Swedbank Economic Outlook

Update – April 2015

Budding spring with spells of night frost

- **Mature economies will provide stability in the global recovery, propped up by monetary policy**
- **Emerging economies will face increased volatility, but some are better prepared than others**
- **Sweden has to adapt to ECB expansion; Norway to oil price swings, and the Baltic countries to the sharp fall in demand from Russia**

The global recovery is supported by monetary policy

We remain cautiously optimistic on the global growth outlook, mainly because of the continued monetary policy support. Now the turn has come to the euro area, and ECB has been aggressive in addressing the weak growth and low inflation. As a result, we expect activity to pick up, and we revise up the growth forecast, mainly for Germany and Spain. Recent global developments have, however, not been entirely positive. In particular, the US has seen a weaker outcome in late 2014 and early 2015, although mainly on account of temporary factors. As growth returns, we expect the Federal Reserve to start hiking the policy rate in September this year.

A gradual increase in global growth with evenly balanced risks

Diverging monetary policies of the two main central banks will create tensions and risks. The euro will depreciate, boosting competitiveness in the euro area at the expense of others. Thus, the rhetoric concerning "competitive devaluations" is likely to grow louder. Volatility in the currency and assets markets will also affect emerging economies, with large swings and bouts of capital outflows. Some countries will be able to cope, such as India and China, while others will be more exposed, like Russia and Brazil. The risk with the largest negative impact on the global economy would be an uncontrollable unravelling of Chinese imbalances, but we expect that the Chinese authorities will be able to handle it. There is also a non-negligible probability that the recovery in the euro area will be stronger than anticipated. Our main forecast, however, is a gradual increased in global growth over the next two years.

Squeezed between bigger players on the global scene

In **Sweden,** policy remains unbalanced, with a strong tilt towards monetary policy. As fiscal policy remains overly tight and the ECB exceptionally expansionary, the Riksbank has no choice but to continue to pursue an aggressive policy expansion. We expect the repo rate to be cut to -0.5% and the asset purchase program to grow. At the same time, growth will benefit from a pickup in the euro area, and from a relatively weak krona. Thus, we revise up growth forecasts this year to 2.6%, and for the next to 3.2%. The upward pressure on the krona will be suppressed and market interest rate pushed lower throughout the yield curve.

Growth in the **Norwegian** mainland economy will continue to slow. Oil investments are expected to fall substantially this and next year, but demand is also held back by weak mainland business investments. There is, however, a positive contribution to growth from net exports, boosted by the weaker krone. We revise our growth projections down slightly to 1.2% for this year and to 1.4% for next year, with risks on the downside.

The **Baltic** countries are holding up fairly well, given the Russian turmoil– both raising export sales to other markets and thanks to strong domestic demand. But there is a negative impact on external trade and sentiment. In **Estonia**, the growth forecast is revised up marginally on the back of stronger domestic demand. In **Latvia** and **Lithuania,** growth forecasts are kept unchanged as exports and investments are affected by geopolitical uncertainty, while domestic demand remains strong.

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The global economy: Recovery propped up by monetary policy

We remain cautiously optimistic on the global growth outlook, mainly because of the continued support from monetary policy. Now the turn has come to euro area and the ECB has recently been determined and aggressive in addressing the weak growth and low inflation with expansionary monetary policy. As a result, we expect activity to pick up, and we revise up the growth forecast, mainly for Germany and Spain. Recent developments have, however, not been entirely positive. In particular, the US has seen a weaker outcome in late 2014 and early 2015, although mainly on account of temporary factors. As growth returns, we expect the Federal Reserve to start hiking the policy rate in September this year.

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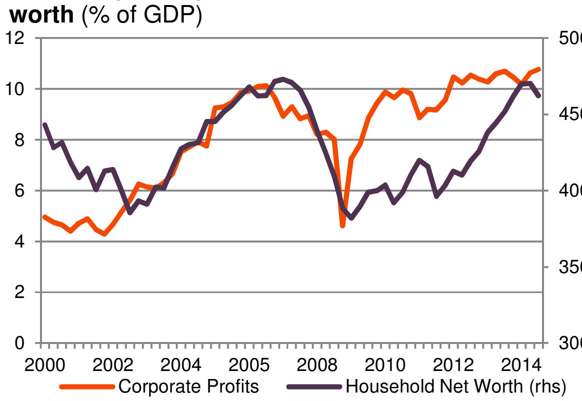
Pick up in mature economies despite some set backs

We expect USA and …

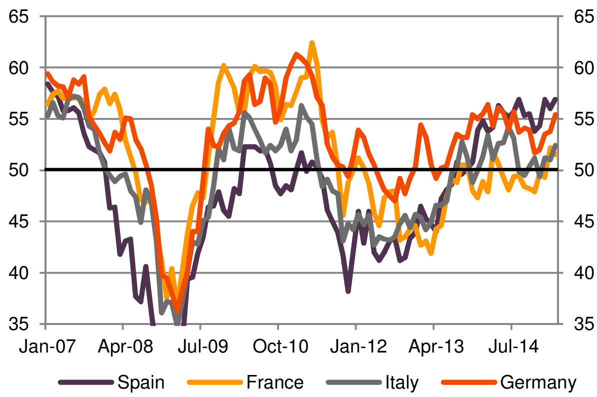
After a very strong rebound in the second and third quarters last year, growth in the US slowed around year's end. Fourth-quarter growth dropped to 2.5% annualised, and indicators suggest that the start of this year also was weak. However, to some extent this can be explained by temporary factors, such as the winter weather, port disruptions, and a slowdown in the energy extraction sectors. A weaker momentum was seen not least in the labour market. Job creation dropped, and the labour force participation rate remained subdued. This reduces the pressure on wages and thus on inflation. The Federal Reserve (Fed) opened the possibility for a June hike at the latest meeting by dropping the term "patience," but since then real activity in the US economy has slowed. However, we expect growth to pick up in the remainder of the year, and many members of the FOMC are becoming increasingly uncomfortable with the very expansionary monetary policy stance. Thus, we stick to our forecast that the first hike will be implemented in September, but that the hiking pattern will be limited to two hikes per semester during 2016. This is dollar and bond positive, which will increase volatility and risks in both the US (nonbank) financial markets and in emerging economies. US growth is expected at 2.9% in 2015 and 2.8% in 2016, slightly lower than in our January forecast, mainly on account of the weak ending of 2014. Underlying factors, such as household and corporate balance sheets, are strong.

USA: Corporate profit and household net worth (% of GDP)



Source: IIF

EMU: Composite PMI



Sources: Reuters EcoWin and Swedbank

….Germany to lead the way

We are revising up our growth forecast for the euro area on the back of the massive expansion of monetary policy and depreciation of the euro and due the positive effects from the decline in oil prices. Recent data suggest an increase in activity, not least in Germany. Following a pickup of growth in the fourth quarter, retail sales and consumer confidence point to continued strong activity in early 2015. We also see that the decline in credit expansion throughout the euro area has slowed, and that private credit is rising. This follows the extensive bank stress exercise last year and current stimulus from the ECB. Banks, however, are still plagued by high levels of nonperforming loans, which will limit credit expansion. In addition to Germany, we expect activity in Spain to pick up the most, but the purchasing managers' indices in all of the major economies are suggesting a broad recovery. We expect the ECB to continue with its asset purchase program until September next year, although, as growth picks up, inflation returns and the availability of purchasable asset dwindle, the debate on an early exit will intensify. It will be difficult, however, for the ECB to exit early (cf. the experience of the Fed). All in all, we revise up the overall growth forecast for the euro area to 1.4% in 2015 and keep our forecast at 1.9% in 2016.

