Baltic Sea Report

Swedbank's analysis of the economic conditions
and structure of the countries around the Baltic Sea
from a corporate perspective

Swedbank Baltic Sea Analysis No. 24 • 30 June 2010

Baltic Sea economies expand again – but to remain competitive, more reforms are needed

- We expect GDP in the Baltic Sea region, after shrinking by almost 6% last year, to grow by 2.6% in 2010 and 3.1% in 2011. The European sovereign debt crisis, with lower demand and financial turbulence as possible consequences, poses major forecast risks.
- Russia and Ukraine show the strongest growth over the forecast horizon (2010 and 2011), following substantial declines last year and with the support of higher commodity prices. However, without a more ambitious reform agenda, growth will not be sustainable. Russia (4.5) and Ukraine (4.1) also score the lowest in the region in our new Baltic Sea index (BSI) on business conditions, in which the average for the region is 7 (out of a possible 10).
- Poland has avoided a recession and is set to grow by a moderate 3% per year, as domestic demand growth will slow when budget consolidation takes off. Also, Poland has room for improvement on structural reforms, scoring 5.8 in our BSI. The goal to join EMU remains, but entry is not likely to be before 2015.
- Estonia, on the other hand, is set to join EMU in 2011. Latvia and Lithuania plan to follow in 2014 if their budget consolidation processes continue. The Baltic countries will grow by 3-4½% next year and have already started to recover slowly after the recession. Estonia (7.3) scores above the BSI average (high on foreign trade, governance, and education), while Lithuania (6.5) and Latvia (6.3) must accelerate structural reforms to catch up.
- The Nordic countries score the highest in the region on the BSI and are, at 8.5-8.8, among the 15% most competitive countries in the world. GDP in Sweden and Norway (2 ½-3% per year) will grow faster than GDP in Denmark and Finland (1-2% per year), but all four countries must boost labour supply as competition and demography remain major challenges.
- Germany is projected to grow by 1½-2%, with exports recovering. As fiscal consolidation starts next year, there is a risk that domestic demand will slow. As for all countries undertaking fiscal consolidation, the negative effects on demand must be compensated for by economic reforms that create room for higher medium- and long-term growth. Germany, scoring 8 on our BSI, is doing well, but there is room for improvements, especially with regard to labour markets and tax policy.

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Economic conditions around the Baltic Sea [1)]

June 2010

Economic indicators

	GDP growth [2)] (%)			Inflation (CPI, %)			Current account balance [3)] (% of GDP)			Fiscal balance (% of GDP)		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
Poland	1.7	2.9	3.2	3.4	3.0	2.7	-1.5	-2.0	-2.5	-7.0	-5.5	-4.5
Estonia	-14.1	1.5	4.5	-0.1	1.5	2.5	7.4	8.5	8.0	-1.7	-1.4	-1.0
Latvia	-18.0	-2.5	4.0	3.5	-2.0	0.0	11.8	12.4	9.7	-9.0	-8.5	-6.0
Lithuania	-15.0	-2.0	3.0	4.5	1.0	1.0	7.2	4.2	3.0	-9.1	-8.0	-6.0
Russia	-7.9	4.3	4.5	11.7	9.0	8.0	3.9	3.0	2.0	-6.0	-3.0	-2.0
Ukraine	-15.0	3.5	4.5	15.9	18.0	9.0	-1.6	-0.5	-1.5	-9.0	-6.0	-3.0
Germany	-4.9	1.5	2.0	0.3	0.8	0.9	4.8	5.5	6.0	-3.3	-6.0	-5.1
Denmark	-4.9	1.3	1.6	1.3	2.0	1.7	4.1	2.4	2.4	-2.8	-5.5	-4.4
Norway	-1.5	2.1	2.7	2.1	2.2	2.7	13.8	15.2	12.0	19.6	11.0	13.0
Finland	-7.8	1.1	2.1	0.0	1.5	2.5	1.5	1.9	1.7	-2.4	-4.2	-2.3
Sweden	-5.1	2.5	2.8	-0.3	1.4	2.2	7.2	6.2	6.5	-0.8	-1.9	-1.7

GDP for Baltic Sea countries in total [4)]	2009	2010	2011
	-5.9 (-3.3)	-2.6 (0.8)	3.1

1. The report also covers Norway and Ukraine.
2. Not calendar-adjusted.
3. Includes the capital account for Estonia, Latvia and Lithuania.
4. Percentage increase using 2008 GDP weights (PPP). The figure from the March 2009 forecast is in parentheses.

Sources: National statistics and Swedbank’s own calculations.

The Baltic Sea region – an important market for companies

Trade, investments, environment, and culture – there are many reasons for more integration in the Baltic Sea region

Why is there a need for a report on the Baltic Sea region? We maintain that our home region is important for several reasons: trade, investment, environmental cooperation, and other types of integration (academia, policy thinking, culture, etc). This report is mainly written for companies planning to expand operations in the region, and/or are curious about the developments in a particular country or the region as a whole. We combine macroeconomics with microeconomics, and the economic outlook with structural reforms. We also focus on economic and political risks that could jeopardize investments, at least in the short term.

Large companies have been global for a long time. However, for small and medium-sized companies (SMEs), internationalization is less common, and the first step of expanding abroad is usually taken in markets close to home. For a Swedish company, it makes sense to expand into the Nordic market first, and, for a Latvian company, there are many advantages to finding more business opportunities in other Baltic countries. The next step is to expand farther, and to understand the vast opportunities – but also the risks – that open up, for example, in large consumer markets, such as Russia, Poland, and Ukraine.

Our view on spatial integration follows Newton's law, which states that the attractive force between two bodies (countries) is directly related to their size and inversely related to the distance between them. Thus, it is natural to seek more trade and investments between countries close to each other, and the larger the market the greater interest.

The region is suitable for division of labour and specialisation – but more can be done

Another reason for integration in the Baltic Sea region is Adam Smith's famous thesis on the division of labour and specialisation. As Russia, Ukraine, Poland, and the Baltic countries converge with the Nordic countries and Germany, there is room in the process to divide labour according to wage levels and competence, and to specialise according to comparative advantages in trade. We believe that the region could utilise these windows of opportunities even more.

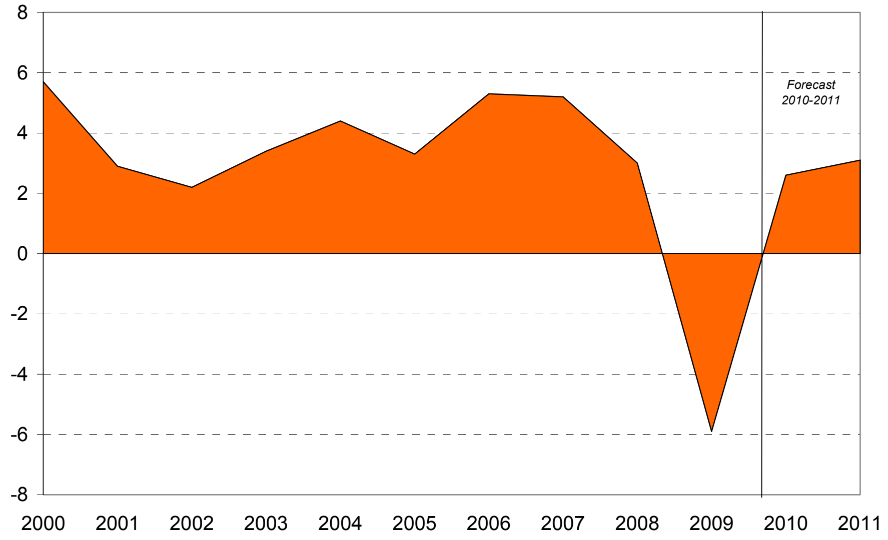
The financial crisis has made companies and the financial sector more reluctant to expand abroad, but, with the recovery, internationalisation plans will start coming back. More will be needed to attract trade and investments after the crisis, and reforms in each country need to focus on attractiveness going forward. The convergence process will continue, but not automatically.

Growth picks up in the region

After a great fall last year, the region is now set to grow by 2.6% and 3.1% in 2010 and 2011

In our most recent Baltic Sea region report from March 2009, we projected that the region's GDP for that year would shrink, and we also expected very low growth during 2010. In our current report, data show that the outturn was even more negative: GDP fell by 5.9% in the region last year. On the other hand, growth prospects look somewhat more positive, and GDP is expected to grow by 2.6% and 3.1% in 2010 and 2011, respectively.

GDP growth in the Baltic Sea region (annual percentage change)



Sources: National Statistics and Swedbank. PPP-weights from World Bank, 2008.

Only Poland avoided a recession

The largest falls in GDP during last year occurred in the Baltic countries, Ukraine, Russia, and Finland, which experienced negative growth rates of some 7-18%. Sweden, Germany, and Denmark came close to this range, showing falls of some 5%. Even if Norway almost avoided a recession (-1.5%), it was only Poland that had growth during a year when almost all industrial countries were hard hit.

A vulnerable business structure is one reason for a greater fall …

Important factors explaining the developments last year are the size of imbalances in the respective countries, their openness with regard to trade and investments, and their business structure. While Finland and Sweden had sound macroeconomic situations to start with, the type of products in the two countries' exports was important in explaining the fall in output. Sweden's car industry was hard hit, as were Finland's telecommunications, wood, and pulp industries. The Nordic countries and Germany will grow by 1-3% in 2010 and 2011, with Norway and Sweden showing the highest growth rates, and with Denmark, Germany, and Finland lagging somewhat.

For Poland, on the other hand, a large domestic sector, which benefited from tax cuts and increased public spending, could contribute to growth. The zloty depreciated and gave support to exports. The banking sector was relatively sound, and no major credit crunch occurred. EU structural funds also helped to support investments. Poland is set to grow moderately during the next two years, as consumption growth slows and exports pick up.

… while in some cases domestic imbalances before the crisis also worsened the situation

The financial and property crises in the Baltic countries made it more difficult for them to stay resilient when the global recession started. Large imbalances had to unwind, and, as currencies were fixed to the euro, all of the adjustment took place through internal devaluation, a process that is still ongoing. Even so, growth is starting to come back, although slowly and with a dependence on a global recovery. Projected growth of some 3-5% next year – and with domestic demand still dampened – means that there is a rather long way back to higher potential growth rates.

Another factor was a heavy dependence on falling commodity prices

For Russia and Ukraine, countries that depend heavily on world commodity markets, the global recession hurt production, labour markets, financial institutions, and public finance. Capital left, and so did confidence among investors. In Ukraine, the political turmoil also mattered, and the country had to seek help from the IMF to balance the economy. After large falls last year, the recovery has started, which should bring on modest growth of some 3-5% over the next two years.

The global recovery continues – emerging markets the main impetus

For most of the countries in the Baltic Sea region, the dependence on exports and thus on a global recovery is large. Since we published our *Swedbank Economic Outlook* on April 22, financial market volatility has increased due to the euro zone crisis, the euro has depreciated more than expected, and the oil price has fluctuated.

Our April global forecast already included tighter fiscal policy – but market turbulence was larger than expected

As we had already envisaged budget consolidation starting this year in many industrial countries and continuing in the years to come, our forecast had incorporated a negative impact on demand growth, especially in the euro zone. However, the impact from more turbulent financial and commodity markets was not included, and it is still difficult to evaluate how this will affect overall growth – for example, through lower confidence among companies and households.

We see no reason to alter our global outlook – and risks are balanced

We reiterate our projection that global GDP will increase by 3.9% this year, slowing to 3.6% next year. Compared with the April outlook, growth in China, India, and the US may be slightly higher, but as the euro zone crisis hit harder than expected, it does not seem reasonable to lift our forecast at this stage. The global risks are thus balanced between, on the one hand, the risk of higher growth in particular in the emerging markets, and, on the other, the risk of lower growth in the industrial countries. The main finding persists: the world economy is mainly driven by high growth in Asia, Latin America, and the Middle East, while industrial countries, especially in the euro zone, are lagging behind.

We view the inflation outlook as remaining stable and modest in industrial countries because unoccupied resources are abundant; however, the risks for overheating are building up in some of the emerging economies. Polarization also rules with regard to sovereign bond markets, as state risk has returned, bringing higher interest rates in indebted economies (southern Europe) and lowering them in what – at least from a financial market perspective, at this moment– look like safe havens (US, Germany, e.g.).

We have not altered our oil price projection, as we were already moderate in our assumptions of US$75 this year and US$85 next year. As long as the financial markets remain turbulent, the oil price may go lower, but we expect it to recover towards the end of the year, when the financial markets move from weathering the turbulence to muddling through in the global recovery.

Euro zone debt and turbulence create risks

Even if the global recovery is set to continue, there are great risks to the outlook. The main ones deal with how to value the impact from the escalating sovereign debt in many industrial countries; the domestic effects on demand, and, subsequently, also, the effects on exporters to these markets.

However, there are also other risks involved and below we list them, as they will also have an impact on the growth outlook for Baltic Sea countries:

- Loss of demand as many industrial countries raise taxes and cut budget expenditures. Most of the export markets for Baltic Sea countries will be affected, as will budget-consolidating countries such as Germany and the Baltic countries, as well as, to some extent, Finland and Denmark.
- Turbulence on bond, currency, and equity markets due to increased uncertainties with regard to euro zone policies (new institutions, rules, and regulations for euro zone cooperation). The interbank markets spreads are rising again, but not to the same extent as after the Lehman Brothers' bankruptcy.
- Strict and incoherent regulations of the banking sector, which may increase financial market volatility, decrease confidence, and contribute to a credit squeeze as banks must shrink balance sheets further while facing rising funding costs.
- Continuation of deleveraging in the financial and other parts of the private sector, especially in industrial countries. The possible collapse of banks and need for new rescue plans also pose risks.
- Higher bond interest rates in the light of gradually increased competition with regard to funding public deficits (and banks).
- Loss in confidence due to falling asset prices.
- Difficulties when exiting monetary policy stimuli in some countries.
- A further fall in the oil price, thereby dampening Russia's growth outlook but improving oil-importing countries' outlook.
- Increased protectionism as governments struggle to lower imbalances.
- Asset price bubbles bursting in some emerging markets, such as China, where real estate prices constitute a risk to stability.

- Political and security tensions (such as on the Korean peninsula), leading to more turbulence on financial markets and also affecting the real economy in some countries.

On the upside, there are countries gaining from looser monetary policy, and lower bond rates, such as Sweden, where the fiscal position is in order. A weaker currency following market turbulence, such as the euro, krona and zloty, could also support the export outlook.

Not all roads to EMU look the same to Baltic Sea countries

Estonia is about to join the EMU next year, pending a formal final decision by the Economic and Financial Affairs Council (ECOFIN) on July 13 of this year. Poland has postponed its membership plans, and Swedish voters are becoming more reluctant to join the euro after the Greek crisis and the difficulties encountered by the euro zone policymakers in agreeing on the needed measures.

Five relevant questions:

1. **What type of union are countries that apply for membership joining?**

EMU is at a crossroads. The problems of increasing debt and weakening competitiveness in southern Europe have been building up over many years, and real interest rates have been too low in relation to these countries' overall economic situations. Apart from increasing debt in the private and public sectors, wages have risen much faster than productivity, resulting in high and unsustainable growth in unit labour costs. Current accounts have shown large deficits in southern European countries, while northern European countries have shown surpluses and increased competitiveness. Divergence has ruled.

Stability and growth pact was not followed – this will now change, but exactly how?

The stability and growth pact – to safeguard against undisciplined fiscal policy – has not been followed. Even Germany has broken the pact, sending signals to others that softness is acceptable. Only once since 2000 has Greece fulfilled the criterion of a budget deficit of 3% of GDP, and on average the deficit was twice as high as the country's first estimate.

There are great uncertainties about the new rules and regulations – meanwhile, old ones are being violated

In reaction to the Greek crisis, euro zone governments have violated what was seen as principles of EMU: the no-bailout clause and the neutrality of the ECB regarding fiscal policy (not buying government debt). There is already a rescue package available to support countries in crisis, and the IMF is part of the package – which includes financial support conditioned on implementing an economic reform programme.

There are many uncertainties with regard to EMU, and it will take time to get a better understanding of the future framework:

- What are the new euro institutions supporting countries in crisis?

- How can moral hazard be avoided, and what are the sanctions for countries not fulfilling the criteria?
- Will the “Maastricht union” change into a “transfer union” where funds are channelled across countries, and how much and in what way will fiscal policy be coordinated? Will Baltic taxpayers finance Greek financing gaps?
- Will the ECB give up the target of price stability (not likely), becoming less like the Bundesbank and more like the Bank of Italy or the Bank of Greece?
- How will the EU Commission/ECB and other institutions get involved in national budgets and reform policies? Is peer pressure no longer sufficient?

2. Is there even the slightest risk of a breakup of the EMU?

It depends on how policymakers solve the current problems. Without sanctions, rescue packages would increase moral hazard problems, and divergence could become even larger. Important to note is that without EMU, it will also be difficult to increase integration in the EU. There is a lot of political capital invested in both the EU and EMU that politicians will want to safeguard.

It is hardly in any country’s interest to force other countries to leave EMU, as creditors are affected in all EMU countries, and the country being pressured to leave will be disadvantaged by higher interest rates, turbulence, and debt. On the other hand, internal devaluation, by cutting prices and wages, is also a difficult road to higher competitiveness without a devalued currency. Organized insolvency, which also puts pressure on creditors to improve risk assessments, is one of the solutions.

There is a lot of political capital invested in EMU – a collapse will not be accepted easily

Germany’s response to the crisis is now the focus of attention. The population of Germany will not accept higher taxes to bail out other countries. Also, price stability is important for Germans. To have more influence over other nations’ fiscal policy and reforms can be one path that Germany can take, going forward.

3. Is there a difference when making the decision on adopting the euro for, for example, Poland and Estonia?

Poland has benefited from a depreciating zloty during the global recession. The country still has the goal of entering the euro zone, but would gain by waiting as there is a need for it to see how the the euro zone institutional setup develops and to fulfil the Maastricht criteria. In addition, membership should not be rushed, and by waiting, there is more time for organized budget consolidation.

Poland has benefited from a floating currency during the crisis …

For Estonia, the situation is different. The kroon has been fixed for a long time, and all Maastricht criteria have been fulfilled. There is a history and culture of not depending on a weaker currency. For it to take the step to full membership is logical, as this improves investor confidence and Estonia benefits from a larger market with regard to financing, labour, investments, and trade. The same strategy and rationale for joining apply to Latvia and Lithua-

… while Estonia has had a fixed exchange rate regime for many years

nia as to Estonia, but with a lag for these countries, mainly due to a larger need for fiscal consolidation.

For Sweden, the situation is more like Poland's. There is no rush, and the opinion polls show less interest in joining. For Denmark, since it is already part of ERM2, it would make more sense to take the next step to full membership when uncertainties about EMU are reduced.

4. What are the risks for EMU of letting, or not letting, new countries in?

By saying no to Estonia, one of the few countries in the euro zone fulfilling the Maastricht criteria, confidence in EMU would have decreased even further. The positive response towards Estonia seems logical also from EMU's point of view.

The risks when letting new countries in concern sustainability

The risks of letting new countries in must be seen in a longer-term perspective of sustainability. Before the crisis, the economies in prospective member countries overheated, and, during the process of internal devaluation, there has been deflation. The question is where to find equilibrium going forward. The equilibrium with regard to inflation, the current account, and wage developments/competitiveness, respectively, will be of special interest in making these decisions. The conclusion is for euro institutions and EMU countries to monitor these factors in the coming years, in order to avoid the same mistakes that were made in Greece and other southern European countries.

5. What is the most likely membership timetable for the Baltic countries, Poland, Denmark, and Sweden?

Country	ERM2	EMU
Estonia	Yes	2011
Latvia	Yes	2014
Lithuania	Yes	2014
Poland	2013	2015
Denmark	Yes	After 2015
Sweden	After 2014	After 2016

Political will and consensus can make difficult goals achievable

There are still uncertainties with regard to Latvia and Lithuania's reaching their goals in 2014, as these countries have a long way to go to reach the intermediate goal of reducing their budget deficits to 3% in 2012. The strong political will to succeed in both countries is one factor that makes it possible, and not unrealistic, even if there are major challenges. Poland may experience difficulties in reducing its deficit to 3% of GDP in 2012 but should be able to do so in 2013, which would make the goal of 2015 look more achievable.

For Sweden and Denmark, the uncertainties are more related to public opinion: is a majority in favour of, first of all, taking a referendum on the subject, and, second, voting for membership? The performance of the euro zone is an important factor, as well as Sweden's and Denmark's relative economic position at the time these votes are taken.

Important to avoid imbalances regardless of currency regime

Countries can no longer hide in EMU – fundamentals are more important again

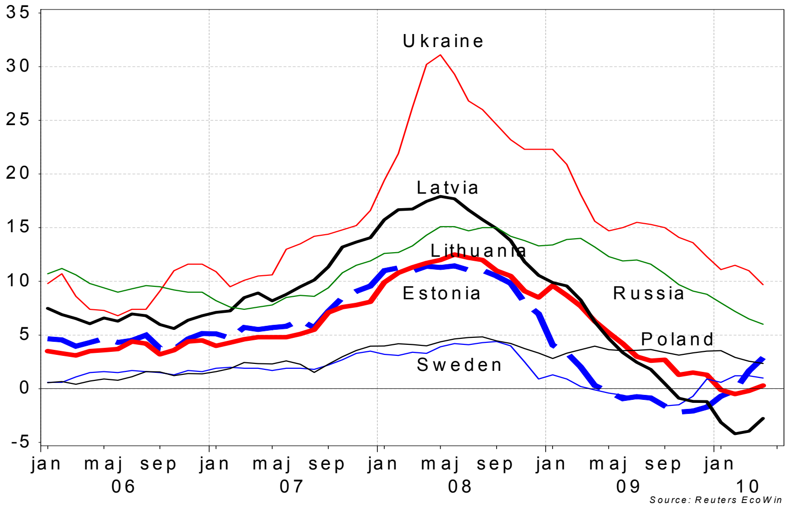
The Greek crisis has shown the importance of having sound public finances, as well as a competitive trade and industry, regardless of the currency regime chosen. It will not be possible to hide in the euro zone as investors will treat countries differently depending on their situation and outlook.

