Baltic Sea Report

Geopolitical challenges require closer collaboration

- Cooperate more to grow more
- Income inequality and poverty: is a higher minimum wage the best answer?
- Taxes in the Baltics: which way forward?

Cooperate more to grow more
Russia is in the midst of a recession, while the rest of the Baltic Sea region sees its economy expanding. The Baltic Sea index (BSI) points to somewhat closer institutional integration within the region, excluding Russia (which is drifting away), and marginal improvements in competitiveness. Yet, developments are uneven, and the region’s countries are in different stages of their business cycles, implying different political and economic policy agendas. Politicians falling behind the curve in addressing structural problems and reducing overheating risks, as well as an unprecedented refugee influx, pose risks to growth and political stability. More economic integration and policy cooperation – within the region, with the rest of the EU, and globally – is necessary to reduce these risks and boost sustainable medium-term growth. The BSI shows that progress in countries that are catching up from lower levels has slowed, and there is a lack of progress for the most advanced ones. There is something to think about and to do for everybody.

Income inequality and poverty: is a higher minimum wage the best answer?
Income inequality may be both the consequence of underdevelopment and the cause of lower growth potential, as well as the general prosperity of the society. In terms of income inequality and poverty, the three Baltic countries are at the lower end of the EU. There has been remarkable progress since the EU accession, but much is still to be done. Most recently, governments have responded by vigorously increasing minimum wages. This can raise incomes of the poor and shrink the grey economy by legalising part of the wage income. But if pushed too far, it destroys lower-skilled jobs and dents a country’s competitiveness. There are other policy choices available. One is raising the nontaxable threshold for low earners. The government revenue losses would be tangible, but not unmanageable. But the key policy option is to strive to improve the quality and accessibility of education. To create competitive economies and prosperous societies, governments’ task should be to ensure the equality of opportunity, not the equality of outcome.

Taxes in the Baltics: which way forward?
New budget deficit rules, a moderate growth environment, calls for more public spending, and a willingness to safeguard labour cost competitiveness will force the governments to improve their tax systems. Taxes should be viewed as a system that should be neutral and fair. Simple tax systems are preferred to complex ones, e.g., multiple exemptions make taxes less transparent, difficult to enforce, and easier to evade. To start with, all three countries need to clamp down on tax evasion, and here it seems that Latvia and Lithuania have more ground to cover. But it is not only administrative and criminal measures that should be used to reduce tax evasion. For example, the taxation of residential real estate is impossible to evade (i.e., property cannot be hidden), it is progressive (i.e., more affluent individuals tend to have more expensive real estate), and it has no direct negative impact on business costs and competitiveness. Raised revenues from such sources could be used not only to reduce tax evasion but also to shift tax burden away from labour to other tax bases that does less harm to economic growth.
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: cooperate more to grow more

Russia is in the midst of a recession, while the rest of the Baltic Sea region sees its economy expanding. The Baltic Sea index points to somewhat closer institutional integration within the region, excluding Russia (which is drifting away), and marginal improvements in competitiveness. Yet, developments are uneven, and the region’s countries are in different stages of their business cycles, implying different political and economic policy agendas. More economic integration and policy cooperation – within the region, with the rest of the EU, and globally – is necessary to reduce risks to political stability and boost sustainable medium-term growth.

Global environment: improving, but still patchy, with many political risks

Global growth remains patchy, and developments vary across the globe. Economic growth in the US remains quite firm and unemployment is declining. Although inflation pressures remain muted (with a still-negative output gap), we believe that the Federal Reserve (Fed) will raise its policy rate at the December meeting for the first time since 2006. The euro area (and Europe overall) is lagging behind, but also slowly improving – in the second quarter of 2015, no country in the European Economic Area was in recession vs. five of them a year ago. Yet, with growth still weak, unemployment high, inflation and inflationary expectations low, the European Central Bank is likely to deliver more monetary stimulus this December, via a lower deposit facility rate and/or more asset purchases. Norges Bank and Riksbank are expected to continue with expansionary monetary policies. The Polish central bank lowered its interest rates earlier this year. As a result, interest rates in Europe will remain very low for many years to come. Only the Russian central bank hiked sharply its interest rate in late 2014 to stabilise the falling rouble, and, although it has since cut down its policy rate, this rate still remains much above its level before the oil price shock.