Other developed economies are facing uphill battles

Finland and Denmark, important trading partners for Sweden and the Baltic countries, are still struggling to overcome the impact of the financial crisis. In Finland, this is made worse by a homegrown structural crisis and the large exposure to the Russian economy, but we expect growth to turn positive after three consecutive years of contraction. Also, the outlook for Denmark is revised up, not least due to its successful defence of the krone, which boosts competitiveness. In the UK, a weak start to 2015, combined with the highly uncertain outcome of the elections, leads us to lower our forecast. We also expect the Bank of England to postpone the first rate hike to early 2016 on the back of the very expansionary ECB stance. In Japan, growth is expected to accelerate this year, but at a very modest rate. We expect inflation to moderate, which will cause additional monetary stimulus. However, progress on structural reforms has been very limited.

Emerging economies in between energy prices and Fed

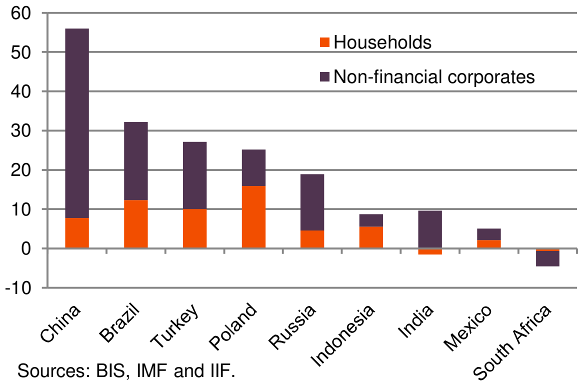
Different fates across emerging economies

The emerging economies are becoming less and less homogenous, and they are also facing different challenges. However, most are exposed to the positive effects of declining energy prices and the negative effects of a strengthening dollar, albeit to varying degrees. The extent to which a stronger dollar will cause volatility depends on the macroeconomic reforms that have been implemented and the reserves that have been built up. In China, the economy is facing a broad-based weakening and rising leverage ratios. However, reserves are large and fiscal balances sound, which increases the room for stimulus policies. We revise down the growth forecast for both 2015 and 2016. In India, the perquisites for a growth surge are in place, but reforms need to be approved and implemented, while Brazil is hit by both domestic weakness and a long period of domestic mismanagement of economic policies. We expect a period of volatile economic developments in emerging markets.

No upside for Russia

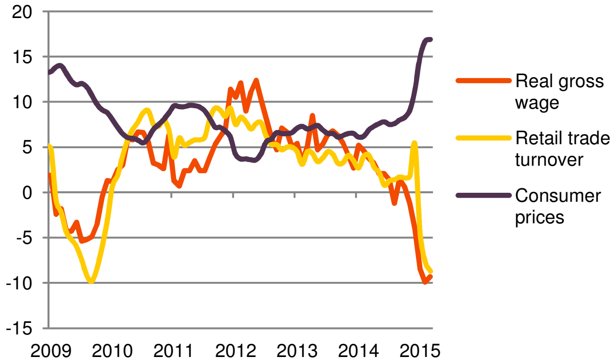
Russia will continue to suffer from multiple negative hits to the economy. Although oil prices have recovered somewhat from their lows early in the year (so did the rouble), oil price increases are expected to be moderate (the potential opening up of Iran's production and declining Chinese demand). Furthermore, sanctions will prevail and domestic sentiment will erode. This together with high inflation will worsen the situation for Russian households. In federal budget, defence spending and social spending is increased at the expense of public sector investments and health care. Private investment will also plummet due to massive financial squeeze and credit crunch. We expect capital outflows to continue and the rouble to depreciate. Yet, due to less weak rouble and somewhat higher oil price we inch up GDP forecast to -5.5% in 2015 and -2% in 2016 (from -6% and -2.5%, respectively).

Emerging economies: Private Sector Debt
%-points difference between 2007 and 2013



Sources: BIS, IMF and IIF.

Russia: Growth of retail, wages and prices (%, y/y)



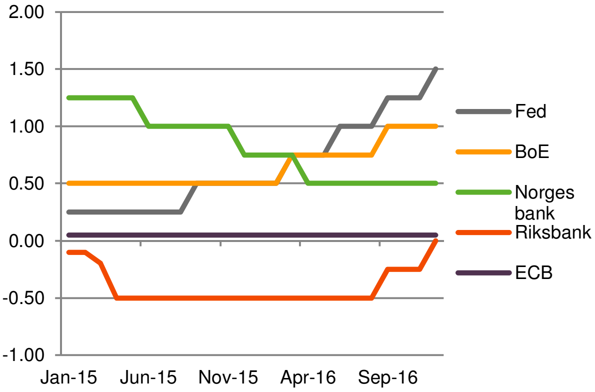
Source: Reuters Ecowin

Monetary policy tensions spread to currency markets

Monetary policy or competitive devaluations?

A key theme during 2015 and 2016 will be monetary policy divergence, and this will have widespread consequences across the globe and markets. Although we expect only a gradual adjustment by the Fed, the rate hike in the autumn of this year will raise the pressure on the US dollar. Not least, emerging markets with large external imbalances and/or a high degree of dollar-denominated private sector debt will face speculations and be exposed to capital outflows. As we expect the ECB to stick to its stated intentions and continue to expand its balance sheet until September 2016, the euro will be weak. This will raise questions, in particular in the US, of an "unfair" currency doping, particular as the exchange rate drops below parity. Also, small, open developed economies will face pressures, as experienced in Switzerland and Denmark. These, including Sweden, will do whatever it takes not to lose competiveness vis-a-vis the euro. Moreover, in China the objective of keeping the yuan stable against the dollar is likely to be questioned as competitiveness is eroded while growth is slowing.

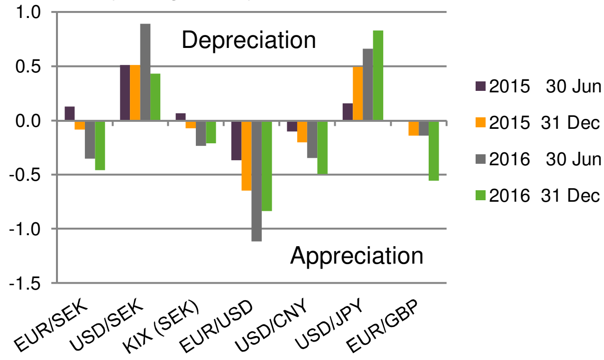
Central bank policy rates (%)



Source: Swedbank's forecasts

Exchange rate movements

Forecast (change in %)



Sources: Reuters EcoWin and Swedbank.

Overall growth roughly unchanged and risks evenly balanced

A slow global recovery

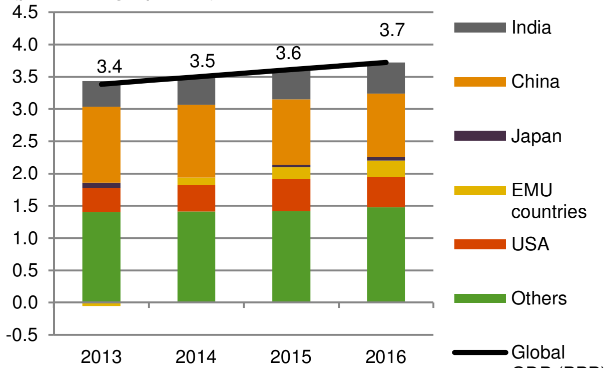
For overall global growth, our forecasts from January remain roughly unchanged, although there are quite substantial revisions across countries. We foresee a growth rate of about 3.5% for 2014, and then a gradual increase in 2015 and 2016. The main revisions compared with our January forecast are a reduction of US growth in 2015, and an upward revision for the euro area. Brazil is looking significantly worse, and Chinese growth is expected to slow, while prospects in India have improved.

