Close-by crisis raises reform pressures in the Baltic Sea Region

- The Baltic Sea region will be affected by the weaker economy and crisis in the euro zone, and GDP growth rates will increase by a modest 2.2% this year, 2.4% next year before a somewhat stronger global growth yields 2.9% in 2014.

- Our structural index – the Swedbank Baltic Sea Index – has improved from 7.0 to 7.1. Overall, the region is ranked among the 30% most competitive economies in the world. Tax systems and entrepreneurship are, however, weak, and need further reforms.

- The business cycle in Germany has shifted down and GDP is expected to grow by about only 1% this and next year. Unemployment is so far unchanged, but we expect an increase, which together with the euro zone crisis, will affect the elections to the Bundestag next year.

- Poland has so far fared relatively well, but the economy is now slowing down. In addition to a weaker external demand, a necessary budget consolidation will dampen GDP growth to about 2.5% this and next year.

- The Baltic economies still remain in a recovery phase, and although export prospects are weakening, domestic demand is picking up. GDP growth will slow down to 2.5% – 4.0% in 2012, before increasing to 3.5% – 5.5% in 2013 and 2014. Despite impressive reforms so far, further efforts are now required to raise the value added and meet growing competitiveness pressures.

- The political developments in both Russia and Ukraine are taking steps backward, and the business sectors are plagued by growing corruption and the erosion of the rule of law. The efforts to reform the economies have weakened, but following the elections there are opportunities for new initiatives. GDP growth is forecast at 4% for both countries, which is significantly below potential and what is needed to reduce imbalances.

- Public finances in Finland are strong, but reforms will be necessary to usher in a structural transformation of the private sector. Fiscal policy in Denmark supports domestic demand when export performance falters. In Norway, large investments in the petroleum sector and increasing private consumption drive growth, while at the same time imbalances in the economy are growing.

- Swedish GDP growth is falling back during the autumn as export demand weakens, before increasing to 1.7% in 2013 and 2.4% in 2014. Large increases in public investments and raised budget appropriations to research and innovation aim at strengthening the long-term growth potential. The main challenge in the short term is to protect competitiveness in the Swedish economy vis-à-vis the rest of the world.
Contents

Economic Indicators 3
The Baltic Sea region faces stiff competition 4
Poland – no longer immune to the world’s ills 13
Estonia – slower growth founded on domestic demand 17
Latvia – keep improving competitiveness 21
Lithuania – temporary lower growth and continued reforms 25
Russia – freer trade, but reform needs remain great 29
Ukraine – farther from fulfilling its potential 33
Germany – downshifting, but not in reverse 37
Denmark – a shaky recovery 41
Norway – strong growth but imbalances are increasing 45
Finland – weak growth and competitiveness 49
Sweden – companies brace for a weaker global economy 53
Annex: Content, sources and developments of the Baltic Sea Index 57
Economic conditions around the Baltic Sea ¹)

October 2012

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>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Poland</td>
<td>4.3</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>8.3</td>
<td>2.6</td>
<td>3.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.5</td>
<td>4.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5.9</td>
<td>3.3</td>
<td>4.1</td>
</tr>
<tr>
<td>Russia</td>
<td>4.3</td>
<td>3.8</td>
<td>3.9</td>
</tr>
<tr>
<td>Ukraine</td>
<td>4.1</td>
<td>2.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Germany</td>
<td>3.0</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.8</td>
<td>0.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Norway</td>
<td>1.4</td>
<td>3.8</td>
<td>2.2</td>
</tr>
<tr>
<td>Finland</td>
<td>2.7</td>
<td>0.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.9</td>
<td>0.8</td>
<td>1.7</td>
</tr>
</tbody>
</table>

GDP for Baltic Sea countries in total ³)

<table>
<thead>
<tr>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.6</td>
<td>2.2 (2,6)</td>
<td>2.4 (2,9)</td>
<td>2.9</td>
</tr>
</tbody>
</table>

---

1. The report also covers Norway and Ukraine.
2. Not calendar-adjusted.
3. Percentage increase using 2010 GDP weights (PPP). The figure from the October 2011 forecast is in parentheses.

Sources: National statistics and Swedbank’s own calculations.
The Baltic Sea region faces stiff competition

The shared history of the Baltic Sea and its neighbouring countries is the source of the region’s identity. The fall of the Berlin Wall has been followed by nearly 20 years of strong interest among businesses and politicians in regaining the economic ground lost since World War II. Trade and investment between the countries has grown substantially. During the global recession and financial crisis in 2008-2009 activity slowed.

There is still considerable networking between players in the region. Geographical and cultural proximity, specialisation, sourcing and work-sharing have contributed to greater interaction. At the same time new challenges are arising as the economic climate again cools.

One concern is the declining interest in foreign investment, which also makes it harder for a region such as this one to attract new capital and ideas. The lingering problems in developed economies around the world with huge public debts and weak banks are affecting the willingness to invest and take risk.

The crisis in the euro zone is an especially dark cloud hanging over the Baltic Sea region. Our new GDP forecast for the region suggests a slowdown after two relatively good years of recovery. The likelihood of weak growth in nearby markets for several years to come is the biggest challenge and will require many companies to make a number of important decisions. An environment with credit austerity (but low lending rates), rising taxes and shrinking welfare budgets in several countries could necessitate a change in business models.

In addition to the euro zone’s crisis, which is slowing growth and could shrink the potential market for regional companies, there has been difficulty maintaining the EU’s development work – e.g., further developing the inner market. It is also important to find the resources to invest in infrastructure in the Baltic Sea region, where air, sea and land transportation are all in need of significant improvement.

We also suspect that the crisis in the Baltic countries has affected expansion decisions by the region’s companies. The period of rapidly rising wages before the bubble burst is still fresh in their memories, as is the belief that many reforms have not yet been realised. It is essential that these three countries remain committed to reform, and also that they communicate their achievements and make it better known that production conditions have stabilised in order to attract businesses.

Global competition is steadily growing as hungry new players enter the market and produce improved efficiencies and quality. In this report we discuss economic conditions in the region, but with an emphasis on structural and institutional conditions and how they affect the region’s competitive strength.
Global outlook: Long period of low growth ahead

Compared with our global forecast published in August, we have not made any major revisions. We still see a muddling-through scenario, where the crisis is addressed in the euro zone and the US, but not completely and “at the last minute,” which will affect growth prospects. Since August the biggest changes have been due to revised data from the various countries. Central bank actions were largely known in advance or expected and have therefore led to only a few minor upward revisions. Global GDP growth for 2012 and 2013 is expected to be the same as in August, while growth for 2014 has been revised upward by 0.1 percentage point to 3.5%.

<table>
<thead>
<tr>
<th>Global GDP growth (annual change, %)</th>
<th>October Forecast</th>
<th>August Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.8 2.1 1.8 2.4 2.1 1.7 2.3</td>
<td></td>
</tr>
<tr>
<td>Euro zone:</td>
<td>1.5 -0.5 0.1 0.8 -0.5 0.1 0.8</td>
<td></td>
</tr>
<tr>
<td>of which:</td>
<td>3.0 0.9 1.0 1.6 1.1 1.1 1.6</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.7 0.2 0.5 1.1 0.3 0.5 1.1</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>0.4 -2.2 -1.0 0.2 -2.2 -1.0 0.2</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>0.7 -2.0 -1.2 0.3 -2.0 -1.2 0.3</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>2.7 0.5 1.2 2.0 0.7 1.1 1.8</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>0.7 0.0 1.0 1.7 0.2 1.0 1.7</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>0.8 0.2 1.1 1.3 0.8 1.2 1.5</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>1.4 3.8 2.0 2.3 3.3 2.0 2.5</td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>-0.7 2.2 1.3 1.2 2.2 1.3 1.2</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>9.2 7.9 7.8 7.6 7.9 7.8 7.6</td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>7.2 6.2 6.5 6.8 6.2 6.5 6.8</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>2.7 2.0 3.9 4.1 2.0 3.9 4.1</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>4.3 3.8 3.9 4.3 3.8 3.9 4.3</td>
<td></td>
</tr>
<tr>
<td>Global GDP in PPP</td>
<td>3.5 3.0 3.1 3.5 3.0 3.1 3.4</td>
<td></td>
</tr>
<tr>
<td>Global GDP in US dollars</td>
<td>2.6 2.2 2.3 2.7 2.2 2.3 2.7</td>
<td></td>
</tr>
</tbody>
</table>

We had predicted back in August that the Federal Reserve would buy mortgage bonds, but it now expects to buy a lot more of them since it hasn’t set a time limit. The bond purchases will continue until unemployment begins to decline, probably to below 7%, which could take several years in our estimate. It is now been announced that the repo rate will remain unchanged until mid-2015.

As long as an agreement isn’t reached on US fiscal policy, uncertainty will stifle investment and new hiring by small and medium-sized businesses. Households may loosen their wallets slightly as increased liquidity pushes asset prices higher and reduces the incentive to save. We are revising quarterly growth upward by a tenth of one percent through the end of 2012, raising the annual growth rate from 1.7% to 1.8% in 2013 and from 2.3% to 2.4% in 2014.
German GDP numbers have retroactively been revised slightly, due to which our forecast for this year has been reduced from 1.1% to 0.9%. Our August forecast had already included the ECB’s bond purchases, and although the details became somewhat clearer on September 6, the impact on growth is not expected to be enough to motivate an upward revision. Although the measures created a more positive sentiment in the financial market, it is too early for a turnaround in confidence. Instead we are slightly less optimistic about growth in France and the UK this year. The Nordic growth numbers are discussed in more detail in the section on each country, and the same applies to Russia. Our oil price forecast is unchanged from August at USD 110 a barrel this year. Slightly higher oil prices are expected to be offset by increased supplies from Saudi Arabia.

After two good years the Baltic Sea region’s growth is slowing

In our last Baltic Sea Region Report (October 2011), we forecast regional GDP growth for the year of 3.6%, slowing to 2.6% in 2012 before rising to 2.9% in 2013. And in fact 2011 (like 2010) produced a decent recovery with growth of 3.6%.

It is mainly because of the slowdown in European export markets that the Baltic region is now performing worse in 2012 than we forecast last year, and will continue to do so in 2013. The possibility of a recession in the neighbouring area is hurting investment and export opportunities. Growth is also expected to slow in the US and emerging economies such as China and India.

In our current report, GDP growth in the Baltic Sea region is expected to slow to 2.2% in 2012 before strengthening marginally to 2.4% in 2013 and a little more significantly to 2.9% in 2014. Of course this is still mediocre compared with the period before the crisis, but on the other hand a growth rate of around 6% wasn’t sustainable either. A reasonable level of regional growth is about 4% a year.
All the countries in the Baltic Sea region share an openness and vulnerability to global turbulence with respect to trade and investment on the one hand and to the financial and commodity markets on the other.

We expect the Baltic countries to experience a slowdown this year, but not as severely as the Nordic countries. The recovery since the financial and real estate crises is helping to sustain growth. Conditions improved dramatically in 2011. Growth returned, unemployment fell from high levels, budget consolidation produced results and competitiveness was improved. The creditworthiness of the three Baltic countries was upgraded, and the cost investors have to pay to insure against a default is low today, especially compared with Hungary and Spain (and to a greater extent Ukraine, which isn't shown in the diagram below). The reform work in the Baltic countries has paid off and shows that even countries with fixed exchange rates can bounce back after a severe crisis.

Poland, Russia and Ukraine have grown annually by about 4% in the last two years, and the latter two countries expect little change going forward since they are dependent on commodity prices, which remain high. For Poland, on the other hand, the slowdown will be significant. Households, the growth engine of its economy, are holding back as real wages fall or stabilise. The budget consolidation is also contributing to a slower growth rate. We do not expect a dramatic decline, however, even if the risks are on the downside.

The Nordic region and Germany, with the exception of Norway, will see growth of between 0.2% and 1% this year and slightly over 1% next year. Households in these are export- and investment-heavy economies are becoming fairly cautious. The situation is significantly better than for the crisis countries, however, which have to slash spending, although the finance ministers in Germany and the Nordic region are expected to remain fairly cautious and some austerity will be required in Denmark and Finland.

The reforms in the Baltic countries have paid off!

Poland’s growth engine – households – is slipping slightly

Not the same need for austerity in Germany and the Nordic countries as in the euro zone
Beware of complacency

For the Baltic Sea region’s governments, municipalities and workers, competition for foreign direct investment is tightening. While some regional companies are repatriating their operations from emerging markets in Asia and Latin America, investment is still clearly seeking out markets with the fastest growth – and that doesn’t include the Baltic Sea region, where the population is shrinking. According to the EU commission and the UNFPA, the Baltic Sea Region will lose some 20% of its population during the next four decades. It is difficult to make long term projections, but it is likely that there will some reduction even if will not be that large.

Net inflow of foreign direct investment (FDI) 2011, USD billion, and % of GDP

| 1. US    | 226.9  | 1,50  | 9. Russia     | 52.9  | 2,87 | 74. Latvia | 1.61  | 5.53 |
| 2. China | 124.0  | 1.76  | 13. Germany   | 40.4  | 1.13 | 83. Lithuania | 1.2   | 2.85 |
| 3. Belgium| 89.1  | 17.3  | 24. Poland    | 15.1  | 2.95 | 135. Estonia | 0.3   | 1.16 |
| 4. Hongkong| 83.2 | 34.13 | 25. Denmark  | 14.8  | 4.47 | 167. Finland | 0.05  | 0.02 |
| 5. Brazil | 66.7  | 2.76  | 30. Sweden    | 12.1  | 2.26 |                            |
| 6. Singapore| 64.0 | 25.15 | 41. Ukraine  | 7.2   | 4.37 |                            |
| 7. United Kingdom| 53.9 | 2.24 | 51. Norway    | 3.6   | 0.75 |                            |

Source: UNCTAD.

