Baltic Sea Report

Integrate. Compete. Grow… and repeat!

- In search of growth
- Baltic Sea index: the region’s structural qualities have improved, but still much to do
- FDI in the Baltics: weaker inflows, but growing investments abroad

In search of growth
The region’s growth suffers from lacklustre and patchy global demand, Russia-driven geopolitical uncertainty, and its own structural imbalances. The region’s growth forecast for 2014 has been repeatedly lowered during the year and now stands at only 1.2%, i.e., only half of what we expected a year ago. In 2015, growth will dip to 0.9%. In 2016, the region is forecast to expand by 1.9%, driven by better growth in the euro area and an expected stabilisation of the Russia-Ukraine conflict around mid-2015, which should restore Russia to very pale growth. It will be the fourth year in row of growth below the region’s long-term average. There are structural reasons for growth to slow permanently, e.g., demographics. Growth will increasingly rely on investments and productivity growth, which would benefit from closer regional integration.

Baltic Sea index: the region’s structural qualities have improved, but still much to do
The Baltic Sea index points to improvements in the region’s structural qualities and competitiveness – it has risen to 7.6 from 7.4 last year. Improvement has been across the board, with that in logistics and infrastructure improving most. Only three of the ten subindices – entrepreneurship, tax policy, and foreign trade – have retained their last year’s ranking. The region overall ranks above the EU (7.1), but below the US (8.4). Russia and Latvia have seen the steepest improvements, but notable gains are seen also in Estonia, Lithuania, Norway, and Poland. Finland has seen a little slippage in its rank. The key weakness comes from the region’s uneven structural quality – bringing up those countries lowest ranked would generate the largest gains in the region’s competitiveness. This is happening, but the current reform agenda seems to be weak. Another negative trend for the region’s growth is Russia’s drifting away, driven by political actions that override its structural improvements. Developments in Russia are the main risks to the region’s growth. To reduce the negative impact of such risks, the rest of the region must strengthen its mutual integration and use its competitive advantages to integrate with other expanding economies.

FDI in the Baltics: weaker inflows, but growing investments abroad
Foreign direct investment (FDI) flows in the Baltics have weakened over the last couple of years, as in the EU overall. Meanwhile, with the Baltic economies maturing, outward investments have risen. The Baltics keep attracting FDI with somewhat higher returns and lower costs than the EU’s average; however, returns are likely to decline due to slower convergence with the EU average, while costs will continue to rise. Geopolitical risks due to the Russia-Ukraine conflict will affect FDI flows. Business investments (especially in R&D) are vital to boost the productivity and competitiveness of the Baltics, and FDI is critical. The option of transferring operations to lower-cost countries might become increasingly attractive, going forward. To strengthen competitiveness and boost growth, companies should (i) keep raising efficiency, (ii) find new markets and innovate, and (iii) get out of the grey economy. To support businesses, policymakers can (i) ease the tax burden, (ii) support innovations and R&D, (iii) keep improving institutional environment, and (iv) address demographic and labour market challenges.

Please see important disclosures at the end of this document
The Baltic Sea region and Swedbank Baltic Sea index 2014

The aim of the Baltic Sea Report is to assess the structural quality and strength of the Baltic Sea region economies from the point of the legal and business environment, and to provide analysis and suggest possible interventions by policymakers to support the swift and sustainable growth of their economies. The region includes 10 countries around the Baltic Sea: Germany, Denmark, Norway, Sweden, Finland, Russia, Estonia, Latvia, Lithuania, and Poland. Detailed analysis is provided for Swedbank’s four home markets: Sweden, Estonia, Latvia, and Lithuania.

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Introduction: In search of growth

The region’s growth suffers from lacklustre and patchy global demand, Russia-driven geopolitical uncertainty, and its own structural imbalances. Regional integration must deepen and the economies must search globally for other export markets to counter the risk of growth slowing permanently. The Baltic Sea index points to improvements in competitiveness, but much remains to be done. Russia is drifting away and the region is likely to become less homogenous.

Global growth: patchy; the euro area needs more stimulus

A year ago, when we published our Baltic Sea Report for 2013, we expected the world economy to steer through choppy waters, with recovery deepening and gradually improving. We did not expect it to be easy. But the seas have turned out to be much rougher. There is now ISIS in the Middle East. There is Ebola in Africa. The Sochi 2014 Winter Olympics had barely finished when the Russia-Ukraine crisis broke out. This has led to a sanctions standoff between the West and Russia, reviving geopolitical risks and weighing down on growth, (mostly) in Russia and (to a lesser extent) in Europe. The full economic impact of this is still to come as the end of the conflict is not yet in sight and the extent of Russia’s geopolitical ambitions is still unclear. And Europe is still very slow with structural reforms.

Growth in 2014 for many major economies will be lower than we forecast a year ago, and forecasts for 2015 in most cases are now also lower than we set a year ago. Weak growth and geopolitical tensions have suppressed oil prices below USD 70 per barrel of Brent crude (down about 40% from a year ago). Lower energy costs must support growth in most of the advanced economies (with perhaps some cost to the US shale gas/oil industry) but will be very costly to energy exporters such as Russia. Most other commodity prices have also tanked over the past year, though less sharply.

The US recovery has been bumpy but convincing, and the Federal Reserve ended its bond purchases in October. The market consensus expects the interest rate rise to start mid-2015. It will be a fine balancing act, and most likely the rate will rise moderately, driven by the incoming macro data. On the one side, abundant liquidity and low interest rates run risks of a buildup of asset bubbles. On the other side, too early and too sharp a rise can harm growth. We expect the US economy to speed up from 2.3% this year to 2.9% next year and slow to 2.6% in 2016. It will serve as a major support of global recovery. Growth in Japan has been weak, and “Abenomics” is largely still lacking its third arrow of structural reforms. Japan’s economy is still at a make-or-break point. We forecast only 1% growth per annum over the next two years. China is slowing but, so far, gradually (to 7.4% this year and down to 6.6% in 2016), supported by stimulus measures. China remains the largest contributor to global growth, and its slowing has a detrimental effect on commodity demand.

The euro area is again in intensive care. It did exit the recession in the first half of 2013, but has so far failed to grow enough to confirm that robust recovery is under way. Although we do not think the risk of triple-dip recession to be very high, inflation is trending downwards, and the risks of deflation have grown. The ECB has cut its policy rate to 0.05% (and the deposit rate to subzero) and decided to go “the full monty,” phasing in clear-cut quantitative easing. The ECB is unlikely to start raising interest rates sooner than 2017. The euro has weakened, which will support European exporters. But monetary policy was never to be enough if structural reforms were not put in place to improve competitiveness. It is ever more obvious that such reforms must speed up (especially in France and Italy) and must be complemented with fiscal stimulus from countries with stable public finances and from supra-nationals such as the proposed European Fund for Strategic Investments. Growth in the euro area this year will be poor at 0.7%, with 1.3% forecast for 2015 and 1.9% for 2016. Most of the euro area economies have negative output gaps (i.e., actual GDP below its potential and, hence, high unemployment) that will not close until three-to-four years.

Yet, not all European economies are bad news. The UK has surprised on the upside this year with its GDP expanding by about 3%. The Bank of England is expected to start raising its policy rate mid-2015. Spain has shown that reforms serve as a prerequisite for recovery, with its growth now deepening and broadening.

Overall, global growth is mixed and patchy, and most risks are on the downside. Nevertheless, the global economy is growing, which brings opportunities for agile exporters like the Baltic Sea region economies. This means that companies should search broader and farther for export markets and growth.

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1. Our latest forecasts in detail can be found in the Swedbank Economic Outlook for November 2014 (http://swedbank-research.com/english/swedbank_economic_outlook/2014/q3/index.csp)
Russia is key source of regional uncertainty

The major cause is the euro area stagnation and the Ukraine crisis. But the region’s growth forecast for 2014 was repeatedly lowered during the year and is now only half of what we had expected in our previous Baltic Sea Report. The major cause is weak external demand and the Russia conflict, but also imbalances pertinent to the region’s economies themselves. Only Poland and Norway have fared better than expected; the rest have fallen short of expectations. The largest shortfall is for Russia, whose economy suffers from a lack of structural reforms; the situation has been made worse by its actions in Ukraine and the ensuing sanctions. Official numbers still show growth, but it is to slide into recession; the fall will seem less dramatic only because of a massive imports’ contraction.

