to pick up again, reaching 3.8% (4% previously).

The main source of growth will continue to be exports, but domestic demand will pick up as well. Domestic demand is expected to increase by 7.2% this and by 5.7% and 5% in 2012 and 2013, respectively, supported mainly by corporate and government investments (incl. FDI, CO2 trade revenues, EU funds etc). The growth of private
consumption, however, is still very fragile – the fast price growth has “eaten up” households’ income increase and suggesting possible rise in competition. At the same time, the profit margins seem to have been widening, as inflation has not slowed down while prices of inputs have decreased. Inflation is expected to be around 5% this year and slow down to 2-3% in the next two years.

Labour market faces structural challenges

The labour market has proved to be flexible during the crisis years, and the post-crises recovery has been quite solid. Even though employment has shown strong growth (more than 7% during the first half of this year), several structural problems have arisen that can dampen economic growth and have social consequences in the long run.

The problem with structural unemployment is already visible in several sectors (e.g. ICT, construction, health care) and will continue to widen across sectors. While part of the labour shortage is caused by emigration (as salary levels in the Nordic countries are much more attractive), another source of the problem is that the changes in education and retraining have not kept up with the changing economic structure needs.

The already-shrinking size of the labour force is additionally affected by the growing number of long-term unemployed – this has more than tripled from pre-crisis levels, especially among the very-long-term unemployed (24+ months).

It’s not a time for resting on laurels

According to the BSI the overall legal and business environment has not changed much, but it is still clearly above the average (slightly below Germany’s index).

Estonia: Baltic Sea Index (2007-2010)

The largest improvements are related to the infrastructure and innovation climate. The former is supported by the government (with help of EU funds) on Internet access – in July 2011 all the cities in Estonia were connected to the EstWin cable providing high-speed Internet connection.
Even though the entrepreneurship subindicator has lately worsened, some policy measures for encouraging entrepreneurship have recently been introduced (i.e. the training program “Be Entrepreneurial!”, new supportive measures for firms planning to enter into new markets, loans for starting businesses, etc.). At the same time there are several private initiatives to provide know-how for starting businesses (e.g., Garage48).

Nevertheless, there is still room for improvement. For instance, the public sector administration is still in need of reform (e.g., decreasing the number of local authorities). So far, this has been a politically sensitive topic, and decision making has been postponed several times. There have also been discussions of outsourcing services supporting public sector, like accounting and IT services. The government should be more supportive of initiatives to hire long-term unemployed, including through tax benefits and retraining advantages. On education, the tertiary education system is also under construction – there is room for improvement, but the currently offered solutions might make tertiary education affordable only for wealthier individuals. We are of the opinion that the changes in funding should be looked together with adding flexibility to the labour market (e.g. part-time jobs for students, etc).

Annika Paabut
Madis Aben
Elina Allikalt
Latvia: Export-led recovery, more balanced and resilient economy

| Population: | 2.2 million |
| GDP per capita (PPP) 2010: | USD 16,312 |
| Government: | Under discussion |
| Prime Minister: | Under discussion |
| President: | Andris Bērziņš |
| Next presidential election: | June 2015 |
| Next parliamentary election: | October 2014 |
| Average GDP growth in last five years: | -0.1% |
| Average inflation rate in last five years: | 6.7% |
| Average unemployment rate in last five years: | 11.2% |

Summary

- Economic growth is expected to decelerate from 4.2% in 2011 to 3% in 2012, driven by the global slowdown. In 2013, growth will pick up again to 3.9%. During the forecast horizon growth will remain export and investment driven, and private consumption is anticipated to rise slower than GDP. The economy has already become more balanced, more competitive, and more resilient to shocks.

- The IMF/EC supported program will end in late 2011. Fiscal consolidation will continue in 2012, but to a much smaller extent than before (about 1% of GDP). Austerity measures will mostly include spending cuts, while no tax hikes are expected.

- According to the Baltic Sea index, Latvia's structural framework has improved, particularly in financial markets and infrastructure. Still, the overall index (6.7) is below the region's average – the largest improvements are necessary in financial markets, entrepreneurship, and foreign trade.

Consequences for companies

- Developments across different industries still vary considerably. The largest opportunities for businesses are in exporting sectors; however, there are prospects for new entrants also in locally oriented sectors despite slow private consumption growth.

- Labour costs will grow gradually over the coming years. However, a reduction in labour income tax rates is likely in a few years' time, which would ease the tax burden on businesses.

- The business environment has improved, thus supporting investor activity. There are preconditions for further reforms that would boost medium-term growth and strengthen Latvia's competitive advantages. However, uncertainty remains with respect to which reforms will be implemented and to what extent.
No major shift in economic policy expected

The preceding President Zatlers on May 28, 2011 called for a referendum to dissolve the parliament in order to break the deadlock between the legislative power and the judiciary on the need to eliminate the oligarchs’ grip on the legislature. Citizens voted “for” in the referendum, and the parliament was dissolved, with a new one elected on September 17. The composition of the parliament has changed and the influence of the oligarchs has declined substantially. The winner of the elections was the Harmony Centre (31 seats out of 100). The newly created Zatlers Reform Party (ZRP) got 22 seats; the leader in the last elections – Unity – 20 seats; the National Alliance, 14 seats; and the Greens and Farmers Union, only 13 seats.

Discussions about a new coalition and government are now in progress – new faces are likely in the government, including those from the ZRP, which is more reform-oriented. At the same time, no major shift in economic policy is expected – the exit strategy outlined in the IMF/EC-supported programme still holds, i.e., a gradual reduction of the budget deficit and euro introduction in 2014.

Unfortunately, the previous parliament did not sufficiently make use of the “window of opportunity” for reforms after the elections, while the global economic environment was still favourable. From a political cycle perspective, the window of opportunity is still there, but it has become narrower – municipalities’ elections are planned for spring 2013, and parliamentary elections for October 2014. Meanwhile, the global environment has deteriorated, worsening also the Latvian economic outlook and thus making implementation of reforms more difficult. Currently, taking into account the new composition of the parliament, there are preconditions for a further reforms. However, there is still uncertainty with respect to its implementation – which reforms will be introduced and to what extent.

Improved competitiveness, moderate domestic demand growth

Compared with our August 2011 Swedbank Economic Outlook, we keep our GDP growth forecast for 2011 at 4.2%; however, we revise the 2012 forecast from 3.5% to 3%, accounting for the somewhat weaker global outlook. It should be noted that sizable revisions of historical data and high data volatility make the margin for error quite big. GDP growth for 2013 is still anticipated at 3.9%.

Growth remains export dependent, and consumption will rise slower than GDP during the coming years. Although employment and wages have started to grow, the improvements will be sluggish and uneven. Still, purchasing power growth will somewhat accelerate in 2012-2013 due to easing inflation. Owing to quite strong investment growth, particularly that of exporting sectors and infrastructure projects financed by EU funds, domestic demand growth (excluding inventories) is expected to grow by 6.5% in 2011, slowing to about 5% and 6% in 2012 and 2013.
While weak household demand would suggest intensifying competition, the evidence is controversial. The high concentration in, e.g., retail trade implies a large market power for the main players. It can be seen that profit margins in retail and wholesale trade have gone up in 2010-2011, although still remaining below pre-crisis consumer boom years. Of course, it is hard to say what is a “normal” level for profit margins – a correction after the losses experienced in 2009 is to be expected. Yet, we believe there is still a place for new players in the market.

External competitiveness has improved – unit labour costs in mid-2011 were about 20% lower than the peak in late 2008. Labour costs are low in terms of the European average. They will rise moderately with increasing economic activity and productivity, and skills mismatches also put upward pressure on wages. Thus, labour will gradually become more expensive, but we do not expect a significant deterioration in competitiveness.

Bank financing is becoming more available, and competition among banks is increasing; however, credit activity in the coming years will certainly depend on developments in global financial markets. As capacity utilisation in many manufacturing industries is close to or even above their pre-crisis levels, this opens opportunities for investments in production capacity. The availability of EU funds provides additional support – e.g., about EUR 170 million is still available under the Entrepreneurship and Innovations Programme until 2013.

Fiscal policy to remain conservative

The IMF/EC-supported programme will end in December 2011. If there is no major economic turmoil globally, 2012 is likely to be the last year of fiscal austerity. However, a gradual shift towards a balanced budget will imply restricted spending in the years to come.

Economic growth and the expected reduction of tax evasion will provide revenue expansion. No tax hikes are expected in 2012, except for perhaps a real estate tax. There is also a common understanding among decision makers that labour tax rates should be reduced; however, it is still not clear when and by how much this is to be done. Such a reduction would lower labour costs for companies. Measures to tackle tax evasion are expected to become more active, which would make competition more transparent and fair.

Euro adoption in 2014 is realistic and remains the target for the government. Still, policy action is necessary to ensure it; see our August 2011 Swedbank Economic Outlook for more details.

More bold reforms are necessary

Without doubt, the business and legal environment and, thus, the investor climate have improved (e.g., easier and cheaper bankruptcy procedure, lifting certain administrative barriers for small and me-
medium-sized enterprises, tax reductions for small enterprises, corporate income tax reductions for investments over LVL 5 million in prioritized industries). This improvement can also be seen in the Baltic Sea index (BSI) – Latvia’s position strengthened from 6.3 to 6.7, although this score is still below the region average of 7.

Latvia: Baltic Sea Index (2007-2010)

At the same time, there are many challenges to be addressed. One of them is negative demographic trends – the preliminary 2011 Population Census results revealed only 1.9 million persons (instead of the 2.2 million in official statistics). A diminishing population not only negatively influences domestic demand, but also calls for reforms to make the social safety and pension systems sustainable. On the other hand, a smaller population implies that income per capita and productivity are higher than currently perceived.

Other reforms to be implemented to boost medium-term growth and make public finances sustainable are in the above-mentioned area of tax policy, labour market functioning (to handle structural unemployment and the low participation rate), and the education system (particularly higher and vocational education). According to the BSI, in the region only Russia and Ukraine score worse than Latvia on education. The number of publicly supported universities should be reduced to consolidate resources and improve the quality of education.