One year of data of foreign direct investment (FDI) provide no more than a snapshot. Of the world’s total FDI of USD 1.5 trillion, the Baltic Sea region (net after deducting outflows of similar investments) last year received nearly USD 150 billion, or about 10%. This compares well with the region’s share of global GDP of slightly more than 10%. In relation to the region’s GDP, the share was slightly below 2%. In relation to their populations and GDP, Russia, Poland and Ukraine would seem to warrant a larger volume of foreign direct investment. In other words, there is great growth potential in the region.

Which issues should regional countries focus on to improve their opportunities for direct investment, which in turn would raise productivity growth and increase growth potential?

- Resist reform weariness at home and in relation to the EU – and realise that the region’s favourable position today vis-à-vis the crisis countries in southern Europe will not last. Growing competition is instead coming from emerging markets outside Europe and must be addressed.

- Take labour shortages seriously despite high unemployment, since it arises due to difficulties finding skilled workers. Long-term unemployment is a growing problem that could lead to structural unemployment. Cooperation between businesses, educators and national and municipal governments is essential, as is increased investment in education, including vocational training.

- Adopt a long-term approach with a smorgasbord of measures to address the region’s weakening demographics, which are already contributing to an increased labour shortage (primarily in the Baltic countries and Russia). This smorgasbord includes
creating a dynamic business sector and better work-life balance and opening up to immigration.

Direct actions to counter an erosion of competitive advantages due to cost increases stemming, for example, from real currency appreciation and a faster increase in real wages than productivity. These actions could involve building out infrastructure to expand labour market regions, investing in collaborations between education and research, and adopting laws that improve the efficiency of labour markets.

### Average monthly wages, 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Euro/month</th>
<th>% of EU-27</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>237</td>
<td>8,3%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>472</td>
<td>16,6%</td>
</tr>
<tr>
<td>Russia</td>
<td>576</td>
<td>20,2%</td>
</tr>
<tr>
<td>Romania</td>
<td>647</td>
<td>22,7%</td>
</tr>
<tr>
<td>Latvia</td>
<td>815</td>
<td>28,6%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>819</td>
<td>28,8%</td>
</tr>
<tr>
<td>Poland</td>
<td>922</td>
<td>32,4%</td>
</tr>
<tr>
<td>Hungary</td>
<td>1019</td>
<td>35,8%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>1169</td>
<td>41,1%</td>
</tr>
<tr>
<td>Estonia</td>
<td>1177</td>
<td>41,3%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1326</td>
<td>46,6%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2063</td>
<td>72,5%</td>
</tr>
<tr>
<td><strong>EU-27</strong></td>
<td><strong>2847</strong></td>
<td><strong>100,0%</strong></td>
</tr>
</tbody>
</table>

Sources: Vienna Institute for International Economic Studies (wiiw)

### Real effective exchange rates, index 2004 = 100

Average monthly wages in Eastern and Central Europe are still low compared with the EU as a whole, and thus significantly lower than in the Nordic countries and Germany. Labour productivity is also lower, however, and it is important that they rise in pace in order to avoid imbalances. The financial crisis in 2008-2009, as well as the current crisis in the euro zone, has increased awareness of this.
Respond to an overheated real estate market and rapid debt build-up in the household sector, problems that mainly apply to the Nordic countries and could create growth and stability problems in the future. This is partly a question of creating a well-functioning housing market and construction sector through various types of deregulation and a refocusing of subsidies, and is partly about finding a better balance between taxation and subsidies of household debt and assets.

Major steps have to be taken to reduce the problems of tax evasion, corruption, bureaucracy, weak financing and other issues that are stymieing entrepreneurs and businesses (especially in Russia and Ukraine, but also in the Baltic countries and Poland).

There is currently a debate under way in China on how the economy can extract itself from the so-called middle income trap and transition from exports to domestic demand in order to stimulate growth. This process will take time and is likely to be anything but straightforward.

The Baltic countries, Russia and Poland (not yet Ukraine) have higher per capita incomes than China, but it is still important to consider which growth model will work best going forward. Countries with relatively large populations such as Russia and Poland are able to rely more on domestic demand, while the Baltic countries will remain small, open economies with a strong emphasis on exports.

After a period during which the growth model in the Baltic countries was focused on production of low-cost industrial goods, often as a supplier to large corporations in the Baltic Sea region, more research and innovation are probably needed to maintain these positions and at the same time shift the business sector more toward higher value services (already evident in Estonia) and higher value-added industrial goods. The Baltic countries’ geographical proximity to Belarus, Russia, Ukraine and other countries in the former Soviet Union probably hasn’t been sufficiently utilised and offers further growth potential.

Baltic Sea Index indicates the need for reform

Since 2010 we have published an index of the Baltic Sea region’s competitiveness and structural development, which we call the Baltic Sea Index. The eleven countries are ranked in relation to each other and to the rest of the world. We have selected ten areas as a basis for the overall index. Each category consists of several underlying components. The list is not complete, but should serve as a good indicator of progress in the business climate in relation to other countries.
The Baltic Sea Index – ranking compared with the rest of the world
(10 highest ranking, 0 lowest)


Note that even if every country in the world improves and the Baltic Sea region countries grow at the same pace, our index will not change, since it measures comparative progress. Moreover, the index is slow to react, which is evident not least in the average for the region as a whole. The Baltic Sea Index has risen from 7.0 to 7.1 in the last four years. The changes between countries provide an indication of whether they have improved or slid backward.

In summary, Finland is ranked highest, followed by the other Nordic countries, Germany and Estonia. Considering that Finland is now struggling in the face of Nokia’s competitive problems and a current account balance that in a relatively short time has gone from a large surplus to a deficit, it will be interesting to see whether this affects the index in coming years.

Just below average we find Latvia and Lithuania, followed by Poland. Russia and Ukraine are in the biggest need of structural reform. We showed the same picture in our previous report, but the ranking between the Nordic countries has changed and Germany has again passed Estonia. Since last year (and even compared with three years ago) Finland, Germany, Russia, Poland and Ukraine have climbed in the ranking, while the other countries have dropped slightly.

The Baltic Sea region is doing relatively well with an average of 7.1, but with big differences between countries. While the Nordic countries and Germany ranked among the world’s 12% most competitive and structurally sound countries, Russia and Ukraine are among the world’s 40% lowest ranking countries in this respect. Estonia exceeds the regional average, while Latvia, Lithuania and Poland fall slightly below.

The region ranks among the world’s 30% most competitive – no change in recent years
Finland on top – Ukraine on the bottom

Differences are great within the Baltic Sea region
If we look at the ten categories in the index, we can see that the Baltic Sea region’s strengths are in education (8.3) and innovation (8.2). Finland, for example, ranks among the top countries in the world in terms of education, and Sweden is nearly there in innovation. Poland, Russia, Ukraine and the Baltic countries have to invest more in research to rise from relatively low levels.

The Baltic Sea Index – ranking compared with the rest of the world (10 highest ranking, 0 lowest) with mean values and range between lowest and highest

<table>
<thead>
<tr>
<th>Rank</th>
<th>Category</th>
<th>Value</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Entrepreneurship</td>
<td>6.7</td>
<td>(3.3 – 8.2)</td>
</tr>
<tr>
<td>2</td>
<td>Labour market</td>
<td>7.1</td>
<td>(4.1 – 8.9)</td>
</tr>
<tr>
<td>3</td>
<td>Tax policy</td>
<td>5.8</td>
<td>(0.7 – 8.0)</td>
</tr>
<tr>
<td>4</td>
<td>Financial market</td>
<td>5.9</td>
<td>(1.3 – 9.5)</td>
</tr>
<tr>
<td>5</td>
<td>Foreign trade</td>
<td>7.2</td>
<td>(1.5 – 9.8)</td>
</tr>
<tr>
<td>6</td>
<td>Education</td>
<td>8.3</td>
<td>(6.4 – 10.0)</td>
</tr>
<tr>
<td>7</td>
<td>Governance</td>
<td>7.5</td>
<td>(2.0 – 9.9)</td>
</tr>
<tr>
<td>8</td>
<td>Infrastructure</td>
<td>7.2</td>
<td>(3.3 – 9.7)</td>
</tr>
<tr>
<td>9</td>
<td>Logistics</td>
<td>7.4</td>
<td>(5.0 – 9.7)</td>
</tr>
<tr>
<td>10</td>
<td>Innovation</td>
<td>8.2</td>
<td>(5.6 – 9.9)</td>
</tr>
</tbody>
</table>

The countries in the Baltic Sea region have a weak position with regard to taxes (5.8) and the financial sector (5.9). Strengthening entrepreneurship (6.6) would also seem to be necessary. Ukraine, Russia and Poland are hurting the average in every area, but especially in the financial sector and tax policy. In terms of the latter, the Nordic region and Germany also bring down the region, since their highest numbers are unusually low (below 8.0). Ukraine and Russia are the main reason why the region underperforms in governance and foreign trade, two areas that other countries handle well or very well.

Attracting foreign investment to a region where the population is shrinking and markets are stagnating or declining over time requires a greater commitment to cutting-edge competence. The labour force today is fairly well-educated and the wage structure is favourable relative to productivity. More has to be done here, and the region’s potential for work-sharing and specialisation could probably be better tapped.

In the long run it will be profitable to climb upward in the ranking, which should translate into better opportunities to attract start-ups, know-how, new ideas and capital – something every country and region is striving for at a time of stiffening competition.

Cecilia Hermansson
Poland – no longer immune to the world’s ills

<table>
<thead>
<tr>
<th>Population:</th>
<th>38.2 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (PPP) 2011:</td>
<td>USD 21 281</td>
</tr>
<tr>
<td>Government:</td>
<td>Liberal conservative</td>
</tr>
<tr>
<td>Prime Minister:</td>
<td>Donald Tusk</td>
</tr>
<tr>
<td>President:</td>
<td>Bronisław Komorowski</td>
</tr>
<tr>
<td>Next parliamentary election:</td>
<td>2015</td>
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<td>Next presidential election:</td>
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<tr>
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<td>Average unemployment in last five years:</td>
<td>8.8%</td>
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Summary

- In contrast with other countries in the EU, Poland continues to grow at a decent rate, but with slightly weaker growth of around 2.5% expected in 2012 and 2013, compared with 4.3% last year. Not until 2014 do we expect growth of nearly 3.5%.

- We anticipate a budget tightening, which is also the biggest domestic risk for the Polish economy. However, there is room for rate cuts when inflation nears the target next year.

Consequences for businesses

- Poland’s relatively strong development is benefitting the region’s exporters, despite that the economy is slowing. In the next two years we don’t expect Polish households to keep spending at the same pace, but the situation should improve when concerns about the budget consolidation process and crisis in the euro zone have subsided.

- Poland as a supplier: Cost increases in recent years are in line with the EU. The average monthly salary of 922 euros is still about one third of the EU average and is higher than in Latvia and Lithuania, but lower than in Estonia.

- Companies that export and even outsource production to Poland should also keep a close eye on exchange rates, not to mention the government’s EMU targets, which have now been delayed due to uncertainty about the currency union’s future.

- A Baltic Sea Index rating of 6.2 shows that Poland has a long way to go to improve its institutions, which is crucial to its long-term growth potential. EU accession has already led to regulatory improvements, but that is also true of other countries in Eastern and Central Europe. The biggest room for improvement is in tax policy and entrepreneurship.

- Poland also lags far behind in terms of innovation. Most manufacturing is “low tech” or “mid tech”, and companies account for only about one third of R&D expenditure, compared with around 70% in Sweden.
Euro zone’s slowdown is catching up to Poland

The Polish economy continued to strengthen during the global recession of 2008-2009, but activity is now slowing. During the second quarter GDP grew by 2.4% at an annual rate, against 3.5% in the first quarter and 4.3% last year. We anticipate GDP growth of 2.4% this year, followed by 2.6% in 2013 and 3.5% in 2014, when global growth increases.

There are several reasons for the slowdown this year, which we expect will be accentuated in coming quarters.

1) The country’s export industry has been strongly affected by the slowdown in German industry, and the crisis in the euro zone is impacting retailers and the financial sector. A weaker zloty against the euro is providing some help, but the decline is just as much due to slumping order bookings.

2) Investment growth has slowed following the infrastructure spending for the European football championship held last summer in Poland and Ukraine. Euro 2012 has accounted for a total of 6% of GDP in the last five years, as well as increased employment. Now a hangover is expected. The construction industry in particular is slowing. Lower order bookings now that public sector demand has dried up are creating more bankruptcies among small and medium-sized businesses.

3) Households have been an important growth engine to date, but are beginning to hold back slightly. Still, retail sales increased by nearly 7% at an annual rate this summer. Expectations that Euro 2012 would have even more of a positive effect on retail sales came to naught. Now real wages have also weakened at the same time that tighter lending and economic policies are reducing demand. Retailers will be affected more and more by slumping confidence, slightly higher unemployment and a greater need by households to adjust their balance sheets.

Unemployment in Poland has officially fluctuated around 12-13% of late and will now rise slightly. Note that employment has stagnated compared with a year ago, when it rose by 3.3%. This is a significant decline that could mean shrinking employment.