Economic growth in the Baltic Sea region, %

<table>
<thead>
<tr>
<th>Region</th>
<th>Average of 2002-2012</th>
<th>2013</th>
<th>2014f</th>
<th>2015f</th>
<th>2016f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>0.6</td>
<td>-0.5</td>
<td>0.9</td>
<td>(1.7)</td>
<td>1.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.9</td>
<td>1.6</td>
<td>2.0</td>
<td>(3.8)</td>
<td>2.5</td>
</tr>
<tr>
<td>Finland</td>
<td>1.5</td>
<td>-1.2</td>
<td>-0.2</td>
<td>(1.0)</td>
<td>0.4</td>
</tr>
<tr>
<td>Germany</td>
<td>1.1</td>
<td>0.1</td>
<td>1.4</td>
<td>(1.9)</td>
<td>1.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>4.2</td>
<td>4.2</td>
<td>2.3</td>
<td>(4.3)</td>
<td>2.6</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4.5</td>
<td>3.3</td>
<td>3.0</td>
<td>(4.0)</td>
<td>3.3</td>
</tr>
<tr>
<td>Norway</td>
<td>1.6</td>
<td>0.6</td>
<td>2.4</td>
<td>(2.0)</td>
<td>1.5</td>
</tr>
<tr>
<td>Poland</td>
<td>4.0</td>
<td>1.6</td>
<td>3.0</td>
<td>(2.4)</td>
<td>2.8</td>
</tr>
<tr>
<td>Russia</td>
<td>4.7</td>
<td>1.3</td>
<td>0.2</td>
<td>(2.8)</td>
<td>-0.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.0</td>
<td>1.5</td>
<td>2.2</td>
<td>(3.2)</td>
<td>2.4</td>
</tr>
<tr>
<td>Baltic Sea region (PPP w weights)</td>
<td>2.6</td>
<td>0.8</td>
<td>1.2</td>
<td>(2.4)</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: World Bank, Swedbank forecasts (Swedbank Economic Outlook, November 2014, October 2013 forecasts in parenthesis)

Weak external demand reinforces the need to raise competitiveness

The weak Russian economy, its introduced trade ban, and a massive drop of the rouble (down about 35% against the euro from a year ago) have hurt the region’s other economies. Uncertainty about Russia’s geopolitical ambitions has made the region’s investment activity more cautious. All in all, such geopolitical issues do not bode well for regional growth, especially when growth in other regions has been weak and patchy. While the impact from Russia is negative, so far it has been subdued as companies have grown their sales in other markets. But the patchy global demand reinforces the need for the region to reform to improve its competitiveness. Temporarily, in many of the region’s economies, the key driver of growth is consumer spending. For most, it is not sustainable in the long term, and, if exports do not speed up, economic and thus income growth will dampen permanently.

In 2015, growth in the region will dip to 0.9%, i.e., less than the euro area. Much of this is due to Russia (net of Russia, it is 1.8%), which is the only one forecast to be in recession. The rest are expected to grow, albeit modestly, with rates ranging from 0.4% in Finland to 3.3% in Lithuania. In 2016, the region is forecast to expand by 1.9% (2.4% net of Russia), driven by better growth in the euro area and an expected stabilisation of the Russia-Ukraine conflict around mid-2015, which should bring Russia back to very pale growth.

Germany – the major driver of the region’s growth – has shown a volatile performance this year, just narrowly escaping a technical recession. As the world’s second-largest exporter, it is vulnerable to weak global growth and the Russian conflict. We see this recent lack of growth to be temporary as, with a strong labour market, there is room for more wage growth, consumption, and infrastructure investment to cover for external weakness. Households, firms, and the public sector have the ability to spend more. This would also help the region.

Finland has finally exit the recession, but recovery will be pale. Weak cost competitiveness and ongoing structural changes inhibit export growth; headwinds from Russia make growth more challenging. A worsening labour market weighs down on private consumption. Productivity growth is necessary to gear up growth, but takes time. Denmark has returned to growth, driven by consumer spending, as the labour market and housing prices have strengthened. Exports have been disappointing, and growth is still slow. Norway is slowing as oil investments shrink. Growth is largely driven by household demand, but unemployment has started to inch up as job creation falls short of the rising labour supply. Polish growth has remained quite robust despite the euro area stagnation and the Ukraine crisis. But the downside risks are high, given that growth in major neighbouring countries (not to mention Ukraine, whose economy will get much worse before getting better) is likely to be pale.

Russia’s key risks are political; it is set for a long period of stagnation

Russia is the main source of worry. It suffers from a cyclical and structural slowdown, further aggravated by political risks. The slowdown started long before its actions in Ukraine; investments have been falling since 2012. Russia’s growth model is built on commodities, especially oil, and this served well while prices were rising (in US dollars, its economy has grown nearly tenfold since the post-crisis low of 1999). Alas, the side-effect of this was an ever-increasing dependence on those sectors, suppression of other sectors, and corruption. With oil prices falling and unlikely to see another super-cycle any time soon, the old engine...
is unable to deliver growth rates comparable to the 8-9% seen before the Lehman crash or even the post-crash rebound of 4-5%. The Ukraine conflict has worsened the situation as foreign capital is fleeing and access to financial markets is severed, i.e., there is no investment to shift the growth model towards other sectors and Chinese help is limited. It is not that Russia is inevitably relive the crash of the late 1990s, but it is set for stagnation or very low growth at best. Poor growth itself can be a source of political instability and further weaken the economy. To return to reasonable growth, the rule of law needs to be improved, foreign capital must return, and Russia’s growth model must shift towards sectors other than commodities, which currently seems to be a very tall order... for the time being it means that demand in Russia will contract. The major risks are not economic, but political.

As to Swedbank’s four home markets, all have grown but fallen short of our forecast. All are learning to cope with the trying external environment. In Sweden, the Riksbank has sharply cut its policy rate, and fiscal policy could turn more accommodative. With weak external demand, the export sector is diminishing in importance while domestic demand boosts services. The biggest challenge is to counter the risks of household debt buildup while avoiding triggering a downturn by phasing in macro prudential measures to contain such risks. Despite a sizable output gap, our growth forecast for Sweden is modest and lower than we set a year ago. With weak external demand, household spending has again become the most robust driver of growth in the three Baltic countries. The impact of the Russia-Ukraine crisis is so far small, but it has made companies more cautious in their investment decisions. This may cut into long-term growth potential. As of last year, Lithuania boasts the highest average labour productivity, closely followed by Estonia and then, with a wider gap by Latvia. The major challenge for the Baltics is to keep raising exports and productivity in order to raise wages and contain emigration.

Is growth to slow permanently?
This is not the first year that the Baltic Sea region growth disappoints. This year, it is likely to grow at only half the speed of what we expected last year. Next year, it seems to get worse – the fourth year in row when the region’s growth will be below the long-term average of 2.6%. Indeed, there are risks that were not foreseen; the Russia-Ukraine conflict is one such event. But this observation is applicable not only to our region.

Over the past few years, the market consensus has stubbornly pitched the US GDP growth forecast at 3% (i.e., about the average growth for the two decades prior to the 2008 crash) and then scale it down towards 2% as the data for the year roll in. There is a view that the potential US growth is now at 2-2.5% rather than 3%. This would mean lower global growth, too. Some of the earlier drivers are less strong, e.g., global foreign trade growth has slowed (to about 4% in this decade from about 7% in the decade before). Permanently slower global growth would have major implications for the Baltic Sea region as its growth much depends on exports.

As to the Baltics, there are structural reasons for growth to slow permanently. Populations are shrinking and aging, and employment will start to fall. Labour costs will only rise. Capital stock and total factor productivity (i.e., gains in technology and skills) are thus the sources to rely on going forward. Yet, investment has been insufficient. R&D activity is low, but it is key for innovation and productivity growth. Convergence has been spectacular so far. Latvian average labour productivity is now at 65% of the EU average, compared with just 47% in 2004. Estonian and Lithuanian productivity levels are even higher. But with the gap narrowing, convergence tends to slow. The European Commission now estimates that the potential speed of growth in the Baltics is about 2.5%. We are more optimistic and expect it to be around 3-3.5%. Yet, this is below the last decade’s averages of above 4% for all three countries. If growth is to slow sharply, so would wage growth, thereby aggravating the risks of emigration.

The Baltic Sea region’s growth and competitiveness can gain from further integration. The region has already taken advantage of this. The share of exports to other economies in the region has been rising. Latvia has had the sharpest increase over the past decade (up from 52.6% to 70.1%). The key exception is Russia – a continued trend decrease from 18.3% in 2004 to 15.1% in 2013 as its exports to other countries have grown faster. Financial integration is also strong, especially amongst the Baltics and Nordics. A major role in creating growth is played by foreign direct investment, which we discuss later in the report. But for integration to deepen, solid and similarly good structural qualities across the countries are key.

Baltic Sea index: the region has improved, but still much to do
Since 2010, we have published an index assessing the Baltic Sea region’s structural competitiveness and institutional development: the Baltic Sea index (BSI). The region’s countries are ranked in relation to each other and the rest of the world. Ten areas are used as a basis for the overall index. Each area consists of several underlying components. The list is not complete, but it should serve as a good indicator of improvement in the business
climate in relation to other countries. Countries are ranked from 0 to 10, where a rank of between 9 and 10 implies that in the selected area the country belongs in the top 10% of best-performing countries in the world. A country index is an average of all 10 areas. A regional index is an average of country subindices. The index allows us to track a country’s performance against others overall, and across 10 selected areas against others and its own past. If every country in the world were to improve at the same rate, our index and the country ranking would not change, because it measures comparative progress. The changes in countries’ rankings indicate whether they have improved or slid backward. The index is slow to react to policy change as (i) reforms often are slow to take effect, and (ii) collecting internationally comparable data generates a measurement lag, and index values published in, e.g., 2014 can be based on changes implemented in 2013 or even 2012.