The innovation climate has improved, according to the BSI, but more has to be done to promote productivity growth. Latvia still scores worst in financial markets (5.6), despite significant improvements recently. Although financing availability in the banking sector has been enhanced, alternative sources of funds, like equity or venture capital, have still not been properly developed.

Lija Strašuna
Mārtiņš Kazāks
Lithuania – improved competitiveness and more sustainable growth

<table>
<thead>
<tr>
<th>Population:</th>
<th>3.3 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (PPP) 2010:</td>
<td>USD 18,184</td>
</tr>
<tr>
<td>Government:</td>
<td>Centre-right</td>
</tr>
<tr>
<td>Prime Minister:</td>
<td>Andrius Kubilius</td>
</tr>
<tr>
<td>President:</td>
<td>Dalia Grybauskaite</td>
</tr>
<tr>
<td>Next parliamentary election:</td>
<td>October, 2012</td>
</tr>
<tr>
<td>Next presidential election:</td>
<td>2014</td>
</tr>
<tr>
<td>Average GDP-growth in last five years:</td>
<td>1.4%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>5.2%</td>
</tr>
<tr>
<td>Average unemployment rate in last five years:</td>
<td>9.5%</td>
</tr>
</tbody>
</table>

Summary

- The Lithuanian economy rebounded strongly in 2011, and we expect growth to reach 6.3%. Slowing demand in the euro area, uncertainty, and weak confidence will affect growth in 2012, when GDP growth is expected to ease to 4.2%.

- Average annual inflation is expected to reach 4% at the end of 2011 but, due to cheaper commodities, is likely to ease to 2.5% in 2012. Parliamentary elections will be held in 2012, but we do not expect a departure from the fiscal austerity, and we forecast the government budget to be 3% of GDP in 2012. Inflation may be the main obstacle to meeting the Maastricht criteria next year and adopting the euro in 2014.

- The Swedbank Baltic Sea structural indicator has remained unchanged at 6.6. The government has undergone a few important structural reforms, but much remains to be done. Overall, the Lithuanian economy has increased its competitiveness and productivity and eliminated most of the external imbalances, whereas the private sector has significantly lowered its leverage.

Consequences for companies

- Lithuania’s unemployment remains above the natural level of unemployment, thus the upward pressure on wages will remain weak, and they are expected to increase by 4.6% on average in the next two years.

- Interest rates remain at low levels, but credit growth is somewhat sluggish. Although lending conditions have significantly improved from 2009 and 2010, companies are using less borrowed capital and more retained earnings, equity, and EU structural funds.

- The main priorities of recent government policy were to improve the business climate, reduce the scope of the shadow economy, and attract more foreign direct investment (FDI). These initiatives were successful to some extent.
Upcoming elections should not change current policies

The current government has started its last year in office, as parliamentary elections are set to take place in October 2012. This brings some uncertainties to the political environment, as in the past Lithuanian politicians exhibited tendencies to make populist decisions during parliamentary election years.

The government has confirmed its Convergence Programme, through which it has agreed to lower the budget deficit to 5.3% of GDP in 2011 and 2.8% in 2012 and is determined to stick to it. The government retains the strategic objective of adopting the euro as soon as 2014, even though public opinion and support for this objective are somewhat weaker than previously.

Following Constitutional Court order, retirement pensions will be restored to the 2009 level (they were lowered in 2010 and in 2011 as a temporary austerity measure). This will cost the government some LTL 600 million, or around 0.6% of GDP. This decision is somewhat premature, as public finances are still far from balanced.

In other areas, the government has kept its strict position and dismissed speculations regarding possible increases in public servants’ wages or other discretionary spending. There is an ongoing discussion on whether and by how much Lithuania should increase the minimum monthly salary, which is currently at LTL 800 (EUR 231.70) before taxes and is the lowest in the region. Trade unions are calling for its increase to at least LTL 900, whereas the government has agreed to increase it only to LTL 850.

There will be no major tax changes until 2013--only a few increases on duties on extraction of natural resources. There have been ongoing discussions about the introduction of real estate or other asset taxes, but general public support for these taxes is low, and there is no political agreement to introduce them in the near future.

Stronger growth and more balanced economy

Growth is likely to moderate, and we forecast GDP to increase by 4.2% in both 2012 and 2013. At these growth rates, Lithuania remains below the long-term trend growth; thus, growth is likely to accelerate somewhat in the more distant future. Slow growth and debt problems in developed-world economies will weigh on export growth opportunities, but--more important--on the confidence of households and companies.

Unemployment is decreasing rapidly, but there is an issue of structural unemployment – the mismatch between the skills of the unemployed and the needs of companies. Average annual inflation will be around 4% at the end of 2011, but will come down to 2.5% in 2012, easing the pressure on wage increases. Thus, we predict only 3.5% nominal wage growth in 2012.
Lithuania is much better positioned than in 2008 to meet possible financial crises and recession in Europe. Real unit labour costs have declined the most and are the lowest (index, base year 2005) in the region – a positive consequence of this “internal devaluation” was booming exports, which already exceed the pre-crisis highs by 11%. At the same time, external imbalances have been eliminated – the current account and trade are close to balance. Furthermore, both companies and households have reduced financial leverage, which is currently the lowest among Baltic countries.

Main government targets – FDI and shadow economy

Although FDI will pick up in 2011 and 2012, it will, as a percentage of GDP, likely remain below the 2008 level. One reason for the slow growth in FDI is structural – the business environment is still not favourable, as business-controlling institutions are abundant, inefficient, and corrupt (slow progress is being made in this area, however). Another reason is that the majority of foreign investments are concentrated in services, which are less capital intensive. The government has made progress in positioning Lithuania as a country with high-quality skilled labour (Lithuania has more university graduates per 1,000 inhabitants than any other country in the EU) and has managed to convince a few big international names to invest in service centres. Professional service centres (IT development, research, and even back office, such as accounting) create high value added and are skilled-labour intensive; young professionals also benefit from high-quality, in-company training and can later use these skills in, for example, new start-ups. But investments in these centres do little to alleviate the problem of high structural unemployment. Furthermore, they require little fixed capital besides offices, which means they can be easily reallocated to other countries once conditions become less favourable.

Among the main targets of the current government was to reduce the scope of the shadow economy. To some extent, this was successful. Fines for smuggling and similar activities were significantly increased, the use of cash registers became obligatory in food markets (and will probably later become obligatory in all the markets), and inhabitants now have to pay taxes on fuel in their tanks if they cross the Schengen border more than five times per month. These measures supported retail trade, which reached a record annual growth of 10.1% in August.

Reforms are still needed, especially in labour market

According to the Baltic Sea index (BSI), Lithuania scores high in the areas of education, tax policy, and entrepreneurship. The overall index remained unchanged, mainly due to the rapidly declining financial markets’ indicator. Particular strong performance was seen in the categories of “Tax policy”, “Education”, and “Foreign trade,” as well as “Governance.” However, the areas of “Labour market”, “Infrastructure,” and “Innovation climate” declined since last year.
In Lithuania, the rates of personal income tax and corporate income tax are among the lowest in the region (however, social security contributions are relatively high). In 2010, the corporate tax rate was reduced by 5 percentage points to 15%. Furthermore, companies with turnover below LTL 0.5 million per year pay only a 5% profit tax. The Ministry of Finance has proposed increasing the turnover limit to LTL 1 million, which will further stimulate entrepreneurship.

Lithuanian higher education has undergone an important structural reform, through which a “money follows” scheme has been introduced in the form of student vouchers. This reform should increase the competitiveness of universities and the quality of studies. The number of publicly financed seats in higher-education institutions is declining, intensifying competition among students. Another initiative aims to merge a few universities and thereby optimise their activities and concentrate competencies. These reforms have put Lithuanian higher education on the right track, but much remains to be done.

One of the weakest areas remains the flexibility of the labour market, which is overregulated by the labour code. Some attempts, however, have been made to fix this. The Ministry of the Economy recently proposed to exempt the requirement to comply with some articles of the labour code, if the employee earns more than LTL 6,500 (EUR 1,883) per month. This would be a step towards labour market liberalisation; further reforms in this direction could attract more FDI, encourage entrepreneurship, improve labour market flexibility, and bring down unemployment.

Nerijus Mačiulis
Lina Vrubliauskienė
Vaiva Šečkutė
Russia – a new chance to modernise the economy after the election

<table>
<thead>
<tr>
<th>Population:</th>
<th>141.8 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (PPP) 2010:</td>
<td>USD 19,840</td>
</tr>
<tr>
<td>Government:</td>
<td>Market-oriented</td>
</tr>
<tr>
<td>Prime Minister:</td>
<td>Vladimir Putin</td>
</tr>
<tr>
<td>President:</td>
<td>Dmitry Medvedev</td>
</tr>
<tr>
<td>Next parliamentary election:</td>
<td>December, 2011</td>
</tr>
<tr>
<td>Next presidential election:</td>
<td>March, 2012</td>
</tr>
<tr>
<td>Average GDP growth in last five years:</td>
<td>3.7%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>10.4%</td>
</tr>
<tr>
<td>Average unemployment rate in last five years:</td>
<td>7.1%</td>
</tr>
</tbody>
</table>

Summary

- Vladimir Putin is running for president in March 2012 and has nominated sitting president Dmitri Medvedev as prime minister. Finance minister Aleksei Kudrin was ousted after protesting what he saw as irresponsible economic policies under Medvedev.

- The Russian economy slowed quickly during the summer, but relatively high energy prices and an expansive fiscal policy ahead of the upcoming election will ease the effects of the global slowdown. In the medium term economic policies must deal with macroeconomic imbalances.

- The Russian economy has long performed below its potential, and its dependence on commodity production has increased. Higher productivity growth in other sectors is the key, and membership in WTO would in the medium term contribute to this.