Weaker economy is having political consequences

An increasingly difficult economic situation with weaker demand and higher unemployment is spreading like rings in the political water. Although opinion polls show the government coalition (mainly the governing party, PO) gaining support over the opposition, led by Law and Justice (PiS), confidence in Prime Minister Donald Tusk has diminished. Reforms, weaker growth and even the bankruptcy of the airline OLT, which many investors put their money in and the Prime Minister’s son worked for, have probably affected support for the Prime Minister (who warned his son but not investors in the company).
After the election last year in which the sitting prime minister was re-elected (a unique event in Poland), the governing coalition launched a series of reforms, not all of which Poles have appreciated. This is especially true of the pension reform, where the pension age will gradually be raised to 67 in coming decades. The opposition intends to tear up this reform if they gain power after the next election in 2015. Critics also point to insufficient spending on social development, the labour market and welfare, especially in rural areas, where many opposition voters live. Despite criticism from the opposition and the public, it appears that the coalition will hold onto power until the next election.

Economic policy – push and pull

One of the government's messages is the need for budget consolidation. During the crisis years the budget deficit rose, reaching 7.9% of GDP in 2010. Although it shrunk as a share of GDP to 5.1% last year, the deficit must be reduced to 3% to meet the EU’s target if Poland is going to continue to receive support from the EU, which in recent years has added about 1 percentage point a year to its GDP. The government has therefore remained committed to its fiscal targets, and in fact has as its goal to reduce the deficit to 1% of GDP by 2015. This would help Poland to trim its debt from about 55% of GDP today.

When the economy weakens, it becomes harder to reduce the deficit, however, since spending has to be cut and taxes raised. The opposition feels that the government should be more cautious. While the targets remain firm thus far, there is an opening for slower consolidation if the economy worsens.

Tighter fiscal policy is increasing the need for support from monetary policy. In the last year inflation has exceeded the central bank's target of 2.5%. During that time the weaker zloty, rising commodity prices, relatively strong demand and a decent job market have enabled companies to raise their prices faster. Inflation measured in terms of the CPI reached 4.6% last year, but came down to 4.3% in June. To counteract accelerating inflation, the benchmark interest rate has gradually been raised from 3.5% at the end of 2011 to 4.75% as recently as May. There are already signs of a rate cut, though it is likely that the central bank will wait until inflation is closer to its target, which means that a period of cuts won’t begin until the end of this year or early 2013.

The health of the banking sector has gradually improved since 2009 and just last year profits rose by nearly 40%. Risks are now increasing, however, since 70% of bank assets are owned by foreign banks and there is a relatively strong dependence on short-term financing. Given fairly good GDP growth, decent capital adequacy and high earnings growth to date, we still consider Poland an important banking market. Risks also include falling real estate prices, bankruptcies in the construction sector, household debt in foreign currency (many Poles have loans in Swiss franc, but rate cuts by the Swiss have helped and bad loans aren’t any more prevalent among households with these loans). One result nonetheless is that lending growth is
slowing, which is contributing to lower demand from households and businesses. In the longer term lending will increase faster in Poland than in the euro zone, for example, since household debt corresponds to just over 35% of GDP, compared with nearly 70% in the euro zone.

An important part of the economic policy is what Poland does about EMU membership. Finance Minister Jacek Rostowski has expressed his support for accession, but not until the euro zone is considered safe. Public support for membership has decreased, but would probably rise if the crisis in the euro zone were handled better. Poland continues to introduce reforms to enable it to participate in the currency union, e.g., budget consolidation, but it is difficult to set a date for accession since the country's decision is dependent on the euro zone's crisis.

Reforms needed to increase value added

Poland ranks below the average in the Baltic Sea Index at 6.2, ahead of only Russia and Ukraine. There has been a slight improvement compared with four years ago, however, when its rating was 5.6. The biggest areas in need of reform are taxes and entrepreneurship (starting and running a business, managing the legal system). The labour market also has great room for improvement. For example, there are problems with a simultaneous labour shortage and unemployment, which requires further training and a better match between skills and needs. Logistics and education are otherwise the areas where Poland ranks best. Note, however, that the education rating has fallen in recent years.

Poland has to climb the value-added chain. This makes it more important to invest in R&D and increase the number of patents. A slight improvement is evident, but investments are still below 1% of GDP annually, too little to create the dynamism needed to attract new ideas, foreign direct investment and skilled labour.
Estonia – slower growth founded on domestic demand

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<tr>
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<td>USD 20,380</td>
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<td>Government:</td>
<td>Right-wing liberal and conservative coalition</td>
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<td>Prime Minister:</td>
<td>Andrus Ansip</td>
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<td>President:</td>
<td>Toomas Hendrik Ilves</td>
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<td>Next presidential election:</td>
<td>2016</td>
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<td>Next parliament election:</td>
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<td>Average GDP-growth in last five years:</td>
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</tr>
<tr>
<td>Average unemployment rate in last five years:</td>
<td>10.7%</td>
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</tbody>
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**Summary**

- Economic growth will slow from last year’s 8.3% to 2.6% this year. The foundation of growth is shifting from exports to domestic demand. The improving external outlook will accelerate growth to 3.7% in 2013 and 4.3% in 2014. Private consumption, which is still below the pre-crisis levels, will show stable 3-4% growth rates throughout the forecasting period.

- In a politically stable environment, the government is aiming for a balanced budget and is gradually shifting the tax burden from direct towards indirect taxes. Although the commitments related to managing the euro area crisis will increase the public debt level, it remains the lowest in the EU.

- Estonia ranks relatively high on our Baltic Sea index (BSI) – at 7.4, just behind Germany – with its biggest improvements in the labour market and the innovation climate.

**Consequences for companies**

- Domestic demand recovery has largely been based upon investment activity driven by state projects, while the private sector has been more cautious. In the unstable external environment, companies have preferred a “wait-and-see” strategy and are keeping their inventory levels lean. Nevertheless, along with the rising capacity utilisation rate in the manufacturing sector, corporate sector investments are expected to pick up more in coming years. Corporate borrowing already showed increasing activity this summer, when corporate loan stock stopped shrinking.

- Real wage growth turned positive in the second half of 2011. This has been pushed up by the sectors where the availability of qualified labour is scarcest. Labour cost growth, which has started to exceed productivity gains, highlights the risks related to the growing structural mismatch in the labour market. The recent improvement in domestic labour mobility offers only limited relief in an environment of declining population – preliminary results from the
2011 census indicate that the population in Estonia has fallen by 5.5% since 2000.

- The innovation climate has been improving considerably in recent years, as has companies' readiness to take advantage of it – expenditures on R&D in the business sector have doubled in the last five years. Innovation awareness has deepened public sector involvement, providing research facilities and solutions, while smaller private sector initiatives are increasingly popular as well.

Political stability amidst euro area crisis

The current coalition has been in place since 2007. The incumbent Prime Minister Andrus Ansip’s right-wing/liberal Reform Party won the parliamentary elections in the spring of 2011, and it chose to continue to run the government with its coalition partner, the conservative Pro Patria and Res Publica Union. The opinion polls have been fluctuating this year – although the coalition has often been less popular than the opposition, the Reform Party has remained the most popular party, with support near the levels seen after the elections.

Tax policies have been rather stable. The tax burden increased during the crisis years, but the government is committed to reducing it. The coalition aims to increase indirect taxes (excise and environmental taxes) and lower direct taxes (the unemployment insurance tax in 2013 and the income tax in 2015). To facilitate the creation of high-qualification jobs, a ceiling on social security contributions for monthly incomes over EUR 4,000 (about four-five times the average salary) is planned for 2014; the impact of this on the labour market is considered to be limited.

Several one-off reasons will cause the budget deficit to increase this year, but surpluses are expected to resume in 2014. Expenditures have been kept under control so far. However, increasing public sector wage pressure, especially during the sensitive pre-election period, could become a risk. Public sector wage increases have also been the main reason for recent small-scale strikes (e.g., of teachers), and others can be expected going forward (e.g., of nurses).

Estonia has a very low public sector debt level (6.1% of GDP in 2011). Due to its obligations to the euro area crisis management mechanisms (EFSF and ESM), this will almost double in coming years. Estonia's involvement in these programmes has caused some public disapproval. However, the government justifies its participation as a commitment of solidarity and argues that, as a small, open economy, Estonia can only gain from a faster solution of the euro area crisis.

Domestic demand takes over as growth engine

The recovery after the crisis was driven by exports. However, along with the recent deterioration in external demand conditions, output growth in the export-dependent manufacturing sector has become slightly negative (-1.5% year on year from January to July). Considering the strong performance during 2010-2011 (over 20% growth), this can be considered as a relatively modest standstill. Also, several
smaller sectors are growing at a healthy pace (e.g., metals, wood products, and food products).

Domestic demand started to recover more strongly at the end of last year and is now the main driver of growth. This has been based on strong investment activity (23% growth in the first half of the year) due to a heavy concentration of public sector projects this year. As a result, investment growth will slow next year and become more dependent on the private sector, where investments in machinery and equipment have already started to recover.

Private consumption growth slowed in the first half of this year, but we expect stable growth going forward, supported by favourable developments in the labour market. The persistently high inflation could, however, increase the number of budget-constrained households and dampen consumption on service products other than necessities. The opening of the electricity market in 2013 could raise households’ and smaller companies’ electricity bills by up to 20%. Retail trade, which has been growing faster than private consumption, is getting stronger support from an increase in tourist visits.

Revised GDP data were published in early September. These indicate that the recession was deeper and the subsequent recovery faster than was previously known. The upward revision of last year’s growth (from 7.6% to 8.3%) had a technical impact on our forecast figures published in the August Swedbank Economic Outlook. Due to changes in the historical data and the base effect (i.e., the underlying assumptions and expectations have not changed) we have lowered our economic growth forecast for this year and the next, from 3% to 2.6% and from 4% to 3.7%, respectively; the growth expectation for 2014 remains unchanged at 4.3%.

Structural challenges in the labour market pose risks

The annual reports of major exporters indicate that many foreign-owned companies have shifted an increasing part of their business activity to Estonia, and many companies wish to do so in the future as well. However, unfavourable labour market developments and skills mismatches can lower Estonia’s attractiveness and start to affect investors’ decisions.

The lack of qualified labour, while a bottleneck in most sectors, is most pressingly in manufacturing, ICT, health care, and construction. Structural unemployment can lead to unsustainable wage growth and losses in competitiveness. On the positive side, several private and public sector cooperation projects are being planned to tackle this problem, especially for ICT specialists and engineers. The possibility of using foreign labour is limited due to conservative immigration laws and bureaucracy problems.

Unbalanced improvements in business climate

According to the BSI, the overall legal and business environment has slightly worsened but remains well above the average, at 7.4.
The labour market is the best performing subindex and has also experienced the biggest improvement in recent years. Estonia has a flexible labour market: staff turnover costs are rather low (and were further eased by legislation in 2009) while low unionization holds back wage increases; despite the rise in long-term unemployment, participation rates have risen to all-time highs; and flexibility remains high, which helps the companies to react faster to the changing economic environment.

The innovation climate has also improved considerably. Especially active and fast-growing is the start-up scene, supported by the public sector (including Enterprise Estonia), smaller private initiatives (e.g., Garage48 HUB) and private sector cooperation projects. As the economy becomes more knowledge based, the mindset of companies has shifted more towards innovation; however, there can be other factors (e.g. access to financing and a sluggish bureaucracy) slowing the shift.

A more challenging development can be seen in the logistics and the tax policy indicators. The latter reflects a rather high tax rate on distributed profits, as well as the large share of employer social security contributions. Nevertheless, the tax system in Estonia has remained simple, with very limited tax exceptions, and the overall tax burden is among the lightest in the Baltic Sea region.

_Elina Allikalt_
_Kristjan Tamla_

劳动合同和创新气候显示出最大的改进。
Latvia – keep improving competitiveness

Population: 2 million
GDP per capita (PPP) 2011: US$ 18,928
Government: Centre-right
Prime Minister: Valdis Dombrovskis
President: Andris Bērziņš
Next presidential election: June 2015
Next parliamentary election: October 2014
Average GDP growth in last five years: -1.4%
Average inflation rate in last five years: 6.5%
Average unemployment rate in last five years: 13.1%

Summary

- Economic growth is expected to decelerate from about 4% in 2012 to 3.5% in 2013 before picking up again in 2014 (5.2%). The role of private consumption has strengthened, but, over the medium term, export-related activities will remain the major growth driver. Competitiveness gains have allowed exporters to raise their market shares, but, with recession-driven improvements such as wage cuts fading away, export growth is likely to become more difficult.

- We expect Latvia to fulfil the Maastricht criteria on price and exchange rate stability, as well as public finances. There is more uncertainty about the interest rate criterion; however, we see it likely that Latvia will qualify for euro adoption in 2014.

- Swedbank’s Baltic Sea Index did not show any changes for Latvia (stable at 6.3). This implies that other countries are also making progress and that reforms so far in Latvia have been insufficient to catch up with competitors. While the very recent reforms of late 2011 and 2012 are not yet reflected in the index (e.g., tax cuts), there is much room for improvement.

Consequences for companies

- Labour costs are expected to rise gradually. Yet, approved labour tax cuts (from 25% in 2012 to 24% in 2013, 22% in 2014, and 20% in 2015) are expected both to improve the competitiveness of Latvian companies (by transferring some costs to the state) and support private consumption.

- Given the massive underinvestment in productive facilities and infrastructure in the pre-crisis and recession years, it is of the utmost importance to keep investing to raise competitiveness further. Furthermore, the fragile external environment means that it will be crucial for competitiveness and profitability to keep costs under control.