Illiquid liquidity, "Grexit"; but here is also an upside

The largest risks to the outlook in developed economies are, in the short term, volatile financial markets, and in the medium to longer term, a sustained slow growth (the so called "secular stagnation" with potential growth at a low level). In the US, but recently also in the euro area, the large monetary expansion has led to increased risk taking. Should sentiments change, in particular in connection with greater certainty about the monetary policy intentions of the Fed, rapid exits could create a severe lack of liquidity, leading to exaggerated swings in asset prices. In other words, it could become "crowded in the door" when everyone is exiting. A dollar strengthening could also lead to larger-than-expected capital outflows from emerging markets, with large current account deficits and high indebtedness. The likelihood of a Greek exit from the EMU has increased recently, but the potential negative economic impact outside Greece has, to some extent, been limited. We estimate that the positive risks to the outlook roughly are of the same magnitude as the negative risks, mainly comprising a better-than-expected outturn in the euro area combined with a stronger rebound in the US.

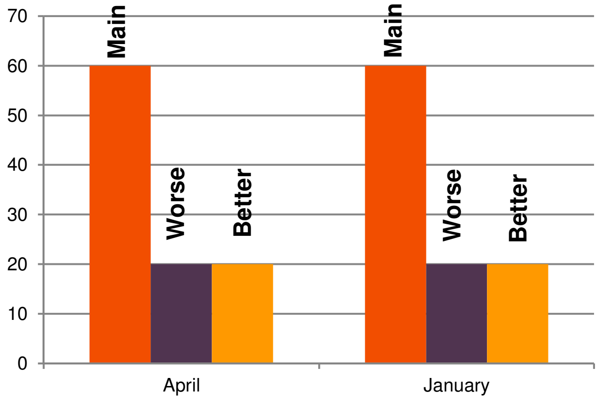
Contribution to global growth

(percentage points)



Sources: Ecowin and Swedbank's forecasts.

Risks to the forecast (prob. in %)



Source: Swedbank

Sweden: Growth supported by monetary policy

We expect the economic policy mix to remain unbalanced, with a strong tilt towards monetary policy. As Swedish fiscal policy remains overly tight and the ECB exceptionally expansionary, the Riksbank has no choice but to continue to pursue an aggressive monetary policy. We expect the repo rate to be cut to -0.5% and the asset purchase programme to be expanded. At the same time, growth will benefit from a pickup in the euro area, and from a relatively weak krona. Thus, we revise up growth forecasts this year to 2.6% and for the next to 3.2%. The upward pressure on the krona will be suppressed and the market interest rate pushed lower throughout the yield curve.

Household consumption will drive growth now, but to a lesser extent in 2016

Since our January forecast indicators have suggested that the Swedish business cycle is on an upward trajectory. Fourth-quarter growth in 2014 surprised positively, with, in particular, domestic demand contributing to growth. We expect the household economy to remain strong and consumption to be the main engine of growth in 2015. Next year, tax increases, higher inflation, and, to some extent, amortisation requirements will constrain purchasing power. Towards the end of 2016, we also expect to see the first significant increase in interest costs since late 2011, as debt levels remain high and the mortgage rate starts to increase.

Higher investment growth

We expect steadily rising housing investments during 2015, but the growth rate will subside in 2016 due to base effects and increasing supply restrictions, such as labour shortages and higher production costs. Business investment accelerated in the last quarter of 2014, when R&D accounted for a significant proportion of the increase (more than 4 percentage points above the historical average). This was mainly due to temporary factors, and we foresee a negative rebound in the first quarter of 2015. Low interest rates, favourable cost developments (lower unit labour costs and low oil prices), and solid domestic demand are expected to raise business investments at a faster pace than previously forecast in 2015 and 2016. Economic policy, however, creates uncertainty that can compromise corporate investment plans. Public investment will regain momentum in 2016, driven by the government's new initiatives in infrastructure and ongoing municipal investment projects.

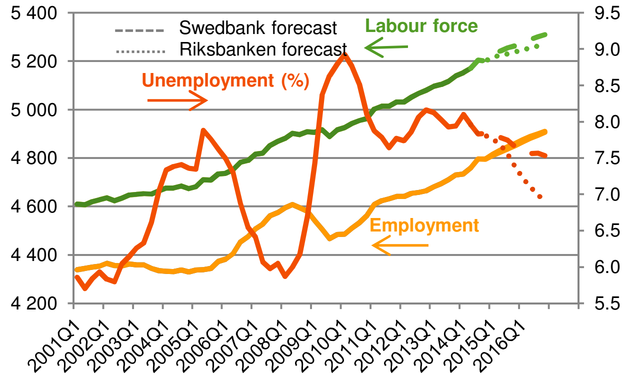
Exports recovering at last

Overall exports picked up significantly at end-2014, driven mainly by increased exports of services. Swedish export prospects will improve when growth in the euro area and the Nordic markets pick up compared with last winter. We expect the total export volume to increase by 5.2% on average in 2015--2016, but to stay below the expected average global market growth of 5.5% for the same period. Lower relative unit labour cost (ULC) and a weaker exchange rate will support Swedish exports during the forecast period and partly offset the decline in market share.

Unemployment rate will fall by less than forecast by the Riksbank

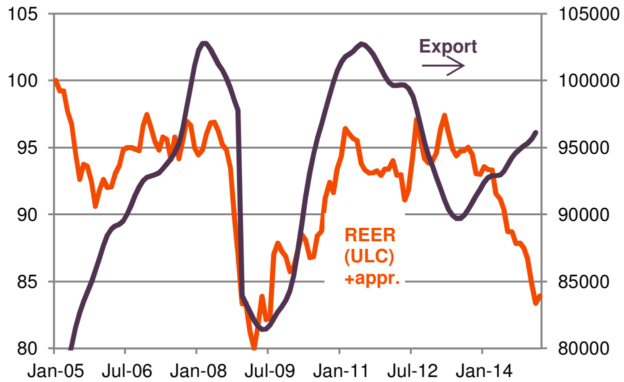
The labour market has continued to strengthen during the early part of 2015. Employment is increasing at a good pace, hiring plans are expansive, and more new job vacancies are being announced. But we expect unemployment to get stuck at a relatively high level, nearly 8%, as the workforce also increases. The previous government's reforms still are affecting the labour supply through a higher participation rate amongst elderly and foreign born. The population is also growing at a rapid pace due to significant net immigration. Not until next year do we expect unemployment to decline more markedly, to about 7.6%. Recent government proposals, including higher unemployment benefits, raised marginal taxes, and higher taxes on young workers may dampen both labour supply and demand.

Sweden: Labour market



Sources: Swedbank, SCB and Riksbank.

Sweden: Export and competitiveness



Sources: Ecowin and BIS.