However, for countries choosing the euro, it is more important to maintain fiscal surpluses in good times and to have room for the automatic stabilizers to work in times of recession. Without a floating currency as a buffer, fiscal policy and structural reforms are the main policy tools. For countries staying outside the euro zone, there is also vulnerability with regard to currency and interest rate developments, and the need to maintain budget discipline and carry out structural reforms to achieve competitiveness is equally important.

The focus on inflation will soon be back, entailing risks for entering countries

The focus on inflation has during the past two years faded due to the recession, as risks have been geared towards deflation and financial risks have been regarded as more relevant. As labour shortages return and wages start to rise, inflation pressures may increase. Other important factors that could raise inflation in a country to unsustainable rates are commodity prices, too expansionary fiscal policy, credit expansion, and higher asset prices. Especially if real interest rates come down after a country has joined EMU, there is a risk of a debt-asset price spiral, which could cause overheating.

Inflation, annual increase in consumer prices (%)



Sources: National statistics; and Swedbank.

Converging countries may have higher inflation as incomes rise

For converging countries, the Balassa-Samuelson hypothesis also seems relevant to consider. There are intercountry differences in the relative productivity of the tradable and nontradable sectors. As incomes rise, prices of the nontradable sectors will increase to levels seen in more mature countries, where prices are higher. As Estonia enters EMU, the real appreciation of the exchange rate may in a vicious circle cause higher inflation, thereby entailing risks with regard to the convergence of inflation in a medium- to long-term perspective.

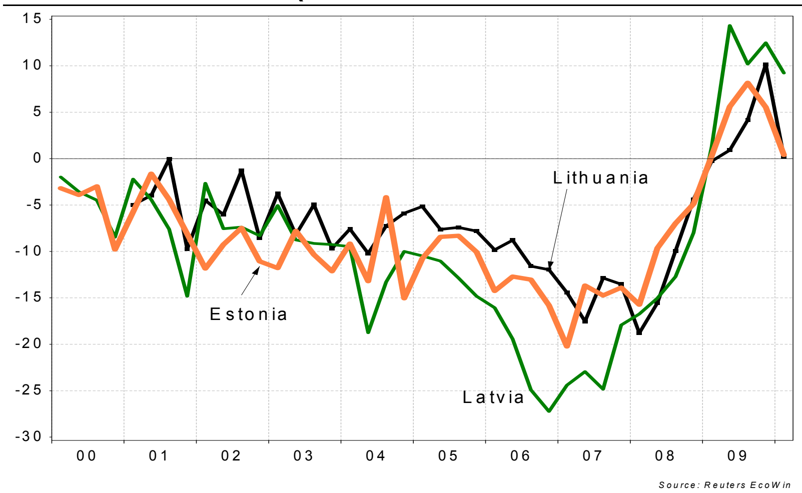
The budget deficit situation differs in the Baltic Sea region. This year, deficits of around 8-9% of GDP will be registered in Latvia and Lithuania, while deficits in Germany, Denmark, Poland and Ukraine will reach 5-6% of GDP. Finland will also need budget consolidation as its deficit will rise above 4% of GDP this year. Meanwhile, Estonia and Sweden will have an easier ride, thereby avoiding the need for a tighter fiscal policy. Interestingly, only Germany, at some 80%, has a gross debt exceeding the 60% of GDP Maastricht threshold. Poland, however, is approaching that level and must, according to its constitution, take action.

It is also important to monitor gross external debt in relation to GDP: this level is around 120% in Estonia, 160% in Latvia, and 85% in Lithuania. These ratios are much higher than in most other countries, such as Poland, Russia, and Ukraine, where external debt ratios are closer to 50% of GDP. It is, however, also important to note that a country such as the United Kingdom, with a large financial sector, has a high ratio of gross external debt to GDP; thus, as financial penetration deepens, the gross external debt ratio often increases.

Current account deficits are natural, but they should not be excessive

The current account deficits that characterised the Baltic countries before the crisis have changed into surpluses on an annual basis. It is reasonable to expect deficits in a few years' time, and, if these are not excessive, they should be seen as natural for countries converging with the rest of Europe.

Current account balance (% of GDP

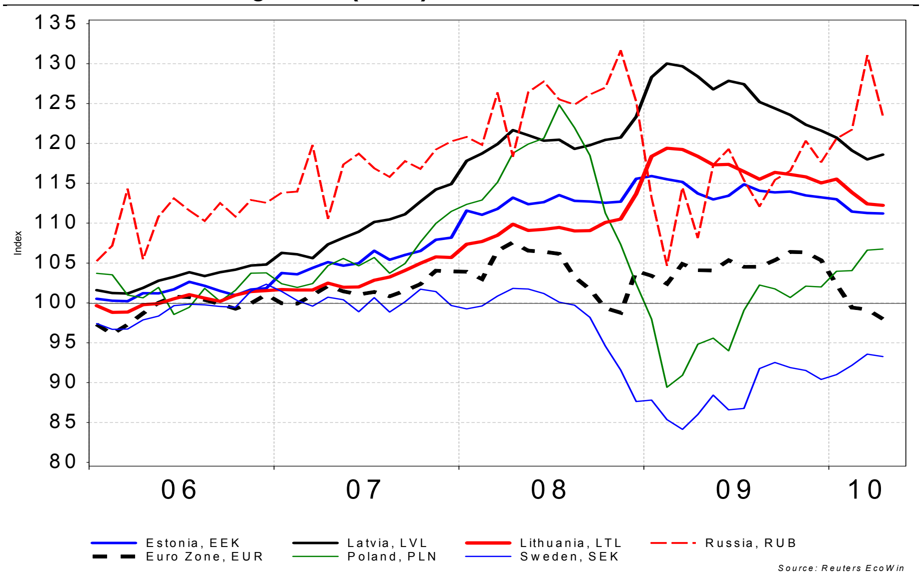


Unit labour costs are expected to decrease – albeit to a varying extent – in nominal and real terms in most Baltic Sea region countries. In relative terms, compared with other industrial nations, Latvia will gain most in competitiveness (but starting from low levels), followed by Estonia and Lithuania. In the Nordic countries and Germany, developments will stabilise.

Competitiveness can also be monitored by analysing real effective exchange rates (deflated by consumer prices), as calculated by the Bank for International Settlements (BIS). There is still a considerable need for internal devaluation in the Baltic countries, going forward. A positive alternative is to accelerate the pace of structural reforms, thereby raising productivity and lowering costs. Competitiveness is also about producing goods high in demand. To strengthen competitiveness, therefore, more R&D should be allocated to increasing value added in production.

Improving competitiveness is a never-ending process – for all countries

Real effective exchange rates (index)



Our new Baltic Sea index indicates room for improvements

There are several institutions producing indices measuring competitiveness and structural performance. Having identified a need for such an index representing the Baltic Sea region, which would rank "our" 11 countries in relation to the rest of the world, we have constructed a Baltic Sea index. The next section gives details on the composition and calculation of this index.

It is now possible to monitor the Baltic Sea region's performance compared to others

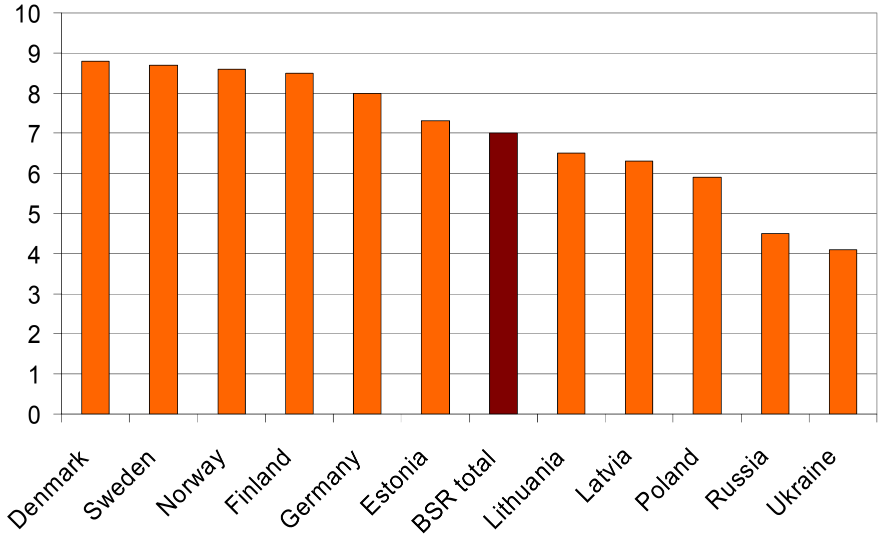
Having established this Baltic Sea Index (BSI), it is important to monitor the changes in it over time, and to deepen the analysis in areas that require improvement. Note that, even if all countries in the world improve, and the Baltic Sea countries move upwards at the same rate, our index will not change, as it measures progress compared with others.

Our BSI is compiled from several other indices, obtained from various sources, and then transferred into a ranking index for these 11 countries. We selected 10 areas that we consider most important to monitor business conditions:

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

Each item consists of several underlying factors. The list is not exhaustive but should function as a good indicator of a country's progress on business conditions in relation to other countries.

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



Sources: World Bank, Transparency International, World Economic Forum, Milken Institute, and Swedbank.

In conclusion, Denmark has the highest ranking, followed by the other Nordic countries, Germany, and Estonia. Just below the average, we find Lithuania and Latvia, followed by Poland, Russia, and Ukraine – where the need to improve performance is the largest.

For countries at the bottom of the list, there is need for progress – not the opposite

Country rankings have changed marginally in the last two years. An upward trend is visible especially in Estonia. The largest fall in our BSI is noted for Ukraine, at the bottom of the list. The areas where Ukraine's rankings are the lowest include governance, tax policy, and logistics – a clear message for the new government on where to switch to a higher gear!

Cecilia Hermansson

A new index to measure business conditions in the Baltic Sea region

A new Baltic Sea Index to make it easier for companies to get access to relevant information

With this report, we launch a new structural and competitiveness index that focus on the 11 countries covered in the report. In an increasingly globalised world economy where trade and production are less bounded by nation states and where firm competitiveness depends on rapid assessments of production and market conditions in other countries, in-depth and accessible information becomes ever more valuable. Much of the information we present can be found elsewhere, but by compiling and presenting these data in a way that is easy to access and interpret, we hope that companies in the Baltic Sea region can more easily inform themselves of important aspects prior to their business decisions. We intend to update the index annually and thereby make possible the monitoring of changes in the index over time and between countries.

The composition and calculation of the Swedbank Baltic Sea Index (BSI)

A significant amount of business-related information is included in the index

The Baltic Sea Index is based on several subindices that are deemed relevant for decision makers when considering expanding abroad. It is compiled from several sources and uses information that has been vetted by other institutions, such as the World Bank, various UN organisations, research institutes, and private consultancy companies. Thus, we consider the data to be the best available. Our index differs mainly in the composition of the subindices, where we have selected variables that we consider particularly relevant for businesses that operate in this region. Furthermore, it is not common to have an index that compares economies of such diversity as exists in this region, which encompasses the Nordic and Baltic countries, Germany, and Poland, together with Russia and Ukraine.

Ten areas that are deemed important for the business climate are covered by the index

After an extensive review of existing data and information that cover all of the countries in this report, we selected 10 main subgroups. We chose not to include macroeconomic conditions, which we cover through our regular monitoring.

<u>Composition of the index:</u> [1]

I. Entrepreneurship

The data in this subgroup assess the practical conditions of starting and operating a business in a country. The indicators include assessments of ease in dealing with the local authorities in, for example, getting licences or registering property. They also cover judicial aspects of the local business climate by assessing investor rights' protection and the enforcing of contracts. The source is a selection of the World Bank's Ease of Doing Business indicators.

[1] For a complete list of subindices and sources, see annex.

II. Labour market

An important factor in the successful establishment of a company is a well-functioning local labour market. In this subindex, we include a measure of the ease of employing workers (from the World Bank survey), which covers aspects such as hiring-and-firing rules. Labour productivity is another key aspect, and we also include in this subgroup data on GDP per person engaged (International Labour Organisation, ILO). Furthermore, through the inclusion of participation rates in the subindex, we aim to capture the flexibility of labour supply (also from ILO).

III. Tax policy

Tax rates matter for profitability and cost of employing workers, and we include in this sub-index both the highest personal income tax rate paid and the corporate tax rate (both from KPMG). The World Bank's assessment of the ease of paying taxes is also included to reflect the efficiency of the local tax administration.

IV. Financial markets

When establishing a business, it is also important to know how the local financial market functions. Daily operations are dependent on an efficient banking sector, and future decisions on whether to expand the business depend on access to more long-term capital. In this context, the possibility of spreading the risks of financing also affects the business decision. To capture this area, we have included a number of indices collected by the Milken Institute, ranging from an assessment of the quality of the banking and financial institutions to the existence of a bond market and access to international funding.

V. Foreign trade

Many companies are looking to establish production in other markets to take advantage of lower costs or to gain access to qualified labour in order to export. In this subindex, we use the Enabling Trade index from the World Economic Forum. This covers such aspects as the efficiency of customs and border administration.

VI. Education

The educational level matters not only for labour productivity but also for overall efficiency in the local administration and among local business partners. In this subgroup, we use the educational ranking produced in the Global Competitiveness Report of the World Economic Forum.

VII. Governance

We also wish to highlight governance as an important factor to be considered when establishing operations in a country. The cost of corruption could be high and the efficiency losses substantial. Governance in our index is assessed through Transparency International's Corruption Perception index, combined with the World Bank's assessment of the rule of law and control of corruption. This last index also covers corruption in public institutions.

VIII. Infrastructure

The extent and efficiency of the physical infrastructure also matter for business operations and profitability. The number and quality of roads and port facilities, as well as the size and quality of the telecommunications sector, are factors that are measured by two indices summarized by this subindex: the first compiled by the World Economic Forum in the Global Competitiveness Report and the second in the Logistical Performance index of the World Bank.

IX. Logistics

Overall logistical efficiency is important for daily business operations; it also matters when companies contemplate expanding their operations. The subindices here are selected from the Logistical Performance index compiled by the World Bank, and we have chosen areas ranging from customs administration to logistical competence and timeliness of operations in the country.

X. Innovation climate

A dynamic innovation climate in a country can not only attract advanced business, but also support already established companies in maintaining their competitiveness. The innovation climate indicator is covered through the inclusion of the Global Innovation index compiled by INSEAD. This index weights together factors such as the political environment, investment in education, market sophistication, and scientific output.

Calculation of the index

The 10 main subgroups are equally weighted in the overall Swedbank Baltic Sea Index. Within these subgroups, we summarise the different indicators also using equal weights. Data availability and coverage are not always perfect. We used the latest available data, which are most often, but not always, 2009 data. Some subsamples do not include all countries in the world, but the sample size is never smaller than 123. In a few instances, data are available only for two time points--2007 and 2009--and, in these cases, we use the average to calculate the midpoint.

Data are not always perfect, and we use what is most relevant and available.

The country scores in the index are ranked according to the percentile of all the countries included in that particular data set. Thus, the index ranks the 11 countries in this report in relation to the rest of the world. A score between 9 and 10 implies that the country for that subindex ranks in the top 10 percent of the countries included in the sample. This means that a country could improve its score but still fall behind if the progress in other countries is faster. This, in our view, reflects the importance of monitoring developments in other countries. Furthermore, because investors adopt a broad outlook prior to making sales and location decisions, it is the country's relative quality as a business destination that matters.

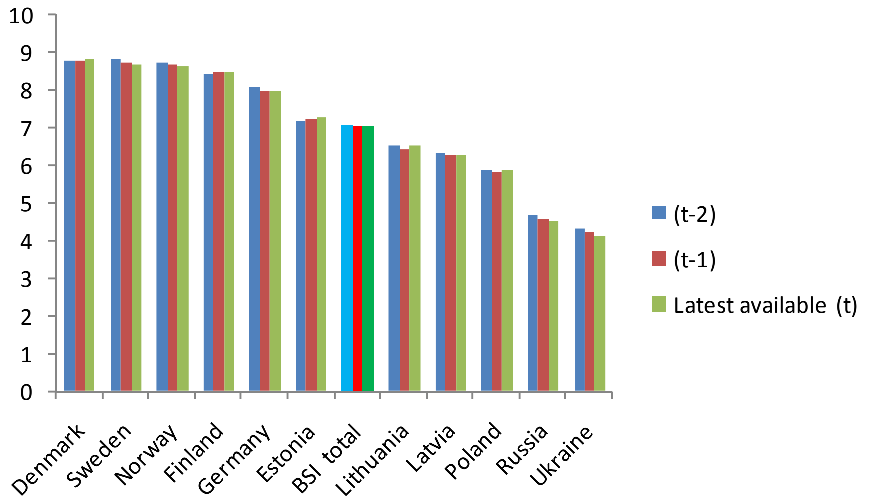
The index measures the Baltic Sea countries' performance compared with others

The 2010 Swedbank BSI

The countries included in the region ranks from the top 20% to below the global average

The results of this first compilation of the Swedbank Baltic Sea Index indicate that the Nordic countries and Germany rank among the top 20% performers of the world. While these rankings are high, they also indicate that there is still room for improvement. Furthermore, as other countries keep reforming, the Nordic countries also need to pursue continuous adjustments to maintain their positions. Estonia, the only country that has improved its ranking during the period, falls in the 7th decile bracket (i.e. top 30% performers of the world), above the average for the Baltic Sea region countries, while Lithuania, Latvia, and Poland rank slightly below average. Russia and Ukraine are lagging and fall significantly below the average. In these two countries, the payoff from reforms will be greatest.

Swedbank Baltic Sea Index – country ranking compared with rest of world

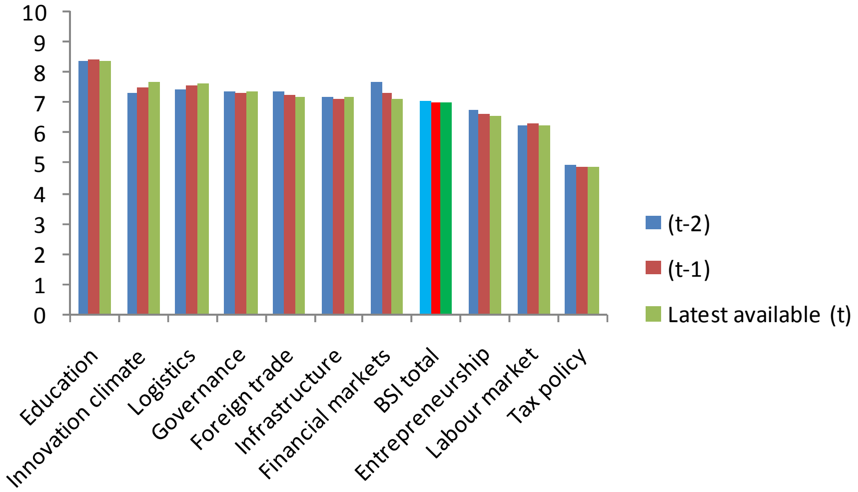


Source: Swedbank calculation based on information from the World Bank, ILO, KPMG, Milken Institute, World Economic Forum, Transparency International, and INSEAD.

Estonia is improving its position, while Ukraine is falling behind

Countries' positions have changed marginally in the last two years. Estonia has improved the most and is, thus, moving up in the global ranking as an economy in which it is advantageous to do business. It is in particular in areas such as logistics and innovation climate that Estonia has improved the most over the last couple of years. The largest decline in the index is noted for Ukraine, which is already at the bottom of the list. The areas where its rankings are the lowest include governance, tax policy, and logistics.

Swedbank Baltic Sea Index – category ranking compared with rest of world



Source: Swedbank calculation based on information from the World Bank, ILO, KPMG, Milken Institute, World Economic Forum, Transparency International, and INSEAD.

Education and innovation climate are strong in the region, while labour markets and tax structure reduce the attractiveness

For the region as a whole, the strength is clearly in education and innovation climate, while tax policy lags behind. This is influenced by the relatively high tax-to-GDP ratios found in many of the countries. Overall, there has not been much change over the period. This means that the region has held up as an attractive destination for investing and doing business during the financial crisis. While financial market indicators fell due to the widespread banking crisis, the region improved in infrastructure and logistics. The challenge for the region, is to get credit markets functioning again while making the tax structure more beneficial for doing business and, thus, for increasing employment.