In summary, the region’s structural qualities as gauged by the BSI have improved from last year’s reading (from 7.4 to 7.6). This means that the structural qualities’ improvement (which subsequently should improve the region’s competitiveness) has outpaced that of the rest of the world. The improvement has been across the board, with that of the logistics and infrastructure segments the strongest. Only three of the ten subindices – entrepreneurship, tax policy, and foreign trade – have not improved on (i.e., have retained) their last year’s ranking. The region overall ranks above the EU (7.1), but below the US (8.4).

Most of the improvement in the region’s index comes from those countries that rank below the regional average and have more to catch up. Russia and Latvia have seen the steepest improvements, but notable improvements are seen also for Estonia, Lithuania, Norway, and Poland. Finland has seen a marginal decrease in its rank (alas, for the second year in a row), while the rest of the pack has largely retained its earlier ranks. Finland’s fall is largely due to logistics and infrastructure – this may impair its recovery going forward, but perhaps not that much given its still-good overall quality.

The region’s strength is in education, logistics, and governance, where it ranks in the top 20 in the world. The key areas to improve are foreign trade, tax policy, and financial market diversity. But the key weakness comes from the region’s uneven structural quality (e.g., see the massive spreads for the subindices of foreign trade and governance). Bringing up those lowest-ranked countries would generate the largest gains in the region’s competitiveness. And this is happening – the average spread has decreased from 5.0 points last year to 4.4 in the BSI for 2014. Somewhat worrying, though, is the lack of progress for the most advanced economies – only Norway has managed to inch up in the rankings. Improving structural qualities and, thus, competitiveness is a key source for growth when the global economy is
weak. Improving against one’s past performance is not sufficient: to climb up the ranks, one must improve faster than others.

**Russia is drifting away**
The Russia-Ukraine conflict has changed the landscape. Despite its improved BSI rank (some of which could be reversed next year as the data updates come in), recent political developments have virtually pulled Russia out of the common convergence trajectory of the Baltic Sea region. Political risks will override many of the gains. For instance, what does it help to improve regulation of securities exchanges if foreign capital flees the country afraid of a further escalation of the Russia-Ukraine conflict? Integration of Russia with the rest of the region will be increasingly called into question. At present, we see that integration (of trade, investment, and other) will weaken going forward. Different values mean a different business environment, and different risks. This will not only cut into Russia’s long-term growth potential, but also likely lessen it for the rest of the region. For these economies to minimise such a negative impact from Russia, the best policy is to integrate closer amongst themselves and become more open by searching globally for other export markets.

*Mārtiņš Kazāks*
Sweden: Challenging times ahead

The Swedish economy is expected to grow by 2.4% on average during 2014-16. With depressed prices and increasing domestic competition, the Riksbank’s policy rate will remain at zero until mid-2016. Household debt levels continue to increase, raising the need for measures to reduce risk. In the Baltic Sea index, Sweden has an unchanged score of 8.7; this was the second best amongst the Baltic Sea countries, but the gap with other countries is decreasing.

<table>
<thead>
<tr>
<th>Economic indicator</th>
<th>2002-2012</th>
<th>2013f</th>
<th>2014f</th>
<th>2015f</th>
<th>2016f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>2.0</td>
<td>1.5</td>
<td>2.2</td>
<td>2.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Consumer price growth, %</td>
<td>1.5</td>
<td>0.0</td>
<td>-0.2</td>
<td>0.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>7.2</td>
<td>8.0</td>
<td>8.0</td>
<td>7.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Gross nominal wage growth, %</td>
<td>3.3</td>
<td>2.6</td>
<td>3.0</td>
<td>3.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>7.0</td>
<td>5.2</td>
<td>4.3</td>
<td>3.8</td>
<td>3.1</td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>0.9</td>
<td>-1.2</td>
<td>-2.3</td>
<td>-1.6</td>
<td>-1.0</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden, Swedbank

Solid domestic demand while exports lag

The economy has been resilient despite weaker external demand. In the first half of 2014, GDP increased by 2.6% at an annual rate. The slower export growth has been made up for by a continued solid domestic demand, in particular from household consumption and investment in housing. The labour market continued to show strong employment growth, mainly driven by the private services sector, while in industry the number of employees continued to decline. The labour supply is growing at a robust 1.4% rate in annual terms, driven by demographic factors and large inflows of immigrants; this explains why the decline in the unemployment rate has been modest. The deteriorating growth outlook for the euro area and Germany particularly, but also for Norway, will dampen export demand in the Swedish economy. Overall, we expect that export companies will continue to lose market shares in global trade for the remainder of the forecast period, which will dampen overall export growth. However, as households will benefit from the solid labour market developments and lower interest rates, as well as from prior tax rate cuts, private consumption – and, by extension, investment in residential real estate – will provide the main growth pillar over the next two years. Overall, we foresee GDP growth of 2.4% next year and 2.7% in 2016. This will support a further decline in unemployment rate.

Inflation will not reach Riksbank’s 2015-2016 inflation target

The inflation rate is far below the Riksbank inflation target of 2% and will remain so during the coming two years. In October the inflation rate, measured as the consumer price index (CPI), was -0.1% - the third month running with a negative inflation rate. Falling global commodity prices, increasing domestic competition, and digitalisation are putting downward pressure on domestic prices in Sweden, and we still anticipate continued low inflation during 2015-2016, despite solid domestic demand. The underlying inflation rate (CPIF) is expected to pick up to 1.0% on average next year from 0.4% this year, and to rise to 1.6% in 2016.

Monetary policy – still tools left in the toolbox

The policy reaction by the Riksbank has been substantial, in particular after it dropped the objective of “leaning against the wind” to combat the increasing household debt levels. Faced with falling inflation and the threat of deflation, it followed up its 50-basis-point cut of the repo rate in July by slashing the rate to zero in October and signalling its intention to keep rates low until there are significant signs of a pickup in prices. The Riksbank has also stated that it is ready to go further with unconventional tools, should it become necessary. An exchange rate floor à la Switzerland’s is amongst the tools whose use is more probable than quantitative easing, if the inflation rate continues to surprise on the downside. We do not, however, believe that deflation will become entrenched or that the Swedish krona will appreciate substantially. Thus, our main scenario is for the repo rate to stay at the zero lower bound until the second half of 2016, when a gradual normalisation will be initiated.

Unconventional tools could be necessary

Measures to dampen household debt

High household debt pose a threat to economic growth
Sweden: The Swedish Financial Supervisory Authority's (FSA) decision in November 2014 to implement a requirement to repay down to 50% the loan-to-value ratio will include only new borrowers and will be implemented next year. The Riksbank has commented that this is insufficient and recommends additional measures to dampen household indebtedness. We foresee only a minor direct impact on household consumption based on the FSA decision, but it could make it more difficult for young people to enter the housing market. In addition, the indirect and psychological effects should not be underestimated as these could lead to lower demand and falling housing prices. On the other hand, the diminishing supply of houses and the reduced flexibility in the housing market could drive housing prices upward.

Insufficient housing supply growth is a fundamental factor behind the rise in residential property prices, especially in metropolitan areas, where ongoing urbanisation and immigration trends are boosting demand. This has resulted in higher housing prices, driving up the size of mortgages. While some steps have been taken, containing house price pressures will require a continuing effort to expand the stock of affordable housing and further reforms to zoning, permitting, and the rent-setting process.

Uncertainties about fiscal policy increasing vulnerability in Swedish economy

After the Swedish parliamentary election in September, the political outlook is more uncertain. The new minority government, since October, includes Social Democrats and the Green party, supported by the Left party, but reaches only 45.6% of the total mandate in the parliament. Its minority status and the increased parliamentary presence of the far-right Sweden Democrats – now the third-largest party in Sweden – are likely to undermine the new government's effectiveness. This reduces the degrees of freedom in fiscal policy at a time when monetary policy has reached the zero lower bound.

The theme in the budget presented in October is a reallocation from private to public consumption and from high-income to low-income earners. The increase in public expenditures of SEK 25 billion for 2015 is directed to education, labour market policy, health, and the environment. This will be fully financed by higher taxes, mainly through higher payroll taxes for youth, a decline in tax reductions for high-income earners, and postponed deductions for private pension savings.

Although the Minister of Finance said during the election campaign, and repeated when in office, that all reforms will be fully financed, we expect that, should the business cycle worsen, fiscal policy will become more expansionary. Next April’s supplementary budget provides one opportunity for action. Higher expenditures on immigration—due to large inflows of refugees and on defense following the worsening of the geopolitical environment in the Baltic region—could lead to higher public expenditures and a larger deficit in the government budget balance than we have in our forecast.