Consequences for businesses

- Domestic demand has been the primary growth engine since early 2010. Household finances have improved thanks to rising real wages and a stable labour market. An expansive fiscal policy will benefit households in the short term, and in the medium term we expect disposable income to continue to grow at a steady rate. After a relatively quick recovery, investments will level off unless the government implements structural reforms.

- The business climate in Russia continues to be defined by corruption, bureaucracy and a lack of competition. This poses great difficulties for both domestic and foreign companies. The relatively undeveloped Russian business sector is creating opportunities for a solid, however not without risk, return for companies with a longer horizon.

- The government's reform agenda is ambitious, and there are hopes that progress will be made after the election.

- Swedbank’s Baltic Sea Index indicates that Russia continues to rank low in terms of competitiveness in an international compari-
son. Development in the financial market and foreign trade is lagging, while the educational system is still relatively strong.

Switch at the top consolidates the political order

Few Russian observers were surprised to hear that Dmitry Medvedev will step down as president and hand over the position to Vladimir Putin. Putin in turn will nominate Medvedev as prime minister, an arrangement that apparently had been agreed to some time ago. Even though this was expected, it undermines Russian democracy, and the elections that are scheduled for this year and next increasingly seem to be a pro forma exercise.

It is harder to interpret Finance Minister Aleksei Kudrin’s resignation. He had long been a close associate of Putin, back to his time in St. Petersburg. As finance minister, he made himself known as a proponent of tight fiscal policy and was responsible for building up the federal buffer funds that were utilised to ease the economic slowdown during the financial crisis. The reason given for his ouster was that Kudrin couldn’t accept Medvedev’s plans, as future prime minister, to adopt more expansive fiscal policies. There is probably much more behind it and Kudrin is likely to remain influential in Russian economic policy circles on account of his relations with Putin.

Fiscal policy and energy prices are stabilising the economy

The recovery in the Russian economy has slowed in 2011, with growth retreating during the second quarter. Inventory among companies has been reduced, and also household consumption growth fell slightly. There are signs that confidence in the economy is weakening. The slowdown is noticeable across the economy, and industrial production and retail sales have both lost speed. On the other hand, oil production was stable, and thanks to fairly high oil prices Russia has been able to maintain its current account surplus. Capital outflows are increasing, however, which also points to growing uncertainty about the Russian economy.

Household finances steadily improved in 2010 in early 2011, with rising real wages and falling unemployment, and household consumption has been the main growth engine in the economy. As a result, retail sales have risen strongly after the financial crisis in 2008-2009. Investments have also contributed positively, but the lack of competition in the Russian economy means that a large part of consumption and investment flows out in increased imports.

We expect the Russian economy, especially households, to continue to benefit from the fiscal stimulus in late 2011 and early 2012 in connection with the election campaigns. In addition, we don’t expect oil prices to drop much, so financing the budget shouldn’t face difficulties. Late in 2012 and in 2013 growth impulses will recede, and without credible, extensive economic reforms we expect the Russian economy
economy to grow significantly below its potential, estimated at 5-8% (IMF).

Economic policy in the short term will be dominated by the parliamentary election in early December and presidential election in March 2012. Fiscal policy will be expansive and it is unlikely that monetary policy will be tightened. In the medium term macroeconomic imbalances could worsen, however. After trending downward during the summer due to lower food prices, inflation will be pushed higher by growing domestic demand that isn’t matched by a corresponding increase in production. As a result, monetary policy will have to be tightened to keep prices in check. Fiscal policy in turn is becoming increasingly dependent on high oil prices. At present it is estimated that an oil price of around USD 110 a barrel will be needed to balance the budget, and rising spending is pushing this number even higher. We expect slightly tighter policies after the election, which, together with the international economic slowdown, will reduce growth to 4.2% in 2012 and 4.5% in 2013.

Russia’s entry into the World Trade Organization (WTO) would provide an opportunity to diversify its export structure and increase competition in domestic markets. Both factors would help to raise Russia's growth potential. After negotiating since 1993, membership now seems closer. There are still some trade-related issues to resolve, but the biggest obstacles are Georgia’s veto threat (due to the previous war) and that leading Russian politicians and businessmen are not completely convinced of the benefits of membership. The immediate advantages for the Russian economy are limited, and many fear that increased competition will hurt profits in previously protected industries. Moreover, Prime Minister Putin continues to argue for a customs union consisting of former Soviet republics.

The Russian economy has long performed below its potential. To improve prospects of higher growth, macroeconomic policies must focus on reducing the imbalances. Increased foreign trade would contribute to diversification and higher productivity.

A number of significant challenges still remain. Large investments are necessary to upgrade public infrastructure. Due to demographic patterns, the labour force is shrinking at the same time that the social burden is increasing. At the same time, an increasing number of Russians are expressing a willingness emigrate, which also can be derived from the political developments. Health care costs are rising in pace with an aging population, which will place tougher demands on household finances and the public sector.

Plenty of room to improve the business climate

Business conditions and the investment climate also play a key role in creating a sustainable and stable economic development. The Russian investment climate has long been a drag on the private sector – and on broader, more diversified growth. This deepens and extends
the dependence on commodity production and vulnerability to fluctuations in the global markets.

The preconditions for a more dynamic and well-diversified Russian business sector, and thereby also productivity enhancements and growth, are limited by lacking infrastructure, but also by a perception of corruption, bureaucracy and the lack of competition. This also applies to foreign companies that want to establish in Russia, and cooperation with Russian partners is therefore key.

At the same time a relatively undeveloped business sector creates opportunities. Russian manufacturers not only have a hard time competing with imports, they have also difficulty establishing in foreign markets. In the early 2000’s oil and natural gas accounted for about half of Russian exports, a percentage that has since risen to two thirds. This contradicts the frequently voiced intentions of the Russian authorities. Consequently, there is considerable room in the Russian market to compete with imports, but also to use Russia as a base for exports.

The Russian government signalled recently that it is willing to speed up the pace of economic reform and invest in an innovation climate to stimulate and attract high-tech production. President Medvedev’s push for an innovation centre in Skolkovo, outside Moscow, is an example of this. The government has also launched a ten-point action plan to strengthen the investment climate:

1. Lower payroll tax rates and reduce healthcare procurement costs
2. Develop a system to follow up corruption complaints
3. Simplify regulation for investment and business
4. Appoint an investment ombudsman in the federal districts
5. Reduce state interference in private business
6. Improve access to corporate information for minority shareholders
7. Create a state-backed private equity fund to facilitate foreign direct investment in non-natural resource sectors
8. Reduce the authority of the state commission on foreign investments in strategic sectors
9. Improve public service for businesses
10. Involve the President’s Office in monitoring the quality of public services

The Russian economy also has sectors with considerable investment potential, which could be interesting from a business perspective in the slightly longer term. These include energy efficiency, waste management and infrastructure investment. Public infrastructure has to be modernised quickly, but resources are limited. There may be opportunities for co-financing and participation. The government also intends to accelerate its privatisation programme. If its promises of greater transparency and protection for foreign investors are kept, this could create additional business opportunities.
In Swedbank's Baltic Sea Index, Russia scores a 4.0 and ranks in the lower half the world's economies and has declined slightly in the last four years. The labour index in particular is falling and reflects productivity and efficiency in the labour market. Improvements are mainly evident in the innovation climate and infrastructure. In the sub indices for financial market and foreign trade Russia ranks among the lowest 20% of all economies.

Magnus Alvesson
Ukraine – lack of reforms and political uncertainty are eroding the business climate

| Population: | 45.9 million |
| GDP per capita (PPP) 2009: | USD 6,658 |
| Government: | Market-oriented, conservative coalition |
| President: | Victor Yanukovych |
| Prime Minister: | Mykola Azarov |
| Next parliamentary election: | 2012 |
| Next presidential election: | 2015 |
| Average GDP growth in last five years: | 1.5% |
| Average inflation rate in last five years: | 14.5% |
| Average unemployment rate in last five years: | 7.1% |

Summary

- Political divisiveness remains the overriding theme in Ukraine. The trial against opposition leader Yulia Tymoshenko has raised questions about the justice system.

- The Ukrainian economy has experienced a moderate recovery since the severe crisis in 2008-09, but another global slowdown could reduce economic growth going forward.

- Ukraine continues to play its main trade partners, the EU and Russia, against each other and may end up making both sides unhappy. The IMF is still waiting for raised energy tariffs before normalising its lending programme.

Consequences for businesses

- Despite slightly slower economic growth, domestic demand has risen fairly strongly, not least due to higher real wages. Investment has also accelerated, driven in part by the Euro 2012 Championship next year.

- A delay expanding EU relations with Ukraine and friction in its relationship with Russia mean that companies can expect that trade opportunities to remain limited. At the same time Ukraine is a large market in itself, with trade potential both east and west and close proximity to fast-growing Turkey.

- Despite that some reforms have been introduced, including in the tax system and small business regulations, there is a feeling that the government is still placing higher priority on control than on a dynamic business climate. The sense that corruption is growing and that the government’s economic interests take precedence is becoming more prevalent.

- Swedbank’s Baltic Sea Index indicates a falling trend from already low levels. Ukraine still ranks low in terms of business climate compared with other countries.
Power struggles continue to dominate Ukrainian politics

After last year’s parliamentary and presidential elections there were hopes that political conditions would stabilise and speed up the reform process. The Orange Revolution failed to reform the economy in a meaningful way, and its leaders’ time in power was mainly distinguished by internal conflict and controversy. The newly elected president, Viktor Yanukovych, has the support of parliament and is working together with Prime Minister Mykola Azarov. This raises prospects of quickly implementing economic reforms that will improve the business climate and raise economic growth in the country. Their first year in office has, however, mainly seen a consolidation of power and lack of interest to push through on the reform agenda. It seems that the country’s current leadership has given higher priority to control over the state apparatus and business sector than to a more dynamic private sector.