The year 2015 has marked a change in the drivers of global growth – growth in advanced economies, although still patchy, has started to broaden, whereas emerging markets that were by far the major drivers of growth in recent years are stumbling now. The stronger US dollar and probability of a Fed hike has created headwinds for many emerging markets, where debt levels had risen. China is slowing, trying to restructure its economy more towards consumption and service sectors and gradually liberalising its financial markets. It was expected, widely discussed, and is finally happening. Of course, such shifts bring uncertainty and increased volatility in financial markets. But we see it positively – such an overhaul is impossible without mistakes, and it is better to err and learn when the global financial market repercussions from China are still relatively small. Just like it is better to have chicken pox while a youngster rather than an adult.

If we look back one year, there have been two game changers since then that undoubtedly have influenced the Baltic Sea region and will keep doing so. First, substantially cheaper commodities, especially oil. When writing our Baltic Sea Report 2014 in late November last year, Brent oil had already been down to about USD 70 (from about USD 110 that summer), but now it is trading at about USD 45 per barrel. Part of the story is increased supply through US shale oil, unwillingness of OPEC to cut their supply, and Iran supply possibly coming back to the market. But part of the story is slowing China, as it is one of the largest commodity consumers in the world. As a baseline scenario, we anticipate oil prices to recover gradually to about USD 60-65 per barrel in 2017, but there is certainly a high degree of uncertainty to this forecast, and the risks are seen to be tilted downwards. Second, the worsening geopolitical situation in the Middle East and the resulting refugee crisis in Europe. The latter can boost growth but also brings fiscal costs and political risks, not only for national governments, but also to the EU as a whole.1 Overall, we forecast global growth to pick up from 3.1% in 2015 to 3.6% in 2016 and 3.8% in 2017.2 For the Baltic Sea region, a net exporter, this opens opportunities for maintained growth through exports. Yet, external environment remains uneven, and risks are skewed to the negative side.

The Baltic Sea region: rather robust growth, but Russia drifts away

In 2015, the region’s economy is doing worse than we had forecast a year ago. Instead of its GDP expanding by 0.9% it is set to shrink by 0.5%. But this forecast error is largely due to the Russian recession, as the rest of the region keeps growing. Cheaper oil has boosted the purchasing power of consumers across Europe, but hit oil exporters – most notably, Russia. A massive oil price fall led to a drastic depreciation of the rouble and aggravated Russia’s

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1 See our Swedbank Macro Focus, November 2015, for more details here.
2 See our Swedbank Economic Outlook, November 2015, for more details here.
... but rather good growth in the rest of the region

cyclical and structural problems, already made worse earlier by international sanctions in response to Russia’s annexing Crimea and its alleged incursion into East Ukraine.

If we exclude Russia, we forecast the region’s nine remaining economies to expand altogether by 2% this year, which is a tad swifter than in 2014 (1.9%) and also faster than we had forecast a year ago (1.8%). This is mostly owing to stronger-than-expected growth in Poland and Sweden (also benefitting from a weaker currency), and to a lesser extent in Germany and Denmark. Norway’s growth has been undermined by the fall in oil prices globally, but so far it has held on quite well. The performance of the Baltic countries and Finland has been weaker than expected, much due to weaker exports to Russia. The Baltics have seen their goods exports to Russia sink by 20-40% this year, but they have been surprisingly agile in finding other markets. Much of their export growth has been to the rest of the EU, showing their increasingly closer integration into the European economy and growing separation from Russia.

We expect the Baltic Sea region overall to return to growth over the coming two years as Russia emerges from recession. Excluding Russia, growth is forecast to level off at 2.1%, which would be a tad higher than the 1.8-1.9% growth forecast for the euro area.