The opposition criticises the government’s budget, particularly regarding the introduction of trainee jobs for young people in the public sector and higher payroll taxes for youth. The postponement of infrastructure projects in the Stockholm area and the closure of Bromma airport are other areas where the government has been criticised not only by the opposition, but also by the private business sector. Due to the fragile parliamentary support, the risk of a new election is on the table, although we would still assign it a low probability. Prime Minister Stefan Löfven has signalled that the government will step down if the Alliance's budget wins the vote. This doesn’t have to mean a new election. After sounding out the parliament’s parties, the speaker may decide to ask Stefan Löfven to try again to form a government. According to the latest pool surveys, support for the government has decreased. In a recent TV4/Novus poll, the government got 42.8% of the voters’ support, versus 43.6% on election day, September 14. The former four-party government garnered 42.1% support, compared with 40.4% in the September election.

Baltic Sea index – speed of reforms decreasing

Sweden still ranks amongst the highest-scoring countries in the Baltic Sea region. In 2014, Sweden’s total index is 8.7, unchanged from last year. Sweden is ranked as the second-best country in the Baltic Sea region, together with Finland, surpassed only by Norway. However, the trend in the aggregated index is downwards, which should sound an alarm and indicate a deceleration in the pace of structural reforms. The lowest rankings are still in fiscal policy, entrepreneurship, and foreign trade.

The subindex for entrepreneurship is unchanged, at 7.5, in 2014, slightly above the average for the Baltic Sea region, but far below the US index of 8.2. At the same time, other countries are catching up to Sweden. Amongst the challenges Sweden faces is cutting the red tape for Swedish small and medium-sized enterprises (SMEs), as this process has not worked out as expected. More than two-thirds of the new firms in Sweden are created in the private services sector. Deregulations, specialisation, new technology and increasing demand for services are the main driving forces. The government’s proposal to limit profit
withdrawal in firms in welfare services has led to an intensive debate, with the business representatives arguing strongly against the proposal. They are warning of the negative impacts of such an action on the creation of new enterprises and on the labour market.

Tax policy is the subindex in Sweden with the largest improvement potential—even though the index has already improved slightly, with a rise in its score from 6.7 in 2013 to 6.9 in 2014. The total tax burden eased during the former government from 48.3% of GDP in 2006 to 44.3% in 2013, according to the OECD. Lower income taxes have strengthened household purchasing power and have probably had a positive impact on labour supply.

Although Sweden still scores above average on the education index, at 9.1, the trend has been declining in recent years. Since 2010, Sweden’s index has fallen the most of the Baltic Sea countries, and during the latest year Sweden was ranked as number four. This trend differs from Finland’s, which still has the highest score of 10.0. According to the OECD’s latest PISA (Programme for International Student Assessment) survey, Sweden’s scores have continued to decline, confirming the challenges the Swedish education system is facing. The knowledge-intensive services sector accounts for a large part of the job creation in the economy. The need for high-skilled labour will remain, driven by specialisation and increasing competition. To secure the supply of labour needed, additional measures to improve the education system should be taken.

Well-coordinated steps to gradually increase land supply and strengthen the incentives to invest in residential construction would help ease supply-side restrictions, e.g., making additional reforms in the rental market, simplifying building regulations, and stiffening competition in the construction sector. The government’s goal is to increase the number of dwellings by 250,000 by the year 2020. Public infrastructure investments, coordinated with the municipalities, would also make private housing investments more attractive.

Sweden: Swedbank Baltic Sea Index 2014

Swedbank Baltic Sea Index 2014

Source: Swedbank

Jörgen Kennemar
Estonia: Growth below potential

Estonia’s economic growth will remain below potential as export demand stays relatively weak. Estonia’s business environment improved slightly for the second consecutive year in 2014, but more efforts are needed to increase competitiveness and productivity levels. Logistics and infrastructure remain the main business bottlenecks in the country, according to our index.

<table>
<thead>
<tr>
<th>GDP per capita, PPP (2013): 71% of EU28</th>
<th>Economic indicator</th>
<th>2002-2012</th>
<th>2013</th>
<th>2014f</th>
<th>2015f</th>
<th>2016f</th>
</tr>
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<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>3.9</td>
<td>1.6</td>
<td>2.0</td>
<td>2.5</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td>Consumer price growth, %</td>
<td>4.1</td>
<td>2.8</td>
<td>0.0</td>
<td>1.3</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>9.8</td>
<td>8.6</td>
<td>7.5</td>
<td>7.2</td>
<td>7.1</td>
<td></td>
</tr>
<tr>
<td>Real net monthly wage growth, %</td>
<td>9.0</td>
<td>7.5</td>
<td>5.2</td>
<td>7.4</td>
<td>6.5</td>
<td></td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>-7.4</td>
<td>-1.4</td>
<td>-0.6</td>
<td>-0.8</td>
<td>-0.5</td>
<td></td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>0.6*</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.4</td>
<td>-0.2</td>
<td></td>
</tr>
</tbody>
</table>

* based on ESA95 methodology


Growth remains slow and main risks on the downside
In Estonia, economic growth has been driven by domestic demand, especially private consumption, for the past two years. This is not sustainable in the long run for such a small, open economy. It could also lead to widening imbalances in the economy. So far, the current account deficit, inflation, and unemployment remain low.

Economic growth is expected to accelerate gradually in 2015-2016 on the back of improving external demand, which will support the growth of exports and investments. This would, it is hoped, decrease the economy’s dependence on the growth of consumption. But the economic growth rate will remain below potential as export demand remains weak. The euro area’s growth forecasts have been revised down. The conflict between Russia and Ukraine will reduce trade and investment flows in the region, bringing down Estonia’s growth rate by up to 0.5 percentage point a year. Economic sanctions between Russia and the EU will have an impact on some economic sectors (mostly agriculture, the food industry, and transportation), but the overall effect of the sanctions is expected to remain limited.

The main risks to the balanced, sustainable growth of Estonia’s economy stem not only from the too-high growth of the prices of certain assets (stocks and real estate, both locally and globally), but also from wages, which have increased more than the general macroeconomic development of the economy would have suggested. The high growth of wages and real estate prices have been caused by the limited supply of labour and higher-quality apartments in Tallinn, rather than a (credit-driven) domestic demand boom. The growth of real estate prices, one of the fastest in the EU, has slowed, and the number of transactions has decreased since the second quarter of this year, due to the increased supply of apartments in the hot spot of the real estate market, Tallinn. We expect this trend to continue in 2015.

Tensions in the labour market will continue. The supply of labour will decrease, as the working-age population and the unemployment rate will decline, making it even more difficult for companies to hire additional labour, especially when demand picks up next year. This will push up wages even if the general macroeconomic environment and export order books are still weak.

Productivity has been at a standstill for four years
Productivity growth is a necessary precondition for the growth of wages and living standards. In 2013, Estonia’s labour productivity amounted to 70% of the EU28’s, based on purchasing power standards (PPS) per employed; it was even less, 62% of the EU28’s, based on PPS per hours worked. Both indicators were flat during 2010-2013, so there was no convergence with the EU in productivity levels, according to this indicator. Estonia lags behind most of the countries in the EU, excluding Bulgaria, Romania, Latvia, and Poland (in the case of hours worked).

The gap between the growth rates of wages and productivity will, it is hoped, narrow in 2015-2016, when the growth rates of GDP and productivity will accelerate. Enterprises statistics show that, in the first half of 2014, labour costs increased by around 8%, while overall costs as well as sales decreased by 1%, year on year. At the same time, investments in tangible fixed assets decreased by 11%, including a decrease in investments in computers and other machinery of 20%, compared with the first half of 2013. This is not good news for future productivity growth.
Elections should be a good opportunity to accelerate development

This spring, with a continuing decline in its popularity, the liberal Prime Minister’s Reform Party changed its coalition partner from the national-conservative Pro Patria and Res Publica Union to the Social Democrats of Estonia. The two-party so-called spring coalition did not change the general political course of the country, however. The biggest change in the political agenda was an increase of child benefits. The Reform Party kept its previous goals of reducing labour taxes and raising indirect taxes such as excise and environmental taxes. Despite growing disagreements and declining ratings (51% of the votes in November), the current coalition is expected to carry on at least until the next elections in March.

Both parties from the previous coalition – which lasted from 2007 until the spring of 2014 – the Reform Party and the Pro Patria and Res Publica Union, have lost public support. If elections were held tomorrow, the conservatives and the liberals would both get around 4–5 fewer seats in the 101-seat-parliament than during the previous parliamentary elections. At the same time, as the current coalition partner, the Social Democrats, has become more visible and also more popular, it would get 3 seats more. The fourth major party, the leader of the opposition, the left-wing Centre Party, has lost 4 seats, compared with four years ago, according to the latest polls.