Successful wage negotiations depend on making the inflation target

Although current agreements will run for another year, discussions on the new wage negotiations are already under way. These will be difficult, not least due to the low inflation rate and the recent decline in long-term inflation expectations. Unions argue that the inflation target of 2% should form the floor for wage revisions, while employers point to the significant real wage growth in recent years following the low actual price increases. Currently, wages are growing at less than 3%. Swedbank expects central wage agreements in line with current contracts, about 2.2%. As the unemployment rate begins to decline and it becomes more difficult to find skilled labour, we expect wage drift to gradually increase. Wage growth is expected to remain relatively modest, and average wage growth is expected to amount to about 3.3% in 2016.

No aggregate demand effect from fiscal policy

Fiscal policy, as presented in the Spring Budget bill, is fully financed and focuses on redistribution from private to public consumption. Hence, it does not contribute to aggregate demand and puts pressure on the Riksbank to conduct a very expansionary monetary policy. Raised taxes dampen private consumption and reduce employment, while spending on education and infrastructure raise government consumption and investments. The net effect on the Swedish economy is expected in the short term to be neutral to slightly negative. The bill includes proposals for hiking taxes nuclear energy and together with likely tax increases on fuel and the reduction of the tax credit for house improvements, this will raise headline inflation by at least 0.35 percentage point, according to our calculations. It is a temporary effect, however. The government does not use fiscal policy to stimulate demand even though the Riksbank's tool kit is becomes increasingly depleted. This is putting pressure on monetary policy.

Higher inflation, but mainly due to temporary factors

Inflation has bottomed out, and we expect inflation controlled for interest rate effects (CPIF) to increase to 1.0% in 2015. This is partly due to base effects. In 2016, CPIF is set to increase to 2%, driven by higher energy prices and tax increases. However, core inflation impulses are expected to remain muted.

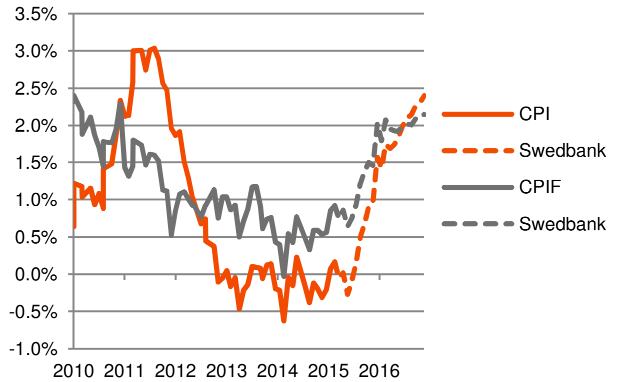
The Riksbank has gone all in fighting low inflation

The Riksbank has since last summer pursued a more aggressive monetary policy and in March surprised, in an interim Board meeting, by cutting the repo rate to -0.25% and expanding its purchases of government bonds by a further SEK 30 billion. This clearly shows how determined the Riksbank now is to bring up inflation. Persistent low inflation, declining inflation expectations, the impending wage negotiations and the ECB's very accommodative monetary policy provide the main rationale.

Further easing ahead

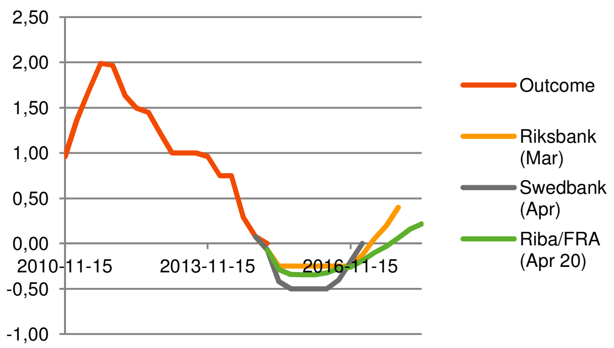
We expect further monetary easing during the spring, presumably through another cut of the repo rate to -0.5% at the monetary policy meeting in April. Furthermore, an expanded asset purchase package is likely when the current one expires in early May (Swedbank expects SEK 50 billion in a new package that also could include papers such as municipality and mortgage bonds). A continuing purchase programme in the fall should not be ruled out, in particular if the appreciation pressure on the krona does not abate.

Sweden: Inflation forecast



Sources: Statistics Sweden and Swedbank.

Sweden: Repo rate path



Note: The Riksbank path (March) is an estimation from the press rel.
Sources: Swedbank, Riksbanken and Bloomberg

Norway: Slowdown continues

Growth in the Norwegian mainland economy continues to slow, in line with our expectations. Oil investments are falling, but demand is also held back by weak business investments and muted public demand. Manufacturing production has peaked and is set to fall in oil-related segments. On the positive side, there is now a strong positive contribution to growth from net exports, which is likely to continue, given the weaker krone. Norges Bank's regional network reports an expected growth rate below 1% for the first half of the year. We revise our growth projections slightly downwards to 1.2% for this year and 1.4% for next year, with risks on the downside.

The oil price has recently risen to above 60 per barrel. We believe oil prices are past the trough and we expect prices now to rise gradually. Nevertheless, we see little scope for an upswing in oil investments on the Norwegian continental shelf over the next few years, even with higher oil prices. The slowdown in oil investments had already started when the oil price was still well above USD 100 per barrel, on account of a combination of high costs and competition from other relatively more attractive petroleum fields. These concerns are likely to continue for some time. And we expect the petroleum companies, having experienced lower prices and weaker cash flows, to be more cautious with their investment plans for some time as well.

Unemployment has stayed low so far. but is set to rise

Registered unemployment rose but stood at only 3.2% in March, which was, in fact, a tad lower than a year earlier. Unemployment has risen noticeably in oil-related sectors and regions, but slower than most had expected. Elsewhere, it has remained stable. The labour force survey (AKU) has reported a sizable upswing in unemployment since last summer, but this is not a very reliable survey. At the same time, there can be little doubt that the announced downsizings in oil-related sectors will eventually be implemented. This, together with the weak demand for labour, suggests that a significant rise in unemployment can be expected in the coming year. The leading labour union LO, has taken the economic slowdown and the prospective rise in unemployment seriously by accepting zero real wage growth this year, a significant shift down from previous years. With only 2½-2¾% wage growth, domestic cost pressure will recede, and inflation is set to fall below target.

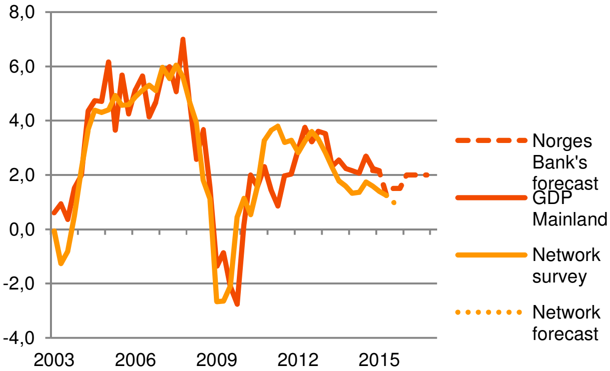
More rate cuts, eventually

Norges Bank kept its main policy rate unchanged at 1.25% in March but projects that it will be cut later this spring, to 1%. The bank sees the need to stimulate the economy to limit the rise in unemployment and keep inflation close to target. However, the bank is worried about the effects a rate cut could have on the housing market and a buildup of household debt.

The bank's worries about a too-strong growth in house prices may be about to recede, as price growth has abated in recent months, to only 0.1% in March. In Stavanger, which is hardest hit by the oil slowdown, house prices are now falling, and we expect prices for the country on average to flatten and eventually fall later this year, as the economic slowdown takes a broader hold. The slowdown in price growth should ease the trade-off for Norges Bank. Moreover, the FSA has proposed to tighten access to credit.