The arrest and subsequent trial of former Prime Minister Yulia Tymoshenko reinforces the impression of Ukraine as a country that lacks legal certainty and democratic principles. Even if her jail sentence of seven years is overturned (due to pressure from the EU, Russia and public opinion), the process shows that the authorities are prepared to resort to drastic measures to thwart political criticism and competition. The crime Tymoshenko was convicted of, an “unfavourable” gas deal with Russia, and the seven years of jail time, if it holds, suggest that the accusations are politically motivated. Seven years would mean that one of the country’s most important opposition leaders cannot participate in next year’s parliamentary elections or the presidential election in 2015.

Global turbulence poses a risk to vulnerable Ukrainian economy

The Ukrainian economy has reported positive growth since its major drop-off in 2008-09, but is still far from its previous GDP levels. Since the beginning of 2010 the annual real growth rate has fluctuated around 5%. The economy has principally benefitted from rising commodity prices, since the steel and metal industry accounts for about 25% of GDP. In addition, we see a rebound in agricultural production after last year’s drought and poor harvest. As a result, inflation should ease from a rate of over 10% in early summer to about 6% this fall. Inflation is mainly being held back by food prices, however, and the underlying price increases are still a problem for economic policymakers.

While domestic demand has stabilised, rising real wages and a fairly strong labour market have helped to stimulate household consumption, and it expanded last year by about 5% and by 15% in the first half of 2011. Since early 2010 annual GDP growth has been around 5%. Unemployment was 7.7% in mid-2011, slightly less than during the same period last year, while real wages have risen by over 5% on
an annual basis in 2010 and 2011, compared with a decline of nearly 10% in 2009. Investment is also increasing again, not least because of next year’s European football championship, which requires major infrastructure spending around the arenas and in the transportation sector. Unfortunately the lack of competition in Ukraine means that the increase in domestic demand has largely resulted in higher imports.

Global macroeconomic developments and a downward revision to growth prospects primarily in the euro zone could again weaken the Ukrainian economy. The biggest uncertainty is its dependence on metal and energy prices. This means that the fixed exchange rate policy vis-à-vis the US dollar could also be in jeopardy. Relations with the IMF have been on shaky terms as well. After instituting a pension reform that raised the retirement age and extended the vesting period, adjustments to energy tariffs are now the main obstacle to reinstating the IMF programme. The government is against this for political reasons while at the same time the IMF sees the deficit being run by the state energy company as a growing threat to a balanced budget. It is likely that some form of compromise will be reached whereby energy prices are raised slightly and the government cuts its spending. As a whole we expect that renewed concerns about the global economy as well as lack of reform in Ukraine will limit the growth rate to less than 5% in the next two years. This means that the nearly 15% drop in GDP in 2009 will not be fully compensated.

Further manoeuvring between East and West is impeding trade

Ukraine’s foreign policy balancing act between Russia and Europe continues, and there is a risk that relations with both could worsen. Negotiations with the EU on an extended trade pact, which Ukraine had hoped to sign in 2011, are threatened by the jailing of Yulia Tymoshenko. The EU had previously warned Ukraine about what it considers a politically motivated trial and that their cooperation could be at risk if she were convicted. Now it is likely that the integration process will be delayed, even if the sentence is overturned. The consequences for companies active in Ukraine could be significant. In addition to liberalising trade with the EU, there was a proposal for a simplified visa process. Russia has also expressed its displeasure with the Tymoshenko trial. There it was seen as an attempt to tear up the gas agreement that had been signed by the two countries and as a threat to Russia’s efforts to increase its influence in the region. Ukraine is therefore at risk of straining relationships with its major trade partners to both the east and west.

At the same time Ukraine is a large economy in itself and is strategically located from a trade perspective between large markets: Russia, the EU, former soviet republics and, not least, fast-growing Turkey. This creates considerable potential for companies that are willing to take the risk and are patient. The slow pace of reform means, how-
ever, that expectations of a quick return on investment should be tempered.

Companies are struggling in an unfavourable environment

Despite pledges by the current government, the pace of reform in Ukraine has been slow since it took over in early 2010. On the contrary, business leaders and observers are seeing growing signs of corruption and authorities that are tightening control and protecting the government’s economic interests. Swedbank’s Baltic Sea Index, which reflects business conditions, also fell slightly last year.

Some of the reforms that have been implemented could mark the beginning of more business-friendly policies. New tax legislation designed to simplify rules has been passed by parliament. Many businesses, however, still cite the tax system as one of their biggest obstacles and claim that it is being used to expand the interest of government business interests. The extensive delays in VAT refunds for exporters are slowly being alleviated. Capital requirements and the paperwork for new start-ups were reduced during the summer, which could have an effect in the slightly longer term. The market for buying and selling farmland has been liberalised, but so far only for Ukrainian citizens, and export restrictions on agricultural products have been eliminated and replaced by export taxes. Lastly, Euro 2012 means that Ukrainian and foreign companies can establish contacts and evaluate business opportunities.

In summary, Swedbank’s Baltic Sea Index shows a slight decline for Ukraine in 2010 from an already low level. This means that it still ranks in the lower half of global economies in terms of business climate. The labour market and foreign trade in particular are falling, while improvements have been evident in the financial market. The infrastructure index is decreasing as well. The sub-index for governance is continuing its downward trend observed over the last four years.

Magnus Alvesson
Germany – benefitting from earlier labour reforms, but more needs to be done

| Population: | 81.7 million |
| GDP per capita 2010: | USD 37 591 |
| Government: | Liberal-conservative coalition (CDU/CSU/FDP) |
| Chancellor: | Angela Merkel |
| President: | Christian Wulff |
| Next parliamentary election: | 2013 |
| Average GDP growth in last five years: | 1.7% |
| Average inflation rate in last five years: | 2.1% |
| Average unemployment rate in last five years: | 8.3% |

Summary

- We expect Germany’s GDP to grow by nearly 3% this year, before dropping significantly to slightly over 1% in 2012 and 1.5% in 2013. Inflation is slowing, and together with lower unemployment and sound household balance sheets is contributing to an increase in private consumption. Investments will also continue to provide a slight, though positive contribution to growth, as exports slow.

- Germany has implemented important labour reforms, but has to do more structurally, especially with regard to tax policy. Its Baltic Sea Index rating of 7.5 leaves room for improvement.

Consequences for businesses

- The euro crisis is hurting confidence among households, making them less willing to spend, at the same time that pent-up demand will eventually benefit retail and auto sales.

- It is expected that construction investments will continue to rise, though at a slightly slower pace. When export prospects slacken, machinery investment growth will also decline, although demand from emerging economies provides opportunities for further, cautious investments in the export industry. Although the credit crunch in the euro zone could hinder investments, many companies have solid balance sheets and have prepared for slower growth.

- After a period in which labour costs were fairly flat, we expect slightly higher wage growth in coming years. Companies are still working to improve productivity, which also increases investment needs.

- Inflation will decline in the next year, as will interest expenses as the ECB cuts its benchmark rate. We expect the euro to weaken against the US dollar, which could help export prospects slightly in an otherwise sluggish export market.
Major challenges for the sitting coalition

On May 9 the government coalition, comprised of the conservative Christian Democratic Union (CDU) and Christian Social Union (CSU), along with the liberal Free Democratic Party (FDP), suffered two disappointments. After five years it lost power in Germany’s most populous state, North Rhein-Westphalia, while also losing its majority in the upper house. Earlier in the spring the CDU lost the election in Baden-Württemberg, where it had held power since 1953. Shortly thereafter FDP’s party chairman, Guido Westerwelle, stepped down after having lost the people’s confidence and was succeeded by Philipp Rösler. However, Westerwelle still serves as Foreign Minister, while Rösler is Economics Minister.

There are several reasons why the coalition government has lost ground. Chancellor Angela Merkel’s supporters include many eurosceptics who oppose supporting Greece and other crisis countries in the euro zone. Secondly, the smaller coalition party, FDP, lost voters due to Westerwelle’s policy stumbles and conflicting statements recently by Rösler regarding Greece in particular. Thirdly, the state of Baden-Württemberg was affected by Japan’s nuclear accident, and the green party, Alliance ’90/The Greens, instead received strong voter support.

The next federal election isn’t until September-October 2013, which means that the government, though slightly weaker, will retain power. Merkel has signalled that tax cuts will be put off. This hurts the FDP, which had supported cuts in the campaign. Speculation which coalition will take shape after the next election includes a new grand coalition between CDU and the Social Democrats (SPD) or a coalition between CDU and the Greens or SPD and the Greens. One of the two latter alternatives seems more likely.

On September 29 the Bundestag supported an expansion of the European Financial Stability Facility (EFSF), with 523 votes for and 85 votes against. This shows that German politicians strongly support the euro’s rescue. Despite euroscepticism among the public, a majority wants the euro.

The need to recapitalise banks has recently led to discussions between Germany and France, since the French want to use the EFSF (i.e., German tax revenue), not their own money (i.e., French tax revenue) to bolster French banks. The issue is complex, since French creditworthiness is at stake, as is the EFSF, but in the long run German creditworthiness is also threatened if the euro crisis worsens and more countries besides Greece have to write down their debt. In Germany’s view, resolving the euro zone’s acute problems will require the crisis countries to implement the necessary reforms and banks to recapitalise in order to take greater responsibility.
Growth is slowing – but households are in a fairly good shape

GDP is expected to increase by 2.9% this year. The first quarter was surprisingly strong, with GDP rising by 1.35% compared with the first quarter, but in the second quarter it fell to 0.1%. Based on various economic indicators, the third quarter is now expected to produce growth of around 0.5%, while the fourth quarter this year and first quarter next year are likely to be significantly weaker.

We expect that Germany can continue to grow next year, though at a modest 1.1%, before strengthening slightly in 2013 to 1.5%. The fact that the euro zone’s problems seem to be under control, that the German labour market has improved and that the balance sheets of German households are relatively sound suggests that a recession can be avoided. The household debt ratio (debt in relation to disposable income) has decreased from 115% a decade ago to 95%. This points to a cautious increase in household consumption. The construction sector is also maintaining a decent level of activity. At the same time machinery investments are growing, but will slow as the global economy weakens.