The TNS Emor opinion polls (the latest from November 2014) show that the Prime Minister’s Reform Party is the most popular party, with 29% of the votes, followed by the Centre Party and the Social Democrats, with 22% of the votes each, and the Pro Patria and Res Publica Union, with 18% of the votes. Simple math shows that, in these circumstances, the current coalition would get just enough votes to carry on next spring. However, other options are possible, although a liberal-wing coalition is more likely; this would mean no major change in the current economic policy agenda.

Less than four months before elections, the parties’ programs are being finalised. A further reduction of labour taxes and an increase of minimum wages and pensions have been proposed by several sides. These measures would be covered by an accelerated raise of excise and environmental taxes. None of the major longer-term issues, such as the shrinking and aging population, and low productivity and health indicators, have been touched upon so far in the potential election platforms.

The working-age population is shrinking fast, by around 10,000 persons a year. This is adding pressure on the labour market and public finances. Encouraging the immigration of labour, especially high-skilled labour, is an opportunity definitely worth considering. Recently, the Prime Minister suggested the easing of current immigration restrictions and the offering of start-up visas to people with PhD degrees.

According to Statistics Estonia, Estonia’s population will have declined by 10% by 2040. In order to maintain the current ratio of persons employed to pensioners, the retirement age should be 65 in 2020, 68 in 2030, and 70 in 2040. At the moment, people are retiring much earlier, at the age of 59 on average, often for health-related reasons. According to the current legislation, the retirement age is being gradually shifted to 65 years by 2026.

Estonia’s business environment at the Baltic Sea region’s average

According to Swedbank’s Baltic Sea structural index, the overall business environment improved slightly in Estonia for the second consecutive year in 2014. Estonia’s index remains at the average level of the Baltic Sea region’s 10-country average included in the
Estonia ranks below Norway (which has the highest score), Finland, Sweden, Denmark, and Germany, but above the EU28 average, Latvia, Lithuania, Poland, and Russia (which has the lowest score).

Estonia’s index has improved by 0.3 point from the previous year to 7.7 points in 2014. While all areas, included in the index, improved, biggest achievements were recorded in the areas of logistics and infrastructure. Assessments of the logistics sector are based on the World Bank’s logistics performance indicator, which shows that the efficiency of not only customs clearance, but also other areas of logistics services, have improved in 2014, compared with the previous World Bank’s worldwide survey of companies carried out in 2012. The quality of trade and transport-related infrastructure has also improved, based on the World Economic Forum’s executive opinion survey.

Still, logistics and infrastructure remain the main business bottlenecks in the country, according to our index. To strengthen Estonia’s competitiveness, further investment in infrastructure is required, as the transport infrastructure in particular is not yet up to Western European standards. Estonia received the lowest scores in the criterion of availability of air transport. And although Estonia, with its tiny population, relatively low income level, and geographical location far north, would probably never make it a major transport hub, recent plans might improve the air transport infrastructure somewhat. A restructuring plan submitted to the European Commission for approval foresees that Infortar, a joint owner of the Estonian shipping company Tallink, will become the majority shareholder of Estonian Air. If the plan is approved by the Commission and then the Estonian government, the new investor will try to make Estonia’s national carrier profitable again. There are also plans to widen the flight network, after the conclusion of the current phase of concentrating on the most popular and profitable destinations.

Estonia is ranked high globally in the areas of education, labour market, and governance. Good scores have been received globally in the areas of secondary and tertiary education enrolment, and quality and quantity of education. Still, education reforms continue, and efforts are being made to better match labour market needs. One of the major reforms in education includes higher education reform, which is being implemented gradually starting in 2013. One of the main objectives of the reform is to enable Estonian-language students of public universities to study for free.

Estonia’s labour market is also more efficient than most countries’ in the region due to flexible wage determination, low redundancy costs, and relatively high participation rates. Governance has received a high rating in Estonia because of its strong, transparent, and efficient institutions and low corruption levels.

Over the past five years, Estonia has made the biggest gains in the areas of innovation climate and logistics. Estonia has made a strong commitment to advance its technological readiness. At the same time, Estonia has been at a standstill, in a five-year-comparison, in the areas of entrepreneurship, tax policy, and foreign trade. In the tax policy area, total tax rate as a share of profit has increased over time. The foreign trade index is lower not only because of the complexity of the EU’s system of customs tariffs, and difficulties in accessing foreign markets and hiring foreign labour, but also because of the availability and quality of transport, especially air transport.
Latvia: Finding new sources for growth

Although the Latvian economy is now more balanced and competitive than before the crisis, growth is likely to be permanently slower, going forward. Our Baltic Sea index shows some progress in institutional quality, but it is still below the region average, with the innovation climate and financial markets microstructure needing the most improvement. Yet, the current reform agenda is quite pale and lacks ambition.

### A relatively competitive and balanced economy...

Although the Latvian economy is still about 7% smaller than at its pre-crisis peak, it is now much more balanced and competitive, compared not only with 2007-2008, but also with 2004, i.e., before EU accession and the real estate bubble. For instance, the share of exports in GDP rose from about 40% in 2004 and 39% in 2007 to about 60% in 2012-2013. It is now only slightly below the share of household consumption (61-62%, similar to what it was in 2004 and 2007) and imports (63-64% vs. 54% in 2004 and 58% in 2007). Consequently, the current account deficit is now down to 2-3% from 12% in 2004 and 21% in 2007, fully financed by capital inflows from EU funds and foreign direct investment.

Latvian companies have deleveraged, and their balance sheets are now much more healthy than prior to the crisis – the debt-to-equity ratio in 2012 was back to the 2006 level, i.e., 2-1. Labour costs are of course higher than in 2004, although still lower than in the EU28 on average, but productivity has also risen. Unit labour costs have been rising recently after a notable correction during the last recession, but this has not endangered competitiveness so far. Government finances are now much sounder, and fiscal discipline rules are incorporated in national legislation.

### ... but growth will be slower, going forward

All that said, further growth will be slower than the historical average and post-crisis rebound – not only in the short term, e.g., due to the Russia-Ukraine conflict and weak euro area economy, but also permanently, as the convergence gap narrows and potential growth has perhaps come down to 3-3.5% with the current institutional framework. The European Commission estimates that the output gap for Latvia has already closed. This implies that there is no spare capacity in the economy that can be easily used to boost growth above potential speed. Exports are a fundamental growth driver for the small and open Latvian economy; however, expanding the existing export base (e.g., production capacities) and moving up the value-added chain is crucial to support faster growth. However, investments have been rather weak recently, partly owing to the weak external environment and cautiousness of the companies due to geopolitical uncertainty. In 2012-2013, gross fixed capital formation was about 24% of GDP, compared with 29% in 2004 and 36% in 2007^2.

Another fundamental factor hampering growth going forward is the shrinking and aging population. This is starting to have a more visible effect in the labour market, as the falling labour supply is hindering employment growth. The number of young people is and will continue to drop faster than that of the pre-pension age workers, thus reducing the labour supply. Slower economic growth and rising geopolitical uncertainty are having a cooling effect on the labour market, but risks of labour shortages boosting unsustainable wage growth and, thus, causing a deterioration in competitiveness are so far largely dormant.

Energy costs could present one more challenge for preserving competitiveness and boosting export growth. For instance, electricity costs (including taxes) for energy-intensive industrial users are already higher than in the EU28, on average. A rise in feed-in tariffs (the mandatory procurement component) has now been held back by the introduction of a subsidised electricity tax, which will be paid by companies receiving financial support for

<table>
<thead>
<tr>
<th>GDP per capita, PPP (2012):</th>
<th>64% of EU28</th>
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<tbody>
<tr>
<td>Next parliamentary election:</td>
<td>October 2018</td>
</tr>
<tr>
<td>Next municipalities election:</td>
<td>3 Jun, 2017</td>
</tr>
</tbody>
</table>

A balanced, more resilient, and competitive economy...

... but investments are insufficient ...

... while the shrinking and aging population hinders employment growth

Energy costs are relatively high...

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^2 The year 2007 is of course not the best benchmark, since that was in the outburst of the real estate boom, and such investment flows were unsustainable.
power generation; however, this is a temporary solution (for three years). The 2020 targets in the EU energy directives that Latvia is supposed to achieve, e.g., the use of renewable energy, and energy efficiency, are quite challenging and (if implemented in the currently proposed way) could harm cost competitiveness.

At the same time, there are positive signs/developments that might reduce energy costs in the future. For instance, the EU has recently allocated half-a-billion euros for six energy infrastructure projects in the Baltic region, two of which are in Latvia. Both of them will improve existing electricity grids and connections to Nordic suppliers – Kurzeme’s ring (part of a larger NordBalt project, planned to be finished by 2019) and the third Latvian-Estonian interconnection (scheduled to be done by 2020). The recent opening of a liquefied natural gas terminal in Klaipėda (Lithuania), which is connected to the Inčukalns gas storage facility in Latvia (a Lithuania-Poland gas interconnection is also planned), diversifies gas supplies in the region. Yet, liberalisation of the gas market in Latvia – including the network operator from the current monopoly and opening the market to alternative suppliers – has been postponed until 2017; therefore, Latvia will not gain from it for now.