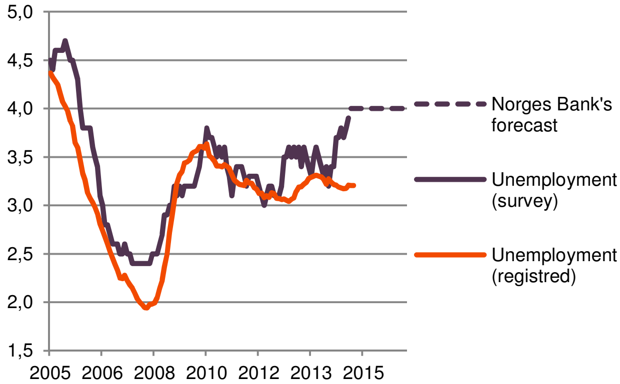
Looking a year or two ahead, the bank's concern about the housing market may be turned on its head. The key uncertainty with regards to the Norwegian economy is, in our view, whether the spiral of rising house prices, credit growth, and consumption seen over the past years could go in reverse. In most other countries, households have consolidated their balance sheets since the financial crisis through increased savings, causing a prolonged period of slow growth in consumption and, consequently, in GDP, employment, and income. With a deeper, more long-lasting downturn in the economy, the main policy interest rate would be cut more and then kept low for a longer period. We expect the rate to eventually bottom out at 0.5%.

Norway: GDP outcome and forecast (%)



Sources: Reuters EcoWin, Swedbank and Norges Bank.

Norway: Unemployment in %



Sources: Reuters EcoWin and Swedbank.

Estonia: More opportunities for growth

We have revised Estonian GDP growth marginally upwards to 2.1% for this year due to the stronger-than-expected economic growth at the end of last year, faster growth of government investments, and slightly improved outlook for foreign demand. In addition, accelerating growth of net wages, strong consumer confidence, and lower fuel prices are contributing to the faster growth of private consumption. Inflation is expected to return in the second half of this year.

Foreign demand weaker in 2015, but outlook has improved

The year 2015 has started with the decelerated, but still decent growth of manufacturing sector output volume, as well as export turnover. The major contribution to the growth comes from the electronics sector, wood processing, production of metal products, and repair of machinery and equipment. According to the Swedbank survey, manufacturing enterprises expect some slowdown in the growth of turnover in 2015, primarily due to the increased competition, weak foreign demand, and labour force shortage. Exports to Russia have decreased substantially, but our enterprises have increased their exports to several other markets--the most to Sweden, but also to the Netherlands, the US, Poland, and Spain. Although the average foreign demand of our main trading partners will be weaker in this year than in 2014, we expect it to be slightly stronger (especially in Sweden and Germany) than we forecast in our last *Swedbank Economic Outlook* in January. In principle, the euro depreciation will contribute to the improvement in price competitiveness of our exports, but this will have a direct effect on only the one-third of our exports that are denominated in US dollars.

Major contribution to investment growth comes from government sector

Enterprises, on average, are financially strong in Estonia. Total profits have gradually increased, and, due to the modest growth of lending, the business sector debt-to-equity ratio is low. Considering the favourable interest rate environment, enterprises have good opportunities to invest more in order to raise their competitiveness. However, the economic sentiment of enterprises has not improved this year (seasonally adjusted), and we do not expect a notable growth in business sector investments in 2015. At the same time, we have revised upwards government sector investments according to the updated information that incorporates the shift of external funding from last year. In addition, the funding from the new EU budget (2014-2020) will start to affect government investments gradually this year, as well.

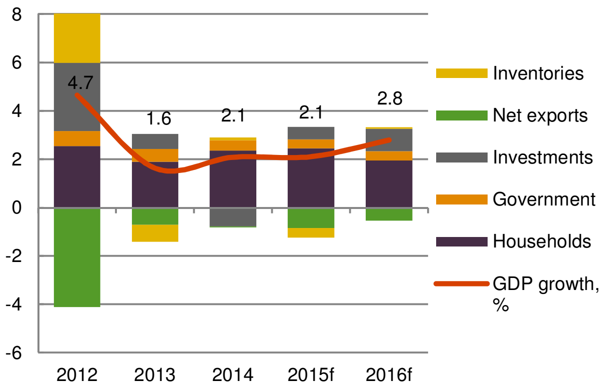
Household consumption will remain vigorous

The labour market is expected to tighten in 2015-2016; thus wage growth will remain strong. The working-age population is decreasing, the employment rate is already high, and the unemployment rate will drop further. Employment will increase marginally this year due to the labour registration obligation, which will push up official employment statistics in the first half of the year. Next year, employment is expected to fall because of a lower supply and demand of labour (due to bigger investments in machinery). Households' real purchasing power will grow markedly this year, due to lower labour taxes and zero inflation. A rise in pensions and other social benefits will further support private consumption, which will be the biggest contributor to GDP growth both in 2015 and 2016. Despite the economic crisis in Russia and the constant flow of worrying news from the East, Estonian consumers feel economically secure, and retail sales have remained very strong.

Inflation is expected to return in second half of 2015

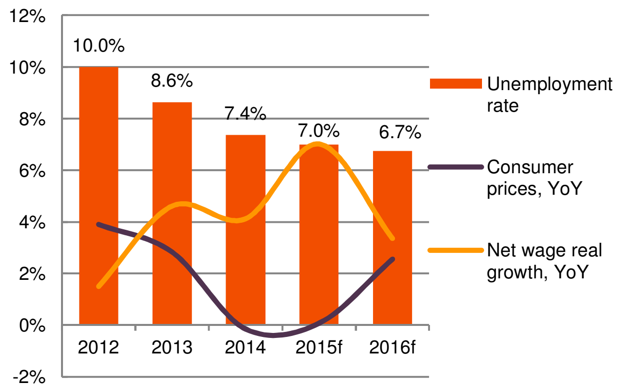
Consumer prices are expected to start climbing higher, on a year-on-year, in the second half of 2015, mostly because of lower energy and food prices during the previous year, but also because higher prices of US dollar-denominated imports will start to kick in. The crude oil price is expected to fluctuate around USD 55-65 per barrel in 2015 and USD 65-75 per barrel in 2016. Next year, inflation will accelerate, as energy and food prices will increase, and another round of excise tax hikes will lift the prices of alcoholic drinks.

Contributions to GDP growth, pp



Source: Statistics Estonia, Swedbank

Labour market indicators and inflation



Source: Statistics Estonia, Swedbank

Latvia: Consumers driving growth

We keep the growth forecast unchanged for 2015 and 2016. Latvian GDP growth will be mostly consumption driven this year, owing to continued wage growth and weak inflation. Exports and investments are hindered by geopolitical uncertainty, the downturn in Russia, and the slowness of the administrative framework and process for EU funds, but are set to pick up next year as the global economy speeds up.

We keep our GDP growth forecast at 1.9% for this year and 3.5% for next year. Growth will largely keep its pace at the end of last year and bottom out in the middle of 2015 before picking up towards the end of the year and in 2016. After three years of positive net export contribution to growth, we expect this to become slightly negative this year. Downward risks remain sizable, related mostly to political and economic developments in Russia, but there are also upward risks – household spending growth might be somewhat stronger if there is, indeed, a permanent shift in consumer behaviour as shown by the strong retail trade data in the first two months of 2015. A quantitative easing undertaken by the European Central Bank (with national banks buying government bonds in their countries) has already caused government yields to decline. Yet, we do not expect a major positive impact on the Latvian economy from this, but mostly an indirect effect from stronger growth in the euro area.