### Economic growth in the Baltic Sea region, %

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<tbody>
<tr>
<td>Denmark</td>
<td>0.5</td>
<td>1.1</td>
<td>1.9</td>
<td>(1.7)</td>
<td>2.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.4</td>
<td>2.9</td>
<td>1.6</td>
<td>(2.5)</td>
<td>2.6</td>
</tr>
<tr>
<td>Finland</td>
<td>1.2</td>
<td>-0.4</td>
<td>0.1</td>
<td>(0.4)</td>
<td>0.5</td>
</tr>
<tr>
<td>Germany</td>
<td>1.1</td>
<td>1.6</td>
<td>1.6</td>
<td>(1.5)</td>
<td>1.8</td>
</tr>
<tr>
<td>Latvia</td>
<td>3.8</td>
<td>2.4</td>
<td>2.4</td>
<td>(2.6)</td>
<td>3.3</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4.2</td>
<td>3.0</td>
<td>1.8</td>
<td>(3.3)</td>
<td>3.3</td>
</tr>
<tr>
<td>Norway</td>
<td>1.5</td>
<td>2.2</td>
<td>1.1</td>
<td>(1.5)</td>
<td>1.1</td>
</tr>
<tr>
<td>Poland</td>
<td>4.0</td>
<td>3.3</td>
<td>3.5</td>
<td>(2.8)</td>
<td>3.5</td>
</tr>
<tr>
<td>Russia</td>
<td>4.4</td>
<td>0.6</td>
<td>-4.5</td>
<td>(-0.6)</td>
<td>-2.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.0</td>
<td>2.3</td>
<td>3.2</td>
<td>(2.4)</td>
<td>3.3</td>
</tr>
<tr>
<td>Baltic Sea region (PPP weights)</td>
<td>2.5</td>
<td>1.4</td>
<td>-0.5</td>
<td>(0.9)</td>
<td>0.6</td>
</tr>
<tr>
<td>Baltic Sea region, excluding Russia</td>
<td>1.6</td>
<td>1.9</td>
<td>2.0</td>
<td>(1.8)</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: World Bank, Swedbank forecasts (Swedbank Economic Outlook, November 2015; November 2014 forecasts in parenthesis)

The region’s countries are in very different stages of their business cycles, e.g., recession in Russia, slowing in Norway, stagnation in Finland, but quite speedy in Sweden and Denmark. The unemployment rate is at its lowest levels in Germany and seems to be set to keep falling. In Finland and Norway, unemployment is on the rise, although from very different levels and for different reasons. Finland has a large negative output gap, while Germany seems will soon start developing a positive one. Industry developments vary a lot, e.g., the construction boom in Norway has retreated, while one is starting to build up in Sweden. Overall, these opposing developments not only create opportunities for businesses, but also imply different political and economic policy agendas.

Swedbank’s four home markets are facing different challenges. Growth in the three Baltic countries has slowed, partly due to geopolitical risks and recession in Russia. At the same time, the diminishing labour supply (negative demographics and net migration) and falling unemployment rates are pushing up wages, while productivity growth is very slow, partly because of too-cautious investments. With external demand improving, investment and credit cycles turning, and robust wage growth continuing to support household spending, GDP growth in the Baltics is expected to flatten out at about 3% per annum in 2016-2017. This seems to be about their potential speed of growth, which is much lower than before. To push up growth and speed up convergence with more affluent EU countries, productivity will need to rise significantly faster than that. Faster productivity growth will also be crucial to address the risk of wage growth continuously outpacing that of productivity and so putting competitiveness at risk. We have warned of these risks to competitiveness many times before. The latest data on export shares show that such risks are already here – after a brisk expansion during 2010-2013, the Baltics now see their export shares in the EU stagnating, while those of their competitors from, e.g., Poland are growing. Boosting productivity is certainly easier said than done, it will be an uphill struggle. On the other hand, growth in Sweden has picked up, owing to strong domestic demand, not least because of the expansionary monetary policy and growing construction sector. But expansionary policy at a time when the economy is booming may bring risks – high household indebtedness, for one. An unprecedented influx of asylum seekers is expected to boost Swedish GDP growth even more, depending on how successfully Sweden integrates refugees in the labour market.
Political implications of a fragile economy