We see digitalisation as a great potential source of growth for the economy. Digitisation not only provides opportunities to improve efficiency in traditional production, but also makes physical goods digital and internationalises services that have traditionally been local. This reduces the size disadvantages of the small Latvian economy. Latvia scores relatively well in internet speed and coverage and has the human capital (although the IT sector is one of those facing the most severe labour shortages) to develop the new products and services demanded on the global market (e.g., Airdog and Infogram).

Focus on combating shadow economy

From the political cycle point of view, the window of opportunity for bolder reforms is open, as the parliamentary elections have just passed. The new government was approved on November 5, and the coalition remained the same, i.e., centre-right, comprising three parties. The Prime Minister and part of the government have remained in office, making it easier to continue with already-initiated measures. Alas, the previous government did not show much willingness to undertake major reforms, and its rhetoric was more suggestive of stability than of stark, pro-growth reforms. In addition, the upcoming EU presidency in the first half of 2015 will take much of the politicians’ attention and administrative capacity. We thus believe that bolder reforms can, at the earliest, appear in the 2016 budget. One of the legislative changes announced for the 2015 budget is a rise in the minimum wage from EUR 1,260 to 1,380 as of next year also remains in place. We believe it would be more appropriate to raise tax-exempt income, to support lower-income earners and reduce income inequality.

Decent institutional improvement so far, but what next?

There has been rather good institutional improvement during the last few years. Our measure of structural and institutional strength – the Swedbank Baltic Sea index (BSI) – has improved notably during the last two years, after a stagnation in the previous three. In 2014, the BSI reached 6.9, up from 6.1 two years ago, implying that Latvia ranks in the top 31% of the best performing countries in the world. It was actually the second-strongest improvement in the region after Russia, which anyway lags behind the region’s other countries substantially, at 5.2. Latvia also managed to surpass Lithuania (6.6), although it still trails Estonia (7.7) and the region average. There is some measurement lag in calculations of the BSI; therefore, any index improvement during the last two years (2013-2014), is likely to

1Financial support for power generation from renewable energy and combined heat and power plants is being financed by all electricity consumers via a mandatory procurement component. The more electricity is produced, the greater the overall financial support and the larger this component is.

2 The declaration of the new government mentions a target of one-third of GDP, but no target date has been set. According to the medium-term budget plans, the tax burden eases to 26.5% of GDP in 2016, which is in stark contrast with the policy objective.

include reforms implemented in 2011-2012. Since the reform progress already began to stall in 2013, and there was even less progress in 2014 prior to the parliamentary elections, Latvia’s BSI ranking might stagnate or even decline somewhat in the coming years (as the BSI measures the progress relative to other countries).

The largest progress during the last two years has been in infrastructure and logistics. The quality of overall infrastructure and of electricity supply strengthened only marginally, but mobile subscriptions increased more notably. The improvement in logistics was across the board – international shipments, customs, tracking and timing – but note that these data are survey based and thus subjective. The logistics indicator is now nearly at the region average, while that for infrastructure still lags behind.

In most other subindices, improvements have been smaller, but visible – both comparing scores (i.e., absolute change) and ranks (i.e., change vis-à-vis other countries). Upgrading border administration and the business environment allowed the foreign trade index to rise, even despite some worsening of the market access indicator. While access to loans in Latvia remains the worst in the region (survey based; this can largely be attributed to insufficient financial market diversity), somewhat better venture capital availability and the soundness of the banks shifted the financial markets index up. The rise in the participation rate and productivity has improved the labour market index, while labour market efficiency has not changed. As for tax policy, there has been both a marginal decline in the total tax rate and improvements in procedures reducing the time required to comply with tax payments. The quality of education improved only marginally, but a growth in enrolment rates allowed the education index to rise.

Although the entrepreneurship index is at the region average and a tad higher than two years ago, it inched down this year. Improvements in the business environment have stalled (e.g., construction permits, registering property, enforcing contracts, resolving insolvency, etc.), and other countries have managed to move faster. The judiciary system, e.g., courts and the insolvency process, certainly remains one of the key areas for improvement.

The innovation climate remains a major disappointment. It has worsened during the last two years. There have been some improvements in capacity to innovate and the quality of scientific research institutions; yet, there has been a deterioration in companies’ spending on R&D, government procurements of advanced tech products, and the availability of scientists and engineers. Innovation input (e.g., environment and human capital) seems to be a bit better than innovation output (e.g., knowledge creation, and creative goods and services), but both are way below the region’s average. The innovation climate and diversity of financial markets remain the two areas that require the largest improvement.

We have already pointed to the necessity to improve education, science, and innovation, and the linkages amongst them in our previous Baltic Sea report, and this policy suggestion still holds. Without this, productivity growth will lag and economic growth will be slow – to shift the speed of growth a gear up in a sustainable manner, one needs more R&D and innovation. The ongoing digitalisation introduces another angle to this discussion – for digitalisation to bear fruit, specific knowledge and skills are needed. Other policy suggestions outlined last year are still valid as well, to address the too-slow productivity growth and demographic challenges, as well as tax policy. Although some measures have been undertaken (e.g., see above for tax policy), much remains to be done. There will be growth, but we worry that it will be too slow – Latvia can do better than 3-3.5% per year.

Mārtiņš Kazāks
Lija Strašuna

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6 ibid
**Lithuania: Dormant structural progress**

This year’s growth will be dragged down by the loss of confidence and the obstruction to trade, but it is expected to accelerate to 3.3% in 2015. In 2016, GDP is likely to grow by 3.8% – above its potential growth rate. However, the potential growth rate has dropped sharply compared with last decade’s rate, mainly due to the shrinking labour force and underinvestment. Structural reforms have been lagging, although they are the major source of sustainable faster growth.

Unfavourable factors of production

Economic growth has been relatively stable during recent years – annual growth has been fluctuating between 3% and 4%. Although the Lithuanian economy has been one of the fastest-growing EU economies for a few years now, the growth rate is nowhere near its pre-crisis level. But, as the pre-crisis growth was overinflated by rapid credit expansion and irrational exuberance, it is not an excellent benchmark. More important, potential growth has been dragged down by a rapid shrinking of the labour force and employment, as well as by business underinvestment. The European Commission estimates that before the crisis Lithuanian potential output growth rate was around 6% per year. Now it is almost two times smaller. Demographic changes are strongly characterised by high inertia and are difficult to influence in the short term, and investors are likely to remain wary in the coming years; therefore, it is up to the government to implement growth-boosting structural reforms.

Potential growth is almost two times lower than it was before the crisis

The Lithuanian working-age population – regardless of how you define it (see chart) – is shrinking quite rapidly, and by the end of this decade it will be 20% smaller than it was in 2005. At the same time, unsurprisingly, the number of pensioners is going to increase. Public finances are less stretched – the budget deficit is going to drop to 1.3% of GDP this year – but balancing the government books in the future will be even more difficult. Thus, the need to implement structural reforms is not going to go away, especially if Lithuania wants to continue converging towards the EU average. In last year’s Baltic Sea Report, we proposed 10 game-changing reforms\(^7\) that were likely to boost competitiveness and economic growth. We are not shocked by the fact that during this one year not many things have changed.

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Reforms can go many ways – not all of them in the right direction

One way to solve the problem of the shrinking labour force and rising age-dependency ratio, which is set to double from current levels by the year 2040, is to loosen immigration rules and take measures to attract competent workers. This year, the immigration rules were improved somewhat, but the bar for immigrants from non-EU countries remains incredibly high – an immigrant has to have a job proposal that pays roughly triple the country’s average salary. Lithuania is aiming for the very talented and skilled – those who usually can choose amongst many countries - and Lithuania is unlikely to be their dream destination. Recent surveys show that the Lithuanian population, especially the elderly, remains quite xenophobic; thus progress in this area is unlikely to be rapid.

The monthly minimum wage was raised again this year to EUR 300, and there is a plan to increase it to EUR 325 in the middle of next year. Minimum wage regulation seems to have become a master key to solving most of Lithuania’s problems – not only is it a measure to help the low earners combat income inequality, but it is even considered as an appropriate measure to lift the country’s average wage. All three objectives address a serious underlying problem and are welcome, but the measure chosen has too many unwelcome effects – it would narrow the wage gap between skilled and unskilled, especially in the public sector, and employment of the less skilled becomes more difficult. Cutting taxes for the low earners and improving the functioning of the labour market could do the job better. Stabs were made at revising the labour code, by which some archaic regulations were eliminated, but the underlying story remains unchanged – the labour market is rather rigid (as indicated by the relevant subindex of the Baltic Sea index; see below).