Exports still holding up well

A 5% annual growth of goods exports in January was followed by a 3% decline in February. As expected, there has been a major fall of exports to Russia (by 29% in the first two months). This has been largely compensated for by export growth to other markets (mixed evidence towards where, exactly). Export development is very volatile, both across and within different industries. For instance, wood manufacturing, as well as manufacturing of machinery and equipment, keeps growing, while food and textile industries continue falling. Yet, the development is very uneven across subindustries and companies, and months of growth are alternating with months of decline. Volatility will persist, but we still expect a slow growth of export volumes in 2015. The largest steel plant, Liepājas Metalurgs, resumed production in March, with very small volumes for now, but these are set to rise, supporting export growth in the second half of the year. Given that somewhat swifter growth is now forecast for the euro area, we raise our export growth forecast a bit for this year.

Concerns about 2016 government budget

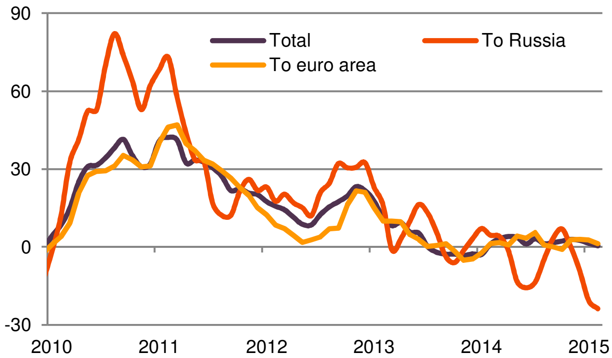
The government has acknowledged a slower growth environment, and the Ministry of Finance has revised downwards its forecasts. We still expect a larger government budget deficit than the current 2015 budget law suggests, but do not see major problems with it this year. In the first quarter of 2015, tax revenues grew by 5.9% in annual terms, but fell 0.5% behind the plan. However, the lower base of 2015 poses greater challenges for 2016. With revenues falling short of planned spending, we believe that the government will not be able to reduce the personal income tax (PIT) in 2016 by 1 percentage point, as planned, and will continue raising smaller taxes, like, e.g., the excise, and fighting the shadow economy.

Household spending to drive economic growth

We are revising our consumer price inflation forecast upwards a couple of decimal points for 2015-2016, owing to somewhat more expensive oil, weaker euro and a planned excise tax hike on alcohol in July 2015. Labour market forecasts also remain largely intact – employment is to stagnate, and strong wage growth to continue. In 2015, wage growth is again supported by a minimum wage hike (similarly to last year). We reduce the net wage growth forecast for 2016 because of the anticipated cancellation of the PIT reduction.

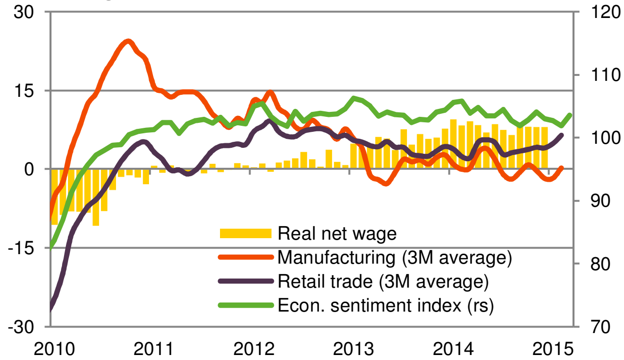
We have not changed our household spending forecast – it will be a major growth driver this year, as real incomes will continue to rise. There was a pickup in retail trade annual growth to 6% (excluding fuel) in January-February, which was twice as strong as last year. It is hard to see yet whether this is a permanent change in consumer behaviour (last year, household spending growth was slower than that of real incomes) or short-term volatility driven by, e.g., substantially cheaper fuel.

Annual growth of goods exports (3 month average), %



Source: CSBL

Annual growth of retail, manufacturing, and wages (%) and economic sentiment



Source: CSBL

Lithuania: Wearing long johns until the summer

As expected, it was a cold winter for the companies trading with Russia – during January and February, exports to Russia were 34.7% lower than a year ago. But the problems are localised – most of the hit was taken by re-exporting companies and some local food manufacturers. Consumption was also weak in the first quarter of this year, but on both fronts there are rays of hope – the economic winter may be over by summer.

Weak first quarter due to shrinking exports and lagging domestic demand, but pickup is likely in the second half of this year

Despite a quite gloomy first quarter of this year, we keep our GDP forecast unchanged – the economy will expand by 2.3% this year before accelerating to 3.5% in 2016. The export weakness was localised – if we exclude the ailing oil refinery and exports to Russia (mostly re-exports), we see that exports were still growing at the beginning of this year. Amongst the EU countries where Lithuania has expanded its market share were Ireland, Denmark, France, and Germany. Growth to countries excluding the US, EU, and CIS was also relatively strong. We expect this to continue and compensate for losses in Russia, but overall exports will still shrink this year.

Consumer confidence has improved significantly; consumption shall follow

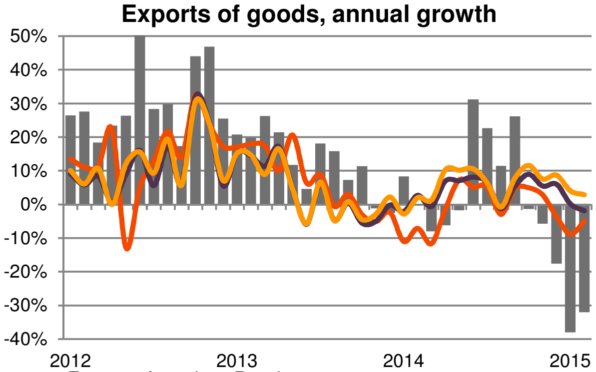
Retail trade growth has also weakened – annual growth in January-February was 2.7%, down from a brisk 8.2% in December. Part of this is cautiousness after the euro adoption; thus, household consumption is likely to recover later this year. Consumer confidence was also weak, mainly due to the tense geopolitical situation. However, there is positive news on the domestic front. In March, there was a remarkable turn in expectations – the consumer confidence index increased to its highest level since the autumn of 2007. Although households still indicate a higher propensity to save, not consume, this sentiment is also changing. If the military conflict in Ukraine does not resume and there are no other external shocks to confidence, we can expect a strong rebound in household consumption in the second half of this year.

Fundamental factors are favourable for household consumption-driven growth. Unemployment continues to decline, and wage growth is likely to accelerate somewhat this year and especially in 2016. Inflation will not be an issue in 2015 – we forecast prices to shrink by 0.5% on average. This will further boost purchasing power of households. Increasing oil prices and labour costs will push inflation to 2.5% next year, but recovering exports and an expansionary fiscal policy will help to return to trend growth.