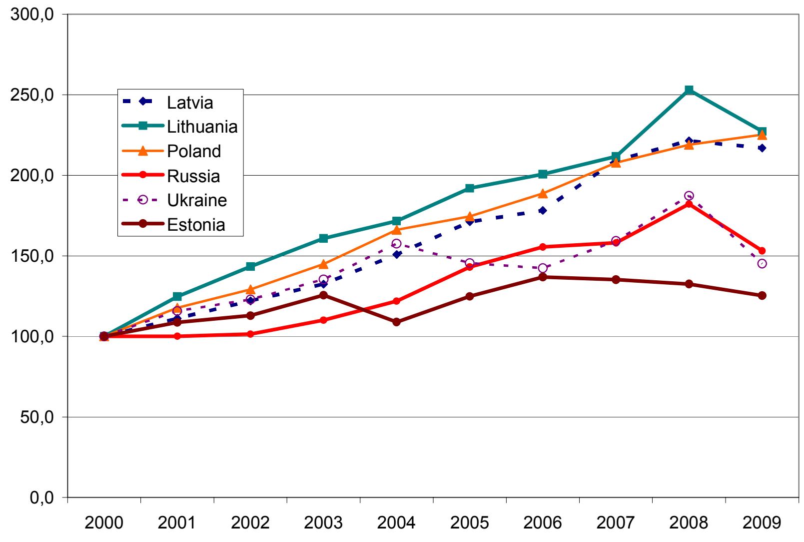
Magnus Alvesson

Export performance in the Baltic Sea region

In this section, we analyse the export performance for the countries in the Baltic Sea region during 2000-2009 by using the export value in U.S. dollars for each country divided by the global import value. The percentage change in market shares is then rebased using the year 2000. However, since the foreign trade figures are in nominal terms, price differences on energy or other commodities could lead to larger fluctuations in export performance for an individual country.

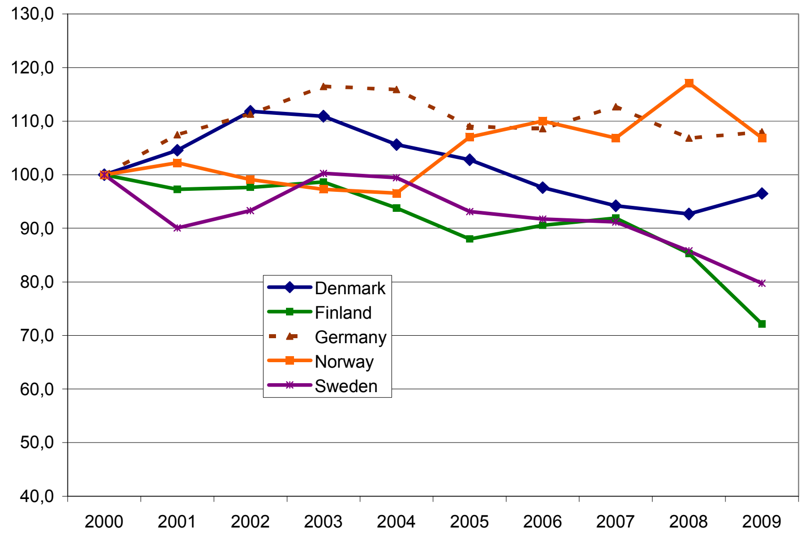
Our results show significant differences in export performance among the Baltic Sea countries. In the Baltic states (Estonia, Latvia, and Lithuania), market shares have been growing strongly during the whole period, although from low levels. The exception was 2009 due to the deep global recession. The largest export market gains have been recorded in Lithuania and Latvia—a doubling of the market share-- while in Estonia the market share has increased by 25%. Poland, which is less dependent on exports, has also shown a positive export performance along the lines of the Baltic states. In Finland, Sweden, and Denmark a downward trend in market shares is obvious. The largest losses have occurred in Finland-- nearly 30% since 2000--and the market share has decreased from nearly 0.7% of global imports in 2000 to 0.5% 2009.

Change in Export Market Shares for the Baltic Sea Countries, 2000=100



For Sweden, the accumulated losses were 20%, and the market share has now fallen to around 1% of the global market. In Norway, however, the export performance has been more favourable even though the country is at a competitive disadvantage compared with its partner countries. Higher prices on oil and gas, which account for more than 50% of Norwegian exports, could explain the growing export market shares. Changes in export prices for oil and other commodities are also a cause for concern in Ukraine and Russia, as these changes can partly exaggerate the countries' export performance. Germany, which is the largest export nation in the world, also has registered a positive export performance, due to small increases in unit labour costs and a favourable export composition. Its export market share increased to nearly 9% in 2009 from 8.2% in 2000.

Change in Export Market Shares for the Baltic Sea Countries, 2000=100



The differences in export performance among the countries are to a large extent an effect of the globalisation of, and specialisation in, the production of goods and services. Countries with a favourable business climate and stable macroeconomic environment benefit from the growth in global trade and increase in foreign direct investments. The integration with the EU is an important reason for the growing market shares of the Baltic states and Poland. A stronger global demand for commodities means new export possibilities for countries with large proportions of commodities in exports. This is particularly relevant for Russia, Ukraine, and Norway.

The decrease in export market shares for the Nordic Countries (except Norway) is raising questions about competitiveness and export composition. Due to the increasing globalisation and tougher competition, which we foresee will continue, additional investments in research will be important to strengthen competitiveness and broaden these countries' export bases. Promoting a flexible labour market and increasing the access of educated people are other important structural challenges facing several countries in the region.

Jörgen Kennemar

Russia

Russia – returns to growth

Population:	142.0 million
GDP per capita (PPP) 2009:	USD 14,920
Government:	Market-oriented coalition
Prime Minister:	Vladimir Putin
President:	Dmitry Medvedev
Next parliamentary election:	December, 2011
Next presidential election:	March, 2012
Average GDP growth in last five years:	4.0%
Average inflation rate in last five years:	11.4%
Average unemployment rate in last five years:	7.1%

Summary

- Politics remained stable during the crisis year of 2009, but, as the economy starts recovering, strains are emerging both in foreign policy and domestically. Renewed Russian interest in the “near abroad” could cause some nervousness there but is also seen as a step to re-establish old trade and economic links. Domestically, there have been some recent incidents of public protest and social unrest as the impact of the crisis is still strong. In the run-up to the parliamentary and presidential elections in 2011 and 2012, respectively, the cohabitation of President Medvedev and Prime Minister Putin will be tested.

- Fiscal policy became very expansive during 2009 and mitigated the impact of the global financial crisis on the household, and on the financial and cooperate sectors. However, fiscal reserves are decreasing, and, with a more modest oil price going forward, fiscal retrenchment will have an impact. As inflationary pressures have been subsiding, the central bank has lowered policy rates and reduced the appreciation tendencies of the ruble. Increasing risk appetite and a better economic outlook has led to a return of capital inflows and a rebound of the stock market. We project a return to positive growth rates in 2010-2011 of 4.3 % and 4.5%, respectively, while inflation and unemployment rates will remain below 10%. Russia scores 4.5 on the Baltic Sea Index, among the lowest of the group. In particular, Russia scores low in the categories of “Foreign trade” and “Governance.” In “Tax policy,” Russia ranks above average in the overall global sample.

Consequences for companies

- Business opportunities in Russia are still held back by pervasive corruption, lack of competition, a heavy- handed public sector, and lack of public infrastructure. At the same time, the upside for successful investment in Russia is substantial because of its large underdeveloped market. Furthermore, President Medvedev is increasingly emphasising the importance of reforms and of modernisation of the economy. So far, however, there has been limited actual policy implementation.

- Domestic demand is set to grow over the next two years, albeit from low levels. Household consumption held up fairly well during the downturn, while investment fell back sharply. The appreciation of the ruble will help hold back inflation pressures and increase the real purchasing power of Russian consumers, while the unemployment level is expected to remain around 10%. The still-weak labour market will limit wage demands, while the competitiveness of production in Russia is moderated by the stronger ruble.
- Russia is a diverse economy where the conditions for business vary significantly. Moscow, although the largest single market, is considered to be the most difficult to do business in. Kazan, on the other hand, with a well-developed financial sector and a diversified economy, is hailed as being very dynamic.
- Public policy is likely to continue to provide opportunities for private companies in different sectors. The privatisation of public companies and assets is likely to be accelerated and public investments and procurement could benefit private companies. Apart from consumer goods, areas such as energy efficiency, utlitities, and IT and telecommunications should provide opportunities for private sector and foreign suppliers.

Economic crisis causes political strains

Political crisis management has been strong, but tensions are rising

The cohabitation of President Medvedev and Prime Minister Putin has worked well throughout the crisis. The forceful interventions in the manufacturing sector to preserve jobs, and in the financial sector to save banks, have contained much of the social unrest that could have been expected to follow the rapidly deteriorating economic conditions. Lately, however, there have been signs that discontent is spreading. A large-scale public demonstration took place in the Kaliningrad enclave to protest the loss of jobs. In particular, Prime Minister Putin is showing little patience for diverging views, and opposition has been met with harsh reactions and impatience.

Foreign policy interest is focused on the east, while trade discussions with WTO make little progress

In the foreign policy arena, Russia is trying to extend its presence and role in the “near abroad”. Following the brief war with Georgia in 2008, Russia has made it clear that it intends to strengthen its political and economic ties with, in particular, former Soviet republics. Trade links have been re-established, and cooperation, particularly in the energy sector, have been strengthened. The “gas-for-fleet” deal with Ukraine, in which the lease of the Russian marine base was extended in exchange for lower prices for natural gas, confirms the close links between foreign policy and trade relations. On the other hand, as the recent gas dispute with Belarus indicates, Russian manoeuvres in the “near abroad” will not be frictionless. At the same time, there are no signs that Russia has moved any closer to accession to the WTO and, thus, to greater integration with the global economy.

Medvedev is outlining an independent platform

The upcoming elections have started to create some speculation that the peaceful co-habitation of Medvedev and Putin could come to an end. It has been expected that Medvedev would not run for a second term and that Putin, thereby, would be a shoo-in for his third presidential term. President Medvedev has, however, started to build a political platform that emphasises a preference for more liberal and anti-authoritarian policies as the best conditions for political and economic development in Russia. It is unclear whether this platform has been built with the approval of Prime Minister Putin, or whether Medvedev is aiming at an independent bid for the presidency in 2012.

Back to growth, but dependence on energy remains

Positive economic growth is mainly on account of energy prices and fiscal stimulus

The Russian economy showed positive real growth rates in the 1st quarter of 2010. Preliminary data suggest that the economy grew by almost 3% annually, up from a negative 4% at the end of 2009. Thus, the sharp downturn of 2008-2009 which led to a cumulative loss of 9% of GDP is over. Recovering external demand, aided by increasing oil prices and an expansive fiscal policy, are the main engines behind the turnaround.

Large reserves alleviated the impact from the crisis, but lack of reforms exposed weakness in domestic economy

The Russian economy faced the crisis from a position of strength, but the financial turmoil has also exposed many weaknesses. Nine years of rapid economic growth preceded the crisis, and Russia built up a sizable foreign currency reserve. This has come in handy in mitigating the impact of the crisis. The public sector has provided support to large groups of the population, such as the pensioners, and directly intervened by bailing out banks and large companies. With the recovery of world energy prices and a stabilisation of the global economy, risk appetite has returned to the Russian economy, and capital is again flowing in. However, the economic crisis revealed the extent to which the Russian economy is dependent on external events, and to which the lack reforms has increased the vulnerability of the economy.

Domestic economy is making a comeback

Also, domestic demand is making a comeback after suffering sharp declines last year. The official unemployment level has stabilised below 9 percent, although the real rate is likely significantly higher: many do not report as unemployed, and others are forced to reduce work time or take unpaid leave. Retail trade picked up early in the year and showed positive growth rates in the 1st quarter. In addition, credit markets are thawing, but in many cases demand for credit is lagging behind. Banks are still suffering from doubtful assets on their balance sheets and are struggling to identify nonperforming loans. After an initial bounceback in domestic demand, it is thus likely that the recovery will become more protracted as corporate and financial sector firms clean up their balance sheets.

Growth will pick up, and the risks are balanced

Overall, we project real economic growth rates of 4.3% in 2010 and 4.5% in 2011, and inflation and unemployment levels that will remain below 10%. Domestic demand will rebound from the sharp contraction in 2009, but the low capacity utilisation in domestic production and weak labour market will limit growth rates. The mix of upside and downside risks to the economy over the next two years is balanced. Downside risks are mainly external, and derive from a slow recovery in the rest of the world and decreasing world market energy prices.

The main domestic risk is worse-than-expected financial sector imbalances. A rapid increase in nonperforming loans could significantly impair the ability of banks to extend credit to the private sector; such an increase also carries substantial fiscal risks. However, positive developments are plentiful. Oil prices, despite the recent falls, are higher than a year ago, and this benefits both the private sector and public finances. Confidence in the Russia economy has returned, and capital flows are resurgent, while exchange rate volatility and inflation is coming down.

Macroeconomic policy in place – structural reforms are lagging

Fiscal expansion will be phased out, while monetary stance continues to support the economy

The large expansion of fiscal policy helped cushion the economic downfall, and, without it, the contraction would have been deeper. However, the large deficits have eroded fiscal balances, and we expect the deficit to decline to 3% of GDP in 2010 and 2% of GDP in 2011. This will increase the importance of the private sector for growth. As inflationary pressures have fallen, the central bank has been able to lower monetary policy rates since the middle of last year. Although the transmission mechanism to lower market rates is weak in Russia, appreciation pressures on the ruble have eased. This has improved the competitiveness of the non-oil and import-competing sectors.

Russian economy still dependent on natural resources and held back by governance issues

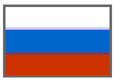
Many weakness remains, however. The Russian economy is still very dependent on natural resources, and other sectors of the economy have remained underdeveloped. Ownership is often concentrated, and then in oligarchs with ties to the government sector. This reduces competition, and undermines ownership rights and rule of law. The small and medium-sized business sector is underdeveloped, and a weak institutional setting and poor management practises limit the dynamics and capacity for domestic production to compete with imports.

Continued state support of the economy could benefit private sector firms

Some government stimulus measures are likely to remain in place. Many private firms still suffer from impaired balance sheets, and government assistance, directly or indirectly through state-controlled banks, is needed. Furthermore, public investment in infrastructure is growing, and the private sector could benefit from increased state procurements. To boost government funds, public authorities are also set to add to the list of companies to be privatised, and other state-owned companies could sell core and noncore assets.

The Russian authorities continue to advocate a better business climate and modernisation of the economy

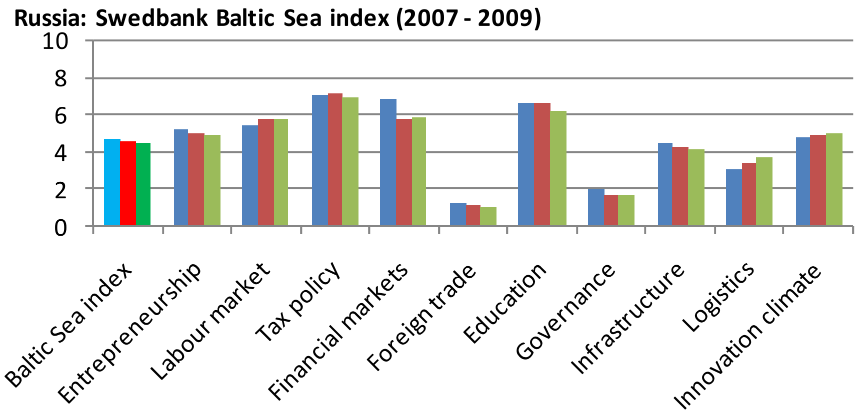
President Medvedev has pledged to curb corruption, improve the business climate for small and medium-sized enterprises, and expand investment in public infrastructure. He also relaunched the privatization process and expanded the list of public companies up for sale. As the economy stabilizes, the Russian economy's medium-term growth potential would benefit significantly from continued modernisation and diversification, i.e., if plans were translated into action.



For businesses – large regional differences

The recent uptick in growth, coupled with restored macroeconomic stability, provides an improved basis for foreign companies to again take a closer look at Russia as an investment destination. However, risks remain high, and the returns on long-term investments are still stymied by a weak overall business climate. In the Baltic Sea Index, Russia ranks among the lowest in the group, and on a global basis in the lower half. In particular, Russia scores low in areas such as “Foreign trade,” “Logistics,” and “Governance,” while it fares better in the categories of “Education,” “Labour market,” and “Tax policy.” Over the recent period, Russia has fallen back and lost ground to other countries.

Better conditions for business, but Russia still ranks low internationally



While Russia is often seen as a single economy, the conditions for doing business vary vastly between cities and regions. Primarily, the business environment depends on the basic economic structure in the region. Big cities naturally have more developed retail markets, but competition is also stiffer in those places, and it could be worthwhile for investors to seek out less developed markets despite other hurdles such as language and infrastructure. Regions depending on natural resources are likely to have more fiscal means to develop infrastructure and their populations to have a higher purchasing power. On the other hand, ownership is likely concentrated in these cities, and the authorities have fewer incentives to seek out other investors. History also plays a role: industrial concentration from Soviet times has in many cases resulted in so-called monotowns, which are often plagued by overdependence on one company, high unemployment, and social despair.

For investors, it would pay to differentiate between regions of Russia

In a recent study by the World Bank, eight cities in Russia are ranked according to ease of doing business. Moscow is considered the least easy place to do business, with St. Petersburg ranking only slightly higher Kazan, the capital of Tartarstan in the middle of the European part of Russia, ranks the highest. Kazan is one of the largest industrial and financial centres in Russia, and has a diverse composition of industries, such as mechanical engineering, chemical, petrochemical, light, and food industries. In particular, in Kazan it is easiest to comply

Moscow and St. Petersburg rank among lowest and Kazan highest on ease of doing business scale with the regulatory framework. Moscow, on the other hand, scores low on most subindices.

Investment opportunities in areas related to government interventions and recovering economic activity

Also, investment conditions among sectors differ. In particular, as government support continues, areas such as infrastructure investments, public utilities (including the upgrading of energy efficiency and water and waste management) should see growth over the next years. The high-tech market (IT and telecommunications) is still not saturated, and there is pent-up demand for equipment upgrades among companies in the aftermath of the economic crisis. Also, fast-moving consumer goods and the retail market will have some potential for growth as the economy recovers.

Magnus Alvesson

Ukraine

Ukraine – finding its footing after a year of economic and political turmoil

Population:	46.3 million
GDP per capita (PPP) 2009:	USD 6,339
Government:	Market-oriented, conservative coalition
President:	Victor Yanukovych
Prime Minister:	Mykola Azarov
Next presidential election:	2015
Average GDP growth in last five years:	1.0%
Average inflation rate in last five years:	15.3%
Average unemployment rate in last five years:	7.1%

Summary

- Victor Yanukovych was elected president in February 2010 after the former “Orange Coalition” partners failed to unite amidst turbulent economic developments. President Yanukovych has built support in the parliament and has started to repair the relationship with Russia. After a relatively smooth transition of power, a more stable political situation has emerged. The new president and government face significant reform challenges. To put the Ukrainian economy back on track for strong growth, deep-rooted and wide-aiming public sector reforms are necessary. Ukraine scored 4.1 on the Baltic Sea Index, the lowest in the region. In particular, the categories of “Governance” and “Entrepreneurship” brought down the score, while “Education” fared relatively well.

- The sharp macroeconomic decline appears to have halted in early 2010. Preliminary data suggest that the economy grew in real terms in the 1st quarter on the back of strong external demand. Domestic consumption and investments are, however, expected to lag behind as many households face slow wage growth and lingering underemployment; also, companies are still highly leveraged. Taking into account the improvement in macroeconomic conditions in early 2010, coupled with the relatively stable political situation, we have raised our economic growth forecast to 3.5% in 2010 and 4.5% in 2011. We also expect average inflation to remain below 10% in both years and unemployment to start levelling off.

Consequences for companies

- The Ukrainian economy still has a large potential, with a population of 45 million, an abundance of natural resources, and a well-qualified workforce, as well as a location between large markets such as the EU, Russia, and Turkey.
- The rapprochement with Russia improves the possibilities of smoother trading relations. At the same time, Ukraine is seeking closer cooperation with the EU, with the possibility of reaching a free trade agreement.

- Private sector businesses are facing significant costs and hurdles due to overregulation and unpredictability in rules enforcement. Corruption is abundant, and competition is limited in many sectors. Public infrastructure, particularly in transport and communication, is severely limiting.
- Business opportunities exist especially in sectors related to natural resources and agriculture. In the short term, the greatest promise is to be found in the sale and production of fast-moving consumer goods. Also, due to the relatively high education levels and the underdeveloped services sectors, investment in services production, either for local sale or outsourcing, could be advantageous. Long-term investment projects are more risky and depend on the authorities' carrying out real reforms.

A new government facing many challenges

A strong government provides an opportunity for much-needed reforms

Viktor Yanukovych took office in February of this year after a closely fought election, as the parties of the Orange Revolution failed to form a united front. The economic crisis also worked against the former coalition. The new president managed to put together a majority in the parliament by winning the support of parties and individual parliamentarians. This has created a relatively strong executive power that contrasts with the constant infighting that prevailed previously. Thus, there is an opportunity for the new government to make some wide-ranging and much-needed reforms of the Ukrainian economy.

Despite moving closer to Moscow, the Ukrainian government keeps its options open

The new government has moved quickly to rebalance Ukraine's foreign policy position. Following the strong pro-western orientation of the previous government and subsequent deterioration of relations with Russia, a number of actions have signalled that Ukraine is now trying to remedy this situation. In a "gas-for-fleet" deal, the Russian lease of the marine base on Crimea was extended by another 30 years in exchange for a 30% price discount on the previous agreement on gas imports to Ukraine. At the same time, President Yanukovych's first foreign visit was to Brussels, and, at the recent nuclear security summit in Washington, the Ukrainian delegation announced that it would dispose of all weapon-grade nuclear material by 2012. Thus, the reorientation of foreign alliances is characterised by an attempt to be even-handed.