- There is likely to be less EU funds allocated for Latvia for the 2014-2020 planning period, given the overall austerity mood in the EU; thus, attracting foreign direct investment (FDI) will be important for financing investments.
More reform-oriented government in place

Following the general elections, the current government was approved in October 2011, with Valdis Dombrovskis becoming the Prime Minister for the third consecutive term. There are many new faces in the cabinet – of its 14 members, only 3 ministers retained their place from the previous cabinet, and 2 have held posts in past cabinets. The ruling coalition has a majority of 56 of the 100 members of parliament – 20 from Unity, 16 from the Reform Party (formerly Zatlers' Reform Party, or ZRP), 14 from National Alliance, and a group of 6 independents (initially elected as members of the ZRP).

This government is more oriented toward growth enhancing reforms than any recent ones. The discussion is across the board, ranging from relocation benefits to help those from remote areas move to regional centres, so reducing social pressures and improving the labour supply, to reducing rent-seeking activities in the energy sector and improving the corporate governance of state- and municipality-owned enterprises. But, so far, only few reforms have been put in place, most notably a reduction in the personal income tax to support job creation and measures to improve the quality of vocational education.

Resistance to reforms is high in many areas. The “window of opportunity” depends on the political cycle, narrowing prior to elections and opening up when they pass. The next municipalities’ elections are scheduled for spring 2013, and general elections for October 2014.

Private consumption has strengthened

We are keeping our GDP growth forecast as in the August Swedbank Economic Outlook – at 4% for 2012, 3.5% for 2013, and 5.2% for 2014. Yet, with the recent historical data revisions, we now see upward risks for our economic outlook. For instance, private consumption seems to be growing stronger than expected this year, while imports are weaker. Still, in view of the high data volatility and possible further revisions, we are thus far retaining our GDP forecast for 2012.

The recovery has taken root, and export-led growth during the early recovery phase has spilled over to domestic demand and become broad based. In the second quarter of 2012, household consumption was growing faster than exports, and this trend is likely to continue in the coming quarters. The fiscal stance has improved substantially, and taxes that were raised during the recession are gradually being cut, while budget spending is expected to keep rising. This will provide additional support to private consumption and will somewhat counteract a global slowdown. Growing incomes, as wages and employment increase, and low inflation will improve the spending power of households. Private consumption is anticipated to rise about 3-5% per annum in 2012-2014 – still slightly slower than exports (4-7%).

Within Latvia, regional developments will remain uneven. The concentration around the biggest centres of activity is to intensify, as people leave areas where jobs are scarce and incomes low; see our

Focus on costs to keep improving competitiveness

Unit labour costs have bottomed out, and post-recession gains are fading away (cutting employment and wages is no longer possible, and productivity is more difficult to raise). Labour costs will grow, although labour tax cuts (of 5 percentage points over next three years) will allow a partial transfer of these costs from businesses to the state. So far, wage growth has been rather muted, but pressures in the labour market are becoming more pronounced. Businesses will need to give in to higher wage demands, but this should not necessarily hurt competitiveness if lower corporate profitability is accepted.

To keep gaining competitiveness and preserve profitability in the exporting sectors, investments in productive facilities, infrastructure, logistics, innovations, and R&D, are very much needed. There was a heavy underinvestment in these areas during the pre-crisis and recession years, and we expect a quite vigorous investment activity in the coming years, both from incumbent and new investors.

As the new EU fund planning period starts in 2014, and given the poor economic situation in the EU and overall austerity mood, it is likely that there will be less funding allocated for Latvia than in 2007-2013. This has been the major source of financing and driver of investment activity during the last couple of years. Currently, companies are financing their investments mostly with own resources, together with EU funding; however, with sentiment improving and risk appetite rising, the range of clients financed by banks will gradually widen. Public-private-partnerships in developing public infrastructure might also strengthen. We also forecast stable FDI inflows, with economic growth continuing and business environment improving.

Fiscal policy to remain conservative

The fiscal stance has improved notably during the last few years. The budget deficit will be about 2% of GDP in 2012 and continue shrinking in the coming years. Latvia has ratified the EC fiscal treaty, thus institutionally strengthening fiscal discipline. Latvia successfully issued five-year bonds worth US$1 billion in February 2012 (yield rate of 5.375%). Public debt, currently at about 44% of GDP, is forecast to decline in the coming years as the economy grows. Because the state treasury reserves are ample, Latvia has already made early repayment to the IMF, thus reducing future interest payments.

The improving budget situation is obviously creating upward spending pressures on all sides. Tax revenues have been exceeding the plan substantially in 2012, but nearly all additional income has been spent. The tax cuts have already been approved (the value-added tax base rate has been cut from 22% to 21% as of mid-2012, and the personal income tax cuts will start in 2013). Economic growth and the expected reduction in tax evasion will help to shrink the budget deficit, yet
budget expenditures should still be planned cautiously. The 2014 euro target remains on the agenda, and we see it is likely to be fulfilled; for details, see the recent Swedbank analysis, “Fulfilling the Maastricht criteria – mission possible for Latvia and Lithuania?”

Reforms should deepen to catch up with competitors

There has been reform progress – the entrepreneurial environment has become friendlier, tax collection has improved and the tax burden is being reduced, and the financial sector has become stronger (capital adequacy is high, and the portfolio quality has improved). There are discussions to increase quality in education, industrial policy, the social benefit system, etc. These trends are expected to continue.

The Swedbank Baltic Sea index has not improved for Latvia and remains at 6.3; however, structural improvements have somewhat accelerated in 2011-2012 and are not yet reflected in the index. Another issue is that Latvia is not the only country trying to improve its institutional framework – in the fragile and uncertain global environment, competition between countries for capital and goods flows is very intense. This implies that Latvia needs to deepen and accelerate the reform process to improve its position relative to competitors.

Reforms should be broad based to bring notable results, as the current challenges are very much interrelated. For instance, improvement of infrastructure and logistics is vital to be able to expand the export base. This calls for investments; to finance these, developing further the financial markets is crucial, as well as attracting FDI. This, in turn, demands a reduction in tax evasion and improvement of governance. It is also hard to expand tradable sectors substantially without a sufficient, qualified labour force, which requires improving the education system and addressing the demography challenges.

Lija Strašuna
Mārtiņš Kazāks
Lithuania – temporary lower growth and continued reforms

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<td>Centre-right</td>
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<td>Andrius Kubilius</td>
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<td>Dalia Grybauskaite</td>
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<td>2014</td>
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<td>14 October, 2012</td>
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Summary

- The Lithuanian economy has been slowing after a rapid expansion in 2011, when GDP increased by 5.9%. Growth of 3.3% is still expected this year, despite weaker demand in the euro area and, especially, gloomier sentiment. The economy is likely to return to its long-term growth trend next year and in 2014, when it will expand by 4.1% and 4.5%, respectively.

- Average annual inflation is expected to fall slightly below 3.0% at the end of this year but will be slightly higher in 2013 and 2014. As for adopting the euro, the government has delayed action and will probably not set an official target for adoption in 2014.

- The Swedbank Baltic Sea index structural indicator barely changed during the past four years. The important structural reforms Lithuania has undergone during the past few years, are likely to bear fruit, and the index is likely to edge upwards in the coming years.

Consequences for companies

- The upcoming parliamentary elections (October 14) create uncertainties, as polls suggest a change of government. This may slow some reforms; however, we do not expect government policy to stray from fiscal prudence and reforms.

- Unemployment has been decreasing rapidly but will remain well above the natural level in 2013 and 2014; thus growth in wages will be weak. We forecast average unemployment to be 10.4% during the next two years. Over the longer term, demographic trends will create some challenges.

- A number of structural reforms addressing the shadow economy, and excessive bureaucracy and regulation were implemented last year. The labour and financial markets are functioning better, but reforms to improve labour market flexibility are lagging behind.
Upcoming election outcome is highly uncertain

There is high uncertainty regarding the outcome of the parliamentary elections to be held on October 14, but polls suggest a change in the Lithuanian government’s composition. No single party is expected to have more than 30% of seats, but the most likely outcome is a centre-left coalition formed from several parties.

Although the minimum monthly salary in Lithuania increased by LTL 50 (6.3%) to LTL 850 (EUR 246.2) as of August 1, this remains one of the lowest in the EU (however, as a percentage of average monthly wage, it is similar to that in other EU countries). Some parties are including a much higher minimum wage increase (up to EUR 521.3) in their programmes; however, it is not likely that any of these suggestions will be realised.

Budget revenues this year are slightly above the plan, and the budget deficit should not exceed 3% of GDP at year’s end. Furthermore, the structural budget deficit is close to 2% of GDP. The government has confirmed renewal of Convergence Programme of Lithuania, through which it has agreed that the fiscal deficit will decrease by 1 percentage point each year and be eliminated in 2015.

Domestic inflationary pressures remain mild, and Lithuania is likely to comply with the Maastricht criteria this year; however, there is no longer a strong political will to enter the euro area, and there is also a lack of public support for the euro. A “wait-and-see” strategy best describes the current political consensus on Lithuania’s full participation in the euro area.

Most parties are vowing tax stability; at the same time, however, quite a few of them are proposing a higher progressivity in taxation of personal income. We think that this would be counterproductive, and that a better alternative is a shift from labour to property taxes.

Growth remains robust, but serious demographic challenges lie ahead

Growth this year has slowed due to uncertainties and weaker demand in the EU, which has lowered confidence and affected the willingness to consume and invest. However, growth will still amount to 3.3% this year and increase to 4.1% and 4.5% in 2013 and 2014, respectively.

The fall in unemployment, which is expected to be at 13.2% this year, has been limited by the lack of labour market flexibility and skills mismatches. It should decrease more significantly in 2014 to 9.3%, from 11.5% in 2013. Wage growth, however, is likely to remain lower than productivity growth, keeping unit labour costs low.

As a result of emigration and low historical fertility rates in Lithuania, the labour force will be decreasing faster than the total population if the labour force activity rate remains the same. We project that the labour force will shrink from 1.62 million in 2011 to 1.56 million in 2016, as the total population will be decreasing from 3.25 million to...
3.15 million over the same period. However, according to the preliminary census results, the total population fell to 3.054 million in 2011, or about 6% fewer than previously estimated. This means that the labour force is smaller as well and might actually decrease to 1.4-1.5 million by 2016.

Demographic change will put pressure on the social security system; it might also have a negative effect on consumption growth and decrease the potential output of the whole economy. However, the effects of demographics can be mitigated by productivity growth and perhaps by a more relaxed immigration policy. This underscores the importance of continuing the current structural reforms, regardless of election outcome.

Structural reforms addressed the shadow economy

The main structural reforms in Lithuania have been aimed at reducing the shadow economy, making the labour market more flexible, and downsizing the bureaucracy. More progress, however, has been made in some spheres than in others.

Last year, the issue of frequent Russian and Belarusian border crossings and attendant potential smuggling was addressed. If a person crosses the border more than five times a month, carried goods are subject to value-added and excise taxes. The rotation of custom officers has been intensified, and some larger-scale smuggling activities have been uncovered. The introduction of cash registers in markets also has probably reduced the size of the shadow economy.

The controlling of illegal work has intensified. For example, this year, the state tax inspectorate started inspecting companies employing large numbers of "part-time" employees. This is an attempt to address the quite common practice of paying only a fraction of salary officially and paying out the remainder in cash without paying taxes.

Also, somewhat more transparency has been introduced in bureaucratic procedures, and changes have been made in business-controlling institutions. Since the end of last year, controlling institutions’ inspection of companies (mainly small businesses) have been conducted using standardised sets of questions, which are transmitted to the companies in advance. A one-year transitional period has been introduced for new enterprises, during which they will not be punished for not complying with the tax code; instead, they will hold consultations with state tax inspectorate officers.

The continuation of these structural reforms would level the playing field and ease the pressures on the social security system, as well as create a better investment climate and encourage entrepreneurship.
Labour market improves, despite lagging reforms

According to the BSI, Lithuania scores high in the areas of “Education,” “Innovation climate,” and “Entrepreneurship.” The overall index is equal to 6.4 and has barely changed during the last four years. The situation has improved more significantly in the areas of “Financial markets,” “Labour markets” and “Innovation climate” but has worsened in “Tax policy,” “Infrastructure,” and “Logistics.” Lithuania has introduced a residential real estate tax (on very expensive property); however, overall tax policy remains favourable, especially for business.

The financial markets indicator has increased mostly due to a better score for financing through local equity markets and venture capital availability. State institution for business guarantees (INVEGA) has also announced that it is creating two high-tech venture capital funds, “Seed and Start-up,” which should help to finance innovative ideas in the early stages of their development.

At the same time, interest rates are at an all-time low, and bank liquidity has increased considerably during the past year. With negative real interest rates and banks competing to expand their loan portfolios, borrowing conditions are very good for sound investment projects.

The labour market in Lithuania has improved due to strong productivity growth and a rising activity rate. However, the score for labour market efficiency fell. As an attempt to increase labour market flexibility, the government has prepared and submitted to parliament labour code amendments. These include the reduction of annual vacation, a shorter maximum period of notice before contract termination, a smaller maximum severance pay, and somewhat more flexible work time. More flexibility in the labour market would contribute to further improvements in the investment climate and, consequently, higher employment and productivity growth. However, trade unions continue to resist such changes, and a decision on these amendments will probably be made by the new parliament only later this year.

Nerijus Mačiulis
Vaiva Šečkutė
Russia – freer trade, but reform needs remain great

Summary

- The political climate has deteriorated in 2012, with major protests, increased repression of dissidents and signs of a political split at the top level.