Although the tax-exempt income amount was increased somewhat, the overall tax system has not been reshuffled, and taxation of labour remains disproportionately high. There is a plan to cut the residential real estate tax from 1% to 0.5% and to lower the non-taxable threshold of real estate value, but the tax base will still be very narrow and tax incomes will remain meagre. Lithuanian government revenues from taxes and social contributions as a share of GDP are the smallest in the EU – thanks to virtually no property taxes and abundant exemptions in income and value-added taxes. The size of the state, however, remains too large to be supported by the relatively low tax receipts – social security is weak, and public sector wages are paltry and discouraging. Thus, the government should choose either to become leaner (e.g., by reducing the number of functions, institutions, and employees), or look for additional budget revenues by making state-owned enterprises (SOEs) more profitable, eliminating tax exemptions, or introducing property taxes.

The government is considering listing a fraction of the SOEs’ shares (bravo!), but that day is still to come. Unfortunately, the envisaged SOE reform, which aimed to increase the transparency and efficiency of their management, died on the vine. The education system is still focused on the quantity of graduates, rather than their quality. The Ministry of Education is proposing to impose a minimum exam grade threshold on school-leavers applying to universities. This seems like a no-brainer policy that could curb those universities that are hunting for paying but not studious students. However, the law has yet to be passed through the parliament.

During this year, the parliament has passed some questionable laws that seem to be dampening the country’s ability to attract investments. For example, restrictions were imposed on companies’ ability to lower their payable profit taxes with losses incurred during previous years. Even more questionable were the restrictions imposed on purchasing agricultural land in excess of 10 hectares – a buyer now must have a relevant education or experience in farming.
mean that transportation and logistics have improved as much as indicated by the indices; in fact, they might not have improved at all.

The governance subindex has picked up a bit as well on the back of improvements in corruption perceptions, the control of corruption, and the rule of law. Although Lithuania ranks lowest (together with Russia) in terms of financial market functioning, the subindex has improved somewhat since last year. This is due to an increase in venture capital availability, easier access to loans, and greater possibilities of financing through the local market. Meanwhile, the progress in the entrepreneurship subindex was achieved because of an improvement in procedures for construction permits and starting new businesses.

Although nothing much has changed regarding the procedures for paying taxes and the tax rates in Lithuania since last year, the tax policy subindex has declined somewhat simply because other countries have made bigger progress. Meanwhile, the decline in the innovation climate subindex was caused by a deterioration in innovation output (e.g., patent applications, scientific and technical articles, online creativity, etc.) and the availability of scientists and engineers. The availability of educated and a highly skilled labour force will continue to be of the utmost importance for the country’s long-term growth prospects. Therefore, the government should put more effort into boosting the quality of education and promoting occupations related to science and engineering. Even though the education subindex is close to the region average, there has been no progress in this area for the last five years.

**Lithuania: Swedbank Baltic Sea index 2014**

![Swedbank Baltic Sea index chart]

Source: Swedbank

*From left to right, (t-4) to latest available (t) – Region average (t)

Nerijus Mačiulis
Laura Galdikienė
FDI in the Baltics: How to benefit?

Foreign direct investment (FDI) inflows have weakened in the Baltics in the last couple of years, as in the EU as a whole. Meanwhile, with Baltic economies maturing, outward investments have risen. Our countries keep attracting FDI with somewhat higher returns and lower costs than the EU’s average; however, returns are likely to decline due to slower convergence with the EU, while costs will continue to rise. Geopolitical risks due to the Russia-Ukraine conflict will affect FDI flows.

The Baltics need FDI to boost competitiveness and growth
The Baltic countries need more investments, including FDI, to boost productivity and sustainably fast economic growth (see our recent analysis for more details8). The direct effect of FDI inflows includes higher levels of capital formation and output growth, and faster job creation, as well as export expansion and diversification. An indirect effect of FDI comes also from raising productivity in the domestic economy by inducing greater competitiveness amongst enterprises and by upgrading business activities of foreign affiliates themselves.9 FDI is believed to lead to the introduction of new management practices, and improvements in product and services quality, cost, and innovation, and to have a positive impact on productivity and wage levels. In general, it is not only the financial capital that comes with foreign investments, but also know-how, which sometimes is even more important. The positive impact of FDI is also evident in the Baltics.10 FDI is often preferred over other types of investment (e.g., portfolio investment) because of its more stable and longer-term nature.

Estonia has been able to attract more FDI than Latvia and Lithuania
Estonia’s inward FDI stock is substantially higher, relative to the size of its economy, than most European countries. This may be explained by the earlier start of structural reforms after Estonia’s independence in 1991, its cultural/language proximity to Finland (one of the main sources of FDI in Estonia), and the abolition of income tax on retained earnings in 2000. As a result, Estonia has enjoyed not only larger FDI inflows than Latvia or Lithuania, but also higher returns for investors.

Inward FDI stock in 2013, % of GDP

![Graph showing inward FDI stock in 2013, % of GDP](Image)

Source: Eurostat

Note: 510% of GDP in Luxembourg, not included in the graph

FDI inflows in Latvia and Lithuania have been dominated by equity capital, either greenfield investment (i.e., new projects) or additional capital from existing investors. On the other hand, in Estonia, most of the FDI inflows have been reinvested earnings11 of existing investors. In all three countries, there have been very few mergers and acquisitions. A much larger part of distributable profits has been paid out as dividends in Latvia and Lithuania than in Estonia. For instance, according to balance of payments data, during 2012-2013 about 60% of profits were taken out as dividends by foreign direct investors in Lithuania and about 80% in Latvia, but only about 35% in Estonia. This can likely (at least partly) be explained by the more favourable tax regime for reinvested earnings in Estonia.

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8 Swedbank Analysis, November 2014 (available [here](#)).
9 UNCTAD 2011 (available [here](#)).
11 Hereinafter by “reinvested earnings” we mean the part of the profits not paid out as dividends (as in the balance of payments terminology), i.e., it is used as a synonym for “retained earnings”.
FDI rates of return have been relatively high in all three Baltic countries – higher than in the EU and similar to those in the CEE, but also more volatile.\(^\text{12}\) This has been supported by a faster catch-up with the EU average income levels. Because the pace of convergence with the EU has since slowed, rates of returns have also decreased, although they are still higher than the EU’s average.

As regards the inward FDI stock, the economies are quite highly integrated in the Baltic Sea region. The smallest share of foreign direct investors coming from the region is in Latvia; this decreased in recent years to 54\% in 2012. In Estonia and Lithuania, each country’s share was 69\% – Lithuania’s share has been largely stable, while Estonia’s share has diminished somewhat. Sweden is the most important FDI investor in all of the Baltic countries. FDI from the Netherlands is also sizable for Latvia and Estonia, but these are overestimated – often these are investors from other countries (sometimes even from the Baltics) who have been registered in the Netherlands due to its tax regime. Finland is a major investment partner for Estonian companies, as are Germany and Poland for Lithuanian ones.

Motives to invest
Investors go abroad either to find new markets, improve efficiency, use natural resources, or garner strategic assets. In the Baltics, the majority of FDI has been motivated by a desire to find new markets or improve efficiency, i.e., lower costs. Geographical location (e.g., a position advantageous for transport activities between East and West or that can serve as a stepping stone for companies entering Russia, and/or benefit from the proximity to Nordic markets), as well as the liberalisation of certain sectors (e.g., banking) and an improvement in the institutional environment overall has also played a role.

According to the World Economic Forum’s survey,\(^\text{13}\) companies in the Baltics perceive themselves as being halfway up the value chain ladder, i.e., halfway between seeing low production costs as the main competitive advantage and seeing unique products and processes as the main competitive advantage.

Composition of inward FDI stock by industry in 2013

The largest share of FDI in the Baltics has gone into the nontradable sectors: finance, real estate, and domestic trade. The share of manufacturing is smaller, except in Lithuania.

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\(^{12}\) A dramatic fall in returns during the recent crisis in Latvia and Lithuania was mostly caused by losses in financial sector. In Latvia and Lithuania provisions for bad loans were considered as a part of reinvested earnings in the balance of payments data, while in Estonia they were not.

\(^{13}\) Available [here](#).
where more than half of the inward FDI stock in manufacturing is the manufacturing of refined petroleum (the Polish company PK Orlen purchased the oil refinery in Mazelkiai in 2006).

**Corporate taxation strategy – a race to the bottom?**

Corporate taxation is found to have an impact on FDI in the manufacturing sector of the EU; its impact is greater in smaller EU countries, although relatively minor.\(^{14}\) Corporate taxation is especially important in countries that have lower productivity because these countries compete with each other on the basis of cost levels. According to some studies, corporate taxation is one of the main factors attracting bigger investment inflows into the Baltics.\(^{15}\)

The Baltic countries have adopted somewhat different approaches, though. In 2000, Estonia introduced a tax regime that applies zero income tax on retained earnings, offering a stimulus to investment and capital accumulation. Upon distribution, the underlying profits are taxed at 21% (20% as of 2015). As already shown above, this might have helped to attract more investments and encouraged foreign companies to use reinvested earnings in their affiliates in Estonia for investments abroad. Several studies have demonstrated the positive impact of tax reform on Estonia’s economy.\(^{16}\)

On the other hand, Latvia and Lithuania have lower corporate tax rates (15%; dividends are taxed at 10% in Latvia and at 15% in Lithuania), but these apply also to reinvested earnings. In recent years, tax incentives for specific projects/industries were also adopted, particularly for R&D investments; however, these incentives are rather complex and the scope is limited, making them more accessible for large companies (see more details in our recent analysis\(^{17}\)). Offering tax incentives for specific projects could be useful for promoting growth in certain sectors, but it is crucial to design these incentives in a way that minimise rent seeking and administrative costs while targeting “right” industries.