Germany’s economy is still dependent on exports, though less than a few years ago. After years of cautious wage growth, there is pent-up demand among households. We expect wages to grow slightly faster, also creating the possibility of increased consumption. New car registrations are 20% lower than they were just over a decade ago. Unemployment has fallen to its lowest level in 20 years, at 7%, at the same time that employment is 1.5% above the pre-crisis level. The Hartz reforms that began in 2003 have helped to increase flexibility in the job market and better match the unemployed with vacant jobs. Through so-called working time accounts and corridors, employers and employees can adjust working hours based on demand, which is an asset, especially in the manufacturing industry. Labour costs have risen only slightly for a number of years, which has strengthened profits and opportunities to increase employment. On the other hand, consumption could be held in check by declining future confidence and higher inflation. German households are very sensitive to price increases, but we now expect inflation to decrease from 2.3% this year to just under 2% next year.

Banks are the focus of economic policy

Germany has decided to reduce the federal structural deficit to 0.35% of GDP by 2016 and wants the states (länder) to be in structural balance four years later. The aim is to improve budget discipline while at the same time avoiding a procyclical fiscal policy. The budget deficit is expected to be a modest 1.7% of GDP this year and slightly over 1% next year. Germany could resort to more expansive fiscal policies, but also has to set an example for other euro countries.

The current account surplus is still relatively high at just over 5% of GDP. According to the most recent data from July, Germany had the
world's largest trade surplus at USD 194 billion, i.e., bigger than China, Russia and Saudi Arabia, three other countries with huge surpluses. Slightly higher wage growth could lead to higher German household consumption if export opportunities diminish – and could eventually reduce the surplus.

The focus in German economic policy is on its banks. Besides Landesbanken, Commerzbank is in need of significant recapitalisation, since both are relatively vulnerable to debt write-downs in Greece and other crisis countries. Unlike French banks, however, German banks have been working on their balance sheets for a while. Still, more will be needed, especially if the write-downs are larger than agreed to thus far.

Structural reforms have been implemented – but more is needed

The reforms in the labour market have improved flexibility, which benefits the German economy. It still needs further reforms, however. Germany's Baltic Sea Index rating of 7.5 is only slightly higher than the average for the region.

Germany ranks high in terms of education, foreign trade, governance, innovation and infrastructure. The area where it trails is tax policy, where it has both high taxes (and tax wedges) and complex rules. The labour market also needs to do more, e.g., in terms of labour market participation and employment rules. Germany also ranks fairly low in entrepreneurship and the financial sector. The consolidation among banks is expected to continue in the years ahead.

Germany has a strong reputation as a manufacturer, and the business climate is fairly good. It has bolstered its competitive strength by keeping a lid on labour costs. What Germany now needs, among other things, is to further deregulate its service markets and adopt additional measures to support women and older workers in the labour market.

Cecilia Hermansson

German banks have worked on their balance sheets, but more needs to be done

Germany would benefit from lower taxes and less complicated tax rules

Cecilia Hermansson
Denmark – new government tries to kick-start growth

<table>
<thead>
<tr>
<th>Population:</th>
<th>5.5 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (PPP) 2009:</td>
<td>USD 39,558</td>
</tr>
<tr>
<td>Government:</td>
<td>Center-left coalition</td>
</tr>
<tr>
<td>Prime Minister:</td>
<td>Helle Thorning-Schmidt</td>
</tr>
<tr>
<td>Next parliamentary election:</td>
<td>2015</td>
</tr>
<tr>
<td>Average GDP growth in last five years:</td>
<td>0.1%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>2.1%</td>
</tr>
<tr>
<td>Average unemployment in last five years:</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Summary

- The impact of declining housing prices on the domestic economy and slower global economic conditions will limit GDP growth in Denmark during the forecast period. This year we expect GDP to rise by 1.3%, before climbing by 1.7% in 2012 and nearly 2% in 2013.

- Fiscal austerity will ease in 2012-2013 at the same time that the new government introduces measures to increase the labour participation rate. The aim is also to reduce a budget deficit that is already significantly lower than the EMU average.

Consequences for businesses

- Lower income taxes and inflation are strengthening real household purchasing power and paving the way for a higher consumption increase during the forecast period 2012-2013 compared with this year. Increased household savings to reduce debt in the wake of the declining housing prices and an uncertain job market are having the opposite effect, however.

- Low capacity utilisation by businesses and a property surplus mean that any increase in investment will have to wait until 2012 at the earliest. At the same time the low investment level points to growing future investment needs in the Danish economy. Increased investment in infrastructure and new energy will raise total investment volume in 2012 and 2013.

- In Swedbank’s Baltic Sea Index, Denmark ranks highest among all the countries in the Baltic region together with Finland. A flexible labour market and competitive corporate climate stand out. The biggest potential for improvement is in its tax regime, which ranks lowest in the index.

New government wants to modernise

The parliamentary election on September 15 led to a change at the top of Danish politics. After ten years in power, the conservative coalition was succeeded by a coalition of the Social Democrats, Socialist People's Party and Social Liberal Party with the support of the Red-
Green Alliance, the big winners in this year's election. The Social Democrats' election results were its worst in over 100 years.

Helle Thorning-Schmidt, who leads the Social Democratic Party, has taken over as Denmark’s first female prime minister. In many respects, the Social Liberal Party supports conservative policies and earlier this year it signed an economic reform agreement with the previous conservative government, which could make it hard to adopt traditional social democratic policies without risking one or more conflicts between parties.

The new government wants to kick-start the economy in part through 10 billion Danish kroner in infrastructure spending. It also wants to get more people working and eventually balance the budget. In its previous budget outlook from August, the government forecast that the budget deficit would grow to 4.6% of GDP in 2012 from 3.8% in 2011. A re-examination of the social insurance system, lower income taxes and less immigration regulation are planned. Tax hikes will be introduced on, among other things, fatty foods, which business organizations have criticised. Energy and environmental issues are high on the government’s agenda. This will be evident when Denmark takes over the EU’s rotating presidency in January 2012.

Weak domestic demand limits growth

The Danish economy grew by an average of 2.1% last year, but lost considerable speed in the fourth quarter 2010, which continued during the first three months of this year. As a result, GDP fell two quarters in a row, which technically constitutes a recession, in contrast with the other countries in the Baltic region. The quarterly declines ended in the second quarter of this year, when GDP rose by 1%, corresponding to an increase of 1.8% on an annual basis.

The recovery in the Danish economy will mainly come from higher exports, not least through strong demand in Germany and Sweden. On the other hand, domestic demand – consumption and investments – has softened, because of which the current account surplus remains large at around 5% of GDP. Negative wealth effects through lower housing prices and high debt ratios are contributing to modest consumption growth and increased household spending. Low capacity utilization in the business sector and a surplus of commercial property has led to modest investment growth. Investment volume as a share of GDP is the lowest in several decades.

During the summer and fall growth prospects for the Danish economy were downgraded. This year we expect GDP to rise by 1.3%, before climbing by 1.5% in 2012 and 1.8% in 2013 with the risk of weaker growth. A soft global economy will mean slower export growth, especially to EU countries, which account for two thirds of total exports. At the same time Danish exporters are suffering from a cost disadvantage, even though wage growth is expected to be modest in 2012-2013, when the labour outlook worsens.
The likelihood that private consumption will take over as a growth engine after exports hasn’t increased during the second half of the year. Household sentiment has again turned lower, and plans for major purchases have been adjusted downward. Low inflation and the government’s plans to cut income taxes could strengthen household purchasing power during the forecast period, however, despite low nominal wage increases. On the other hand, the current debt reconstruction is limiting private consumption, because of which we expect only a modest increase in consumption in 2012 and 2013.

Investment plans by businesses remain on hold with the risk that they will delay investments given the current economic uncertainty. Increased public investment in infrastructure and energy in 2012-2013, as the government has announced, will also spread to private business. The housing market, on the other hand, is still being weighed down by a surplus of properties, because of which housing investments will be limited in the next two years.

Higher global commodity prices are one reason why the average inflation rate in Denmark will be higher in 2011 than the previous year. The Danish krone’s peg to the euro within a range of plus or minus 2.25% also means that the euro’s decline against the dollar makes Danish imports more expensive. We expect inflation to average nearly 3% this year, before falling to below 2% through lower commodity prices and modest wage increases.

Consolidation of the Danish banking sector

In the wake of the household debt crisis, several small Danish banks with large portfolios of mortgage loans and inadequate financing have gone bankrupt. Denmark has received international attention for its tough attitude toward troubled banks, and it feels that additional write-downs are necessary. This has made it hard for the banking sector to secure public financing and explains why certain banks have reduced their lending and placed tougher loan conditions on businesses and households. In "Bankplan 4", the political parties have agreed on guidelines whereby healthy banks can take over unhealthy ones. This will be done by extending public guarantees beyond 2013. The purpose of the strategy is to increase the consolidation of the Danish banking sector.

Few new jobs are being created

Sluggish GDP growth in the Danish economy has led to weak job growth. Since 2005 employment has shrunk by an average of 0.2% per year, while in Sweden, Norway and Finland it is increased by between 0.5-1.5%. In a study by the European Labour Force Survey, mostly low-qualified jobs were created in Denmark 2008-2010, while the number of high qualified jobs declined. In France, Germany and Sweden, the opposite was true, with more hires among people with a higher education at the same time that low-wage jobs decreased.
In spite of this, the Danish labour market remains tight, with an unemployment rate (net) of around 4% of the working population. Instead, the number of people in labour market programmes or studying has increased, which is not factored into the labour force. Increasing labour market participation is something the new government wants to prioritise in order to improve public finances. It concerns lower income taxes and changes in the social insurance system. Steps are planned to increase the number of students in higher education, while making sure that their time is spent more efficiently.