Despite high capacity utilisation, investments will stagnate

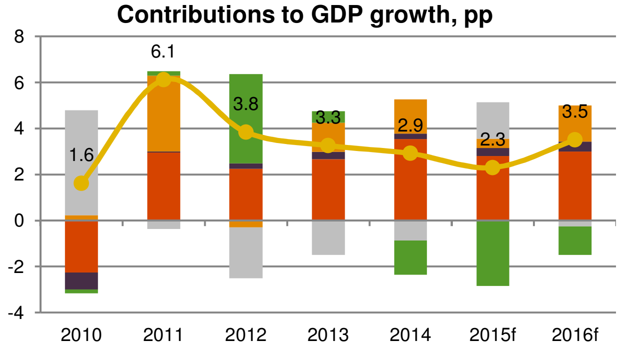
Together with decreasing exports production, capacity utilisation level at the beginning of this year also fell from the historic highs reached at end of 2014. This might further depress investment activity. Investment in fixed tangible assets in the second half of 2014 increased by only about 1%, and investment in machinery equipment and transport even decreased by 6.7%. However, capacity utilisation did not decrease in all sectors. The capacity utilisation level in furniture and chemicals manufacturing, whose exports were still increasing, reached or remained close to historical highs in March. Nevertheless, investment growth is likely to remain weak, as real estate market activity will moderate this year and companies are likely to postpone their expansion plans due to falling exports to CIS countries and the fear of a possible escalation of geopolitical risks. Positive surprises, however, should not be ruled out.

Exports of goods, annual growth



Exports of goods to Russia
Exports of goods
Exports of goods produced in Lithuania (w/o mineral pr.)
Exports of goods produced in Lithuania (w/o mineral pr. & Russia)
Source: Statistics Lithuania

Contributions to GDP growth, pp



Net export
Inventories
Investment (excl.invent.)
Government consumption
Household consumption
GDP growth, %
Sources: Statistics Lithuania and Swedbank forecasts.

Forecast tables

I. Global Outlook

Swedbank's global GDP forecast [1/] (annual percentage change)

	2013	2014		2015f		2016f	
USA	2.2	2.4	(2.4)	2.9	(3.2)	2.8	(2.8)
EMU countries	-0.4	0.9	(0.8)	1.4	(1.1)	1.9	(1.9)
Germany	0.2	1.6	(1.5)	2.0	(1.5)	2.2	(2.2)
France	0.4	0.4	(0.3)	0.9	(0.6)	1.8	(1.7)
Italy	-1.7	-0.4	(-0.4)	0.1	(0.0)	1.2	(1.2)
Spain	-1.2	1.4	(1.3)	2.5	(2.0)	2.5	(2.3)
Finland	-1.3	-0.1	(-0.3)	0.1	(-0.0)	0.9	(0.8)
UK	1.7	2.8	(2.6)	2.4	(2.5)	2.4	(2.2)
Denmark	-0.5	1.1	(0.9)	2.0	(1.8)	2.3	(2.3)
Norw ay	2.3	2.3	(2.6)	1.2	(1.3)	1.4	(1.7)
Japan	1.6	-0.1	(0.2)	0.8	(1.0)	1.1	(1.1)
China	7.9	7.6	(7.5)	6.8	(7.1)	6.6	(6.8)
India	6.3	6.9	(5.2)	7.3	(6.6)	7.7	(7.0)
Brazil	2.7	0.2	(0.2)	-1.2	(0.7)	-0.8	(1.8)
Russia	1.3	0.7	(0.5)	-5.5	(-6.0)	-2.0	(-2.5)
Global GDP in PPP [2/]	3.4	3.5	(3.4)	3.6	(3.7)	3.7	(3.8)

1/ January 2015 forecasts in parenthesis.

2/ World Bank weights (rev ised 2014). Sources: IMF and Swedbank.

Interest and exchange rate assumptions, %

	Outcome	Forecast			
	2015	2015	2015	2016	2016
	17-Apr	30 Jun	31 Dec	30 Jun	31 Dec
Policy rates					
Federal Reserve, USA	0.25	0.25	0.50	1.00	1.50
European Central Bank	0.05	0.05	0.05	0.05	0.05
Bank of England	0.50	0.50	0.50	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10
Government bond rates					
Germany 2y	-0.3	-0.3	-0.3	0.1	0.5
Germany 10y	0.1	0.2	0.4	0.8	1.3
US 2y	0.5	0.6	1.1	1.7	2.2
US 10y	1.9	1.9	2.3	2.7	3.1
Exchange rates					
EUR/USD	1.08	1.03	1.00	0.95	0.98
USD/CNY	6.2	6.1	6.1	6.0	5.9
USD/JPY	119	121	125	127	129
EUR/GBP	0.72	0.72	0.71	0.71	0.68
USD/RUB	52	57	65	65	65

Sources: Reuters Ecowin and Swedbank.

II. The Swedish Outlook

Key Economic indicators, 2013-2016 [1/]

	2013	2014f	2015f	2016f
Real GDP (calendar adjusted)	1.3	2.3	2.6	3.2
Industrial production	-0.7	-1.3	1.8	4.2
CPI index, average	0.0	-0.2	0.2	1.9
CPI, end of period	0.1	-0.3	1.0	2.4
CPIF, average [2/]	0.9	0.5	1.0	2.0
CPIF, end of period	0.8	0.5	1.5	2.1
Labour force (15-74)	1.1	1.3	1.3	0.9
Unemployment rate (15-74), % of labor force	8.0	7.9	7.8	7.6
Employment (15-74)	1.0	1.4	1.4	1.1
Nominal hourly w age w hole economy, average	2.6	3.0	3.0	3.3
Savings ratio (households), %	15.6	16.0	15.6	15.7
Real disposable income (households)	2.1	2.8	2.8	2.5
Current account balance, % of GDP	6.9	5.8	6.1	6.1
General government budget balance, % of GDP [3/]	-1.4	-2.1	-1.7	-1.2
General government debt, % of GDP [4/]	38.6	40.6	40.5	39.7

1/ Annual percentage growth, unless otherwise indicated. 2/ CPI with fixed interest rates.
3/ As measured by general government net lending. 4/ According to the Maastricht criterion.
Sources: Statistics Sweden and Swedbank

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2013	2014		2015f		2016f	
Households' consumption exper	1.9	2.4	(2.4)	3.2	(2.7)	2.5	(2.3)
Government consumption exper	0.7	1.9	(1.4)	2.2	(2.0)	2.5	(2.1)
Gross fixed capital formation	-0.4	6.5	(4.6)	4.5	(5.3)	6.3	(6.3)
private, excl. housing	-1.6	4.6	(0.8)	3.3	(3.4)	6.2	(6.7)
public	1.7	1.7	(5.1)	0.4	(4.8)	4.6	(4.3)
housing	2.1	20.3	(19.3)	13.1	(12.4)	7.9	(6.8)
Change in inventories [1/]	0.0	0.2	(0.3)	-0.1	(-0.0)	0.0	(0.0)
Exports, goods and services	-0.2	3.3	(2.1)	4.5	(3.5)	5.4	(5.2)
Imports, goods and services	-0.7	6.5	(5.1)	5.5	(5.3)	5.7	(5.5)
GDP	1.2	2.1	(1.8)	2.8	(2.4)	3.4	(3.2)
GDP, calendar adjusted	1.3	2.3	(1.9)	2.6	(2.2)	3.2	(2.9)
Domestic demand [1/]	1.0	3.0	(2.5)	3.1	(3.0)	3.3	(3.1)
Net exports [1/]	0.2	-1.1	(-1.0)	-0.2	(-0.6)	0.1	(0.1)

1/ Contribution to GDP growth. Sources: Statistics Sweden and Swedbank
January 2015 forecast in parenthesis.