**Outward FDI has grown as the economies mature**

Although investments abroad remain very low for Latvian and Lithuanian companies or for foreign affiliates in these countries (5-6% of GDP), outward FDI stock has grown notably over the last decade from nearly zero levels in the early 2000s. So has it grown for Estonia, to much higher levels of 26% of GDP. Given that saving levels are rather low in the Baltics and the industry structure of inward and outward FDI stock is quite similar, it is likely that a large part of investments abroad is actually done by the foreign investors who have acquired companies in the Baltics (partly or fully) – this is why investments abroad are bigger in Estonia. There is, of course, also an opportunity to borrow in the Baltics to be able to finance investments abroad; this is also sometimes used by local companies and foreign investors.

**Small, but growing outward investments...**

The main destination countries for outward investments have been close neighbours (other Baltic countries, Russia, Ukraine, Poland, and, for Estonia, Finland), as well as some countries that most likely stand out because of their tax/legal systems. For instance, Cyprus is the number-one destination for Estonian investments; Switzerland and Luxembourg are the second- and third-most-important destinations for Latvia; and the Netherlands is the number-one destination for Lithuania. Because much of the FDI to these countries involves the activities of holding companies, the importance of these countries as investment destinations is overestimated, as is the FDI from these countries. As a result, Baltic investments in the Baltic Sea region are lower than those received from there – the share of the region’s countries in the Baltic outward FDI stock ranged from 42% in Latvia and Lithuania to 52% in Estonia in 2012.

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\(^{14}\) Raudonen 2014 (available [here](#)).

\(^{15}\) Nikula, Kotilainen 2012 (available [here](#)); Raudonen 2014 (available [here](#)).

\(^{16}\) Masso et al 2011 (available [here](#)); Võrk et al 2010 (available [here](#)).

\(^{17}\) Swedbank Analysis, November 2014 (available [here](#)).
Baltic enterprises have invested abroad mostly in the financial sector. Lithuania has invested heavily in the manufacturing of refined petroleum products, as well as in a broad category of professional, scientific, and technical activities (e.g., registering head offices abroad). Investments abroad from Estonia in administrative services consist mostly of holding companies registering themselves in countries with favourable tax systems, as discussed above.

**Composition of outward FDI stock by industry in 2013**

Overall, despite growth in investments abroad, net direct investment stock is still negative for all Baltic countries, i.e., investments into our economies are greater than our investments abroad. This is rather normal for countries whose cost and productivity levels are still relatively low (e.g., with respect to the EU average). With costs continuing to rise, there will be larger incentives to move (parts of) operations to other markets, where costs are lower.

**What next?**

The Baltic countries have been relatively successful in attracting FDI, but they could do more to generate even larger volumes, as well to increase the positive spillovers associated with FDI. We see the following two main trends, going forward.

The Baltics’ FDI returns are relatively high, the institutional environment is improving, and cost levels are still lower than in many Western European countries. However, with a slower pace of convergence with the EU, returns are likely to decline. At the same time, production costs are rising and will continue to do so, while populations are aging and shrinking. These trends will reduce FDI that is based on the low cost of labour, if new investors do not come onboard or incumbent investors are exiting. At the same time, FDI abroad could be increased, if local companies or foreign investors relocate part of their operations there. For instance, there are already cases of Baltic companies in low-skilled manufacturing sectors, such as textiles, moving their operations to other lower-cost countries.

**Cost levels will continue rising gradually**

**Geopolitical risks will affect both FDI inflows and outflows**

The Baltics compete for investments also between themselves. Production costs (e.g., labour and construction costs, as well as real estate and transport prices) in Estonia are generally higher than in Latvia and Lithuania, which can put Estonia under pressure sooner than other two Baltic countries. Energy prices are trickier, as they differ depending on consumption patterns. However, for medium-volume industrial consumption, electricity prices are the lowest in Estonia, while the gas price in Latvia is the lowest.

The Russia-Ukraine conflict and increased uncertainty about geopolitical developments in the region are likely to have a mixed effect on FDI flows, both in the short and long term. On the one hand, these factors could deter FDI inflows to the Baltics, especially those (Western) investors who have used our markets as a platform to enter Russia and other CIS countries.

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*Source: Bank of Estonia, Bank of Latvia, Bank of Lithuania*

*Source: Eurostat, national statistics, Swedbank*
Implications for businesses

What does this imply for businesses in the Baltics?

Competitiveness and continuous increase in productivity is the name of the game:

1. Invest to increase efficiency – this is already being done by most (especially exporting) Baltic companies, but gains will reach their limit at some point. Going forward, the option of transferring part of a company’s operations to lower-cost countries might become increasingly attractive.

2. Invest in new product development, i.e., research and development (R&D) and innovations. The Baltic companies have already benefitted from technology transfer via FDI, but business investments in R&D remain clearly inadequate, especially in Latvia and Lithuania. Attracting a foreign investor may help to attract not only financial inflows, but also know-how.

3. Get out of the grey economy – to be able to do the two aforementioned points, companies need to get bigger. Transparent financial information is thus crucial for them to be able to get financing and/or attract foreign partners.

Implications for policymakers

What does this imply for policymakers?

The main policy suggestion is to support businesses in addressing all of the above-mentioned issues:

1. Easing the tax burden can help, but it has its limits

Reducing taxes helps to improve cost competitiveness; however, this might be a race to the bottom. The labour tax burden is gradually being eased in the Baltics, but also in, e.g., Sweden. As it seems that abolishing the corporate income tax on retained earnings attracted more FDI to Estonia, it could thus be useful to do this also in Latvia and Lithuania. This could not only help to promote investments, but would also lessen incentives for companies to hide their profits and, thus, help to reduce the grey economy, making the business environment and financial situation of businesses more transparent. The question is whether Latvia and Lithuania can afford to follow suit, since their tax revenues as a percent of GDP are already amongst the lowest in the EU.

2. Support innovations and R&D

Technological progress and innovation are much needed in the Baltics to support productivity and sustainable economic growth, and more is needed to support R&D. Baltic investment promotion agencies’ data show that Lithuania was more successful in attracting R&D projects in 2013 – 14 R&D projects were started in the Baltics, and out of these 3 in Estonia, 4 in Latvia, and 7 in Lithuania. At the same time, overall investments in R&D in Latvia and Lithuania remain way below Estonia’s (and the EU’s average), and Lithuania lags Estonia and Latvia in turning investments into patents. A substantial amount of EU structural funds has been assigned for innovations and R&D in the new planning period of 2014-2020. However, efficient allocation is crucial for these funds to support productive innovations.

3. Keep improving the overall institutional environment

According to the respondents of the EY’s survey, the most important factors for investors to consider when deciding on a location to establish operations are stability and transparency of the political, legal, and regulatory environment. As our Baltic Sea index results show, there is still much to be done in these areas (see the country chapters for more details).

4. Addressing demographic and labour market challenges

Given the diminishing labour supply in all three Baltic countries, one option to consider is the facilitation of immigration, particularly of high-skilled labour. Using immigration to fill labour and skill gaps is only a matter of time, but the Baltic countries have so far been reluctant to design adequate immigration policies. Fostering the return of emigrants is politically more feasible (but is likely not to be enough) than opening borders to immigrants from other countries. There have been attempts to do so (e.g., re-emigration plans in Latvia and Estonia), but thus far they have been too little. Given the geopolitical tensions, it might now be easier to attract high-qualified labour from Ukraine and Russia.

Lis Elmik
Lija Strašuna

18 EY 2014 (available here).
Appendix: Swedbank Baltic Sea Index

The Swedbank Baltic Sea index assesses the Baltic Sea region’s competitiveness and structural development. The region’s countries are ranked in relation to each other and the rest of the world on the basis of ten areas that are considered relevant. Each area consists of several underlying components. The list is not complete, but it should serve as a good indicator of improvement in the business climate in relation to other countries. The samples vary, but in most cases cover most countries in the world. Countries are ranked from 0 to 10 where having a rank between 9 and 10 implies that in the selected area the country belongs to the top 10% “best” performing countries in the world. A country index is an average of all ten areas. A regional index is an average of country indices. The index allows to track a country’s performance compared to others overall and also across ten selected areas against others and own past.

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I Entrepreneurship
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Source: Global Innovation Index (INSEAD (Institut Européen d’Administration des Affaires)) and Global Competitiveness Report (World Economic Forum)

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Swedbank Baltic Sea index 2014

![Swedbank Baltic Sea index 2014 chart]

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