Competitive economy still facing challenges

In terms of the structural conditions in place for sustainable economic growth, Denmark topped Swedbank’s Baltic Seal Index for the fourth consecutive year together with Finland. Denmark received its highest ranking for its job market, which is more flexible compared with other countries in the Baltic region. This applies not least to rules on hiring and dismissing new employees, which were introduced in connection with the implementation of “flexicurity”, where job seekers receive generous but limited unemployment compensation. At the same time there has been criticism that compensation levels are too generous, that the right educational investments aren’t being made.

Denmark's highest rankings were in the areas of governance, foreign trade, the labour market and innovation climate. The most room for improvement is still in taxes, which received the lowest ranking (4.7) of the nine areas. A slight improvement has been made in the last two years, however.

Swedbank’s Baltic Sea Index also shows the biggest decline which was in infrastructure. This explains why the new government in Denmark is planning to invest extensively in infrastructure in the years ahead. The impact of the decline in housing prices on the Danish financial market can be clearly seen in the Baltic Sea Index’s sub indicators, where Denmark as recently as three years ago ranked highest among the countries in the region.

Jörgen Kennemar

Tight labour market – but also more people which is not active on the labour market

Healthy business climate but still room for improvement in taxes
Norway – robust domestic demand but high household debt concerns

Population: 4.9 million  
GDP per capita (PPP) 2009: USD 56,894  
Government: Labour, Socialist Left and Centre Parties  
Prime Minister: Jens Stoltenberg  
Next parliamentary election: September, 2013  
Average GDP growth in last five years: 0.7%  
Average inflation rate in last five years: 2.3%  
Average unemployment rate in last five years: 3.1%

Summary

- The Norwegian economy is reporting solid growth despite a weaker global growth outlook. We expect GDP for the whole economy to rise by nearly 3% in 2012 and slightly over 2% in 2013. This is a higher growth path than the last five years. The largest economic risks are the high debt ratios among households and substantial decline in crude oil prices.

- Fiscal policy will be weakly expansive in 2012 given the low level of unemployment. This also means that monetary policy won’t have to be tightened as much as previously expected. At the same time demands are increasing to expand the labour supply.

Consequences for businesses

- Conditions are in place for continued consumption growth in 2012-2013, although increased economic uncertainty and rising household savings may limit the growth consumption somewhat. Housing construction and investments in the oil sector are expected to rise substantially and lead to higher imports of input and investment goods.

- Increased migration has helped to limit Norway’s labour shortage. High wage costs and a strong currency are still a competitive disadvantage for the country’s exporters and are increasing the need for rationalisation and efficiency improvements.

- We expect the low unemployment and increased domestic demand to contribute to nominal wage increases of about 4% per year in 2012-2013, more than in competing countries.

- Norway ranks at the top of Swedbank’s Structural Index, but still has room for improvement, especially in terms of taxes.
New political winds

The tragic events on Utøya on July 22 are still having an impact on Norwegian society and politics. In this year's municipal elections in September the conservative party, Høyre, had its biggest success, while the Progress Party (Fremskrittspartiet) was the big loser. Results from local elections indicate that the sitting coalition would not retain its majority if a parliamentary election were held today. Although the Labour Party gained in local elections and remains the country's largest party, the losses by the Socialist Left were enough to alter the balance of power between the opposition and the government.

One of the stated objectives of the sitting government is to have the lowest unemployment in Europe. This should also be reflected at a local level, which requires increased activity around the country. This is reflected in the government's fall budget, where more resources are allocated to municipalities and county councils to protect, strengthen and improve the welfare system. At the same time there are growing demands for a balanced budget, since the municipal sector is facing rising deficits. Environmental issues are a priority. The government wants Norway to be a pioneer in environmental policy and is increasingly investing in renewable energy. However, the growing economic importance of the oil industry could lead to conflicts of interest within and outside the government.

Stable growth in Norwegian economy

The Norwegian mainland economy (excluding the oil sector) grew by 2.1% last year driven by increased private and public consumption in the wake of an expansive fiscal policy. In 2011 the recovery strengthened. GDP for the mainland economy is expected to increase by nearly 3% for the full year, while the total economy is growing by slightly over 1% due to lower global oil demand. A further increase in domestic demand will be the main driver of GDP growth, which is projected at 2.8% for the entire economy in 2012. Deteriorating global growth prospects and competitive disadvantages are weighing on exporters, however. In 2013 GDP is forecast to increase by slightly over 2% when investment growth by businesses subsides.

The purchasing power of Norwegian households has benefitted from low interest rates and a strong labour market. An unemployment rate of 3.5% in August was Europe's lowest at the same time that employment has returned to the same levels as during the economic boom in 2007-2008. During the first half of the year real wages rose by 4.5% on an annual basis, which leaves room for further consumption growth. To date, however, consumption has grown less than income, because of which the savings ratio as a share of disposable income rose to 8.5% during the second quarter, double the historical average. Consumer debt, which is now as high as 200% of household income, is a cause of concern and a risk factor in economic analysis with respect to both private consumption and housing prices.

The government goal is to have the lowest unemployment in Europe

The debt ratio for household is now 200%
Gross investment, which fell by 7.4% in 2010, has increased broadly this year. This is especially true of the oil industry, but also other private businesses, which have increased their investment activity. Housing construction has grown substantially, though still from low levels. Rising home prices, low interest rates and a housing shortage, especially in regions with strong immigration, are increasing the incentive to maintain a high level of housing construction. As a whole we expect gross investment to grow by slightly over 8% this year and next before falling slightly in 2013. This fall’s major oil discovery on the Norwegian continental shelf and in the Barents Sea can provide further fuel for the Norwegian economy and higher revenue for the state. But it could also lead to increased competition for available resources with a risk that wage costs will rise even faster.

Rate hikes are on hold

The average annual inflation rate during the first nine months of the year was 1.4%, compared with 1.9% in the same period of 2010. Lower global commodity prices and the appreciation of the Norwegian krone are contributing to lower domestic price pressures. While the high level of resource utilisation in the economy suggests that inflation may rise slightly faster in 2012 and 2013, it will be limited by imported inflation, which is being held in check by lower commodity prices and a continued strong currency.

International economic uncertainty and a projected inflation rate below the 2.5% target have allowed Norway’s central bank to pause before raising interest rates. We expect the central bank’s benchmark rate, the site deposit rate, to be maintained at the current level of 2.25% and not be raised until the second half of 2012. This is provided that fiscal policy isn’t too expansive. In the government’s budget bill presented in October, fiscal policy will be weakly expansive next year.

Higher interest rates should lead to a stronger currency with negative effects for the competitive sector. Unit labour costs in manufacturing were 50% higher last year than the EU’s trade-weighted average for the common currency. The high cost level makes Norwegian export industry vulnerable to lower product prices, higher wages and a stronger krone.

Structural reforms for long-term growth

The reliance on the oil-related industry could eventually leave Norway vulnerable in pace with the global energy transformation that will gradually take place in the decades ahead. Norway still has no long-term growth strategy. Nearly half of the country’s total exports consist of oil and gas. Higher oil prices and new oil discoveries raise the risk that the dependence on the oil related industry will further increase at the expense of other industries.
The business sector’s internationalisation, excluding the oil sector, hasn't been fully utilised. The mainland economy's exports account for less than one fifth of GDP. Making the economy more competitive in the long term and broadening the export base will require more value-added production. Spending on research and development corresponds to slightly over 1.5% of GDP, the lowest rate among the Nordic countries.

A high domestic cost level suggests a lack of competition. Further deregulation of product markets, privatisations and more foreign investment could lead to more competition and strengthen Norwegian household purchasing power.

The demographic challenge facing the economy will place greater demands on higher workplace participation. Together with the Netherlands, Norway is the European country where employees work the fewest hours. Increased labour market programs and efforts to reduce sick leave absences have therefore been intensified.

In Swedbank’s Baltic Sea Index, Norway ranks third after Denmark and Finland. Its top ranking in entrepreneurship for the fourth consecutive year shows that there is still fertile soil for new businesses in Norway. Education, the financial market and logistics are other areas that rank high in the index.

Infrastructure is the component that improved the most in 2010. Efficient infrastructure is a major competitive advantage, especially in a small, open economy like Norway’s. This contrasts with taxes, where its ranking continued to fall, to 4.2 in 2010 from 5.1 in the preceding survey.

Jørgen Kennemar
Finland – political challenges as the economy slows

| Population: | 5.4 million |
| GDP per capita (PPP) 2009: | USD 36,660 |
| Government: | Right-left coalition |
| Prime Minister: | Jyrki Katainen |
| President: | Tarja Halonen |
| Next parliamentary election: | 2015 |
| Next presidential election: | January, 2012 |
| Average GDP growth in last five years: | 1.2% |
| Average inflation rate in last five years: | 2.0% |
| Average unemployment rate in last five years: | 7.5% |

Summary

- The recovery in the Finnish economy is slowing as the global growth outlook worsens. We expect GDP to rise by 2.8% this year and 1.5% next year, before increasing by nearly 2% in 2013.

- There is a increasing need for structural reforms, particularly in the labour market, in order to meet demographic challenges. Another important goal for the new government is to strengthen the public finances.

Consequences for businesses

- Domestic demand is expected to grow, though slowly, throughout the forecast period, when household purchasing power is limited by lower real wage increases and higher indirect taxes. At the same time households are expected to be less willing to dip into their savings when economic prospects are so uncertain.

- Swedbank’s Baltic Sea Index shows that Finland has a favourable business climate. The country retained its top position in education. Good access to well-educated employees in ICT, makes Finland an attractive, competitive region for research and development in IT.

Political extremes in the same government

Dissatisfaction with the established political parties and the EU has grown in connection with the fiscal crisis in the EMU countries. This was clearly evident in last spring’s parliamentary election, when the EU-critical True Finns, led by Timo Soini, were the big winners.

Finland’s new government may certainly cause confusion abroad, perhaps even astonishment. The reason is that the six-party government, which is led by the chairman of the conservative National Coalition Party, Jyrki Katainen, spans the parliament’s
political extremes from left to right. The parties in between, the Centre party and the True Finns, became the opposition. Domestic political tension concerning the EU will certainly be felt in the Finnish parliament and could impact the government if the True Finns continue to grow in popularity.