An orderly transition of power, but democracy is still not deep rooted.

Despite the largely peaceful and orderly transition of power, not a small feat considering the depth of the economic crisis, the democratic credentials of the new government are being questioned. The investigation for bribery against the former Prime Minister Yulia Tymoshenko has been reopened, allegedly in an attempt to discredit and sideline her. Discrediting former office holders is not novel in Ukrainian politics. The past government initiated several lawsuits against the current President Yanukovych, while ignoring its own misdeeds. Despite the grassroots-initiated Orange Revolution in 2004, democracy in Ukraine continues to manifest itself in rotating stints of different groups of oligarchs. Simultaneously, there is growing apathy and widespread discontent among the population, as well as a risk of a widening divide between the pro-Russian, industrialized east and the more western-oriented western part of the country.

Macroeconomic freefall over

The economy is stabilizing after a 15% real contraction in 2009.

Although macroeconomic conditions seem to have bottomed out, the recovery is likely to be slow. In particular, external demand has picked up. Along with increasing world market prices, steel production rose by almost 18% in the 1st quarter of 2010. Production in agriculture, beset by crop diseases and bad weather early in the season, will slow after a solid growth of more than 5% last year. Lack of financing is also hampering investment in agriculture.

Consumption spending slow to pick up, but underlying demand is there

Domestic demand is expected to lag behind. Although there have been some recent improvements in consumer confidence, the household sector has been hard hit by the crisis. Unemployment has not increased as much as was feared, but many have been forced to move to part-time jobs and to take unpaid leave. Also, real wage development has been slow, declining by an average of 9% in 2009. Nevertheless, with the crisis likely to be over, households could start increasing spending again and reduce precautionary saving. The decline in retail trade has slowed but is nevertheless continuing to fall in 2010.

Investments will lag, but significant needs will eventually lead to a revival

Financial sector weaknesses and necessary consolidation in the banking sector will limit the near-term growth of private sector lending. The number of creditworthy borrowers has decreased and those that remain are coveted by many lenders. The exchange rate depreciation of more than 50% since mid-2008 has also left companies with a growing debt burden as many took out loans in foreign currency. However, the investment needs are substantial, despite significant capacity underutilisation in the industry. Technology renewal and an upgrade of infrastructure have been neglected for a number of years. Also, the lack of public sector funding could increase private sector participation in public infrastructure projects. Furthermore, with a less negative external risk assessment of Ukraine, foreign financing could pick up, thus creating some impetus for higher capital spending.

Fiscal policy risks remain, with less pressure from monetary policy

A fiscal budget for 2010 was adopted in late April, entailing a decrease of the budget deficit to less than 6% of GDP, compared with the 9% of GDP estimated for 2009. Expenditures are set to rise by more than 30% as the new government keeps its promises to increase minimum wages. On the other hand, the budget's revenue projections are considered to be very optimistic, putting the deficit target in doubt. A major concern, in particular for export-oriented companies, is the continuing buildup of arrears on value-added tax (VAT) refunds. The government has proposed to issue bonds with 5% interest rates, but this would only partially compensate for the losses currently suffered by the companies. Pressure on the exchange rate has reversed, and, since February, the central bank has intervened in the foreign exchange market to prevent the hryvnia from appreciating. The renewed confidence in the currency stems from a de-dollarization of household savings and larger external capital inflows.

Outside views on Ukraine less negative, but concrete confidence-building actions still needed

The improvement in internal and external macroeconomic conditions has resulted in an upgrade in Ukraine's sovereign bond rating by Standard & Poor, and the currency default spreads have continued to decline following the elections. This implies that foreign investors view assets in Ukraine as slightly less risky, which will reduce public borrowing costs and increase capital inflows. However, Ukraine is still considered to be a high-risk investment destination.

A renewal of IMF lending lingers

A resumption of the lending arrangement with the IMF would add to international credibility. The government has announced its intentions to seek a new enhanced borrowing arrangement with the IMF. While the improved economic outlook eases some of the constraints facing program conditionality, it is likely the IMF will continue to call for a significant reduction in the government's spending plans, in particular considering the optimistic revenue projections. Transfers to cover losses due to energy subsidies are also likely to become a sticking point. On the other hand, as external financing constraints for Ukraine ease and foreign reserves grow, the pressure on the new government to conclude an agreement with IMF will subside.

Tall order of reforms is facing the new government

Inefficient government regulations increase costs for business and weaken competition

Government regulations and public sector bureaucracy inflict large costs on existing business and deter many new companies from entering into the market. In particular, an overly complicated tax system and unpredictable application of rules and regulations cause significant delays and disturbances in daily business activities. Furthermore, corruption is pervasive in dealings with the public authorities. A lack of strong and independent judicial powers also constrains competition, and the entry barriers into many markets are prohibitively high. Thus, rent seeking is pervasive in the private sector.

The government signals reform intention and aims for closer cooperation with the EU

The government has set out an ambitious reform agenda, and President Yanukovych has emphasised the importance of reforming the tax system, easing regulations for small and medium-sized enterprises, improving conditions for investments, reforming the social security system, and creating a functioning market for agricultural land. This is in line with most external recommendations, but the real challenge will be in overcoming vested interests and reform inertia. The government hopes to conclude an association agreement with the EU, which includes free trade and possibly visa-free travels, before the end of 2010. However, the prospects of EU enlargement remain significantly farther down the road.

Room for improved business conditions

Patience and realism are key when engaging with Ukraine

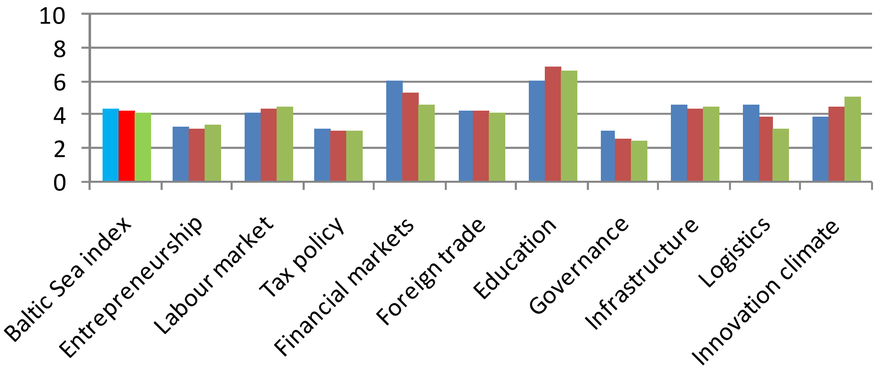
For foreign businesses looking for either a large end-user market or a low-cost and high-skills location for production, Ukraine is an economy that, although with substantial potential, also entails significant risks and red tape. Staying power and a realistic outlook will increase the likelihood of success of these businesses.

Ukraine

As indicated by the Baltic Sea Index (BSI), Ukraine ranks low on most subindices. Furthermore, Ukraine has declined in the overall ranking over the last couple of years. In particular, it has declined in areas such as financial markets, governance, and logistics.

Ukraine ranks low on the Baltic Sea Index

Ukraine: Swedbank Baltic Sea index (2007 - 2009)



However, a number of factors also speak in favour of Ukraine as an investment-destination country. With a population of more than 45 million, it is a large, but underdeveloped market, with significant pent-up demand, both for consumer and investment goods. As a member of the WTO and with a free trade agreement with Russia and other CIS countries, production in Ukraine has access to large markets in the vicinity. Thus, there would be an advantage in producing fast-moving consumer goods for sale not only in Ukraine but also in surrounding markets. The European football championship hosted jointly by Ukraine and Poland in 2012 (EURO2012) has already stimulated public investments and is expected to continue to have a positive impact on the development of the economy and infrastructure.

Ukraine is a hub-and- transit economy, and will get a boost from EURO2012

In addition, there are significant natural resources in Ukraine and, despite a fairly low technological level, a long history of industrial production. Industries exist in the areas of steel production, chemicals, shipbuilding, carmaking, and machinery production for agriculture. As the soil of Ukraine is fertile, there is a potential for agriculture, agribusiness, and food processing. A relatively high level of education has drawn increased interest from services producers. Being in a time zone close to the main European markets, Ukraine could serve as a "near-sourcing" site of, for example, IT programming. Also, the significant lack of systems in energy efficiency and other utilities, such as water and waste management, could provide business opportunities.

Ukraine is well endowed with natural resources and human capital

However, poor governance in both the private and the public sectors remains a major obstacle to the recovery and expansion of the economy. Ultimately, the speed at which Ukraine will develop and grow and, thus, provide an opportunity for foreign investors rests on the willingness and ability of the government to take speedy and bold action to restore the competitiveness of the economy.

Governance in both the private and public sector remains a challenge

Magnus Alvesson

Poland

Poland – convergence continues

Population:	38.1 million
GDP per capita (PPP) 2009:	USD 18,072
Government:	Liberal Conservative
Prime Minister:	Donald Tusk
President:	Bronislaw Komorowski
Next presidential election:	July, 2010
Next parliament election:	October, 2011
Average GDP-growth in last five years:	4.7 %
Average inflation rate in last five years:	2.7 %
Average unemployment rate in last five years:	11.3 %

Summary

- Poland has avoided a recession, and the economy is set to improve during 2010 and 2011 as GDP grows by 2.9 % and 3.2 %, respectively. However, the relatively decent growth performance has come with a price: a deteriorating fiscal position, which will have to be dealt with during 2011, a parliamentary election year.
- The earlier goal of joining EMU in 2012 has been altered, and a new goal for 2015 seems more reasonable, as this will, inter alia, give more time to bring the fiscal deficit down to 3% and ensure that the debt ratio stays below 60%.
- As growth most likely will stay below potential growth (around 4-5%), the reform process must be accelerated, at least after the elections. Doing so will help Poland to realize its potential for improving its rating in our BSI, especially with regard to the labour market, business climate, and tax policy.

Consequences for companies

- Domestic demand will grow, but household consumption is expected to stay weak due to a deteriorating labour market. Still, considerable medium-term business opportunities will be presented as GDP per capita converges with the rest of the EU's and the population grows somewhat.
- Unemployment is expected to increase further and reach 9.5% next year. As the European crisis is lingering, we expect migrant workers to stay longer at home. Labour costs will be under pressure, but will not decrease as in the Baltic countries, and a stronger zloty can actually weaken competitiveness going forward. Unit labour costs will increase as labour costs rise faster than productivity gains.
- The inflation outlook seems favourable at around 2 ½% due to the stronger zloty and the weak labour market. We do not foresee a raising of the central bank key interest rate until next year.
- As capital markets recover, the speed of privatization is picking up; this will stabilise debt. Thus, in many different sectors there is room for investment from Baltic Sea region companies in the years to come.

Poland

Up for presidential elections

The accident will have implications for politics

The tragic accident in Smolensk, where President Lech Kaczynski and a number of prominent Polish politicians, civil servants, and other prominent members of society were killed, has changed the political setting in Poland – both with regard to domestic politics and to external relations.

Emotions are part of the elections

One of the 10 registered candidates for the Polish presidential election on June 20th was Lech Kaczynskis' twin brother, Jaroslaw Kaczynski, who is also leader of the PiS (Law and Justice) Party. The other main candidate was the temporarily appointed President and lower house speaker, Bronislaw Komorowski. The election results show that Kaczynski (36%) has reduced Komorowski's (41%) lead somewhat, they will have to meet in a second round election on July 4th. The date is favourable to Kaczynski because his voters in the rural areas are more likely to vote, while a large part of the population in cities (who lean more to Komorowski) will be on vacation and thus less likely to vote. Because of the tragedy, the campaign has been low key, and, this has been more beneficial for Kaczynski, who has previously been seen as rather aggressive. He can now win political points on the strength of the emotions following his brother's death. Komorowski, meanwhile, has the advantage of being in charge at the moment, and has accordingly more opportunity to present himself as a statesman.

For companies, the focus is more on the parliamentary elections next year

For companies, the parliamentary elections next year are of greater interest. If Kaczynski were to become president, Prime Minister Tusk of the Civic Platform Party – who is working to modernize Poland – may face challenges in pushing through reforms. Before the 2011 elections, there may be hesitance about the reform process anyway, but this situation of having both a president (with the capability of vetoing proposals) and a prime minister has prompted more voices to call for a reform of the constitution. Such a reform does not seem likely at this stage, but may be subject for discussion in the years to come.

Stronger relations with Russia, even before the accident …

Poland's foreign relations have also been affected by the accident. Prime Minister Tusk had already started to strengthen the rather tense relations with Russia, but the tragedy has created even stronger ties between the two countries' politicians. Russia, for example, is in charge of investigating the plane crash. Among some segments of the Polish people, this involvement of Russia has raised suspicions about Russia's intentions, and the number of conspiracy theories is increasing.

… and strong relations with EU as Poland is preparing for chairmanship next autumn

Poland – with Prime Minister Tusk - is also working to strengthen its ties with the EU. In the autumn of next year, it will hold the chairmanship. One of the strong points for Poland during its chairmanship will be the fact that it has been the only EU country without a recession during the last couple of years, and can thus inspire confidence as a country with a stable financial sector and moderately growing economy.

The economy is strengthening – but risks are mounting

Many factors explain Poland's growth during the global crisis – lack of imbalances is one

Poland's resilience to the global economic crisis can be explained by its rather small export dependence, and the mild growth experienced by its large domestic sector. In addition, Poland benefited from large EU structural funds. Importantly, the country also had relatively sound financial sector developments and small macroeconomic imbalances before the crisis, and has been affected positively by its flexible exchange rate.

Growth will increase, but stay below potential and there are downside risks

Last year, GDP grew by 1.7%, and we expect growth to increase to 2.9% this year and 3.2% in 2011. Domestic demand will pick up, especially public investments. Capital inflows may recover somewhat. Exports will also strengthen, even if there are risks to the outlook such as a stronger zloty and faltering demand in neighbouring countries. Other risks include growing unemployment and deteriorating fiscal balances. As inflation will be contained and growth will be below potential, we do not foresee a need for the National Bank of Poland to raise its key interest rate above current 3.5% this year. In addition, the zloty is expected to appreciate somewhat against the euro. If the situation in the euro zone becomes more turbulent, the zloty may weaken as investors search for larger and safer currencies.

Household markets will stay weak in the short run, but the medium-term potential is good

For companies selling on Polish markets, households are expected to benefit from contained inflation due to weak labour markets and a stronger zloty. Still, purchasing power will be rather flat and consumption will thus be rather weak. Households, however, may use some of the savings built up during the global recession (the ratio of saving to disposable income is some 8%). On the investment side, business opportunities related to infrastructure spending will arise, and most of it will be funded by the EU. Specifically, EUR 20 billion will be available for roads, airports, and stadiums (Poland is co-hosting the soccer championships with Ukraine in 2012). For exporters, we foresee unit labour costs increasing moderately during the forecast period; a stronger zloty could also present a challenge.

Economic policy – focus on EMU

Concerns with the public deficit and the increasing debt ratio are building

Because Poland's public finances are deteriorating and the budget deficit reached over 7% last year, the ratio of debt to GDP, which stands at some 50%, is also rising. The government must present action plans to the parliament in order to avoid reaching the constitutional ceiling of 60%. If the debt ratio rises above 55%, a surplus is needed, and such austerity may need to be imposed during an election year. Increased privatisation of the many state-owned companies is one of the measures that could be taken to stabilise or lower debt. The reasons for the higher deficit, which is well above the Maastricht Treaty's criterion of 3%, are the so-called automatic stabilizers that were allowed to work when the government spent more and received less income to the budget during the global recession. In addition, a fiscal stimulus package of 2% of GDP was implemented to avoid a larger fall in the economy. The goal is now to lower the deficit to 2.9% of GDP in 2012.

Many reasons to consolidate the budget as Poland becomes more vulnerable and wants to join the EMU

There is a risk that, as is common in many countries, the upcoming elections may increase public spending and thereby worsen the fiscal position further. To improve the position as soon as possible is important for many reasons. First, the overall sovereign debt crisis in Europe makes Poland's situation more vulnerable and could hurt its credit rating. Second, it is necessary to avoid breaking the constitutional threshold and the difficulty of managing an upward debt spiral. Third, the goal of joining EMU is also a reason.

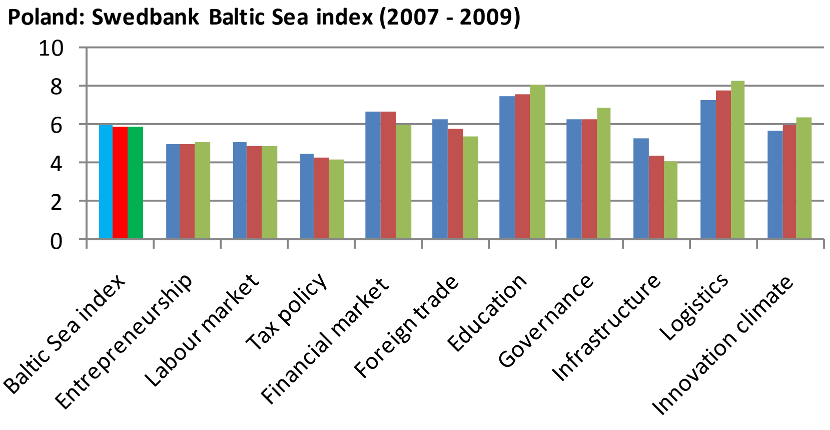
We find 2015 likely as the year Poland joins EMU

The earlier goal of joining EMU in 2012 has been altered to allow a more gradual budget consolidation. Other more implicit reasons for changing the plan could be the overall uncertainties within the euro zone and the fact that Poland has benefited thus far from the floating exchange rate. There is little opposition to joining, rather a view of finding the right timing and that entering into ERM2 could be postponed until the threshold of 3% is in reach. Other (minority) views hold that Poland should enter into ERM2 before the target date of 2012, as it would then be possible to fix the rate at a more favourable (weak) level. We see the most likely outcome as Poland joining EMU in 2015, and entering into ERM2 in 2013, when the deficit would be approaching 3% of GDP. At this stage, Poland does not have to rush into EMU but can instead continue on its road towards membership step by step.

Reforms needed to boost business climate

Poland could perform better – structurally

There are several structural problems in the Polish economy. Some of them are being dealt with, others not sufficiently. The low employment rate is a major concern, and so are the business climate and the tax system. Poland's rating in our structural index has room for large improvements. Poland rates better than Ukraine and Russia in our BSI, but not better than the Baltic countries. The main weaknesses can be identified in the areas of the labour market, entrepreneurship, foreign trade, tax policy, governance, and infrastructure; meanwhile, Poland has strengths with regard to education and logistics.



We expect the speed in implementing reforms to accelerate after the parliamentary elections next year. Still, in the meantime we do not foresee any backtracking in this area. Poland – a country that is converging with the EU and is slowly, but safely, moving towards a better functioning of its economy – could thereby attract more trade and investments.

A gradual improvement is foreseen – the convergence continues

Cecilia Hermansson

Estonia

Estonia – EMU membership comes closer

Population:	1.3 million
GDP per capita (PPP)2009:	USD 17,908
Government:	Right-wing liberal and conservative coalition
Prime Minister:	Andrus Ansip (Reform Party)
President:	Toomas Hendrik Ilves
Next presidential election:	2011
Next parliament election:	March 6, 2011
Average GDP-growth in last five years:	1.8%
Average inflation rate in last five years:	5.1%
Average unemployment rate in last five years:	7.6%

Summary

- The Estonian economy is slowly recovering from the recession. We expect GDP to grow by 1.5% this year, and 4.5% next year. Exports will support growth, and the main risk for the outlook is thus the global economy, not least the euro zone.

- The most important change in the economy will be the likely adoption of the euro in 2011, pending a final decision by July 13 of this year. Joining EMU will boost sentiment and help to attract more foreign investments.

- Estonia ranks relatively high on our Baltic Sea Index at 7.3, where governance and education score well, while there is room for improvement in labour market policies. Estonia also has a positive track record with regard to fiscal policy and openness. Looking forward, economic policy should be focused on supporting the business climate, and the focus should be sharpest on improving the functioning of the labour market, not least as aging will be a major challenge in the years to come.

Consequences for companies

- Estonia is about to join EMU in 2011. Euro adoption will improve risk estimates and may, therefore, attract additional inflows of foreign investments, which, in turn, will increase economic activity and create jobs.
- The Estonian institutional setting is relatively strong, and, at the same time, the tax level for enterprises is relatively low (for instance, there is no tax on reinvested profit).
- Consumer spending will remain weak this year and start to recover next. We expect inflows of investments to increase at the end of this year and next, due to improved risk estimates after euro adoption in 2011. Investments will be supported by EU structural funds.

Up for elections next year

The Estonian political environment is very diversified. However, because there are many parties that have enough supporters to get into the parliament, it is quite difficult to form a majority government.

Minority government maintains strong support despite unpopular decisions

Estonia has a minority government, which consists of the Pro Patria and Res Publica Union, and the Reform Party. The latter is, according to a poll, the most popular party in Estonia. The government, led by Prime Minister Andrus Ansip, assumed office on April 5, 2007, and since then has received remarkable support from the citizenry (even though there was a possibility of political instability after the Social Democratic Party left the government). The next parliamentary election will take place on March 6, 2011. The presidential elections will also be held the same year.