- Russia is highly vulnerable to fluctuations in the global economy and commodity markets. With a slowdown in the euro zone and our forecast of falling global oil prices in 2013, we expect growth to remain modest in the years ahead. For 2013 we are projecting growth of 3.9% and for 2014 4.3%, compared with 3.8% in 2012.

- Russia’s monetary policy framework has been strengthened in the last year, and the central bank is sharpening its focus on controlling inflation. As a result, the exchange rate could fluctuate more. At the same time fiscal discipline has weakened and we expect inflation pressures to grow.

Consequences for businesses

- Domestic demand has been strong in the last year as a result of an expansive election-related fiscal policy and rising commodity prices. Improvements to the economy have had a positive effect on retail sales, but rising prices, increased unemployment and a dose of fiscal austerity are likely to dampen demand.

- Corruption and a lack of rule of law are growing threats to businesses. However, the increased attention that has been paid to recent cases and the renewed initiatives that have been taken recently could eventually lead to improvements.

- Russia’s membership in the World Trade Organization means lower import duties and greater access to the Russian market. This could create opportunities for companies that are focused on the consumer segment, though demand from Russian manufacturers could also create opportunities for foreign producers of investment and input goods.

- Swedbank’s Baltic Sea Index indicates small improvements in structural conditions for businesses, but big deficiencies remain.
Political tension, repression and in-fighting

Despite a wide margin of victory in the presidential election in February 2012 (accusations of election fraud were rampant), Vladimir Putin and the Russian authorities have shown less tolerance for dissidents and protests. The demonstrations in connection with the elections have led to stepped-up repression, including in the form of huge fines for participating in protests. Although crowds have dropped slightly, demonstrations continued during the summer (with crowds of 50 000 – 70 000). Putin’s legitimacy as a president is also being eroded by the harsh treatment of marginal protests such as “Pussy Riot”. The lack of due process for businesses, Russian and foreign, is a challenge as well. Courts and authorities are used to penalise businesses that are not loyal to the current regime.

There are also signs of a split between Putin and Prime Minister Dmitry Medvedev, which may signal that the latter’s modernisation ambitions are losing momentum. Medvedev, who was previously president, had been considered a close ally of Putin and was the driving force behind opening up the business sector and liberalisation efforts. During the late summer Putin criticised Medvedev for not introducing budget policies in keeping with election promises earlier in the year. This has been interpreted to mean that Medvedev may be at risk of losing influence, which could impact the implementation of the reform agenda.

Recovery in the economy, but imbalances are growing

The Russian economy continued to grow during the first half of 2012, mainly driven by strong domestic demand. This was chiefly the result of a fairly extensive fiscal stimulus in connection with the campaigns for the parliamentary election in December 2011 and the presidential election in February 2012. This, together with rapidly declining inflation, has led to an average increase in real wages of just over 10% during the first six months of the year. In addition, the credit expansion has grown, further driving consumption.

On the other hand, investments grew at a slower pace. Manufacturing and agriculture both slowed. This coincided with declining sentiment in the business sector. Exports have developed weakly at the same time that imports continue to rise. Relatively high but volatile oil prices (averaging USD 110 a barrel [Ural] during the first eight months of the year) have kept the current account surplus stable despite a continued capital outflow. As global growth slows this fall, we expect growth in Russia to decline to 3.8% on an annual basis in 2012, compared with around 4.4% in previous two years.

Although Russia is struggling with major problems in macroeconomic policy making, progress has been made, particularly in monetary policy. The central bank’s benchmark rate has begun to have more impact on market rates and liquidity in the economy, while interventions in currency markets have decreased. This is because the central bank is starting to transition to using an inflation target for monetary policy and letting the exchange rate be determined to a greater extent.
by market forces. This means that the exchange rate will play a greater role in absorbing global economic swings and that the rouble could fluctuate more going forward.

Inflation has trended strongly lower in 2012 and hit a low in March with prices rising by only about 3% at an annual rate. This was partly a result of tighter monetary policy, but was also because the government delayed the annual increases in fees and duties during the election campaigns. Monetary policy has become increasingly expansive, however, and together with rapidly growing domestic demand, this has started to raise inflationary pressures. Both the actual and real exchange rates have fluctuated significantly during the year, although the trend has been toward a stronger rouble. On the whole, this indicates that inflation is headed higher again and that the rouble could weaken.

If monetary policy has been anchored by specific targets, the opposite is true of fiscal policy. During the financial crisis the goal of limiting the budget deficit to 4.7% of GDP, excluding oil-related revenues, was abandoned. The budget remained expansive last year (with a non-oil deficit of 10% of GDP) and also early this year. It is estimated that the election promises will further burden the budget by about 6% of GDP through 2018. Four of these 6% consist of higher salaries for teachers and doctors. Without politically sensitive austerity reforms, which there is little agreement on among leading politicians, the budget deficit is likely to continue to rise. If the central bank remains committed to limiting inflation, it will mean rising interest rates and a suppression of private sector activity. At the same time it is important to note that central bank’s independence is limited and that it is the political leadership who decide how far to go in fighting inflation.

As a whole, we expect growth in the Russian economy to be modest in the next two years at 3.9% in 2013 and 4.3% in 2014. Declining oil prices in 2013 and then an upswing in 2014 will provide a limited stimulus, at the same time that rising unemployment and inflation will pinch the purchasing power of households and companies’ willingness to invest. A renewed commitment to take on the fundamental structural problems in Russia, or a continued rise in oil prices, would produce a more positive scenario.

Liberalisation of trade is creating opportunities, but major challenges remain

In August Russia joined the World Trade Organization (WTO) after 18 years of negotiations. Even though this had long been expected, it will still have significant benefits for the Russian economy, particularly in the long term. In the short term it will mean lower import duties to Russia and improved access to the Russian market for exporters. The benefits for Russian consumers could also be significant in the form of increased competition and lower prices.
Many Russian companies will face increased competition, but WTO membership also offers advantages. For one thing, it opens new export markets. For another, companies with production in Russia can access to cheaper investment and input goods that could improve their profitability. It could also lead to greater diversification of the economy, and thus less dependence on natural resources. Companies have to be given the right conditions, however, which will require further economic reforms.

Despite an ambitious reform agenda to strengthen the business climate, implementation lags. There are signs, however, that some of the initiatives will be relaunched. President Putin has decided to speed up the process of making Russia more business-friendly. Among other things, an ombudsman is being established to protect the rights of businessmen and the bureaucracy associated with doing business in the country will be reduced. More specifically, there could be business opportunities when the government’s privatisation program is restarted, although previous experience shows that the process can be complicated and associated with a lack of transparency. Major resources are also being invested in the Skolkovo project, where the aim is to create a high-tech centre with the help of huge public investment, tax abatements and subsidies.

Swedbank’s Baltic Sea Index shows that structural conditions for businesses in Russia have improved slightly in the last year, and its rating rose to 4.1. This is still low, however, and means that nearly 60% of the countries in the world offer a better place to do business than Russia.

Despite improvements, major challenges remain

There are a number of areas where development has been positive. Foreign trade has risen from exceptionally low levels, and with membership in the WTO there is significant potential for further improvement. Gains have also been made in entrepreneurship and innovation, which could be the result of investments in innovation and business development around the Skolkovo project. The quality of education in Russia still surpasses the global average, while much remains to be done in terms of the financial market and governance.

Magnus Alvesson
Ukraine – farther from fulfilling its potential

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Summary

- We expect economic growth to decline to 2.8% in 2012, before rising to 3.5% in 2013. Exports will be the main driver of the expansion, while the domestic economy is likely to tighten. There is a risk that the Ukrainian currency, the hryvnia, will come under renewed pressure following the parliamentary election in late October.

- President Victor Yanukovych has consolidated his power, politically and economically. The prospects of a deepening of the economic reforms appear to be small. Ukraine is becoming increasingly isolated internationally. Political developments, especially the treatment of Yulia Tymoshenko, are reducing the opportunities for further integration with the EU.

Consequences for businesses

- The domestic market will develop slowly in the year ahead and in 2012-2014, and will fall far short of the potential Ukraine has due to its large population and proximity to major markets. Investments in the retail sector could be of interest if the investment horizon is sufficiently long.

- There is also a market for investment and capital goods for Ukraine’s traditional manufacturers. With growing exports and aging technology, producers are in significant need of upgrading their facilities. The energy sector in particular has neglected efficiencies. It is doubtful, however, whether Ukrainian businesses will have the capacity to meet these needs in the short term.

- Swedbank’s Baltic Sea Index shows a marginal improvement in the business climate, and this is mainly because Ukraine has improved its rating in terms of infrastructure and logistics. The business sector is still plagued by corruption and legal uncertainty, which, coupled with an ineffective tax system and deficiencies in the financial market, is why Ukraine ranks lowest among the Baltic Sea countries.
The political power is concentrated

The political debate in Ukraine is currently dominated by the parliamentary election on October 28. Since the last elections, and especially since Victor Yanukovych won the presidency in 2010, the electoral system has been changed. The most discussed reform is that this time half of MPs will be elected in single-mandate districts, while the 225 remaining members will be elected proportionately through party lists. The stated objective is to increase the direct link between voters and their representatives and in that way strengthen democratic representation, although many also speculate that the main reason for the reform was to weaken the opposition in parliament. With a larger number of single-mandate districts, party loyalty will be weaker and it will be easier to build a majority for proposals by reaching deals with individual members.

The opposition in Ukraine appears to continue to be weak, especially since Yulia Tymoshenko’s imprisonment. Thus, the opposition lacks a charismatic leader. A number of new political parties with uncertain affiliations have also been created. The president's party, the Party of Regions, currently heads the government in coalition with two other parties. Polls show that the Party of Regions will remain in power after the election, and many are speculating that several of the new opposition parties will support it. There have also been warnings about voter fraud, especially in the new single-mandate districts.

Uphill battle for economic growth

The recovery in Ukraine’s economy has slowed in 2012. We expect growth to fall to 2.8% this year after having reached 5.1% in 2011 and 4.2% in 2010. The economy has been hurt by weaker external demand. Manufacturing in particular has had a difficult year. Industrial production and steel manufacturing had both shrunk at mid-year compared with the same period in 2011. Instead domestic demand has contributed to GDP growth. Fiscal policy has been expansive in 2012, which has led to large increases in real wages and private consumption. The rapid expansion in investment can also be traced to the public sector and the Euro 2012 football championship.

As the global economy stabilises next year we expect slightly better growth in Ukraine, but macroeconomic risks remain high. In particular, important export markets such as the EU face great uncertainty. It is also likely that domestic spending will be slashed after election-related increases this year. Assuming that the global economy stabilises, exports will be the main contributor to growth, which is forecast at 3.5% in 2013. In addition, it is not unlikely that the hryvnia will weaken after the election, which could strengthen Ukraine's competitiveness. Since mid-2009 the exchange rate has been pegged against the US dollar, and depreciation pressures have increased in the last year. The domestic economy will, however, face austerity and lower public investment.
It is becoming harder to manoeuvre internationally

Ukraine has been trying for some time to balance between East and West. Its proximity to rapidly emerging Central Asia and the Middle East has been cited as a strong reason for operating in the country. However, the relationship with the EU has worsened in recent years, not least due to the treatment of Yulia Tymoshenko, but also because of an increasingly authoritarian government. The relationship with Russia is also undermined by suspicion and hampered by a disagreement over energy imports and pricing.

Even though it succeeded in issuing five-year bonds for USD 2 billion (at a rate of 9.25%) in the Eurobond market this summer, Ukraine is having difficulty financing its budget deficit at a reasonable cost. As a result, officials have turned more to China, where they have raised loans collateralised against agricultural production. Moreover, after joining the World Trade Organisation, WTO, Russia could attract investment that previously went to Ukraine, and at the same time Ukraine has indicated that it is prepared to raise important duties in order to protect its domestic industry. This has led to protests among other WTO members.

The relationship to The International Monetary Fund, IMF, has become more distant. Earlier this year the IMF put its programme with Ukraine on hold after the government was unwilling to raise energy prices and reduce public spending. Some progress had been made, however, in moving forward some reforms, and we expect that discussions on a new program will be restarted after the election. Still, it is uncertain how far Ukraine can go in committing to the requirements the IMF will make, while at the same time the world’s and IMF’s patience with Ukraine has declined.

Still tough for companies despite attempts at reform

President Yanukovych and the new government that took over in 2010 set an ambitious reform agenda. While some reforms have been implemented, the business climate has worsened due to growing corruption and the increasing involvement of the president’s allies in the business community. Among the positive reforms that have been instituted are a reduction in number of approvals needed by businesses and simplified taxation and customs rules. Also the government has announced a relaunch of the privatisation process, which could create opportunities for foreign investors. Many businessmen and observers have observed, however, that corruption has increased, and a growing problem is that many entrepreneurs experience an erosion of their legal rights in relation to authorities and influential groups. This means not only higher costs of doing business, but also that long-term investments are being reduced. A deteriorating business climate means that, even if a willingness is there, major efforts will be needed by the new government after the election to reverse the negative trend and strengthen business confidence.
Despite that the business climate remains a major challenge, especially for foreign companies that don’t have a lot of experience doing business in Ukraine; there are still opportunities, especially if the investment horizon is long. With a large population and fairly underdeveloped consumer market, there is plenty of room for efficiency gains in the retail sector, even though we expect private consumption and domestic demand to slow in the short term. Ukraine’s export industry, especially energy suppliers, will also have to upgrade, which is an area where Swedish companies specialising in input and investment goods may find opportunities. Furthermore, education remains one of the few areas where Ukraine is relatively strong, and while a growing number of Ukrainians are worried that well-educated young people are leaving the country, companies can still recruit skilled labour at a relatively low cost.