Interest and exchange rate assumptions

	Outcome	Forecast			
	2015	2015	2015	2016	2016
	17-apr	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates (%)					
Policy rate	-0.25	-0.50	-0.50	-0.50	0.00
10-yr. gvt bond	0.24	0.20	0.60	1.10	1.70
Exchange rates					
EUR/SEK	9.3	9.5	9.3	9.0	8.9
USD/SEK	8.6	9.2	9.2	9.5	9.1
KIX (SEK) [1/]	114.3	116.5	114.9	113.0	113.3

1/ Total competitiveness weights. Trade-weighted exchange rate index for SEK.
Sources: Reuters Ecowin and Swedbank

III. The Estonian outlook

ESTONIA: Key economic indicators, 2013-2016 1/

	2013	2014	2015f		2016f	
Real GDP growth, %	1.6	2.1	2.1	(2.0)	2.8	(2.7)
Household consumption	3.8	4.6	4.7	(4.2)	3.6	(3.6)
Government consumption	2.8	2.3	2.0	(1.0)	2.0	(1.0)
Gross fixed capital formation	2.3	-2.8	2.0	(0.6)	3.5	(3.5)
Exports of goods and services	2.4	2.6	2.1	(1.5)	4.0	(3.7)
Imports of goods and services	3.3	2.7	3.1	(2.1)	4.6	(4.2)
Consumer price growth, %	2.8	-0.1	0.1	(0.3)	2.7	(2.6)
Unemployment rate, % 2/	8.6	7.4	7.0	(7.3)	6.7	(7.2)
Real net monthly wage growth, %	4.6	4.2	7.0	(6.5)	3.0	(3.3)
Nominal GDP, billion euro	18.7	19.5	20.5	(20.4)	21.7	(21.7)
Exports of goods and services (nominal), % growth	3.5	2.4	1.9	(1.5)	4.5	(4.2)
Imports of goods and services (nominal), % growth	2.9	1.1	2.1	(1.9)	5.1	(4.7)
Balance of goods and services, % of GDP	1.4	2.5	2.3	(2.4)	1.9	(2.2)
Current account balance, % of GDP	-1.1	-0.1	-0.3	(-0.9)	-1.0	(-1.3)
Current and capital account balance, % of GDP	0.6	0.6	0.8	(-0.4)	-0.4	(-1.0)
FDI inflow, % of GDP	3.6	6.1	4.9	(3.9)	4.6	(3.7)
Gross external debt, % of GDP	93.5	97.2	93.0	(87.2)	88.8	(83.4)
General government budget balance, % of GDP 3/	-0.5	0.6	-0.5	(-0.4)	-0.5	(-0.2)
General government debt, % of GDP	10.1	10.6	10.2	(9.8)	10.0	(9.5)

1/ January 2015 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Estonia, Bank of Estonia and Swedbank

IV. The Latvian Outlook

LATVIA: Key economic indicators, 2013-2016 1/

	2013	2014	2015f		2016f	
Real GDP growth, %	4.2	2.4	1.9	(1.9)	3.5	(3.5)
Household consumption	6.2	2.3	3.5	(3.5)	4.0	(4.0)
Government consumption	2.9	3.4	0.6	(0.7)	0.5	(0.5)
Gross fixed capital formation	-5.2	1.3	-0.5	(-0.5)	10.0	(10.0)
Exports of goods and services	1.4	2.2	1.4	(1.0)	4.0	(4.0)
Imports of goods and services	-0.2	1.6	2.3	(2.2)	7.0	(7.0)
Consumer price growth, %	0.0	0.6	0.8	(0.5)	2.7	(2.5)
Unemployment rate, % 2/	11.9	10.8	10.2	(10.2)	9.2	(9.2)
Real net monthly wage growth, %	5.7	7.9	5.2	(5.5)	2.9	(3.9)
Nominal GDP, billion euro	23.2	24.1	24.8	(24.9)	26.5	(26.4)
Exports of goods and services (nominal), % growth	2.2	1.8	1.2	(1.1)	5.9	(5.9)
Imports of goods and services (nominal), % growth	0.9	1.2	1.5	(1.6)	8.6	(8.9)
Balance of goods and services, % of GDP	-3.3	-2.9	-3.0	(-3.0)	-4.5	(-4.7)
Current account balance, % of GDP	-2.3	-3.1	-2.9	(-2.6)	-4.4	(-4.3)
Current and capital account balance, % of GDP	0.1	-0.1	0.2	(-0.2)	-1.9	(-2.8)
FDI inflow, % of GDP	2.9	1.5	2.4	(2.4)	3.0	(3.0)
Gross external debt, % of GDP	131.3	138.6	135.9	(136.9)	132.2	(133.7)
General government budget balance, % of GDP 3/	-0.9	-1.6	-1.6	(-1.5)	-1.2	(-1.2)
General government debt, % of GDP	38.2	40.3	39.3	(39.4)	38.3	(38.5)

1/ January 2015 forecast in parenthesis.
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: CSBL and Swedbank.

V. The Lithuanian outlook

LITHUANIA: Key economic indicators, 2013-2016 [1/]

	2013	2014	2015f		2016f	
Real GDP growth, %	3.3	2.9	2.3	(2.3)	3.5	(3.5)
Household consumption	4.2	5.6	4.3	(4.0)	4.5	(4.7)
Government consumption	1.8	1.3	2.0	(2.5)	2.5	(2.5)
Gross fixed capital formation	7.0	8.0	2.0	(2.0)	8.0	(8.0)
Exports of goods and services	9.4	3.4	-2.5	(0.0)	7.0	(7.0)
Imports of goods and services	9.0	5.4	1.0	(2.6)	8.4	(8.5)
Consumer price growth, %	1.0	0.1	-0.5	(0.7)	2.5	(2.0)
Unemployment rate, % [2/]	11.8	10.7	9.7	(9.7)	8.5	(8.5)
Real net monthly wage growth, %	3.8	4.8	5.4	(4.2)	4.0	(4.5)
Nominal GDP, billion euro	35.0	36.3	37.1	(37.7)	39.3	(39.7)
Exports of goods and services (nominal), % growth	8.0	1.0	-3.0	(-2.5)	9.0	(8.0)
Imports of goods and services (nominal), % growth	7.5	2.1	-1.5	(-0.5)	10.8	(10.0)
Balance of goods and services, % of GDP	1.3	0.1	-1.1	(-1.2)	-2.5	(-2.7)
Current account balance, % of GDP	1.6	0.1	-1.6	(-1.7)	-3.0	(-3.2)
Current and capital account balance, % of GDP	4.6	2.9	1.2	(0.9)	0.0	(-0.7)
FDI inflow, % of GDP	1.5	0.8	1.0	(1.5)	1.5	(2.0)
Gross external debt, % of GDP	69.8	70.0	70.1	(68.2)	67.5	(65.8)
General government budget balance, % of GDP [3/]	-2.6	-1.3	-1.6	(-1.6)	-1.0	(-1.0)
General government debt, % of GDP	39.0	41.1	42.1	(42.6)	37.5	(38.2)

1/ January 2015 forecast in parenthesis

2/ According to Labour force survey.

3/ According to Maastricht criterion.

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

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Disclaimer

What our research is based on

Swedbank Research a unit within Large Corporates & Institutions bases the research on a variety of aspects and analysis.

For example: A fundamental assessment of the cyclical and structural economic, current or expected market sentiment, expected or actual changes in credit rating, and internal or external circumstances affecting the pricing of selected FX and fixed income instruments.

Based on the type of investment recommendation, the time horizon can range from short-term up to 12 months.

Recommendation structure

Recommendations in FX and fixed income instruments are done both in the cash market and in derivatives.

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Regarding the cash market, our recommendations include an entry level and our recommendation updates include profit and often, but not necessarily, exit levels. Regarding recommendations in derivative instruments, our recommendation include suggested entry cost, strike level and maturity.

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