In the case of the general elections, many different factors favour the current government. For instance, the government has succeeded in leading the Estonian economy through the current economic crisis. However, doing so meant that the government had to make many very unpopular political decisions while trying to control the budget deficit. Nevertheless, the current government can lay claim to having established Estonia as a state with a strong fiscal policy and budget position, something that is extraordinary in the European Union in 2010.

On the other hand, the opposition parties also have strong campaign issues that they can use to attract voters' attention. They can point to the hardships of the unemployed, as well as the insufficient structural reforms of the current government. Nevertheless, despite these strong campaign issues, the ongoing debates and conflicts inside smaller opposition parties may undermine their chances of success in the coming elections. The largest opposition party is the Central Party, which has the support of a large share of voters (15% of the electorate).

The economy – growth is picking up

The Estonian economy is very open. Hence, external demand is important for the outlook, especially as domestic demand is still weak in light of the ongoing internal devaluation. Recent data confirm our expectation of 1.5% economic growth in 2010 and 4.5% growth in 2011.

Main contributors to the economic growth next year are export and investments

In 2010, the economy will grow mostly due to exports, and growing investments – supported by EU funds - will also support the upturn. Private consumption will remain weak. In 2011, we expect domestic demand gradually to contribute more to growth. Developments in the labour market, which will ease at the end of this year, will improve households' income situation; together with higher confidence, this will raise private consumption next year from its current low level. There may also be onetime effects from the euro adoption, as the main fear about the cash changeover is related to the overall price level increase. Therefore, many households may decide to spend their savings by making purchases of goods that they had earlier postponed. Thus, we may see faster consumption growth. However, this means that consumption growth at the beginning of 2011 will lag as consumers cut back their consumption as they try to get used to the new currency.

The period of deflation is over

Prices in 2009 did fall by 0.1% (consumer price index (CPI) annual change); however, the period of deflation in Estonia was relatively short due to changes in energy and other production input prices. The transmission of foreign inflation will affect CPI growth for the next few years. Even though price pressure from the world market is quite strong, weak domestic demand will dampen domestic prices. Hence, we foresee CPI growth of 1.5% in 2010 and 2.5% in 2011.

Wages continue to decrease in 2010 but will grow slightly in 2011

Last year, Estonia experienced internal devaluation. In addition to the price fall, quite strong corrections in wages were observed (total wage payments decreased by 14.4% and average wages by 5% in 2009). We expect this trend to continue throughout this year as well. This belief is related to the fact that, although employees' wages in the private sector were already cut last year, cuts in public sector wages are likely in 2010 since many local authorities did not cut their spending enough. Average real monthly wages will decline by 5-5.5% in 2010, but in 2011 we expect wages to grow by 1.5%. Total wage payments will drop by 1-2% this year and grow by 5-6% in 2011.

The difference in growth between average and total wage payments is explained by the change in working hours: while in 2009 this number dropped, in 2010 it will increase. At the same time, in the long run, the changes in the age structure of the population, together with the decrease in the labour force, will strengthen the pressure for wage hikes.

Unemployment has reached a historically high level

Even though the economy has already started to recover, the labour market will continue to deteriorate and will improve only with a lag. This means that unemployment will reach its highest level in the first half of this year and then gradually diminish as greater foreign demand will eventually increase the need for additional labour input. Next year, we expect that unemployment will fall further as economic activity accelerates.

In the long run, the main source of competitiveness is innovation and technological advancement of goods and services

Even though cost competitiveness may be the main source of survival of Estonian firms, this will not be sustainable in the long run – many world market prices are already increasing, and the convergence process will start to push the wage level up as well (in addition to the structural changes in the labour market). Therefore, the main source of competitiveness in the long run for firms in Estonia should be the creation of goods and services with more value added.

Economic policy focuses on improving the business climate

Estonia is about to become the 17th member of EMU.

Estonia has fulfilled the Maastricht criteria, and the formal process of joining EMU is expected to be finalized by an endorsement by the EU finance ministers on July 13, when also the exchange rate at which the switch will take place will be confirmed. The European Commission's Convergence Report, which was published on May 12, 2010 and supported Estonia's bid to become the 17th member of EMU. On May 10, Estonia received an invitation to become a member of the OECD, and the Accession Agreement was signed on June 3.

There is strong support from the government for entrepreneurship and a healthy business climate

The current government has firmly stated that it will maintain its conservative fiscal policy after joining EMU. In cooperation with different bodies from the public and private sectors, the Ministry of Economic Affairs has developed many programs to encourage and promote entrepreneurship. Some of these have been designed to help start businesses (subsidies for start-ups, loan guarantees, etc). Many of the programs are financed by EU funds and/or the government.

In addition to the above-mentioned programs, substantial funds from the EU are being used to develop programs to improve the quality of the labour force; this is especially important in light of the current movements in the labour market. The EU funds are being used to support the development of programs to promote the creative, entrepreneurial sector and jobs in other innovative fields.

Estonia has well-developed IT sector – e-services, paper-free offices, e-governance, etc.

The government has also developed plans to invest in the transport sector to improve the business climate and open doors for many more enterprises. Estonia is known as a country with a strong e-business sector, and this is also recognised by the government. Especially favoured and subsidised are ideas aimed at promoting more environmentally friendly office procedures like e-governance, paper-free offices, etc. Development of services in this area is also being followed up.

Additionally, there are ongoing reforms in the public sector, as the government is aiming to improve its effectiveness in providing public sector goods and services. Relevant in this regard are reforms of the health and social system, which may suffer in the near future from the aging of the population.

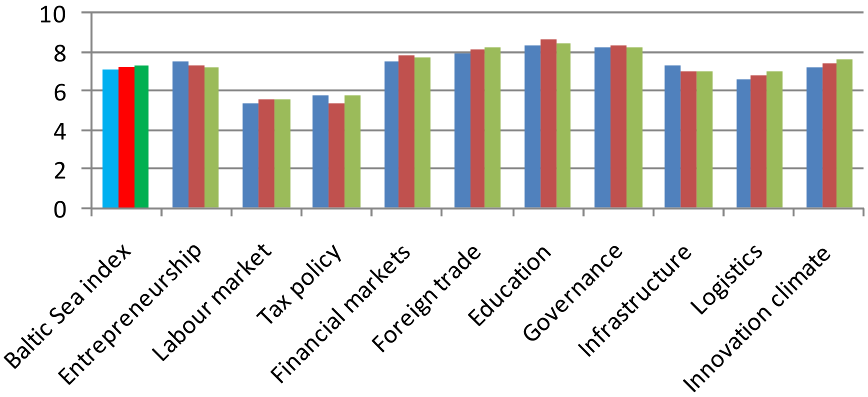
Reforms needed to improve labour market conditions

Estonia ranks above average in the Baltic Sea Index

Estonia ranks relatively high in the Baltic Sea Index, and has shown the most improvements over the last couple of years. More importantly, there have been steady gains in most subindices. Estonia is strong in "Education" and "Governance" but is loosing ground in "Infrastructure". The most room for improvement can be found in "Tax policy" and "Labour market".

Estonia

Estonia: Swedbank Baltic Sea index (2007 - 2009)



The structural problems on the labour market are, however, about to increase: the lack of a qualified workforce, together with high unemployment, is a gradually worsening problem. Because companies are trying to employ qualified workers (as they give notice to less-qualified ones), the pool of the former will gradually diminish. Also, some people will probably move to work abroad, and others will lose their qualifications. The number of highly professional workers is not large in many areas, and currently unemployed persons have mostly worked in jobs requiring low or medium qualifications (e.g., in retail, and in construction and other blue-collar jobs). For a while, the economy and investments could expand while supporting a relatively high number of such unemployed, but this cannot last long.

There are many challenges in the labour market

Although Estonia currently has a high unemployment rate, we forecast that this will start to decline and become low within five to seven years. The reason is aging: there will be more people leaving the labour market than those who will be starting their working life. We are also of the opinion that, at the same time, the share of long-term unemployed will increase. There is, thus, a possibility that Estonia will after some time suffer again from rapid wage increases.

Estonia may suffer from another bout of rapid wage growth due to the structural problems in the labour market

In sum, in making plans for the long term, the authorities and firms should keep in mind that the period of cheap labour will not last long. Even though the wage level in Estonia may stay lower than in the EU on average, it will nevertheless rise. This suggests that production should become more capital intensive and less labour intensive (this kind of change, however, needs additional investments). In addition to the changes in the production process, a reform of the educational system is required to meet the needs of the labour market and to help people to enter and/or re-enter this market. Investments in human capital will become more important, and the government should introduce incentives for firms to invest in their employees.

Efforts are needed from both private and public sectors to solve labour market problems

Annika Paabut
Maris Lauri

Latvia – sharp cost adjustments bring competitiveness gains

Population:	2.3 million
GDP per capita (PPP) 2009:	USD 14,254
Government:	Centre-right minority coalition
Prime Minister:	Valdis Dombrovskis
President:	Valdis Zatlers
Next parliamentary election:	October, 2010
Next presidential election:	May, 2011
Average GDP growth in last five years:	2.1%
Average inflation rate in last five years:	8.4%
Average unemployment rate in last five years:	9.3%

Summary

- Over the two-year forecast horizon, domestic demand will remain weak – we forecast it to contract by 9% in 2010 and grow by 4% in 2011. The economy is anticipated to strengthen slowly in 2010 driven by export growth, and a fall in GDP of 2.5% will be due only to negative carryover effects. In 2011, the economy is expected to expand by 4%.

- The IMF/ EC support programme is on track. Fiscal consolidation is set to continue in 2011-2012, which, while undermining domestic demand, will continue to exert pressure on the government to carry out structural reforms, e.g., to enhance the business environment, and the efficiency of the public sector. Latvia scores 6.3 on the Baltic Sea Index. In particular, it ranks relatively high in the categories "Education" and "Logistics", while lagging in the areas of "Tax policy" and "Financial markets".

Consequences for companies

- Due to weak domestic demand, competition will be tough; thus, price and quality will be the decisive factors for households and companies in choosing products or services.
- The economy has become very polarised. Recovery in demand in such domestic services as construction, real estate, domestic trade, and financial services will be slow; meanwhile, demand in such exporting sectors as manufacturing, tourism, IT, and other commercial services is expected to grow faster.
- Business costs have diminished substantially in 2009, strengthening cost advantages with respect to other European economies.

The upcoming parliamentary elections are slowing the momentum of structural reforms

Deep fiscal consolidation and a global recovery have improved confidence and reduced financial market risks, as shown by decreasing credit default swap rates. The decision of the ruling coalition's largest member, the People's Party, to leave the government on March 17, 2010 was taken calmly by financial markets. The government did not fall, and it is widely expected that the incumbent Prime Minister Dombrovskis will remain in office until the parliamentary elections this October, heading a minority centre-right government.

Closeness of the parliamentary elections has slowed implementation of the structural reforms

The closeness of the upcoming elections has slowed the momentum of reforms, and key decisions on the 2011 government budget and broader structural reforms will most likely be taken only after October. When the new government is formed, the reforms must speed up again, as next year's budget will become more pressing and the political cycle will become more favourable for hard unpopular decisions. The next elections are the municipal elections in 2013 – a long enough time span to implement the reforms. It is impossible to forecast the composition of the next parliament with any degree of accuracy, as the opinion polls are very unreliable this far before the elections. But whichever of the runners-up parties get an opportunity to form the next coalition government, we foresee no radical diversions from the current economic policy path.

Domestic demand will continue to be weak for the next few years

Weak labour market undermines private consumption

After the economy contracted by 18% in 2009, quarterly positive growth of seasonally adjusted GDP resumed in the 1st quarter of 2010, mostly owing to growth in exports. This brought stabilization to the labour market – the job-seekers' rate seems to have peaked in the 2nd quarter of 2010 (at about 21-22%). However, the labour market will remain weak for the next few years, with the unemployment rate still in excess of 15% and cautious wage growth starting only in 2011. Employment will begin to grow only next year and, unless job creation is actively supported by the government, its growth will be very slow. This will undoubtedly also undermine household consumption.

The deleveraging will continue, especially in the construction, real estate, and domestic trade sectors, exerting downward pressure on domestic demand

The deleveraging process will continue, as households and businesses need to reduce their excessive debt levels (which reached 94% of GDP in 2009). This pressure, however, is very industry specific. For instance, we expect weak activity in the highly leveraged construction and real estate market in upcoming years. Residential real estate prices bottomed out at 30% of their peak in mid-2007. Substantial losses are deterring banks from lending to these sectors, and household activity is also quite weak. Meanwhile, large built-up stock of new apartments, many unfinished projects, possible quality problems, and lengthy insolvency procedures will delay these sectors' recovery.

The debt burden in domestic trade increased substantially during the last two years, as did debt servicing for households due to a decline in incomes (the wage bill was down by 25% in 2009). The recovery of retail trade will thus be very slow and volatile, especially in nonfood segment. Retail trade turnover fell by nearly one-third in 2009, although it seems to have bottomed out in the 1st quarter of 2010. Market participants are adjusting to the change in consumer patterns caused by the crisis (e.g., fewer emotional purchases, and a shift to discount stores and outlets).

The demand for intermediate goods in exporting sectors will rise

Such sectors as manufacturing and tourism, as well as IT and other commercial services, have a better outlook. The leverage is not that high in these sectors, and the debt burden is actually easing in, e.g., manufacturing. These are exporting sectors that are benefiting from recovering demand in trading-partner countries and thus are able to increase production volumes. For instance, capacity utilisation in manufacturing is growing, and in some industries it is already close to pre-crisis levels. This indicates that some sectors will soon be willing to raise their production capacity. There will thus be a demand for intermediate goods – materials, energy resources, and new machinery– to continue the expansion.

Local deflationary pressure persists

The increasing heterogeneity of the economy is reflected in price developments. While there is upward price pressure from abroad (for imported inputs) due to higher commodity prices and a weaker euro exchange rate, subtle local demand is maintaining the deflationary pressure. Average consumer price inflation was 3.5% in 2009, mostly owing to the tax hikes in the beginning of the year, as prices had been falling since March. Average deflation of 2% is expected in 2010, followed by roughly stable consumer prices in 2011.

Fiscal consolidation will undermine domestic demand

Overall, domestic demand will be weak for the next couple of years. Another factor that will slow the recovery of local demand is fiscal consolidation (see below), implying public spending cuts, and redistribution of the tax burden. We forecast the economy to grow slowly in 2010 and GDP to fall by 2.5%, due only to carryover effects. In 2011, the economy is expected to expand by 4%. Domestic demand is forecast to contract by 9% in 2010 and grow by 4% in 2011.

Business costs have diminished

Reduction in business costs in 2009 strengthened cost advantages

There was quite a dramatic reduction in production costs in Latvia in 2009 – on average labour costs declined by 24%, construction costs by 11%, and producer prices by 5%. Land and real estate prices also decreased substantially.

Although the weak labour market undermines consumption, it makes it easier to find employees and cheaper to employ them. Hourly labour costs in Latvia in 2008 were about one-fourth of the EU27 average. According to the State Employment Agency, about 37% of officially registered unemployed have received vocational education, and 14% have completed higher education. The available labour force is thus of relatively good quality.

The entrepreneurial environment improved in 2009. For instance, it is now cheaper to set up a limited liability company, and other bureaucratic barriers are being lowered. The new, faster insolvency procedure is expected to come into force this autumn, thereby easing considerably the transfer of assets in the economy. However, uncertainty about tax changes continues to be a drag on business activity. Euro interest rates on new loans are still higher than those in Lithuania and Estonia (due to higher risk premiums). Although we will see other financial markets becoming more important (e.g., risk capitalists, stock exchange), the banks, together with foreign financing, are likely to remain the main source of capital. Financing costs are expected to diminish gradually as the economy slowly recovers; however, the kind of improvement in country ratings that will bring interest rates down is likely only after the elections are over and the 2011 government budget has been approved.

Entrepreneurial environment has improved, but uncertainty is still priced in interest rates

Activity and resources will become more concentrated around main regional centres. The dominance of Riga in the economy will most likely increase (currently, about 55% of the Latvian GDP is produced in Riga). However, there is still unexploited potential in the other parts of Latvia, where labour costs are lower (wages in other countries' biggest cities are on average 25% lower than in Riga). Also, two special economic zones have been established in Liepāja (including the port) and in Rēzekne, both of which benefit from favourable tax treatment and where infrastructure is already developed.

Activity and resources will become more concentrated around main cities

More reforms needed for sustainable growth

The IMF and EC-supported program of internal devaluation aimed at regaining competitiveness via cost cuts and productivity-enhancing structural reforms is being implemented. Fiscal consolidation will continue in 2011-2012, including both tax reform and public spending cuts. The exchange rate peg is expected to be left intact, and, if fiscal consolidation proceeds as planned and structural reforms are implemented, the euro adoption target of 2014 is realistic.

Euro adoption target of 2014 is realistic if structural reforms are continued

Commitments by Latvia to international donors include a long list of structural benchmarks to be completed. One of the most important tasks to be completed by end-June 2010 is a long-term tax system reform. The overall shift in focus from income taxes to consumption and property taxes can already be seen in the policy suggestions prepared by the Ministry of Finance. However, in our opinion, it is crucial to use a "carrot" (reducing the personal income tax) and a "stick" (increasing the residential real estate tax) simultaneously, rather than introducing punishment now and postponing positive motivation to an uncertain and distant future, as has been proposed. Our estimations show that it is possible to make this reform fiscally neutral for the budget.

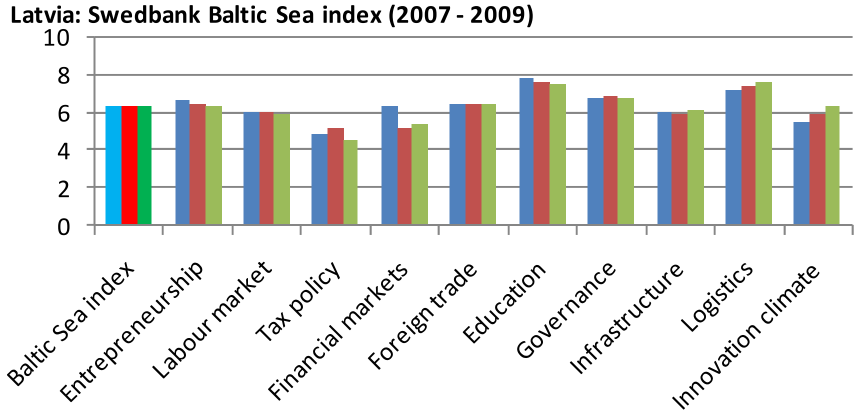
Tax burden will shift from labour income to property and consumption

Tax evasion has grown in the last year, and the current (mostly repressive) administrative measures have not been fully successful in dealing with this problem. However, with a rebalancing of the tax burden, we expect tax evasion to diminish in the upcoming years. This rebalancing would provide additional tax revenues and somewhat reduce the spending squeeze and its negative impact on domestic demand. This would also improve the transparency of competition and ease the entry of foreign-owned companies.

Aging population and emigration require reform in education sector and social insurance benefits system

Similar to the situation in other European countries, the risk factors in Latvia that will have an increasingly significant effect over a 5-10 year horizon are the aging population and emigration. If job creation is slow, emigration will continue, reducing the size and quality of the labour force. In 2009, net wages in Latvia were about 36%, and consumer prices about 68%, of the EU27 average. The job-seekers' rate exceeds 20%, and for youth is close to 40%, thus making incentives to emigrate substantial. In 2015-2017, it is forecast that there will be only half of the current number of students due to demographic trends. This situation makes reform of the higher education sector particularly important, and underscores the urgency of reforming the pension system and reviewing the social insurance benefits system. The latter two reforms are included in the structural benchmarks of the IMF and the EC and are in drafting stage. For instance, it is expected that the pension age will be gradually increased. Education system reform is included in the government's to-do list, but the concerns are that its design is still far from clear and that the government is being pressured not to make any radical changes.

Latvia: Swedbank Baltic Sea index (2007 - 2009)



Regarding Swedbank's Baltic Sea Index, Latvia comes out below the regional average (at 6.3, compared with an average of 7.0). Not surprisingly, the country's performance in "Financial markets" category has declined, but at the same time it is improving in the areas of "Logistics" and "Innovation climate. There is substantial potential for improvement, and further implementation of structural reforms is of the utmost importance for Latvia to become competitive in the region over the long term.

Lija Strašuna
Mārtiņš Kazāks

Lithuania

Lithuania – on the verge of a slow recovery

Population:	3.4 million
GDP per capita (PPP) 2009:	USD 16,542
Government:	Centre-right
Prime Minister:	Andrius Kubilius
President:	Dalia Grybauskaite
Next parliamentary election:	October, 2012
Next presidential election:	2014
Average GDP-growth in last five years:	2.7%
Average inflation rate in last five years:	5.5%
Average unemployment rate in last five years:	7.5%

Summary

- The Lithuanian economy is still being affected by the weak global economy and deleveraging. Internal devaluation continues. The economy bottomed out in the 1st quarter of 2010, and GDP will contract by 2% this year and increase by 3% in 2011. Domestic demand will remain fragile, while the export sector is already recovering. The current account will stay in surplus.
- Consumer prices are being pushed upwards only by global price developments, while weak domestic demand results in clear deflationary tendencies in the majority of product and services groups.
- The government remains committed to euro adoption and has set a goal to achieve all Maastricht criteria requirements by 2012 in order to join in 2014. On the Baltic Sea Index, Lithuania scores 6.5. In particular, labour market indicators are low, while education performs well

Consequences for Baltic Sea companies

- Some improvement in consumer spending and investments is expected in 2011 and will create opportunities for companies throughout the Baltic Sea region. Currently, the main source of investments remains EU funds and company reserves.
- Lithuania’s high unemployment rate continues to push wages down, while a decline in labour costs is encouraging producers. Productivity is starting to recover. The real effective exchange rate is declining, which helps exporters. Competitiveness is gradually being restored.
- Some emigrants returned home during the global crisis; however, another large emigration wave is a clear risk, especially among younger generations. This is likely to reduce the supply of labour over the medium term.
- The rise in commodity prices has increased costs for Lithuanian producers. However, since the Russian economy is likely to benefit from higher oil prices, Lithuanian exporters to Russia are benefiting from the rise in commodity prices to certain extent. An increase

in energy prices had a positive impact for Lithuanian economy via the main oil refinery as well.