Measures to strengthen public finances are a high priority for the government. In their negotiations, the six coalition parties agreed on actions to strengthen the state’s finances, which last year produced a deficit of 5.5% of GDP. A municipal reform is planned to create strong, economically healthy municipalities. This fall’s budget shows, however, that spending cuts and revenue increases alone won’t be enough to stop government debt from rising. It is now expected to grow to nearly 55% of GDP in 2013.

While fiscal conditions are significantly better than in the EMU, a quickly ageing population in Finland will weigh on the public finances. The government has therefore pledged to take additional steps. The question is whether it is capable of doing so considering the colliding interests of the coalition parties and the risk that decisions on several important economic policy issues will be delayed or watered down.

Growth is slowing

The Finnish economy continues to recover after a major GDP decline in 2009. During the first half of the year GDP climbed 3.8% at an annual rate through increased domestic demand, while net exports contributed only marginally. The increase in private consumption was stimulated by rising real disposable incomes and an improved labour market outlook.

Since the beginning of 2010, when open unemployment reached 9% of the labour force, it has trended lower and reached 7.7% in August. Increased capacity utilisation and improved profit margins have led to a broader rise in business investment at the same time that housing construction remains at a high level. On the other hand, Finnish exports have decelerated after last year’s significant recovery. On a seasonally adjusted basis, Finnish export volume declined for two consecutive quarters. This means the export volume is lower compared to last year. Slower global growth and Nokia’s problems are contributing to weaker exports.

We expect the global economic slowdown this summer and fall to spread to the domestic economy, though with a delay, as households become less willing to increase spending and companies delay investments. Household confidence indicators have retreated, though this is not yet reflected in retail sales, which continue to rise.

A weaker labour market and lower real wage increases going forward will result in weaker household purchasing power in the next two years. Fiscal austerity partly through higher indirect taxes is also keeping household consumption in check. We expect real disposable incomes to rise by nearly 1.5% annually between 2011-2013, com-
pared with slightly over 2% in 2010. Uncertainty about the global financial markets, a weaker labour market and high debt should also cause household savings, which fell in 2011, to rise more than expected, as happened in the wake of the financial crisis in 2008. Considering that the Finnish debt level is a historically high 120% of disposable household income, a savings ratio of less than 2% seems low.

We expect GDP for the full-year 2011 to increase by 2.8%, compared with 3.6% in 2010. A weaker second half of the year and increased uncertainty about the strength of the global economy suggests that GDP growth will be further downgraded next year. We forecast an increase of 1-1.5% in 2012, before GDP strengthens slightly in 2013 when the global economy stabilises. The risks are more on the downside, however, especially for lower exports and hence weaker investment growth.

Higher costs and inflation

The rate of inflation in Finland is higher than the EMU average. During the period January-August Finnish inflation averaged 3.4%, compared with 2.6% in the euro countries. This reflects a change after several years in which price increases were lower than in the other euro countries. In addition to higher resource utilisation in 2011, consumer prices are being driven by rising food and energy prices. At the same time unit labour costs have increased faster than in competing countries due to the costly wage agreements signed in 2007/08. Higher global commodity prices and a weaker euro are part of the reason why inflation is expected to remain at around 3% in 2012, in addition to which VAT on several product groups will be raised in order to strengthen the public finances.

Can structural work be intensified by the new government?

Finland has the EU’s fastest aging population. The government faces a major burden as the population ages and workforce shrinks. Its advantage compared with many other EMU countries is that Finland is starting from a significantly better position. In spite of this, demands for higher workforce participation will grow. More efficient government spending, not least at the municipal level, and changes in the social insurance system will be the key to reaching a sustainable spending level. The government is therefore encouraging private solutions and paving the way for new companies.

The employment-to-population ratio (15-64 years) was 68% in 2010, which is lower than the other Nordic countries. To increase the working population, the government has reduced income taxes and social insurance compensation in recent years. Although the government officially raised the retirement age to 65 from 63, there is still a large group of older workers who are retiring early due to generous unemployment compensation. A review of integration policy and more positive stance toward immigration are important to alleviate future labour shortages and increase the dynamic energy in the business sector.
The labour market is less flexible than in the other Nordic countries, which makes it harder to add new jobs. The share of people employed in the private service sector is lower in Finland and temporary positions aren’t as common. Creating a more flexible job market also requires changes in wage formation, which for several decades was handled through centralised negotiations between unions, employers and the government. Experience from the overly generous industry-wide wage agreements in 2007/2008 increases the need for better coordination between labour market parties. The lack of coordination has led to more conflicts and strikes, the most recent example being the risk of a strike in the technology industry.

Its dependence on exports, where a few industries account for a significant share of total exports, makes the economy vulnerable. Improving the small business climate and encouraging start-ups would increase domestic competition. There are several barriers, however, especially a rigid labour market, though also competition laws and capital taxation, which probably have to be modernised. At the same time the government has taken few measures to deregulate and privatise state-owned companies.

In Swedbank’s Baltic Sea Index, Finland ranks high among the Baltic Sea countries. The strongest advantage in Finland is especially true in education, where it received the highest ranking for the fourth consecutive year. Foreign trade, governance and innovation also rate highly. The biggest improvements in 2010 were in the labour market and infrastructure. On the other hand, reform efforts to improve the business climate have slipped from a high level. Like the other Nordic countries, there is potential for improvement in terms of taxes.

Jörgen Kennemar
Sweden – companies are preparing for an economic slowdown

| Population: | 9.4 million |
| GDP per capita (PPP) 2010: | USD 38,947 |
| Government: | Centre-liberal market-oriented coalition |
| Prime Minister: | Fredrik Reinfeldt |
| Next parliamentary election: | September, 2014 |
| Average GDP growth in last five years: | 1.5% |
| Average inflation rate in last five years: | 1.6% |
| Average unemployment rate in last five years: | 7.2% |

Summary

- Swedish politics is distinguished by a weak coalition government and an opposition in crisis. This, together with the global slowdown, could slow the pace of reform in the Swedish economy. The fiscal policy space for reforms are limited and the government could have difficulties finding support in the parliament form deeper reforms of the Swedish economy.

- The crisis in the euro zone will affect the Swedish economy as well. Confidence indicators for households and companies have begun to decline, as will consumption and investment. Industry and the retail sector both face a period of slower expansion.

- We expect the Riksbank to put off any rate hikes in 2011 and 2012, and there is enough fiscal leeway to adopt stimulus measures if needed. Compared with our August forecast, we are revising our growth forecast downward to 1.1% and in 2012 compared to 1.8% and in 2013 to 2.2% from 2.3%.

Consequences for businesses

- After a robust recovery the Swedish economy is now slowing quickly in the latter part of 2011 and early 2012. The business climate remains stable, but economic fluctuations are placing greater demands on flexibility. Domestic demand will slacken, and to compete companies have to be able to quickly adapt.

- Business opportunities in Swedish economy will be limited by a slower rate of increase in both internal and external demand. Public infrastructure investment in particular will, however, create some opportunities.

- Swedbank's Baltic Sea Index shows that Sweden continues to rank high among the world's economies, despite a slight decline in 2010. Entrepreneurship and the financial market show improvement, while the tax system weighs down the overall index.
Weak political alternatives slow the pace of reform

The Reinfeldt government has pushed through fairly widespread economic reforms, and in particular has focused on tax cuts on wage income. At the same time it has managed the effects of the most severe global recession since the 1930s. Much of the focus in terms of policy has therefore been on crisis management. The 2010 election weakened the government’s support in parliament, limiting the degree to which it can implement its policies. In particular, it has not yet been able to institute further labour market reforms, has slowed the pace at which state-owned companies are being sold and has delayed further tax cuts.

The fragmented opposition and leadership crisis in the Social Democratic party have furthermore weakened Swedish politics. Without a strong opposition, the debate is less centred on political alternatives, and there is a risk that the reform agenda will lose focus. However, there is still far to go until the next parliamentary election, in 2014, and the governing parties and opposition both have time to develop and build support for new ideas. There is, however, a risk that weak political conditions, coupled with global economic stagnation, will mean a period of slow reform.

An economic slowdown lies ahead

After a strong rebound in 2010 and first half of 2011, confidence indicators now point to a rapid slowdown in growth in Sweden. The crisis in the euro zone and subsequent financial concerns are expected to slow global demand and Swedish exports. Business orders, especially from export markets, are shrinking, because of which companies are now slashing their production rates. In recent months the purchasing managers’ index has fallen and now shows that the rate of expansion in manufacturing is declining. It also means that many investment decisions are being put off, further contributing to the slowing of the economy.

Worries are also spreading to households, who say that their personal finances as well as the Swedish economy have deteriorated since midyear 2011. Purchases of durable goods are likely to decrease at the same time that many households are boosting their savings.

The labour market improvements are also slowing, and job growth is being held back as companies become more cautious about hiring. Add to that the fact that the pace of wage increases is levelling off and that market interest rates won’t reach their previously low levels, we expect disposable income to grow more slowly. This points to lower retail sale developments in late 2011 and 2012.

Although the economy is now entering a calmer phase, Sweden still has the means to address weaker growth. The Riksbank has tightened monetary policy since last year and now, in contrast with many other central banks, has the ability to stimulate the economy if growth is lower than expected. Our forecast, given the slowdown we have
already seen, is that the benchmark interest rate will remain at 2% for the rest of 2011 and through 2012. This marks a downward revision compared with our August forecast. Inflation pressures are not expected necessitate tighter monetary policy. The krona has also been unusually stable compared with previous periods of global turbulence, which is largely due to Sweden's strong finances.

The budget bill presented in September called for cautious fiscal policy in 2012 in light of the current international uncertainty. To some extent this is caused by the government's weak parliamentary support, but it also leaves room for further measures.