Swedbank’s Baltic Sea Index shows that structural conditions for business development in Ukraine have improved slightly in recent years, but from low levels. According to our index, aspects such as infrastructure and logistics in particular have climbed. A closer analysis, however, shows that in logistics it is not that Ukraine has improved so much, but rather that other countries have declined. As a result, Ukraine’s ranking has inched higher. In terms of infrastructure, Euro 2012 has probably played a role. Among other things, a new terminal was built at Kiev’s airport and investments were made in new roads. The business climate in Ukraine is otherwise eroding, which is evident not least in the financial sector and public administration.

We expect the business climate in Ukraine to remain a challenge, although small improvements are being made, which could produce positive results in time. The low levels for indicators related to the public economy (governance and tax policy) show that confidence in governmental functions is very weak. If it is going to rise up from being the lowest ranking Baltic Sea country, Ukraine will have to significantly intensify its reform efforts.

Magnus Alvesson
Germany – downshifting, but not in reverse

| Population: | 81.7 million |
| GDP per capita (PPP) 2011: | USD 39 414 |
| Government: | Liberal-conservative coalition (CDU/CSU/FDP) |
| Chancellor: | Angela Merkel |
| President: | Joachim Gauck |
| Next parliamentary election: | 2013 |
| Average GDP growth in last five years: | 1.7% |
| Average inflation rate in last five years: | 2.1% |
| Average inflation rate in last five years: | 8.3% |

Summary

- We expect Germany’s GDP to grow by 0.9% this year before strengthening to 1.1% in 2013 and 1.6% in 2014, assuming that the euro crisis gradually eases. Germany still supports the euro, but is understandably concerned about Europe’s integration.

- Germany has a strong reputation as a competitive manufacturer. In our structural index, it received a rating of 8.2, which is above average but still a bit below the levels of the Nordic countries. The biggest reform needs are in taxes, entrepreneurship and the financial sector, while education, infrastructure and logistics are rated positively in our survey.

Consequences for businesses

- We expect the economy to stagnate during the second half, but see gradually rising quarterly growth in 2013. After having been driven by net exports this year, consumer spending and investments will take over as growth engines in 2013, though they are still growing at a modest annual rate of 1 -1.5%. In the short term export-oriented companies are reducing their investment and hiring to remain competitive.

- The euro crisis has made Germany a refuge with its low bond yields. At the same time the euro has weakened. If confidence in the handling of the euro zone crisis improves, we could see a period of overshooting with higher interest rates and a stronger euro – but right now favourable monetary conditions are providing a boost to German exporters. Not even a weaker euro will compensate for declining demand, however, which is why the export engine is dragging considerably.

- After a period of slow growth in labour costs, a slight reversal is expected. A slightly higher inflation rate in excess of 2% may be assumed in collective pay negotiations (since the euro zone average is close to 2%), which would drive up nominal wages more than before. The crisis countries should not hold out too much hope, however, since the German labour market appears to be weakening.
Focus on next year's parliamentary election

There are considerable differences in opinion among German politicians in a number of domestic areas: taxes, social and labour market policies, and energy. On the other hand, there isn't much disagreement about the importance of rescuing the currency union. An overwhelming majority (80% of the population) feel that Angela Merkel is handling the crisis well.

With about a year left before the next parliamentary election, politicians have already begun to position themselves. Chancellor Angela Merkel and her conservative party, CDU/CSU, can ride Merkel's popularity and rest its re-election hopes on, among other things, an energy policy that excludes nuclear power, a lower national debt and the competitive strength to protect the welfare state and standard of living.

The Social Democrats (SPD) are currently discussing which leader to elect: party chairman Sigmar Gabriel, former foreign minister Frank-Walter Steinmeier or former finance minister Peer Steinbrück. Among voters, Steinmeier seems to have the greatest support. The party's current obsession is how to more tightly regulate the financial sector and how social justice can better be achieved.

The question is what kind of coalition might be formed after the election. The CDU's principal partner, the Free Democratic Party (FDP), has lost much of the support it had in the 2009 election and is closing in on the 4% threshold. The Greens possibly could ally with SPD and CDU, and a grand coalition of CDU and SPD – like the one that led the country in 2005-2009 – can't be ruled out either.

With regard to the crisis in the euro zone, Germans support the currency union and the euro. There is also support for that gradual reforms that are hoped will alleviate the crisis, but the “four pillars” – a banking union, fiscal union, economic union and political union – haven't yet been discussed much in the media. The SPD is pushing for greater integration and could be open to shared debt financing through euro bonds. The CDU (and not least the FDP) have more sceptics, including party officials worried about Germany's obligation to "rescue the rest of the euro zone". A majority of Germans place their trust in the constitutional court and are happy that it is looking at the issue of a transfer of sovereignty to European authorities. Although Germans are positive to the euro, a majority want Greece to exit the currency union and see no chance of offering more support.

No headwind yet for the economy – but clouds are forming

Thus far Germany’s economy has performed reasonably well. Quarterly GDP rose by 0.5% in the first quarter, but only 0.3% in the second quarter. Germans don't seem overly worried about it yet with surveys showing that 63% of people feel that the economy is strong or very strong. On the other hand, just over half expect conditions to worsen in the year ahead. The IFO barometer also suggests a slow-
down, and the purchasing managers index points to a decline in industrial production. Industrial companies have begun to reduce investment and are becoming more cautious about hiring.

Unemployment was 6.8% in August, the same figure since December of last year and the lowest since 1992. Employment is now expected to grow more slowly, at the same time there have been warnings of layoffs. There is a risk that consumer spending will also slow, although weaker employment growth could be offset to some extent by slightly higher wages and lower inflation. Even if unemployment rises, it is still relatively low thanks to the so-called Hartz reforms in the mid-2000’s, which have improved efficiencies in the labour market. We therefore expect households to be the growth engine in the year ahead as exports and investment slow.

We forecast that Germany will grow by 0.9% in 2012 and 1.0% in 2013, i.e., weak growth or nearly stagnation during the second half-year before the economy grows at a more modest quarterly rate of 0.3-0.4% next year. This year exports are performing weakly, but imports are growing even more slowly, so the net contribution to GDP is positive. Assuming that the crisis in the euro zone eases, the economy can grow slightly faster in 2014, reaching 1.6%.

Economic policy – mostly applying the brakes

Germany’s budget is benefitting from low interest rates and bond yields (10-year) below 1.5%. Investors are finding it tougher, especially those trying to save for retirement. If this continues, Germans should consider taking on more debt and investing more in equities rather than traditional asset classes such as bank accounts and bonds.

Compared with the crisis countries, Germany is in better position, making it something of an economic refuge. It has a current account surplus (x.x% of GDP) and the budget is almost in balance. Competitively, Germany is in good shape thanks to a modest increase in labour costs (though they are now rising faster) and relatively high productivity growth.

At the same time that it has been accused of pushing austerity policies and contributing to imbalances through its “anorectic” stance, Germany is the country that contributes the most to the rescue funds. Nearly 200 billion euro of the ESM’s 700 billion is guaranteed by Germany. In addition, Germany is owed money by the other central banks in the euro zone through Target2 – over 750 billion euro. If the ECB’s bond purchases from crisis countries aren’t enough of a success and the ECB loses money, German taxpayers will have to fix the balance sheet.

One question that often comes up is whether Germany could adopt a more expansive fiscal policy, but its national debt, at 80% of GDP, is already high. Moreover, the country has reformed its fiscal policy and is close to reaching budgetary targets (structural deficit of 0.35% of GDP in 2016 and balanced state budgets by 2020). The important
thing is that inflation reaches 2% and wages and prices are allowed to rise to the extent the ECB’s targets stipulate, which hasn’t always been the case. This could potentially raise demand, including for products from the crisis countries, and reduce the current account surplus. German officials have even suggested allowing inflation to be slightly higher in Germany given that it didn’t rise over 2% in the euro zone as a whole.

Further reforms benefit Germany and the EMU

Labour market reforms have produced greater flexibility, which has benefitted the German economy as well as the euro zone. In education it has improved as well. The economy is still in need of major reform, however. Our Baltic Sea Index rating has increased to 8.2 and is higher than the regional average of 7.1, but doesn’t reach up to the level of the Nordic countries.

Germany also ranks high in terms of infrastructure, logistics, governance and foreign trade. A slight decline was noted in innovation. One area where it constantly trails is tax policy, where Germany has high taxes (and tax wedges) and a complex bureaucracy. Germany also ranks fairly low in entrepreneurship and the financial sector, and the banking consolidation is expected to continue for years to come.

German competitiveness has also benefitted from the recent restraint in labour costs, though the run of modest wage increases could now change, which would support domestic demand and the euro zone’s rebalancing between north and south. The key for Germany is to continue to deregulate its labour and product markets. The service sector in particular needs an upswing. In addition, there are major demographic challenges that require further reforms by the government and the public sector as well as by businesses.

Cecilia Hermansson
Denmark – a shaky recovery

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Summary

- The Danish economy continues to report weak growth, but is gradually improving during the forecast period with the help of increased domestic demand. We expect the economy to grow by 0.2% in 2012. Next year GDP will rise by 1.1%, before increasing to 1.3% in 2014.

- Fiscal easing in 2012 is leading to increased domestic demand. At the same time the government is implementing structural reforms in the labour market that in time will increase labour force participation and reduce the public finance deficit.

Consequences for businesses

- Lower income taxes and inflation strengthen real household buying power and create the potential for a higher consumption during the forecast period. Increased household savings to reduce debt in the wake of a decline in housing prices and uncertain job market are limiting the room for consumption, however.

- The low level of investment indicates a growing underlying investment need in the Danish economy. Increased public infrastructure spending and investments in new energy are raising the total investment volume in 2012. For 2013 and 2014 we expect the private business sector, excluding housing, to account for the large part of the increase in investment.

- In the Baltic Sea Index Denmark ranks third among Baltic Sea countries. Governance, foreign trade and innovation all rank high. The biggest negative change is in the financial sector, which reached the lowest level in the Nordic countries.

Government losing support

The government is a coalition consisting of the Social Democrats, the Socialist People’s Party and the Social Liberal Party. The Red-Green Alliance also supports it on several issues. The government's work has largely kept to the timetable it presented a year ago. In addition to fiscal stimulus, austerity measures have been taken in the social insurance system that will eventually increase labour force participation
and strengthen public finances. Public spending cuts and stricter rules on unemployment in some respects run counter to the ideologies of the Social Democrats and Socialist People's Party. They have also led to increased dissatisfaction and declining public support for the government. For the Socialist People's Party, public support has fallen by more than half since the election last year, forcing party chairman Villy Søvndal to step down. A split within the parties has resulted in speculation how long the coalition will last. A lack of communication from the government to the public may also be a contributing factor why it has lost support.

Fiscal policy is stimulating domestic demand

Among the Nordic countries, Denmark has had the slowest growth since the global financial crisis in 2008-2009. In 2011 GDP was 6% lower than four years earlier. Despite the government's fiscal stimulus in 2012 and continued low interest rates, growth has not picked up momentum. Negative wealth effects through lower housing prices and high debt levels are contributing to weak consumption and higher household savings. During the second quarter the Danish economy shrunk by 0.3% compared with the previous quarter. This means that GDP for the first half-year was 0.3% lower than the same period in 2011.

Households remain cautious about spending, while investments by businesses and the public sector rose, but with significant fluctuations between quarters. Worsening economic conditions in EU countries, which account for two thirds of Denmark's exports, increase the risk that the Danish economy could again fall into recession in less than one year.

Confidence indicators for households and businesses have weakened in recent months due to global uncertainty, but are still higher than the second half of last year. The government's income tax cuts and early retirement payments are expected to provide a stimulus for the household sector. Lower global commodity prices and slowing inflation are strengthening household buying power. Increased public infrastructure spending, corresponding to DKK 10 billion, is having a positive effect on GDP.

We believe the government's measures will have a greater impact on the economy in 2013, when the global growth outlook gradually improves. Net exports – the engine that has been driving the economy in the last two years – are expected to contribute negatively to growth this year and next. As a whole, the Danish economy is expected to grow by 1.1% in 2013 after a modest 0.2% in 2012. In 2014 it is projected to grow by nearly 1.5%.
Weak labour market limits consumption

Unemployment (gross) has stabilised at around 6% of the working age population in the last year. However, this is more the result of a smaller labour supply. The decrease in the number of working Danes instead shows that the weak growth in the economy is not generating any new jobs. Since 2008 employment has steadily fallen. Our estimate of average GDP growth of just over 1% per year in the next two years is expected to have little effect on employment. This was also evident in last spring’s collective bargaining negotiations for the next two years, which resulted in 1.5% wage increases, excluding wage drift.

A weak job market, high household debt (230% of disposable income) and the shaky housing market will put a damper on consumption growth. This means that private consumption will not drive the economy as it did in 2004-2007, when it rose by 3-4% per year. Instead we expect growth of just over 1.5% in the next two years, less than the projected increase in disposable income.

A low level of business investment and the government stimulus in 2012-2013 suggest higher investment activity. The investments in infrastructure and energy announced by the government will also benefit the private sector. The housing market is still being weighed down by excess supply and low housing prices, because of which housing investments will be limited in the next two years.