- Lithuania is lacking sufficient foreign direct investment, which, if delivered, could bring a positive influence for technological development, increase local know-how, and boost innovation.

Some loss in cohesiveness in the ruling coalition

Economic downturn took its toll on the cohesiveness of the ruling coalition

The ruling coalition, which consists of the leading conservative party, Homeland Union-Lithuanian Christian Democrats (TS-LKD), and three other centre-right parties, has enjoyed a comfortable majority in the parliament since the election in October 2008. Due to the looming economic crisis, the government had to implement austerity measures that were unpopular from the very beginning of its administration. This was the probable cause of the overall loss in cohesiveness in the coalition and several intra-coalition conflicts that erupted during the past year. While the steps taken by the government have been praised outside Lithuania, trust in the government at home is at an all-time low. Arguably, the government did an excellent job in tackling the immediate macroeconomic. However, social security and other much-needed longer-term structural reforms are lagging behind. Looking further ahead, the Lithuanian parliamentary system will likely continue to be plagued by frequent conflicts within the ruling coalition.

A loss of trust in government domestically as social reforms are lagging behind

The attitude towards the government could perhaps be even more negative in Lithuania if President, Dalia Grybauskaite, had not openly expressed support for most of austerity measures implemented by the government. Since winning the presidential election in May 2009, Grybauskaite, the former EU Commissioner, has spoken out about several areas of the economic reform in Lithuania, even though constitutionally her presidential powers are very limited in this area.

The bottom of the recession has been reached

Slow economic growth in the forecast period

We are of the opinion that the bottom of the recession was reached in the first half of 2010. The economy overall is expected to contract by about 2% this year, while a slow and gradual recovery is expected to commence in the 2nd quarter of 2010. This year, however, will still be challenging, as domestic demand remains weak, the real estate market continues to stagnate, and the high unemployment rate will put further pressure on household consumption. The economic recovery will initially be driven by Lithuania's large, export-driven manufacturing sector, with the paper, wood, and plastics industries taking the lead. As domestic demand slowly begins to grow next year, the economy is expected to expand by 3% in 2011.

Real wages will decline in 2010 and stagnate in 2011

Real net wages are set to shrink by about 5% this year, thereby further reducing inflationary pressures and halting the erosion in competitiveness. Wages are expected to stay flat in 2011. Since the private sector has already adjusted significantly, wages will decline in 2010 to a large extent because of public sector wage cuts. The unemployment rate increased rapidly during 2009, and could reach about 16% this year. The high unemployment is putting additional pressure on public finances and nonperforming loans, and, due to looming emigration problems, will be one of the main challenges in the medium term.

Euro adoption set for 2014

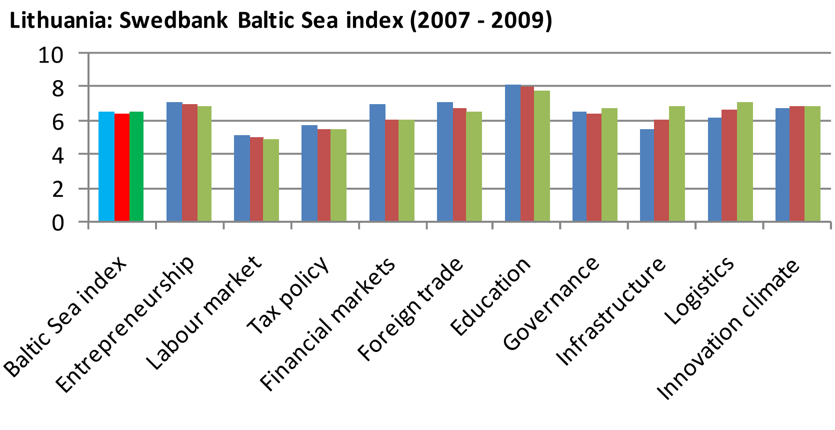
Firm commitment to achieve EMU membership

The government is firmly committed to euro adoption – it has set a goal to achieve all Maastricht criteria requirements by 2012 in order to join in 2014. There could be some pitfalls, however, going forward - for instance, some structural reforms might not be implemented and it might not be possible to maintain fiscal prudence as there will be parliamentary elections in 2012. Therefore, the budget deficit and public debt criterion should be closely monitored. Public debt, nevertheless, remains low in comparison with other countries in the region: it increased to close to 30% of GDP at the end of 2009, compared with the 15.6% recorded at the end of 2008, and is expected to reach 42% in 2011.

While government policy measures addressing the immediate risks to macroeconomic and financial stability have so far been successful, efforts to increase long-term competitiveness are equally important. These include containing the budget deficit in the short term, as well as finding solutions and making improvements in the areas of energy, education, and health care, among others. Although traditional manufacturing activities will always play a significant role in Lithuania, measures should also be enacted to shift manufacturing production towards more higher-value-added products, as well as to increase the services share in the economy.

More needed from the government and business community to increase competitiveness

According to the BSI, Lithuania scores high on education but also on entrepreneurship. There has been a small improvement in recent year in the overall index, and particular strong performance was seen in infrastructure and logistics. Financial market indicators are falling behind, and there are also declines in labour market policies and education.



A positive business climate

It is relatively inexpensive to start a business in Lithuania, and the bureaucratic procedures, although widely criticized domestically, are not so cumbersome when compared with others in the region. Labour costs in absolute levels are low, even though above-productivity wage increases in major industries before the economic downturn put significant pressure on overall competitiveness. Employment regulations, however, remain rather rigid, and non wage labour costs are quite high. Reforms for making employment regulation less rigid are crucial for small and medium-sized enterprises (SMEs), which are the most important employers in the poorer parts of the country. In addition, although the labour force is regarded as well educated, better retraining programmes are needed following the economic downturn to increase long-term competitiveness, as well as to ensure sufficient labour supply in the medium term.

... though a need to improve value added remains one of the more important long-term challenges

Given Lithuania's large, export-oriented manufacturing sector, the measures to improve the competitiveness of the sector will also become increasingly important. While an initial improvement in exports should be achieved relatively easily, as global demand continues to recover, a sustained, badly needed further increase in exports in the longer term, especially to the "old" EU, requires a transformation of the product structure and quality.[2]

Innovation expenditure has so far mainly consisted of the acquisition of equipment and machinery, and even though such acquisitions do add to the high-technology statistics, the improvement is largely a result of imitation. Also, because Lithuanian ranks low in terms of R&D expenditure in the commercial sector, there has not been, until recently, enough market demand to reform public education and R&D systems. Government and business involvement should thus be crucial in providing more incentives for innovative activities carried out within companies; if successful, these efforts would ensure that Lithuanian enterprises do not remain at the lower end of the global value chain.

Ieva Vyšniauskaitė
Lina Vrubliauskienė

[2] Although some success stories are noteworthy, especially in the biotechnology, pharmaceutical, and laser sectors in Lithuania, a closer look at the relative trade balances between the Baltic states and the EU reveals radically different trade specialization patterns: trade between "old" and "new" EU countries is characterized to a large extent by vertical, intra-industry trade, in which the quality advantages of the Baltic countries have up to now remained consistently smaller.

Germany

Germany – growing again, but with political and fiscal challenges

Population:	82.1 million
GDP per capita (PPP) 2009:	USD 34,212
Government:	Centre-right coalition
Chancellor:	Angela Merkel
President:	Jens Böhrnsen (acting)
Next federal election	September, 2013
Next presidential election	June 30, 2010
Average GDP-growth in last five years:	0.5 %
Average inflation rate- in last five years:	1.8 %
Average unemployment rate in last five years:	8.7 %

Summary

- The CDU/FDP has lost its majority in the Bundesrat, and the coalition has also lost popularity with regard to policy both domestically and externally. The much-needed reform process is at risk. At 8 on our BSI, Germany ranks fairly well, but has room for improvement.

- The economy is growing again, and we foresee GDP rising by 1.5% this year and 2% in 2011. A tight fiscal policy and weak labour markets are dampening growth, while low inflation and interest rates, as well as a weaker euro, support growth – in addition to increased demand for German goods from emerging markets.

Consequences for companies

- The recovery in the economy is especially noteworthy in public investment as infrastructure is being used to stimulate growth. Business opportunities will continue to come this year and next.
- Household consumption is expected to remain weak, as unemployment rises and the financial sector turmoil translates into weaker confidence. Domestic demand may wane next year as taxes are raised and expenditures cut.
- Unit labour costs rose last year but have now started to fall again as productivity rises and labour costs develop moderately. A weaker euro will also support German production and exports.
- Germany will move further on financial sector regulation, and credit may be less available than normal as banks deleverage. Other reforms that can be carried out and affect foreign companies are in the areas of labour markets, deregulation, education/R&D, welfare, and tax policy.

The ruling coalition loses popularity

A "warning shot" as CDU/FDP lost majority

The state election on May 9 in North Rhine-Westphalia sent a sour message to the ruling coalition of the Christian Democratic Union

(CDU) and the Free Democratic Party (FDP). The result was – apart from losing power in that particular state – the CDU/FDP also lost a majority in the Bundesrat (similar to the upper house of the legislature).

The leaders of the two parties, Chancellor Angela Merkel of the CDU, and Guido Westerwelle of the FDP, have had difficulties in sending clear messages about their policies. A majority of the North Rhine-Westphalia's voters did not approve of the bailout of Greece. In addition, the FDP's proposed tax cuts have not been regarded as achievable due to the worsened fiscal position in Germany and the other euro countries. Rather, spending cuts are expected. There has also been confusion over the FDP's reform of health care financing. Overall, the coalition has lost popularity as their leaders have been viewed as being indecisive regarding both foreign and domestic policies.

Angela Merkel, although popular as a leader of the grand coalition between the CDU and the Social Democratic Party (SPD), has not found the right cooperation mode with the FDP. Her presidential candidate, following Horst Köhler's unexpect resignation on May 31, is Christian Wulff, the lower Saxony conservative state premier, but the SPD has proposed a more popular candidate, Joachim Gauck, so the outcome is uncertain and could threaten Merkel's status.

Germany receives external critique – but focus on internal goals

European politicians have also voiced the criticism that Germany delayed important action with regard to the Greek crisis until after the state election and thus contributed towards financial markets' seeking safe havens away from the euro zone. Germany's unilateral decision to ban "naked short-selling" has also been criticized. The move may be seen as a way of seeming to take action against speculative markets, and as a way of getting to a parliamentarian "yes" to Germany's financing of the rescue package for the euro zone. Germany's relations are thus strained with other euro zone countries, especially France, where quicker action to craft a rescue plan for Greece was seen as important. In addition, there is a criticism that Germany's development model is based on low salaries, high competitiveness, and an excessive focus on the export sector, while domestic demand remains weak, providing too small a boost to other countries' exports. Germany's response has rightly been that, as the euro zone needs to be more dynamic rather than less, weakening Germany would be the wrong recipe; other countries, instead, need to strengthen their own competitiveness. Still, reforms to improve domestic growth prospects are needed, especially in the eastern part of the country.

The economy is growing again

GDP is showing annual growth – but it will slow after rebound

In the 1st quarter of this year, the economy grew again in annual terms after GDP had lost 5% last year. The main contributors to growth are public consumption and investments. Households continue to lower their consumption, and net exports are contributing negatively to growth as imports are rising faster than exports. Looking ahead, growth will slow because domestic demand will stay weak; meanwhile, exports will support the recovery.

Germany

Fiscal and monetary policy stimulates the economy this year

Germany is still benefiting from its stimulus packages; the first two totaled 3% of GDP, and the third, which was passed recently, was equivalent to some 0.25% of GDP. Tax cuts and the extension of the short-time working arrangements, as well as infrastructure spending, will also support growth during 2010. Maintaining the refinancing rate of the ECB at 1% for a longer period of time, as well as a weaker euro, will give more stimulus to the economy. Also, German bond prices have risen as investors are finding safer havens in Germany than other parts of the euro zone.

Better unit labour cost performance ahead

The worldwide recovery is benefiting German exports, and industrial production is starting to take off. Trade with emerging economies is rising fast, while trade with developed markets is picking up more moderately. Construction is also growing quickly, after the unusually cold winter. Labour costs have come down, after rising during 2009, and productivity growth has recovered somewhat. Also, Germany's unit labour costs are once again set for a downturn, thus allowing the country to stay competitive.

Labour markets hold back consumption

Households will face high and increasing unemployment, which will rise from just below 8% to some 9% over the next year. Still, the German labour market has developed better than normal in recessions and also better than some other countries in the euro zone. *Kurzarbeit*, the short-time working arrangements, are estimated to have saved some 1.2 million jobs, and the rather sound financial position in companies before the crisis has helped to stabilize the labour market. Going forward, wage increases will be slim, but, thanks to low inflation of around 1% in 2010 and 2011, households will have an opportunity for a small increase in consumption during the next two years.

We see mainly downside risks to our outlook due to euro zone turmoil

There are many risks for the German economic outlook. Our forecast of growth of 1.5% this year and 2% in 2011 is challenged by increased uncertainties in the financial markets, which could weaken confidence among households and companies. Budget consolidation in Germany and other industrial countries is a downward risk to export developments and the labour market. Upward risks include stronger growth in the emerging markets, which would offsett some of the falls in European demand.

Economic policy: tighter fiscal policy

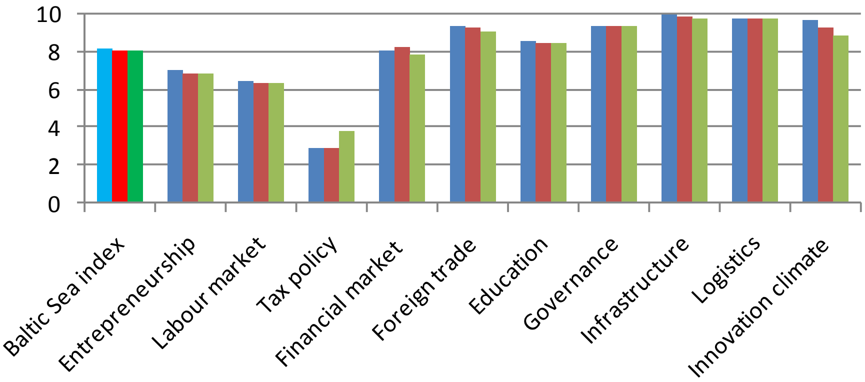
Next year, fiscal policy will be tighter to fulfil euro zone goals

Beginning next year, Germany will embark on a budget austerity programme, thereby hoping to set an example for other euro zone countries. The savings will total more than EUR 85 billion, of which EUR 11.1 billion in 2011, EUR 17.1 billion in 2012, EUR 25.7 billion in 2013, and EUR 32.4 billion in 2014. Despite the coalition's earlier promises to cut taxes, both tax increases and spending cuts can be expected. The budget deficit will come down from the current 5-6% of GDP to 3% in 2013, if the growth outlook remains positive. The structural deficit – compensating for the business cycle – is, in accordance with the constitution, planned to decrease to 0.35% of GDP by 2016. Germany will most likely have an expansionary fiscal policy this year, before embarking on a contractive policy next year. The new policy will worsen Germany's domestic demand outlook and other countries' export outlooks. Even if it is important to show determination in returning to adherence to the growth and stability pact, Germany is one of few countries in Europe that could afford to support growth further through its fiscal policy. Monetary policy will stay loose, and the euro could weaken further against the dollar.

A bolder reform process could make a difference

Germany needs to undertake tax and expenditure reform, in order to abolish some tax exemptions and state subsidies and to make tax policy more effective. This would be positive with regard to budget consolidation, as would a better-functioning labour market. Changes in social benefits may also be needed. Germany scores weakly on our BSI in the categories of "Tax policy," "Financial markets," "Labour market," and "Entrepreneurship." Strong performance is, however, noted in the areas of "Foreign trade," "Logistics," and "Infrastructure."

Germany: Swedbank Baltic Sea index (2007 - 2009)



Education and continuing education has room for improvement

Education is also an area where there is room for improvement; the so-called Bologna process might be able to support the modernization of university education. Labour markets are also demanding better continuing education to reduce the problems with shortages of skilled labour. Germany is lagging behind in dealing with gender issues, but, on the other hand, there is a great labour supply potential in women's participation in the labour market.

Stepping up the reform process in Germany by improving the functioning of various markets could be one way of setting an example for other euro zone countries. The welfare system must be adjusted to new needs and conditions, and, as demographics will have an adverse effect on the economy in years to come, there will always be a need to revise social benefits, pensions, and social services. Encouraging entrepreneurship in the field of social services would be positive for growth and could contribute to a better welfare system. It is important to support the integration of services within the EU, thereby providing new cross-country growth opportunities – and improving business prospects for Baltic Sea region companies.

Cecilia Hermansson

Finland

Finland – after deep recession follows sluggish growth

Population:	5.3 million
GDP per capita (PPP) 2009:	USD 33,555
Government:	Centre-right coalition
Prime Minister:	Mari Kiviniemi
President:	Tarja Halonen
Next parliamentary election:	April, 2011
Next presidential election:	January, 2012
Average GDP growth in last five years:	1.3%
Average inflation rate in last five years:	1.9%
Average unemployment rate in last five years:	7.5%

Summary

- The Finnish economy is showing signs of recovery after last year's major slowdown. We expect GDP to grow by 1.5% this year and 2% in 2011. Finland ranks high (8.5) in our BSI.
- Fiscal constraints going forward will increase the need for structural reforms, especially in the labour market, in order to meet demographic challenges. Next year's parliamentary election and the global recession have pushed long-term growth issues into the background, however.

Consequences for companies

- The domestic market is expected to drive GDP growth in the next two years. Lower income taxes and a more stable job market will boost consumer spending by 2% per year. With capacity utilisation low, business investment is not expected to rise until 2011.
- Unit labour costs rose significantly last year but are projected to drop as wage increases slow and productivity rises. A weaker euro also serves as a stimulus for Finnish exporters.
- Rising global commodity prices, higher interest rates, and tax increases are expected to drive up domestic price pressures. We are projecting average inflation of about 2.5% in 2011, compared with 1.5% this year.

Political decisions delayed until after 2011 election

With less than a year to go until a parliamentary election in April 2011, the current coalition government has named a new prime minister. Mari Kiviniemi, who had served as Minister of Public Administration and Local Government, is taking over as both leader of the Centre Party and PM, succeeding Matti Vahanen. Growing criticism of the Centre Party's leadership and falling approval ratings following a campaign finance scandal were the decisive factors forcing Vahanen to step down. Kiviniemi is considered an innovator who can attract new voters, especially in urban areas. There is little expectation that she will decisively change current policies, partly because of the impending election.

While the government focuses on labour policy, other reforms take a backseat

The government's goal has been to improve social welfare by promoting job and productivity growth. The target has been to add 100,000 new jobs during the current term.

To help businesses, the government also promised to create flexible wage structures and encourage start-ups. The severe recession in 2009 has delayed several of its plans, however, and instead extensive stimulus measures have been taken to avoid a major increase in unemployment.

Continued confidence in the government

Public opinion polls show that Finns support the current government. Lower income taxes and a smaller-than-expected rise in unemployment are probably why it has retained support. This is not true of all the coalition parties, however. The Centre Party's campaign finance scandal has been a growing problem for the party faithful. In the latest polls, its popularity has plummeted after having previously been the country's largest party in 2007; it now ranks third. The other parties in the government have grown stronger, on the other hand.

Finnish economy shows its vulnerability

The Finnish economy has been distinguished for several years by high growth and sound public finances. During the period 1997-2008, the economy grew by an average of 3.6% per year, compared with an EU average of 2.4%. Large government surpluses have helped to quickly reduce the national debt, which reached just over 30% of GDP in 2008. Finland is among the European countries with the strongest public finances.

The recession was severe in Finland

The severe global recession last year has had a dramatic impact on the Finnish economy, and its public finances have suffered. GDP fell by no less than 7.8% in 2009, worse than the recession in the early 1990s. This is also a larger drop in GDP than experienced by the other Nordic countries, with the exception of Iceland.

Uncertainty in the labour market has led to higher household savings

The shrinking GDP was driven by a substantial decline in both domestic demand – consumption and investments – and exports. Consumer spending fell last year for the first time since the early 1990s, as households instead decided to increase their savings, especially in light of an uncertain job outlook.

A substantial decline in demand for investment goods has hurt exports

Slowing global growth for input and investment goods has left an indelible mark on the country's exports. A poor export mix, with too much emphasis on forestry and telecom products, or adopted while the export industry was losing ground competitively due to rising unit labour costs, led to a drop in export volume of just over one-fourth in 2009. Unit labour costs rose by an average of 7% per year in 2008 and 2009, considerably higher than the EMU average of slightly over 3%.