As a whole, we expect the Swedish economy to weaken slightly in the next three years compared with our August forecast, but that the risk of a recession is limited. Economic growth is expected to be 1.1% in 2012 and 2.2% in 2013, compared with 1.8% and 2.3% in our August forecast.

Flexibility is increasingly demanded from companies

Business conditions in Sweden are favourable, but major economic fluctuations require companies to be flexible. The economy has been stronger than in many other countries since the financial crisis, but has also seen bigger jolts. This is largely due to Sweden's dependence on exports. As a result, companies have to be able to quickly adjust to new conditions. At the same time public policy has to be designed to assist companies to adapt production and employment to changing demand.

Experience from the financial crisis showed that the labour market was flexible in terms of employment, but also that wage formation worked well. During the subsequent economic rebound, however, shortages rapidly arose in certain professions at the same time that long-term unemployment climbed. The authorities could do more here to facilitate a rapid return to the workplace, although companies also share responsibility to offer skills development and additional training to strengthen their human resources.

The Swedish economy generally offers good opportunities for businesses, although there are still areas where improvements are possible. Infrastructure and the transportation sector have become increasingly capricious, especially during the winter months. This is largely due to neglected maintenance and underinvestment. Energy stoppages have been costly for businesses and households. In its budget, the Swedish government increased allocations for infrastructure and has also established a long-term energy policy, although it is still not totally clear how energy needs will be met in the long term. The latest budget bill also contained a number of proposals for improving business conditions: lower restaurant VAT, simpler tax rules (including the tax on “experts”) and increased deductions for research and development. In addition, more resources are being invested in corporate innovation, tourism and IT infrastructure.

Growth forecasts are being revised downward and a recession can be avoided

Companies in Sweden have to be able to handle major fluctuations

Business conditions are good, but there is still room for improvement
In Swedbank’s Baltic Sea Index, Sweden still belongs among the most competitive economies in the world, despite a slight decline in 2010. Among the Baltic Sea countries, Sweden with a score of 8.6, together with Finland, ranks as the second most competitive economy, following Denmark. It is primarily the labour market index that has been losing ground, although infrastructure is also dragging down the Swedish average. The Swedish economy is otherwise strong in most areas, with the exception of the tax system, where high marginal taxes are a drag on the index. Tax administration, on the other hand, is relatively effective.

*Magnus Alvesson*
Annex

Swedbank Baltic Sea Index - purpose, method, content and sources

The purpose of the Swedbank Baltic Sea Index is to compile and present information in a useful way for companies that are considering expanding abroad. The index is based on several sub-indices that are considered relevant and all the Baltic Sea region countries are ranked compared to a larger sample. Thus, having a rank between 9 and 10 implies that the country is this particular category belongs to the 10 percent “best” countries. The samples vary, but in most cases cover most countries in the world.

Content and Sources of the Swedbank Baltic Sea Index

I. Entrepreneurship
   - Starting a Business
   - Dealing with licenses
   - Ease of registering property
   - Strength of protecting investors
   - Ease of enforcing contracts
   - Ease of closing a business
   Sources: World Bank Doing business

II. Labour market
   - Labour market efficiency
   - Labour productivity
   - Labour force participation rate
   Sources: World Economic Forum and ILO

III. Tax policy
   - Ease of paying taxes
   - Highest rate of personal income tax
   - Corporate tax rates
   Sources: World Bank Doing Business and KPMG

IV. Financial markets
   - Financial market efficiency
   Source: World Economic Forum

V. Foreign trade
   - Enabling trade index
   Source: World Economic Forum

VI. Education
   - Higher education and training
   Source: World Economic Forum

VII. Governance
   - Corruption perception index
   - Rule of law
   - Control of Corruption
   Sources: Transparency International and World Bank

VIII. Infrastructure
   - Quality of overall infrastructure
   - Infrastructure
   Sources: World Economic Forum and World Bank

IX. Innovation climate
   - Innovation Input
   - Innovation Output
   Sources: INSEAD
# Swedbank Baltic Sea Index: Global position and change

## Swedbank Baltic Sea Index

<table>
<thead>
<tr>
<th>Country</th>
<th>Entrepreneurship</th>
<th>Labour Market</th>
<th>Tax Policy</th>
<th>Financial Sector</th>
<th>Foreign trade</th>
<th>Governance</th>
<th>Infrastructure</th>
<th>Innovation climate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>9.5</td>
<td>9.6</td>
<td>8.7</td>
<td>9.2</td>
<td>9.4</td>
<td>9.1</td>
<td>9.8</td>
<td>9.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>8.8</td>
<td>9.0</td>
<td>9.3</td>
<td>9.6</td>
<td>9.5</td>
<td>9.1</td>
<td>9.8</td>
<td>9.5</td>
</tr>
<tr>
<td>Finland</td>
<td>9.6</td>
<td>9.7</td>
<td>9.8</td>
<td>9.9</td>
<td>9.4</td>
<td>9.1</td>
<td>9.8</td>
<td>9.4</td>
</tr>
<tr>
<td>Latvia</td>
<td>9.1</td>
<td>9.2</td>
<td>9.3</td>
<td>9.4</td>
<td>9.5</td>
<td>9.1</td>
<td>9.8</td>
<td>9.3</td>
</tr>
<tr>
<td>Lithuania</td>
<td>8.5</td>
<td>8.6</td>
<td>8.7</td>
<td>8.8</td>
<td>8.9</td>
<td>8.1</td>
<td>8.4</td>
<td>8.6</td>
</tr>
<tr>
<td>Norway</td>
<td>9.7</td>
<td>9.8</td>
<td>9.9</td>
<td>9.9</td>
<td>9.6</td>
<td>9.1</td>
<td>9.8</td>
<td>9.5</td>
</tr>
<tr>
<td>Poland</td>
<td>9.5</td>
<td>9.7</td>
<td>9.8</td>
<td>9.9</td>
<td>9.3</td>
<td>9.1</td>
<td>9.8</td>
<td>9.3</td>
</tr>
<tr>
<td>Russia</td>
<td>5.8</td>
<td>5.9</td>
<td>6.0</td>
<td>6.1</td>
<td>6.2</td>
<td>6.3</td>
<td>6.5</td>
<td>6.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>8.3</td>
<td>8.4</td>
<td>8.5</td>
<td>8.6</td>
<td>8.7</td>
<td>8.8</td>
<td>8.8</td>
<td>8.9</td>
</tr>
</tbody>
</table>

1 A score between 9-10 indicates that the country is within the top decile of the countries surveyed.
Economic Research Department

Sweden

Cecilia Hermansson  +46 8 5859 7720  cecilia.hermansson@swedbank.se
Group Chief Economist
Chief Economist, Sweden

Magnus Alvesson  +46 8 5859 3341  magnus.alvesson@swedbank.se
Senior Economist

Jörgen Kennemar  +46 8 5859 7730  jorgen.kennemar@swedbank.se
Senior Economist

Anna Ibegbulem  +46 8 5859 7740  anna.ibegbulem@swedbank.se
Assistant

Estonia

Annika Paabut  +372 888 5440  annika.paabut@swedbank.ee
Acting Chief Economist

Elina Allikalt  +372 888 1989  elina.allikalt@swedbank.ee
Senior Economist

Madis Aben  +372 613 9035  madis.aben@swedbank.ee
Senior Economist

Latvia

Mārtiņš Kazāks  +371 67 445 859  martins.kazaks@swedbank.lv
Deputy Group Chief Economist
Chief Economist, Latvia

Dainis Stikuts  +371 67 445 844  dainis.stikuts@swedbank.lv
Senior Economist

Lija Strašuna  +371 67 445 875  lija.strasuna@swedbank.lv
Senior Economist

Lithuania

Nerijus Mačiulis  +370 5 258 2237  nerijus.maciuilis@swedbank.lt
Chief Economist, Lithuania

Lina Vrubliauskiene  +370 5 258 2275  lina.vrubliauskiene@swedbank.lt
Senior Economist

Vaiva Šečkutė  +370 5 258 2156  vaiva.seckute@swedbank.lt
Senior Economist
Disclaimer

This research report has been prepared by economists of Swedbank’s Economic Research Department. The Economic Research Department consists of research units in Estonia, Latvia, Lithuania and Sweden, is independent of other departments of Swedbank AB (publ) (“Swedbank”) and responsible for preparing reports on global and home market economic developments. The activities of this research department differ from the activities of other departments of Swedbank and therefore the opinions expressed in the reports are independent from interests and opinions that might be expressed by other employees of Swedbank.

This report is based on information available to the public, which is deemed to be reliable, and reflects the economists’ personal and professional opinions of such information. It reflects the economists’ best understanding of the information at the moment the research was prepared and due to change of circumstances such understanding might change accordingly.

This report has been prepared pursuant to the best skills of the economists and with respect to their best knowledge this report is correct and accurate, however neither Swedbank or any enterprise belonging to Swedbank or Swedbanks directors, officers or other employees or affiliates shall be liable for any loss or damage, direct or indirect, based on any flaws or faults within this report.

Enterprises belonging to Swedbank might have holdings in the enterprises mentioned in this report and provide financial services (issue loans, among others) to them. Aforementioned circumstances might influence the economic activities of such companies and the prices of securities issued by them.

The research presented to you is of informative nature. This report should in no way be interpreted as a promise or confirmation of Swedbank or any of its directors, officers or employees that the events described in the report shall take place or that the forecasts turn out to be accurate. This report is not a recommendation to invest into securities or in any other way enter into any financial transactions based on the report. Swedbank and its directors, officers or employees shall not be liable for any loss that you may suffer as a result of relying on this report.

We stress that forecasting the developments of the economic environment is somewhat speculative of nature and the real situation might turn out different from what this report presumes.

IF YOU DECIDE TO OPERATE ON THE BASIS OF THIS REPORT THEN YOU ACT SOLELY ON YOUR OWN RISK AND ARE OBLIGED TO VERIFY AND ESTIMATE THE ECONOMIC REASONABILITY AND THE RISKS OF SUCH ACTION INDEPENDENTLY.