Temporary fiscal easing

Denmark has a fixed exchange rate policy where the Danish krone is pegged to the euro at a rate of 7.46 euro per krone and is allowed to fluctuate by 2.25% from the established central exchange rate, i.e., between, 7.63-7.29. This means in practice that changes in economic policy are made through fiscal policy. A large current account surplus and low national debt (44% of GDP) have led to increased investor interest in Danish government bonds in 2012. Interest has also been driven by uncertainty about the fiscal crisis in the EMU. This has pushed Danish short-term bond yields to below zero at the same time that the krone strengthened to 7.43 during the summer. In August and September, however, the krona retreated to the central exchange rate after the risk picture in the euro zone stabilised.

When it took over last year, the government promised to kick-start the Danish economy through public infrastructure investment. Early retirement payments, worth 1.5% of GDP, and temporary tax cuts for investments have had little impact on growth to date, but could have more of an effect in 2013 if confidence in the economy improves. The tax reforms adopted in June will mean lower income taxes and less compensation from the social insurance system, which is a step to increase the labour supply.

As a whole, fiscal policy is more expansive this year than last, at the same time that the new tax reform is underfinanced in the first year. This means that the budget deficit will rise this year to 4% of GDP,
compared with 1.9% in 2011. Cuts in public spending and a recovery in the economy are expected to reduce the public finance deficit to 1.9% of GDP next year.

Competitive economy but with challenges

In Swedbank’s Structural Index Denmark lost one place from last year and was passed by Finland and Sweden. Governance, foreign trade, innovation and logistics rank high. The biggest change in 2011 was the lower rating for the financial market, which fell to 6.0, the lowest of the Nordic countries. One contributing factor is the banking and real estate crisis the Danish economy has struggled with after the global financial crisis in 2008-2009. The rating for education has also fallen, but Denmark still ranks among the highest of the Baltic Sea countries. The progress to date has been through reforms that raise the retirement age and shorten the length of unemployment compensation, which will eventually increase the Danish labour supply. In the area of tax policy, there is greater potential for improvement given the downward trend in recent years.

The declining competitiveness of Danish manufacturing industry is a growing challenge as global competition increases. The manufacture of wind power equipment, which has been a fast-growing sector in Denmark, is now exposed to increased competition from China. Danish global market shares have fallen by 30% since 1995, while German industry’s share has risen by 10%. In addition to improving productivity growth, it is vital to develop and improve products and services that, over time, will strengthen business competitiveness.

Jörgen Kennemar
Norway – strong growth but imbalances are increasing

| Population: | 4.7 million |
| GDP per capita (PPP) 2011: | USD 57,092 |
| Government: | Labour. Socialist, Left and Centre parties |
| Prime Minister: | Jens Stoltenberg |
| Next parliamentary election: | September 2013 |
| Average GDP growth in last five years: | 0.6% |
| Average inflation rate in last five years: | 1.7% |
| Average unemployment in last five years: | 3.0% |

Summary

- The Norwegian economy continues to report high growth despite weaker global conditions. We expect GDP including the oil sector to rise by 3.8% in 2012 and by just over 2% in 2013 and 2014.
- Global uncertainty and low inflation are helping to delay monetary austerity until the second half of 2013. High, rising household debt levels at the same time pose a challenge to financial stability.

Consequences for businesses

- Rising real disposable incomes, low interest rates and a strong currency are paving the way for further consumption growth. Investments in the oil sector have increased substantially this year and mean growing imports of input and investment goods. Housing investments are expected to continue to rise, primarily around the Oslo region, where employment growth is strong at the same time that there is a housing shortage.
- High wages and a strong currency are still a competitive disadvantage for the country’s exporters, increasing the need for rationalisations and efficiency improvements. They have also led to an increased bifurcation between the expansive oil sector with its subcontractors and the rest of the manufacturing industry.
- Increased labour migration to Norway has helped to reduce the labour shortage in construction in particular. Nominal wages are still expected to rise by just over 4% per year during the forecast period, which is more than in competing countries.
- Norway ranks high in Swedbank’s Structural Index, but still has room for improvement. This is especially true in tax policy, but also entrepreneurship.
Headwind for government despite strong economy

The political consequences of the terrorist attacks on July 22, 2011 and the criticism the government received from the 22nd of July Commission have led to a swing in public opinion. The largest governing party, Labour, has seen its support drop in polls from 40 to 30 percent in one year, at the same time that its coalition partners are fluctuating just under the 4% threshold despite strong economic growth and rising real incomes. Although the conservative Höyre Party is beating Labour in the polls, there is the question of what a conservative coalition would look like, especially if the anti-immigration Progress Party (Fremskrittspartiet) joins the government after the parliamentary election next year. The reshuffling of the government in September, when five new ministers were appointed, can be seen as a restart and rejuvenation leading up to the election.

Domestic demand is driving growth

The Norwegian economy continued to grow at a good pace during the first half-year, with GDP rising by 3.7% at an annual rate. The upswing was the result of increased domestic demand, with private consumption growing by 3.6% thanks to strong growth in disposable income and low interest rates. Gross investments, which rose by 9.5% in volume during the first six months, were given a boost by increased housing construction and substantial investment in the oil industry. We are forecasting GDP growth of 3.8% for the full-year 2012. Next year we expect growth to decline to 2.3%, before rising by 2.5% in 2014 due to lower investment in the oil industry. Growth in the mainland economy will remain robust, exceeding 3% per year in the next two years. One major risk in the Norwegian economy is a large drop in oil prices, especially since the oil industry represents one fifth of the country’s GDP.

Private consumption has provided the biggest contribution to GDP growth in recent years. A strong labour market, low inflation and low interest rates have benefitted Norwegian households. We expect real household disposable incomes to rise by an average of 4-5% in the next two years on the heels of higher employment and estimated wage increases of around 4% per year. Despite good income growth, Norwegian households are more indebted than before. Since 1997 gross debt has risen from 135% of disposable income to just over 200%. At the same time households have become more cautious in their spending, partly due to the uncertainty in the global economy. We anticipate a continued high savings ratio during the forecast period at slightly over 9% of household income. The high debt level is a cause of concern and a risk factor in an economic analysis in terms of private consumption and housing prices.

The swings in investment are affected largely by the oil industry’s investment plans. New oil and gas discoveries on the Norwegian continental shelf have led to a major increase in investment volumes, accounting for nearly half of the country’s total increase in 2011 and 2012. The capacity expansion also impacts suppliers within and outside the country’s borders. The added production capacity will lead to...
a gradual slowdown in new investment in the oil sector during the latter part of the forecast period, however. Rising disposable incomes, low interest rates and higher employment will contribute to continued high housing construction in 2012-2014, particularly in metropolitan regions where a shortage is hurting growth. Capacity shortages – including access to skilled labour and planned residential areas – increase the risk of a slowdown in construction activity, however.

A sluggish global economy is contributing to low manufacturing investment. At the same time the sector is affected by rising labour costs and a strong krone. Hourly wages in Norwegian manufacturing were 50% higher last year than the EU average on a trade-weighted and currency-adjusted basis. At the same time productivity has grown slowly, by 0.5% per year in 2006-2010. This means that Norwegian unit labour costs are rising faster than in competing countries, which is limiting export opportunities for Norwegian manufacturers. Competitive problems have led to an increased bifurcation between the competitive business sector not affiliated with the oil sector and the domestic-oriented sector. The bifurcation has also created growing regional differences in the labour market. The municipalities of Oslo and Rogaland accounted for 60% of employment growth last year. In northern sections of Norway the labour market is considerably weaker, with unemployment in some municipalities as high as 7-8%, against a national average of just over 3%.

Monetary dilemma

The Norwegian central bank has an inflation target of 2.5%. Despite that growth has been stronger than expected in 2012, inflation has been below the target. During the first eight months inflation averaged 0.6%, compared with 1.4% during the same period in 2011. A stronger currency and lower prices for imported goods and services are easing domestic price pressures. For the full-year 2012 inflation is forecast at 1% on average, after which it is expected to rise to 1.5% next year and 2% in 2014.

Due to low inflation pressures in 2012 and global uncertainty, the Bank of Norway last spring cut its key benchmark rate, the folio rate, to 1.5% from 1.75%. We expect any rate hikes to be put off until the second half of 2013, when the benchmark rate is expected to reach 2.0%. The high level of household debt and strong rise in housing prices pose a challenge to financial stability. Lending limits have been introduced, but interest subsidies on mortgage loans remain unchanged. As yet there are no signs that credit growth has slowed. In August lending to the household sector grew by 7% on an annual basis. Higher interest rates tend to strengthen the currency, however, which will hurt the export industry’s competitiveness in an already weak global economy.

Fiscal policy is based on Norway’s so-called “handlingsregeln,” the rule that stipulates how much of the state’s oil revenue is allocated to the national budget and how much to the oil fund. According to the rule, the budget deficit excluding oil revenues cannot exceed 4% of the oil fund’s projected return of 4%. Based on the revised national
budget for 2012, fiscal policy is expected to be slightly more expansive next year due to automatic and indexed spending on the household sector.

Reforming the public sector

Its dependence on the oil-related industry could eventually leave Norway vulnerable in the wake of the global energy transition in the coming decades. A long-term growth strategy hasn’t yet been established. Nearly half of the country’s total exports consists of oil and gas. High oil prices and new oil discoveries increase the risk that Norway’s dependence on the oil-related industry will grow at the expense of other industries, which in turn will face increased labour shortages and reduced access to credit. In the longer term the fiscal burden will increase as the country’s oil revenues shrink, at the same time that public spending rises due in no small part to an aging population. Long-term studies show that public spending will grow faster than growth in oil revenues after 2025. Reforms and efficiency improvements in the public sector are among the measures that will eventually be needed to slow the increase in public spending, which in 2011 corresponded to 60% of the mainland economy’s GDP. Higher labour force participation necessitates reforming social insurance systems, which partly explains the high cost of absenteeism and early retirements, which in 2007 amounted to 4.8% of GDP, vs. an OECD average of 1.9%. Reforms are needed here to reduce costs in the long term.

In Swedbank’s Structural Index, Norway ranks fourth after Finland, Denmark and Sweden. The biggest potential for improvement is in tax policy, where Norway’s rating was 7.8, its lowest in the ten categories. In entrepreneurship, Norway still ranks highest among the Baltic Sea countries together with Denmark, although there is room for improvement. There is fertile soil here for new businesses. The innovation climate ranks higher, at 9.1, but is lower than the other Nordic countries. The difference, however, is that there was a significant improvement in 2011 compared with the previous year.

Jörgen Kennemar
Finland – weak growth and competitiveness

<table>
<thead>
<tr>
<th>Population:</th>
<th>5.4 million</th>
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<tbody>
<tr>
<td>GDP per capita (PPP) 2011:</td>
<td>USD 37,581</td>
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<tr>
<td>Government:</td>
<td>Right-left coalition</td>
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<td>Prime Minister:</td>
<td>Jyrki Katainen</td>
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<td>President:</td>
<td>Sauli Niinistö</td>
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<td>Next parliamentary election:</td>
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<td>Next presidential election:</td>
<td>2018</td>
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<tr>
<td>Average GDP growth in last five years:</td>
<td>0.6%</td>
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<tr>
<td>Average inflation rate in last five years:</td>
<td>2.2%</td>
</tr>
<tr>
<td>Average unemployment in last five years:</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

Summary

- Due to the weak global economy and the government's fiscal austerity, the Finnish economy is growing below its historical average. We expect GDP to rise by 0.5% this year and 1.2% next year, before increasing by 2% in 2014.

- Finland's public finances are among the EMU's strongest, but a rapidly aging population will increase the need for supply-stimulating measures in the labour market and reforms in the public sector. The ongoing structural transformation of the Finnish telecom industry and lower productivity growth in the economy are warning signs that should lead to greater reforms in order to strengthen business competitiveness.

Consequences for businesses

- Private consumption is expected to grow slowly throughout the forecast period, when household purchasing power will be 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 the economic outlook is uncertain.

- We do not expect business investment to grow until 2013 and 2014, when global demand gradually rises.

- In Swedbank’s Structural Index, Finland ranks highest in the Baltic Sea region and retains its top position in education. Access to a well-educated workforce, especially in IT technology, makes it an attractive and competitive country for IT research and development. The private service sector has growth potential, but is limited by regulations and a lack of competition, despite improvements in recent years.

Pragmatism, but comprehensive solutions are needed

The broad-based government coalition of six parties, led by the National Coalition Party (conservative) and Social Democrats, has worked better than expected. Critics questioned the viability of the government when it took office last year considering the various ide-

The government's goal is to reduce the budget deficit.
ologies in play. A carefully-parsed declaration issued by the government has been followed, with the main goal being to reduce the budget deficit. The challenges facing the government are great, however, not least a rapidly aging population, which increases the need for budget-boosting measures and more extensive structural reforms in the labour market and public sector. The government has been a strong advocate of stricter rules and opposes the generous support for the economies in crisis in southern Europe. The Finns are unhappy with the EU, due to which the largest opposition party, the EU-critical True Finns, is gaining in opinion polls. In spite of this, a wide majority of Finns want to keep the euro as their currency. In a TNS Gallup poll in August, 63% of respondents said that Finland should become a member of the EMU.

Modest growth outlook

The telecom industry peaked in terms of its importance to the Finnish economy in 2000, when it accounted for 30% of exports. Since then this figure has dropped and last year was just 10%. Nokia's decision not to produce mobile phones in Finland is further proof of the structural transformation the business sector is undergoing. At the same time unit labour costs have increased faster than in competing countries and led to lower global market shares. The structural transformation and competitive decline also partly explain the sluggish recovery in the economy since the financial crisis in 2008-2009. Since the economy bottomed out in 2009, GDP has yet to return to the level before the crisis.