Increased coordination needed between labour market actors

The substantial increase in unit labour costs is unusual for Finland, where business costs have generally risen in line with competing countries. The industry-wide wage agreements signed in 2007-2008 in an attempt to create more flexible wage formation, unfortunately led to significantly higher wage increases than in competing countries. Experience from these wage negotiations shows the need for better wage formation to avoid hurting businesses competitively.

Due to lower production and low capacity utilisation, business investments have fallen on a broad basis. The exception is public investments, which rose thanks to the government's infrastructure spending.

Domestic demand is driving the recovery

The Finnish economy has yet to recover, even though confidence indicators are rising. In the 1st quarter, GDP fell by 0.4% compared with the previous quarter. The fact that exports declined, despite the growth in global demand, raises questions about the ability of Finnish businesses to compete and what they sell. The lengthy port strike last winter is a factor, however, so some cautiousness is needed. Investments continued to fall, while private and public spending rose.

Exports are rising from low levels, but competition is growing

Last year's big export drop will be followed by a recovery during the forecast period, as global demand improves. This is especially true of 2011, when exports are expected to rise by 6.5% in volume, against 3% in 2010. In spite of this, we anticipate that Finnish export opportunities will be limited. Market growth in Europe, where the majority of exports are shipped, is expected to be modest, especially in EMU countries, where extensive budget cuts will be made, primarily in 2011.

Lower income taxes are strengthening household buying power

Growth in the next two years will be driven by higher domestic demand. Growing real wages and income tax cuts are strengthening Finnish households' buying power at the same time that the labour market is stabilising; also, unemployment is expected to fall late next year. We expect consumer spending to rise by 2% this year and 1.7% in 2011. Next year, domestic demand is projected to grow faster when business investments will rise after three consecutive years of declines.

As a whole, we expect GDP to grow by around 1.1% this year and 2.1% in 2011. This means that it will take several years (i.e 2013 at the earliest) before the economy reaches the 2008 levels.

Recession increases need for structural reforms

The big drop in production in the Finnish economy last year and a less favourable fiscal situation have increased the need for structural reforms. The labour market is a priority.

Reforms will raise employment levels

The employment rate (for those between 15 and 64 years old) was around 70% in 2009, lower than in the other Nordic countries. To increase employment in the working-age population, the government has reduced income taxes and lowered social insurance compensation in recent years. Even if it officially raises the retirement age to 65 from 63, there is still a large group of older citizens who are choosing to retire early due to poor unemployment compensation. A reassessment of integration policies and a more positive stance toward immigration are also important in order to offset future labour shortages and make the business sector more dynamic.

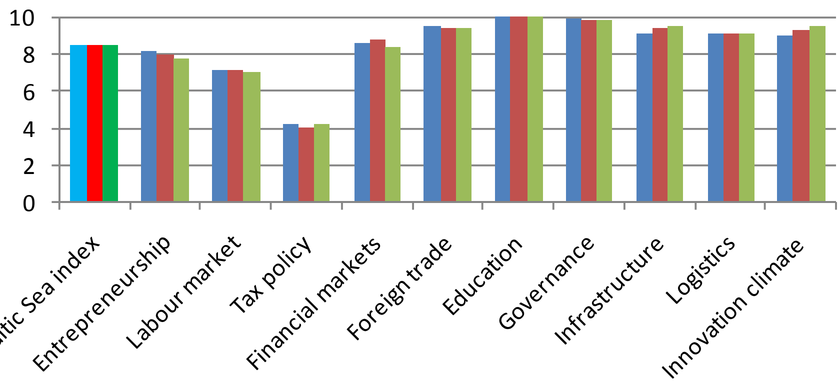
Rising unit labour costs and smaller market shares have called the business sector's competitiveness into question

The labour market is less flexible than in the other Nordic countries, which makes it more difficult to create new jobs. Fewer people are employed in the private services sector in Finland, and temporary jobs are not as common. Creating a more flexible labour market also requires changes in wage formation, which for several decades has been handled through central negotiations among unions, employers, and the government. Experience from the generous industry-specific wage agreements signed in 2007-2008 makes clear the urgent need for better coordination among labour market actors.

Finland's public finances are facing a big hit as the number of elderly increases at the same time that the working population shrinks. Its advantage relative to many other EMU countries is that Finland is starting out in a much better position. Still, demands for higher labour participation will increase. The streamlining of public finances, especially at the municipal level, and changes in social reimbursement systems will be the key elements to achieve financial sustainability.

The dependence on exports, with a few industries accounting for a significant share of total volume, also makes the economy vulnerable. Improving conditions for small businesses and encouraging new start-ups would increase domestic competition. There are several barriers, however, not least a rigid labour market, although competition laws and rules on capital taxation probably also need to be modernised. At the same time, the government has taken few measures to deregulate and privatise public companies.

Finland: Swedbank Baltic Sea index (2007 - 2009)



Finland ranks high, but more structural reforms are needed. In the labour market and for business

In Swedbank's Baltic Sea Index, Finland ranks high in the region. This is especially true in terms of "Education", although "Foreign trade" and "Logistics" also rate highly. Its main weaknesses are in the areas of "Labour market," "Entrepreneurship," and "Financial markets," where more structural changes should be made to make the economy more competitive.

Jörgen Kennemar

Denmark

Denmark – cautious recovery

Population:	5.5 million
GDP per capita (PPP) 2009:	USD 36 300
Government:	Liberal-Conservative coalition
Prime Minister:	Lars Løkke Rasmussen
Next parliamentary election:	November, 2011
Average GDP growth in last five years:	1.7%
Average inflation rate in last five years:	1.9%
Average unemployment in last five years:	4.4%

Summary

- After a major drop in GDP of 5% last year, we expect growth of 1.3% this year and 1.6% next year. This means that the production drop-off and job losses will not be recouped during the forecast period.
- Fiscal policy will be tightened in 2011 after last year's extensive stimulus measures. This is also part of a long-term strategy to balance public finances by 2015.

Consequences for companies

- Private consumption is expected to rise by slightly over 2% per year in 2010 and 2011 and thereby contribute nearly half of GDP growth. Infrastructure investments and inventory build-up, which are positively contributing to GDP this year, are expected to be significantly weaker as public projects are gradually completed and inventory levels return to more normal levels.
- Inflation is rising faster in Denmark than other EMU countries. We expect that increased unit labour costs, rising energy prices, and a higher value-added tax (VAT) will contribute to average inflation of 2.2% in 2010. Next year, inflation will fall to 1.7%, thanks to lower wage increases and stronger productivity growth.
- In Swedbank's Baltic Sea index (BSI), Denmark ranks highest in the region, partly thanks to a flexible labour market and competitive business climate. Additional regulatory reforms are planned to encourage new businesses.

Less confidence in the government

The current coalition government under the leadership of Lars Løkke Rasmussen (Liberal), together with the Conservative People's Party, has a weak position, with only 64 out of a total of 175 seats in the parliament. Its main support comes from the Danish People's Party, a controversial party because of its anti-immigration position. An important goal for the government has been to cut taxes for low-wage earners while creating a more competitive business environment and more job opportunities. EMU membership is also a priority for the government.

The government, which is well on its way to reaching its goal to cut the public debt in half this year (compared with 2001) without raising taxes, now faces the difficult task of overcoming a growing deficit while creating prospects for growth. The unfinanced tax cuts introduced in connection with the tax reform in 2009 are now raising the need for fiscal austerity at the same time that the economy has not yet picked up speed.

Savings are expected next year

With a budget deficit that fell to over 5% of GDP this year and runs the risk of rising further in the years ahead unless something is done, the government, together with the support of the Danish People's Party, has decided to cut 24 billion kroner in 2011-2013. Savings are planned in the social insurance system, e.g., compensation for unemployment, education, and state pensions.

The government is losing support

The austerity package is being implemented as confidence in the current government is on the wane and the Social Democrats are gaining strongly, which is probably partly due to the rising unemployment and pending savings measures. In the latest opinion polls, the Social Democrats, together with the socialist People's Party, would take over the government if elections were held today. The parliamentary election (Folketing) will be held before the end of next year.

The economy is rebounding, but cautiously

GDP shrunk by nearly 5% in 2009, driven by substantially lower domestic demand. Private consumption, which accounts for half of GDP, fell by 4.6% last year despite rising real disposable incomes and low nominal interest rates. A worsening job market and falling housing prices partly why households chose to increase savings from 5.5% to 9% of their income.

The housing bubble has burst

The overheated housing market in 2007-2008 and subsequent global financial crisis exacerbated the slowdown in the housing market. Since peaking in 2007, housing investments have fallen by nearly 40% and now account for around 5% of GDP, against 7% three years ago. Private businesses have also slashed investments.

Denmark's economic recovery, which began during the second half of last year, is continuing. Data for the first three months of 2010 show that GDP rose by 0.6% from the previous quarter. This is the third consecutive quarter in which the economy has grown, though from a low level, and is being driven by increased private and public consumption. On the other hand, the country's investments fell substantially and are now at their lowest level since 2003.

Increased buying power and lower household savings

We are forecasting a GDP increase of 1.3% for the full-year 2010 and 1.6% for 2011. We expect consumer spending to account for the bulk of GDP growth in 2010-2011. Lower income taxes will contribute to a 2.5% increase in real disposable income this year despite lower nominal wage increases. The improvement in buying power will be smaller in 2011 when fiscal policy is tightened. A gradually improving labour market and lower unemployment indicates, however, that the relatively high savings ratio is likely to decline. We expect private consumption to rise by slightly over 2.5% in 2011, compared with 2% this year.

Business investments will not rise until 2011

The public infrastructure investments launched last year have spilled into 2010 and are contributing positively to the country's total investments. Business investment, on the other hand, is being held in check by low resource utilisation and the fragile global economy. Corporate profits are also under pressure from higher unit labour costs relative to competing countries. We expect business investment to rise in 2011, when capacity utilisation improves and global demand is stronger.

Denmark's export mix, with a large share of consumer goods and smaller share of investment goods, has contributed to a more modest decline in exports than in Finland and Sweden, for example. Opportunities for Denmark's exporters will improve this year and next when global demand rises, but will be limited by the modest recovery in Europe.

Lower market shares for Danish export industry

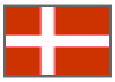
Market shares are trending lower, however, which calls into question the Danish export industry's competitiveness. Since 2000, market shares have fallen by 20%, according to the Confederation of Danish Industry, partly due to higher labour cost increases compared with competing countries, but also because of greater competition from emerging economies in particular. Wage increases in Denmark are expected to be significantly lower this year and next, at slightly over 2% per year, compared with an average of nearly 4% in the last three years. No discernible improvement in competitive strength is expected, however, since cost increases are projected to be low in competing countries as well.

Lower inflation in 2011 when wage costs slow

Higher wage costs and rising energy prices are pushing Danish inflation, which has been higher than the EMU average since 2008, upward. In May the annual inflation rate was 2%, compared with an EMU average of 1.6%. The Danish krone is pegged to the euro within a span of plus/minus 2.25%, which means that the drop in the euro against the dollar in the last half-year makes Danish imports more expensive. We expect the average inflation rate in 2010 to be 2.2% before falling to 1.7% next year, partly as a result of wage increases and VAT increases that are lower than the previous year.

A competitive economy, but challenges remain

Structural measures in recent years have been guided to some extent by the Danish Globalisation Council's recommendations for success, renewal, and security. A globalisation strategy with 350 concrete proposals was presented in 2006 by the previous government.

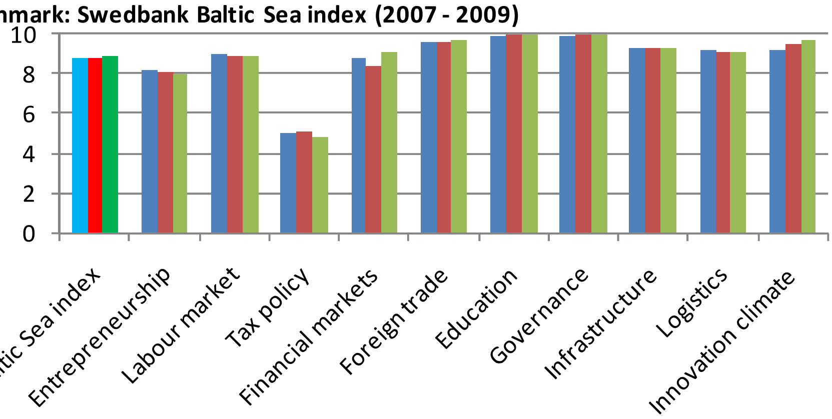


Denmark

In terms of structural conditions for sustainable economic growth, Denmark ranked highest among the Baltic countries in Swedbank's BSI. The labour market is more flexible than the other Baltic countries, particularly with respect to the rules on hiring and firing workers introduced in connection with the implementation of "flexicurity", where job seekers have contracts limited in time but generous unemployment compensation. Lower income taxes in connection with the 2009 tax reform will increase workforce participation, but tax rates on labour income in Denmark are still higher than the OECD average. A reassessment of the social insurance system is probably needed as well to increase the labour supply, which otherwise could be limited by high compensation levels. Tax policy is the variable in the BSI in which Denmark ranks lowest, at 4.8.

A flexible labour market but greater incentive for workforce participation

Denmark: Swedbank Baltic Sea index (2007 - 2009)



The country's business base primarily consists of small and medium-sized companies, which undoubtedly has a different impact on economic policies than in countries where large companies have a bigger role. This is evident in our BSI, where Denmark ranks high in terms of "Entrepreneurship" and "Innovation climate." At the same time, the government decided last year to simplify rules for new businesses in order to encourage start-ups.

Denmark ranks high in Swedbank's BSI on entrepreneurship

The long-term challenge for public finances is demographics, where Denmark faces a shrinking working population. In addition to savings and efficiencies in public spending, the need for higher workforce participation will increase, which is likely to mean a higher retirement age as well as lower income taxation.

Reforms are needed to increase workforce participation

Jörgen Kennemar

Norway

Norway – public expansion is driving the economy

Population:	4.8 million
GDP per capita (PPP) 2009:	USD 52,561
Government:	Labour, Socialist Left and Centre Parties
Prime Minister:	Jens Stoltenberg
Next parliamentary election:	September, 2013
Average GDP growth in last five years:	1.6%
Average inflation rate in last five years:	2.1%
Averge unemployment rate in last five years:	3.2%

Summary

- The Norwegian economy is expected to grow by slightly over 2% this year and nearly 3% in 2011. The economic recovery is being driven mainly by higher domestic demand, which will continue to rise next year when business investment rises. Norway ranks high in Swedbank's index on business conditions (8.6).
- Higher growth and relatively low unemployment are creating a need for fiscal tightening to avoid an overheated economy. Labour policies have to be strengthened in order to increase workforce participation and reduce the risk of future bottlenecks in the labour market.

Consequences for companies

- Private consumption is expected to rise by slightly over 4% annually in the next two years as household savings decline and purchasing power improves. Higher-than-expected interest rates are a risk factor, however, and could slow spending.
- A higher benchmark interest rate and a strong currency are holding domestic price pressures in check despite a fairly tight labour market. We expect inflation, excluding energy and taxes, to be lower than the central bank's target of 2.5% during the forecast period.
- Labour costs are expected to rise at a slower pace (3-3.5% in nominal terms) during the forecast period as companies improve efficiencies to remain competitive.
- Extensive infrastructure investments and measures to reduce CO2 emissions are creating new business opportunities.

Declining support for government

Increased investment in the public sector

After the 2009 election, the red-green coalition government retained a majority with Jens Stoltenberg (Labour) as prime minister. An increase in public sector investment has been a key element in the government's strategic plan to limit job losses and strengthen public services. As a result, more resources have been made available to municipalities, and infrastructure investments have increased. In terms of economic policy, the aim has been to avoid job losses around the country through active measures. Environmental issues have gained prominence, and the government wants Norway to be a pioneer in environmental policy and increase investments in renewable energy.

Tension exists within the coalition government

Ideological differences on several issues could eventually cause friction in the coalition government. This includes fiscal policy as well as defence policy. Looking ahead, the government will have to phase out the stimulus measures implemented in 2009 to avoid an overheated economy. The governing Socialist Left Party is having its doubts, however, and instead is calling for increased public resources to be devoted to strengthening services and quality at the municipal and county levels.

While the government's goal is to make Norway a leader in renewable energy, there are also plans to expand oil production on the Norwegian continental shelf. This will certainly be politically sensitive after the huge oil catastrophe in the Gulf of Mexico.

Public support for the red-green coalition has dropped, and instead the right-leaning opposition is in the lead, according to the latest opinion polls. The party that has lost the most ground is Labour, while the Conservative Party has strengthened its position.

Limited slowdown in Norwegian economy

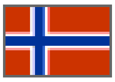
Investments in the oil industry and increased public consumption have softened the decrease in GDP

The Norwegian economy has made it through the global recession relatively unscathed. GDP fell by 1.5% in 2009, compared with the EU average of 4%. A substantial increase in public spending and strong investment growth in the oil industry helped to slow the decline in GDP. On the other hand, net exports contributed negatively to GDP growth as exports fell faster than imports. Aside from slower global growth, the export industry was hurt by rising labour costs and a stronger krone.

Export volume fell by 8% in 2009, though this was considerably less than countries whose exports are dominated by investment goods. Norway's export mix, with a large percentage of oil products and limited exports of engineered products, explains the smaller decline.

More public sector jobs as private businesses cut back

Due to the weak global economy and lower capacity utilisation, business investments fell with the exception of the oil industry. Housing investments dropped substantially last year, even though housing prices turned higher after having fallen by 10-15% on an annual basis in 2008. Due to an increase in savings, household spending remained largely unchanged. The substantial increase in public sector employment was partly the reason why job losses were limited to a modest 35,000 in 2009 and unemployment rose to 3.3% from 2.6% in 2008.



Norway

GDP growth but risks are building

Private consumption will be the growth engine during the forecast period

The economic recovery in Norway was interrupted in the 1st quarter of 2010 when GDP fell by 0.1% compared with the 4th quarter of 2009. A further decrease in investments and the negative contribution to growth from foreign trade were compensated for by higher public and private consumption. Growing optimism among households, rising housing prices, and low unemployment are indications that household savings are turning lower. We expect consumption (private and public) to be the primary engine in the Norwegian economy is 2010 and 2011, which will also create growth in the services sector.

A high debt ratio is an economic risk when interest rates rise

Household debt, now exceeding 200% of disposable income, is a risk that cannot be ignored. Higher interest rates and rising interest expenses are limiting consumption and could have a negative impact on the real estate market, though probably not until 2012.

Export growth is limited by a strong currency

The Norwegian krone's appreciation during the second half of 2009 has continued this year, partly because of the central bank's rate hikes. Although we expect the Norwegian currency to stabilise against the euro at around 7.80-8.00 during the forecast period, there is a strong likelihood that the krone will continue to rise if the interest differential vis-à-vis the euro countries increases. This would also mean that the export increase we anticipate this year and next could be weaker.

The fragile economic recovery in Europe, which accounts for 70% of Norway's total exports, is another uncertainty that could slow export growth, not least for traditional products.

Labour costs are rising, but more slowly

Businesses are feeling constrained by high costs and the strong currency. Increased pressure to improve efficiencies will discourage private businesses from hiring new workers. We expect that a more modest wage increase of around 3-3.5% and higher productivity growth will lead to lower unit labour cost increases during the forecast period. Nevertheless, Norwegian payroll costs will grow faster than in competing countries.

A broad-based increase in investment is not expected until 2011

An increase in investments will have to wait until 2011. After a substantial capacity expansion in the oil-related industry last year, fewer investments are expected as oil and gas production on the Norwegian continental shelf declines. Investments in the mainland economy are expected to decrease in 2010, although more slowly. Not until next year, when resource utilisation is higher than the rest of the private sector and housing construction increases, will total investment volume rise. As a whole, we project GDP growth of 2.1% for the entire economy this year and nearly 3% next year, driven by increased domestic demand.

Fiscal policy is decisive to interest rates

The challenge for the current government is to phase out the stimulus measures taken in 2009 without friction. The fiscal policy since 2001 allows a structural deficit over a business cycle of not more than 4% of the oil fund's projected return.

Fiscal austerity could limit the central bank's rate hikes

In connection with the government's extensive stimulus measures last year, the oil-adjusted budget deficit far exceeded the target, and the deficit is expected to continue to grow this year unless spending is cut. An overly expansive fiscal policy increases the risk of an overheated economy, which could lead to further rate hikes from the Bank of Norway if inflation exceeds its target of 2.5%. Compliance with fiscal rules is also important to confidence in economic policy.

The Bank of Norway has already raised its benchmark rate three times since midyear 2009, from 1.75% to 2%. Although public spending has been reduced in the revised government budget, fiscal policy will remain expansive in 2010, which means that the fiscal target will not be reached before 2012. As a result, there is a risk of further rate hikes and the negative impact that they would have on the competitive private sector, which is also being hurt by a stronger krone.

A stronger currency is keeping inflation in check

After the big increase in energy prices last fall and winter, inflation has fallen off and was 2.6% in May, compared with 3.6% in March. Core inflation, on the other hand, has trended lower since 2008 and was just under 2% in May, a reflection of the stronger krone. We expect a strong Norwegian currency and lower wage increases to keep core inflation below the central bank's target of 2.5% in 2010 and 2011. We also expect the Bank of Norway to raise its benchmark rate during the forecast period to 3.5% by the end of 2011 due to gradually stronger domestic demand and higher global commodity prices.

Need for long-term growth strategy

Norway's dependence on the oil and gas industry could eventually make it vulnerable in the wake of the global energy transition in the decades ahead. A long-term growth strategy has yet to be put in place. Nearly half of the country's total exports consist of oil and gas.

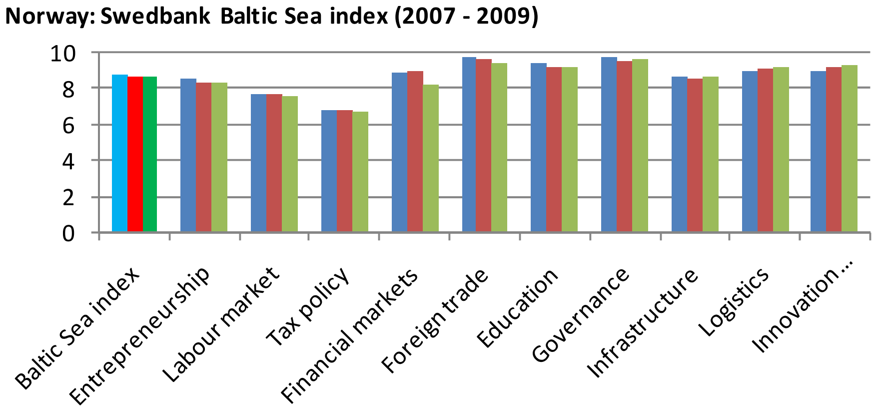
Internationalisation of the business sector

The internationalisation of the business sector, with the exception of the oil industry, has not been fully exploited. The mainland economy's exports account for less than one-fifth of GDP. Strengthening the economy's long-term competitiveness and broadening the export base will require adding value in production. R&D spending represents slightly over 1.5% of GDP, the lowest figure in the Nordic countries.

High domestic costs indicate a lack of competition. Further deregulation of the retail market, privatisations, and more foreign investment would encourage competition while also strengthening Norwegian households' buying power.

Labour policies must be strengthened in order to increase workforce participation

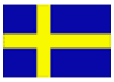
The demographic challenge facing the economy will make it vital to increase workforce participation. Along with the Netherlands, Norway has the shortest average workweek among European countries. This is not sustainable if public finances are to remain sound as the working population shrinks and the share of pensioners rises. Studies by the OECD show that Norway's public spending in relation to GDP is among the highest in the OECD. Productivity improvements in the public sector are likely to be needed.



Good prospects for new businesses

In Swedbank's Baltic Sea Index (BSI), Norway ranks high at 8.6. Its top ranking in the category of "Entrepreneurship" shows that there is fertile ground for new companies in Norway. This is supported by other studies that show that more start-ups are being created than in Sweden, for example. "Education," "Financial markets," and "Logistics" are other areas that rank high in the BSI. "Infrastructure" is an area where more improvements can be made, however, to improve business conditions. Here, Norway ranks last among the Nordic countries.

Jörgen Kennemar



Sweden

Sweden – consumption drives growth

Population:	9.2 million
GDP per capita (PPP) 2009:	USD 35,965
Government:	Centre-liberal market-oriented coalition
Prime Minister:	Fredrik Reinfelt
Next parliamentary election:	September, 2010
Average GDP growth in last five years:	1.1%
Average inflation rate in last five years:	1.4%
Average unemployment rate in last five years:	7.0%

Summary

- The elections in September this year are likely to be close, and the campaigns have so far mainly focused on short-term issues. The political situation would become uncertain should the xenophobic party Sverigedemokraterna manage to get parliamentary representation. In that case, Sweden could see either a minority government or a break-up of the right- and left-wing coalitions, and the emergence of new alliances across the middle. It is unlikely that any major structural reform initiatives will be launched during the run-up to the elections.

- Sweden scores 8.7 on the Baltic Sea Index. Most room for improvement is found in the categories of “Entrepreneurship”, “Tax policy” and “Labour market”.

- The economic recovery is stronger than expected, but mainly on account of restocking by companies and a temporary burst in household consumption. We have raised our growth forecasts to 2½% in 2010 and 2¾% in 2011. The main engine is expected to be household consumption, while investment will continue to lag. The economic policy mix remains supportive, and there is space for further fiscal stimulus should the economy take a turn for the worse.

Consequences for companies

- Strong consumer demand will benefit companies oriented towards end-product markets. The weak investment climate, both in Sweden and in main export markets, will, however, hold back demand for investment and capital goods.
- The political situation could, on the other hand, create uncertainty that the reform process will continue. An unclear election result in September could delay important initiatives and weaken the resolve to tackle key reform challenges.
- Competitiveness for production in Sweden will remain strong. Unit labour costs are expected to fall as wage demands are restrained, prices remain stable, and productivity growth resumes. A sharp appreciation of the krona vis-à-vis key export markets poses a risk.

Sweden

Close elections – a split-up of the blocs cannot be ruled out

Two clear alternatives are presented in the Swedish elections

The ability of Prime Minister Reinfelt to hold together the four-party centre-liberal coalition during the current parliament has prompted the left-of-centre parties to form their own alliance. Following an initial agreement between the Social Democrats and the environmental Green Party, the former communist Left Party joined the red-green alliance. The Swedish electorate faces, thus, for the first time, two clear government alternatives.

The election campaigns so far focus on short-term issues

With the presentation of the 2010 complementary budget bill in April, the government launched the election campaign. The bill contains additional tax relief measures for the pensioners, but few proposals for medium-term reforms. Instead, the government is emphasising the importance of maintaining control of the fiscal balances. The red-green alliance, in its alternative budget, is proposing higher spending on labour market programmes, as well as increased unemployment and health insurance replacement rates. To finance this, they advocate raising tax rates – however, not to the extend that prevailed prior to the current government's introduction of in-work tax credits.

The political landscape could look completely different after the elections

Opinion polls indicate that the elections in September will be close. Recently, the centre-liberal coalition has taken a small lead, but the differences between the blocs are not large enough that a safe prediction can be made. Within the blocs, changes are more distinct. In the red-green bloc, the Social Democrats have been losing support, while the Green Party is polling at around 10%, compared with its 2006 election results of 5% of the votes. In the ruling government coalition, Moderaterna, the largest party, is gaining support, while the smaller parties (Centern and Kristdemokraterna) are edging closer to the cutoff limit for parliamentary representation at 4%. If any of these parties ends up below the limit, there would be a change of government. Furthermore, the xenophobic party Sverigedemokraterna has been gaining support, and there is a possibility that it could gain parliamentary representation. This would throw the current arrangement into turmoil, and, as all of the established parties have declared that they will not cooperate with this party, such an outcome could make it necessary to split-up the blocs in order to form a government. This would significantly weaken the political stability that has characterised Swedish politics over the last decade.

An economic rebound is on its way

Swedish growth dynamics better than expected

During the 1st quarter of 2010, the Swedish economy grew at an annual rate of 3%, significantly higher than was expected. This performance, in combination with revised quarterly growth figures for 2009, means that the Swedish economy has expanded since the 2nd quarter of 2009. Overall, the real economic contraction in 2009 was revised to 5.1%, with the bulk of this contraction in the 1st quarter of the year.

Temporary boost to growth …

Temporary factors dominated the resurgence of growth. Companies resumed restocking after slashing inventories during late 2008 and much of 2009. Household consumption, the other main contributor to growth in early 2010, grew on the back of the unwinding of pent-up demand. Purchases of cars, for example, jumped by 45% in the 1st quarter compared with the same period in 2009. Growth was also supported by rising exports. Swedish production is benefiting not only from more activity in its main export markets but also from the effects of the lower value of the krona. Restrained wage increases over the next couple of years are also expected to support firms operating in Sweden; at the same time, they will restrain consumption growth.

… but steady expansion is expected, driven by consumption.

We expect the Swedish economy to continue to grow during 2010 and 2011. Due to the better-than-expected outcome, we have revised upwards our growth projections to 2½% in 2010 and 2¾% in 2011. In particular, the household sector will remain resilient. The labour market is stabilizing, and the unemployment rate dipped below 9% on a seasonally adjusted basis in May; meanwhile, employment levels have continued to increase. Consumer confidence indicators have been rising since late 2008 and are now back to the levels prevailing in late 2007. As fears of unemployment decline, private consumption should remain stable and thus provide the backbone for economic growth.

Private sector investments will hold back domestic demand

Domestic demand will be weighed down by lagging private sector investments. Industrial production has resumed but remains far from the levels prevailing before the crisis. Thus, capacity utilisation is still low, and there will be no urgent need for firms to start up new investment projects. The services sector has proved more resilient than expected during the sharp economic downturn. Employment levels have declined only marginally, and retail sales, despite falling back somewhat in early 2010, remain stable. The overall competitiveness of firms operating in Sweden will benefit from relatively low wage increases and improving unit labour costs.

Strong economic policy position

Fiscal policy is supportive and public debt level is low

Economic policy continues to provide steady support to economic activity. Fiscal policy has been expansionary, but, thanks to prudent policies implemented prior to the crisis, the fiscal deficit remained below 1% of GDP in 2009. The impact has been felt mainly through lower taxes and increased public sector employment levels. We expect the policy stance to remain loose in the near future as support is maintained. Also, because public debt is low, at around 40% of GDP, there is room for further fiscal stimulus should the economy fare worse than expected.

Normalisation of monetary policy, but yet no threat of inflation

We expect the Riksbank gradually to normalise the monetary policy rate. Having remained exceptionally low for a long period, the policy rate is set to increase, starting this summer. Low interest rates help companies to maintain low financing costs, but they also create risks of resource misallocation. However, we do not expect the adjustment to be very rapid. Inflation and inflation expectations remain subdued.

Structural reforms are taking a backseat

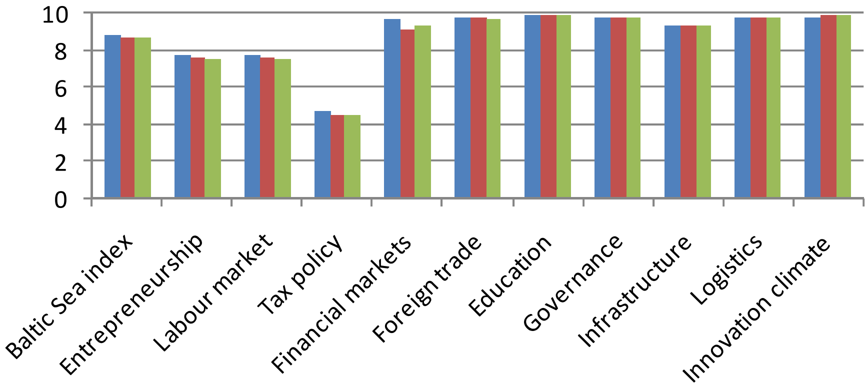
The Swedish model is gradually being reformed

Although the current government maintains that it supports the Swedish model, there have been some, not insignificant, structural reforms initiated in recent years. The introduction of the in-work tax credit lowered direct taxation and will stimulate labour supply, as well as lower wage costs for companies. The government has also reformed the sickness and disability benefit scheme by including a stipulation of a fixed term, together with stronger support for a return to the labour market. This will also increase the labour supply and lower public expenditures, thereby offsetting some of the cost of lowering taxes. In the product market, the main recent reform has been the deregulation of the publicly controlled pharmacy retail market. A number of the state-owned pharmacies were privatised, and competition is expected to increase efficiency and availability.

Sweden is considered a dynamic market economy …

The Swedish economy functions well in a global perspective, as reflected in the Baltic Sea Index. This assessment is reinforced by the recent 2010 evaluation of the Lisbon agenda. In this evaluation, Sweden is ranked 1st among the EU countries and scores particularly well in categories such as “Information society” and “Financial services.” In the Baltic Sea Index, the main weaknesses are found in the categories of “Tax Policy” and “Entrepreneurship”.

Sweden: Swedbank Baltic Sea index (2007 - 2009)



… but many challenges remain.

Thus, many challenges remain. To sustain competitiveness and support growth, the resources of the economy must be used more efficiently. The labour market still suffers from high entry barriers, and in particular, youth and recent immigrants find it difficult to find regular employment. The business climate for small and medium-sized enterprises needs to be improved, and this could be accomplished by further deregulating public sector service production and by ensuring competitive public procurement. For the medium to long term, it is crucial that the high levels of R&D spending be maintained and that the educational outcome, which is lagging behind peers, be raised significantly. It would be worthwhile for the election campaigns to pay more attention to these issues.

Magnus Alvesson

Content, sources and developments of the Baltic Sea Index

Content and sources of the Swedbank Baltic Sea Index

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

Sources: World Bank Doing business

II. Labour market
- Ease of employing workers
- Labour productivity
- Labour force participation rate

Sources: World Bank Doing Business and ILO

III. Tax policy
- Ease of paying taxes
- Highest rate of personal income tax
- Corporate tax rates

Sources: World Bank Doing Business and KPMG

IV. Financial markets
- Financal and banking institutions
- Equity Market Development
- Bond Market Development
- Alternative Sources of Capital
- International Funding

Source: Milken Institute

V. Foreign trade
- Enabling trade index

Source: World Economic Forum

VI. Education
- Higher education and training

Source: World Economic Forum

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

Sources: Transparancy International and World Bank

VIII. Infrastructure
- Quality of overall infrastructure
- Infrastructure

Sources: World Economic Forum and World Bank

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

Sources: World Bank: Logistic Performance Index

X. Innovation climate
- Innovation Input
- Innovation Output

Sources: INSEAD

Annex

Baltic Sea Index: Global Position and change[3]

Swedbank Baltic Sea Index

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	8.8	8.8	8.8	0.0
Estonia	7.2	7.2	7.3	0.1
Finland	8.5	8.5	8.5	0.0
Germany	8.1	8.0	8.0	-0.1
Latvia	6.3	6.3	6.3	0.0
Lithuania	6.5	6.4	6.5	0.0
Norway	8.7	8.7	8.6	-0.1
Poland	5.9	5.8	5.9	0.0
Russia	4.7	4.6	4.5	-0.2
Sweden	8.8	8.7	8.7	-0.1
Ukraine	4.3	4.2	4.1	-0.2
Average	7.1	7.0	7.0	0.0

Swedbank Baltic Sea Index

	(t-2)	(t-1)	Latest available (t)	Change
I. Entrepreneurship	6.8	6.6	6.5	-0.2
II. Labour Market	6.3	6.3	6.3	0.0
III. Tax Policy	5.0	4.9	4.9	0.0
IV. Financial Market Indicator	7.7	7.3	7.1	-0.5
V. Foreign trade	7.4	7.3	7.2	-0.2
VI. Education	8.4	8.4	8.4	0.0
VII. Governance	7.4	7.3	7.4	0.0
VIII. Infrastructure	7.2	7.1	7.2	0.0
IX. Logistics	7.4	7.5	7.6	0.2
X. Innovation climate	7.3	7.5	7.7	0.4
Average	7.1	7.0	7.0	0.0

I. Entrepreneurship

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	8.2	8.1	8.0	-0.2
Estonia	7.5	7.3	7.2	-0.3
Finland	8.1	8.0	7.8	-0.3
Germany	7.1	6.8	6.8	-0.3
Latvia	6.6	6.4	6.3	-0.3
Lithuania	7.1	7.0	6.9	-0.3
Norway	8.5	8.4	8.3	-0.2
Poland	5.0	4.9	5.1	0.1
Russia	5.2	5.0	4.9	-0.3
Sweden	7.7	7.6	7.5	-0.2
Ukraine	3.3	3.1	3.3	0.0
Average	6.8	6.6	6.5	-0.2

II. Labour Market

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.0	8.9	8.9	-0.1
Estonia	5.4	5.5	5.6	0.2
Finland	7.1	7.1	7.1	-0.1
Germany	6.4	6.4	6.3	-0.1
Latvia	6.0	6.0	5.9	-0.1
Lithuania	5.1	5.1	4.9	-0.2
Norway	7.7	7.7	7.6	-0.1
Poland	5.0	4.9	4.8	-0.2
Russia	5.4	5.7	5.7	0.3
Sweden	7.7	7.6	7.5	-0.2
Ukraine	4.2	4.3	4.5	0.3
Average	6.3	6.3	6.3	0.0

III. Tax Policy

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	5.0	5.1	4.8	-0.1
Estonia	5.7	5.3	5.8	0.0
Finland	4.2	4.0	4.2	0.0
Germany	2.9	2.9	3.8	1.0
Latvia	4.8	5.2	4.6	-0.2
Lithuania	5.7	5.5	5.5	-0.2
Norway	6.8	6.8	6.7	-0.2
Poland	4.4	4.3	4.1	-0.3
Russia	7.1	7.1	6.9	-0.1
Sweden	4.7	4.5	4.5	-0.3
Ukraine	3.1	3.1	3.1	0.0
Average	5.0	4.9	4.9	0.0

IV. Financial Market Indicator

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	8.8	8.4	9.1	0.3
Estonia	7.5	7.8	7.7	0.2
Finland	8.5	8.8	8.3	-0.2
Germany	8.0	8.2	7.8	-0.2
Latvia	6.3	5.2	5.4	-0.9
Lithuania	7.0	6.0	6.0	-0.9
Norway	8.9	9.0	8.2	-0.7
Poland	6.6	6.6	5.9	-0.7
Russia	6.8	5.8	5.9	-1.0
Sweden	9.6	9.1	9.3	-0.3
Ukraine	6.1	5.4	4.6	-1.5
Average	7.7	7.3	7.1	-0.5

V. Foreign trade

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.6	9.6	9.7	0.1
Estonia	7.9	8.1	8.3	0.3
Finland	9.5	9.4	9.4	-0.1
Germany	9.3	9.2	9.1	-0.2
Latvia	6.4	6.4	6.4	0.0
Lithuania	7.1	6.8	6.5	-0.6
Norway	9.7	9.6	9.4	-0.3
Poland	6.2	5.8	5.3	-0.9
Russia	1.3	1.1	1.0	-0.3
Sweden	9.8	9.7	9.7	-0.2
Ukraine	4.3	4.2	4.1	-0.2
Average	7.4	7.3	7.2	-0.2

VI. Education

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.8	9.9	9.9	0.1
Estonia	8.3	8.6	8.5	0.2
Finland	10.0	10.0	10.0	0.0
Germany	8.5	8.4	8.4	-0.1
Latvia	7.8	7.6	7.5	-0.3
Lithuania	8.2	8.0	7.8	-0.3
Norway	9.4	9.2	9.2	-0.2
Poland	7.4	7.5	8.0	0.7
Russia	6.6	6.6	6.1	-0.5
Sweden	9.9	9.8	9.8	-0.1
Ukraine	6.0	6.8	6.6	0.6
Average	8.4	8.4	8.4	0.0

VII. Governance

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.9	9.9	9.9	0.1
Estonia	8.2	8.3	8.3	0.1
Finland	9.9	9.8	9.8	-0.1
Germany	9.3	9.3	9.3	0.0
Latvia	6.8	6.8	6.8	0.0
Lithuania	6.5	6.4	6.7	0.2
Norway	9.7	9.5	9.6	-0.1
Poland	6.2	6.3	6.8	0.6
Russia	1.9	1.7	1.7	-0.3
Sweden	9.8	9.8	9.8	0.0
Ukraine	3.0	2.6	2.5	-0.6
Average	7.4	7.3	7.4	0.0

VIII. Infrastructure

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.3	9.3	9.2	0.0
Estonia	7.3	7.0	7.0	-0.3
Finland	9.1	9.4	9.5	0.5
Germany	9.9	9.9	9.8	-0.2
Latvia	6.0	5.9	6.1	0.2
Lithuania	5.5	6.1	6.8	1.3
Norway	8.6	8.6	8.7	0.1
Poland	5.2	4.4	4.0	-1.2
Russia	4.4	4.2	4.1	-0.3
Sweden	9.4	9.3	9.3	0.0
Ukraine	4.6	4.3	4.5	-0.1
Average	7.2	7.1	7.2	0.0

IX. Logistics

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.2	9.1	9.1	-0.1
Estonia	6.6	6.8	7.1	0.4
Finland	9.1	9.1	9.1	0.1
Germany	9.7	9.8	9.8	0.0
Latvia	7.2	7.4	7.6	0.4
Lithuania	6.2	6.7	7.2	1.0
Norway	9.0	9.1	9.2	0.2
Poland	7.3	7.8	8.2	1.0
Russia	3.1	3.4	3.7	0.7
Sweden	9.7	9.8	9.8	0.0
Ukraine	4.6	3.9	3.2	-1.4
Average	7.4	7.5	7.6	0.2

X. Innovation climate

	(t-2)	(t-1)	Latest available (t)	Change
Denmark	9.2	9.5	9.7	0.5
Estonia	7.2	7.4	7.6	0.4
Finland	9.0	9.3	9.5	0.5
Germany	9.6	9.2	8.8	-0.8
Latvia	5.5	5.9	6.3	0.8
Lithuania	6.8	6.8	6.9	0.1
Norway	9.0	9.2	9.3	0.4
Poland	5.6	6.0	6.3	0.7
Russia	4.8	4.9	5.0	0.2
Sweden	9.8	9.8	9.9	0.1
Ukraine	3.8	4.4	5.0	1.2
Average	7.3	7.5	7.7	0.4

[3] A score between 9-10 indicates that the country is within the top deciles of the countries surveyed.

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