The shaky global economy has clearly had an impact in 2012, when Finland's GDP has fluctuated significantly. GDP growth fell by 1.1% during the second quarter after having risen by 0.8% in the preceding period. On average GDP rose by 1% during the first six months.

Growth prospects have deteriorated during the summer and fall. Confidence indicators for industry have fallen at the same time that growth in the EMU countries, which buy 30% of Finnish exports, is declining. Private consumption, which was the growth engine in the Finnish economy in 2010 and 2011, is constrained this year and will be next year as well due to the government's fiscal austerity and a weaker labour market. Low real income increases, high debt levels (80-90% of households' disposable income) and a low savings ratio are expected to cut private consumption growth in half in 2012-2014 compared with the last two years, when consumption rose by slightly over 3% a year. Global economic weakness and low resource utilisation mean that business investment will be modest in 2012. We expect GDP to grow by 0.5% this year, before rising by 1.2% next year and 2% in 2014, when the global economy gradually improves, which will also drive business investment.
Fiscal austerity

Finland's finances are among the strongest in the EMU. Last year the budget deficit for the consolidated public sector fell to 0.9% of GDP from 2.7%. In its draft budget for 2013 the government is forecasting a deficit of just over 1% of GDP. Budget-boosting measures include higher indirect taxes and the elimination of indexed spending. Due to weak growth and increased spending on an aging population, public spending as a share of the economy is expected to further rise in 2012 and 2013. In the last four years the number of pensioners has grown by 100,000 at the same time that the working population has shrunk. Public debt is expected to reach nearly 55% of GDP next year, which is still the lowest level in the EMU. Demographic challenges and continued slow growth increase the need for reforms and efficiencies in public finances, however.

Inflation has been higher in Finland than in the EMU countries since the end of 2010. On average for the first eight months inflation was 3%, compared with an EMU average of 2.5%. Higher indirect taxes to strengthen public finances and higher unit-labour costs are contributing to this. Inflation is expected to exceed the EMU average next year as well. Following a 1% increase in value-added taxes in January 2013, it is expected to be slightly over 2.5% for the full year. The impact of the announced tax increases will subside in 2014, when we expect inflation to fall to 2%.

Structural work must be intensified

The big current account surplus in the early 2000’s has been replaced by a slight deficit, which is expected to continue during the forecast period, 2012-2014. This is partly due to Finland's declining competitiveness, with unit-labour costs having risen faster than the EU average. Productivity growth in the economy has weakened due to structural problems in the telecom industry. A growing service sector with relatively low productivity is contributing to lower productivity growth. Growing global competition and outsourcing of production to low-wage countries are increasing the need for structural reforms and innovation.

The fact that it ranks highest in Swedbank's Baltic Sea Index shows, however, that Finland has room to improve its growth and competitiveness. Education is clearly its highest rated area, although it also ranks high in innovation and infrastructure. The biggest potential for improvement is in taxes, entrepreneurship and the labour market, which received lower ratings than the country as a whole. Progress has been made in tax policy in last year. Simplified tax rules have led to an increase in Finland's rating to 7.7 from 5.9 in the previous year. The big investments in research and development represent just over 3.5% of GDP, beating the EU average. But relatively few new products and services are being commercialised. Increased collaboration between businesses and education is needed.

Since 2009 the Finnish labour market has improved. Unemployment has fallen from 9% to 7.5% at the same time that the share of the
working-age population that is employed (employment rate) has risen to nearly 69%. Slow growth forecasts this year and next increase the risk that the labour market will stagnate, however.

Finland has the fastest aging population in the EU, at the same time that the working-age population is shrinking. This is placing a burden on public finances while at the same time limiting growth potential. By 2030 the number of pensioners is expected to increase by 600 000, while the working-age population (15-64 years) will shrink by 168 000, according to the Ministry of Finance. Finland’s long-term fiscal stability requires greater labour force participation. This requires changes in the pension age, social insurance systems and income taxation, which in the long run will grow the labour supply. More supply-stimulating measures are needed to improve productivity growth in both the private and public sectors and to strengthen the country’s long-term competitiveness and break the downward trend in productivity growth. This includes further deregulation of the service sector, increased flexibility in the labour market and measures to encourage new businesses.

Jörgen Kennemar

Increase incentives to encourage labour force participation
Sweden – companies brace for a weaker global economy

<table>
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<tr>
<th>Population:</th>
<th>9.5 million</th>
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<tr>
<td>GDP per capita (PPP) 2011:</td>
<td>USD 41,447</td>
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<td>Government:</td>
<td>Centre-liberal market-oriented coalition</td>
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<td>Prime Minister:</td>
<td>Fredrik Reinfeldt</td>
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<td>Next parliamentary election:</td>
<td>September 2014</td>
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<tr>
<td>Average GDP growth in last five years:</td>
<td>1.6%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>1.9%</td>
</tr>
<tr>
<td>Average unemployment in last five years:</td>
<td>7.3%</td>
</tr>
</tbody>
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Summary

- The political debate in Sweden is starting to focus on the preparations for the 2014 election campaign. The governing coalition and opposition are both carving out programs that they hope will find the most support in the electorate. Although unemployment will be a priority, business-related issues are already garnering attention. Investments have been promised to bolster infrastructure, research and innovation.

- Renewed concerns in the euro zone will affect the Swedish economy primarily through lower export demand. Instead we expect domestic demand to contribute more to growth in Sweden in the next two years, particularly household spending.

- We are revising our 2012 growth forecast (compared with our August forecast) downward to 0.8% from 1.6%, while raising it for 2013 to 1.7% from 1.6%. The growth forecast for 2014 is also raised slightly to 2.4%, but for the period as a whole growth will be slightly weaker than we forecast in August. Fiscal policy will be mildly expansive, and the Riksbank is expected maintain its repo rate this fall at 1.25%.

Consequences for businesses

- Although companies, especially exporters, will see weaker external demand in the year ahead, at this point they are in a relatively solid position. They are going have to trim personnel and inventory levels in the short term, however, and adjust to the changes in the Swedish krona.

- Increased business opportunities in the Swedish economy will mainly be found in sectors related to domestic consumption, although there will also be possibilities in public investment and research.

- In Swedbank’s Baltic Sea Index, Sweden retreated slightly to 9.0, but it is still among the highest-ranking economies in the world in terms of business opportunities. The biggest room for improvement is in the areas of entrepreneurship and tax policy.
Labour market remains at the political centre

The government, which doesn’t have a majority in parliament and is beset by low poll numbers for its smaller coalition partners, has limited room to manoeuvre. However, the impending election campaign and risk of rising unemployment have intensified its efforts to address unemployment and put more people to work. Unemployment is expected to be the big issue in the parliamentary election in 2014. The government will also be questioned on what it has done to reduce social exclusion, i.e., those who aren't employed or in school.

The largest opposition party, the Social Democrats, has maintained a low profile after a series of changes at the top leadership, but with former union leader Stefan Löfven now firmly ensconced as party leader, a new party platform is expected to take shape, including a strategy for the 2014 campaign. Indications are that there will be a greater focus on business and education issues and that major changes won’t be proposed with regard to taxes. Since the differences between the political alternatives are fairly small, it is unlikely that businesses will see major changes.

Companies under pressure from falling demand and increased uncertainty

We are revising our growth forecast for 2012 downward to 0.8%, compared with 1.6% in our August forecast (calendar-adjusted), largely due to significant revisions to outcome data for the second quarter. Export growth in particular was weaker, although public consumption was revised downward as well. Despite slower growth during the first half of 2012, the Swedish economy has developed strongly since the significant contraction in late 2011. For the entire period since the financial crisis in 2008-2009, real GDP has risen by nearly 4%, considerably higher than economies such as Finland (-4%) and Denmark (-6%). Only Norway (+6%) rose by more among comparable economies. At the same time, however, unemployment has been stuck at around 7.5%.

For the rest of 2012 we anticipate significantly weaker economic growth than during the first half-year. Global turbulence, primarily in the euro zone, will reduce demand for Swedish exporters. Moreover, the Swedish krona appreciated strongly during the summer, especially against the euro, affecting the competitiveness of Swedish companies. Since then the krona has weakened again, but we expect it to strengthen during 2013 and thereafter weaken somewhat in 2014. Fluctuations could be quite significant, however, depending on global developments. At the same time the competitiveness of Swedish companies has improved thanks to labour productivity gains this year as well as due to restrained wage growth. Changes in production costs have to be monitored closely, however, so that they don’t deviate too much from key trade partners such as Germany.

Economic policy has shifted in recent months as concerns about economic development in Europe have grown. In contrast with its own in-
terest rate forecasts, the Riksbank decided in September to cut the repo rate to 1.25% against the backdrop of stronger productivity growth, a lower inflation outlook and a stronger krona. In the government's budget for 2013, reforms corresponding to SEK 23 billion were announced for 2013 and another SEK 4 billion to SEK 27 billion for 2014. Considering our forecast that the Swedish economy will weaken this fall before growth gradually increases in 2013, it makes sense that economic policy is used to support growth. We also expect that the Riksbank will keep the repo rate at 1.25% until the second half of 2013, and then gradually raise it to 2.25% throughout 2014. This would support businesses through lower financing costs.

For the next two years we expect the economy to be relatively sluggish, with growth of 1.7% in 2013 and 2.4% in 2014. The main growth engine will be household consumption, even though we expect that rising unemployment through mid-2013 will keep the savings ratio elevated. Businesses are likely to become more cautious, and we thus revise our investment forecast downward slightly to about 3% in 2012 and just over 2% in 2013. In total, domestic demand is expected to grow by a bit more than 1.5% during the period 2012-2014, down from the two previous years, when growth was around 5%.

Reforms intend to strengthen competitiveness

When it presented its budget for 2013, the government announced a number of proposals to stimulate long-term growth, but also to improve conditions more immediately. The reduction in the corporate tax rate already from 2013, from 26.3% to 22%, corresponding to tax revenue decrease of SEK 16 billion a year, will increase profitability in the private sector and allow for more private investment. The tax cut is mainly being motivated by falling tax rates in other OECD countries and that Sweden has to remain attractive to both domestic and foreign companies. The tax cut will be financed in part by limiting interest rate deductions by businesses (corresponding to about SEK 8 billion), which will make it more expensive to raise capital. At the same time the government is making it easier to finance start-ups and emerging companies through a so-called investment deduction.

A more long-term initiative was to increase investment in infrastructure. New investment and maintenance have been neglected in Sweden for years, which have resulted in traffic disruptions and congestion. Partly this could be a reason why Sweden's rating in Swedbank's Baltic Sea Index has declined slightly in recent years (especially in logistics and infrastructure, see below). The government is mainly focused on improving and increasing rail capacity, including by expanding the main line around Stockholm and adding capacity around Göteborg. These investments will cut transportation costs and expand the labour markets around Sweden's major cities in order to alleviate some of the bottlenecks in these fast-growing areas. Significant investments were previously also made around Malmö (the most recent example being the expansion of the so-called City Tunnel).
The government has also proposed increased investment in research and innovation to encourage new cutting-edge expertise and the development of products, especially in the area of life sciences (pharmaceutical research, medical technology and biotech). In the long term this will also strengthen Swedish productivity and growth.

Furthermore, the government has initiated a so-called jobs pact, where businesses, unions and the government will work together to make it easier for young people to enter the job market. The aim is to create a pathway for them to the labour market through an apprenticeship system where the state contributes through subsidies. For companies, it would facilitate the recruitment of new personnel and access the right skills given the relatively large wave of baby boomers scheduled to retire in the years ahead.

Swedbank’s Baltic Sea Index shows a marginal decline to 9.0, with Sweden losing its top spot from the two previous measurement periods to Finland. Sweden is still in the 10% of the strongest economies in the world in terms of business climate. The reason why the overall rating declined is that the index for logistics decreased, mainly due to transportation issues. Sweden's rating in education has also fallen slightly, while its overall rating has been helped by the continued positive development of the financial market.

Sweden's lowest ratings in the last four years have been in tax policy and entrepreneurship, which are the areas with the biggest room for improvement. The lower corporate tax rate announced in the 2013 budget proposal could help, while measures to strengthen entrepreneurship mainly involve reducing the bureaucracy of running a business and strengthening the rights of employers.

Magnus Alvesson
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

II. Labour market
   Labour market efficiency
   Labour productivity
   Labour force participation rate

III. Tax policy
   Ease of paying taxes
      (incl. number of payments, time, and total tax rate)

IV. Financial markets
   Financing through local equity market
   Ease of access to loans
   Venture capital availability
   Soundness of banks
   Regulation of securities exchanges

V. Foreign trade
   Enabling trade index

VI. Education
   Higher education and training

VII. Governance
   Corruption perception index
   Rule of law
   Control of Corruption

VIII. Infrastructure
   Quality of overall infrastructure
   Infrastructure

IX. Logistics
   Customs
   International shipments
   Logistics competence
   Tracking & Tracing
   Timeliness

X. Innovation climate
   Innovation Input
   Innovation Output

Sources:
- World Economic Forum
- World Bank Doing business
- Transparency International and World Bank
- KPMG International shipments
- World Economic Forum
- INSEAD

Swedbank Baltic Sea Index
Annex

**Swedbank Baltic Sea Index: Global position and change**

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
Kristjan Tamla +3728887952 kristjan.tamla@swedbank.ee
Acting Chief Economist, Estonia

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

Teele Reivik +372 888 7925 teele.reivik@swedbank.ee
Economist

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

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

Kristilla Skrūzkalne +371 6744 5844 kristilla.skrūzkalne@swedbank.lv
Economist

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

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