The economy and politics are highly interlinked – a fragile and patchy economy creates risks of political weakness, as it puts the well-being of voters at risk. Political weakness can further weaken the economy, both through hindering consumer and business confidence and making it difficult for policymakers to take necessary but unpopular decisions. When economies are weak for a lengthy spell, populist parties may come to power (e.g., the Greek endeavour earlier this year). Such newcomers can often have radical and nationalistic views. They tend to be inward looking and protectionist, which makes the economy weaker and runs the risk of a vicious circle of an ever-weaker economy and more political instability. When the economy is strong, such risks of negative vicious circles are much smaller.

Last year, Russian geopolitical risks and their impact on the Baltic Sea region were high on the agenda. Now, we have seen that our economies have dealt with them quite well. But the past year has also clearly demonstrated that key risks are coming not from Russia or elsewhere but from economically weak and politically fragmented Europe itself. This is very clear from the perspective of the Baltics: (i) a weak EU economy means weak export growth and, thus, weak economic growth; and (ii) being busy with internal politics, European countries tend to think locally and have little time to address common problems, which weakens the overall European economy. The top challenge for European political and economic unity currently is the influx of refugees. There are security risks. The influx also lead to more radical (right) anti-EU parties gaining popularity. Protectionist and nationalistic policies (e.g., rebuilding borders within the EU) would inevitably deter growth.

How to break this vicious circle? We believe it is through closer economic integration, not only within the Baltic Sea region (excluding Russia, which will remain an outlier at least for the near future) and Europe at large, but also globally. There are at least two initiatives, long overdue, which could well boost integration and growth – the EU Services directive and the Transatlantic Trade and Investment Partnership. The more economically integrated and politically united Europe is, the easier it will be to cope with challenges like refugee inflows. Greater integration for EU states certainly implies also increased dependence on each other and larger risks of negative cross-border spillovers. But structural solutions are possible (and are already being implemented), e.g., the EU banking Union, to minimise banking risks.

Of course, cheap money injected by the central banks will support economic activity in the Baltic Sea region. The credit cycle in the euro area seems to be taking off, and business investments have been growing. Yet, expansionary monetary policy is only a necessary but not a sufficient condition to boost productivity growth and competitiveness. Reforms in labour, products, and financial markets are needed. But policymakers have been falling behind the curve in addressing both business cycle problems – how to reduce overheating risks – and structural problems – how to boost long-term growth potential.

Baltic Sea index: institutional qualities are improving, but still much to do

Since 2010, we have been publishing an index assessing the Baltic Sea region’s structural competitiveness and institutional development (BSI). The region’s countries are ranked in relation to each other and the rest of the world. Ten areas with several underlying components are used as a basis for the overall index, which 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% in performance of all 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 2015 are often based on changes implemented in 2014 or even 2013.

In summary, the region’s structural qualities as gauged by the BSI have improved somewhat from last year’s reading (from 7.5 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. For instance, the BSI for the EU28 and the US have not changed since last year. However, improvements in the Baltic Sea region were only in three areas: (i) tax policy, especially in Poland; (ii) financial markets, especially in Lithuania and Denmark, due to sounder banks and better availability of alternative sources of financing; and (iii) governance, especially in the Baltics, due to better rule of law and smaller corruption risks. Other indices remained flat, compared with a year ago. The region

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1 For foreign trade and logistics subindices, data are updated biannually; thus this year the same ranking as last year is attributed to them.
overall ranks above the EU (7.1), but largely owing to four areas only: financial markets, labour markets, tax policy, and entrepreneurship. At the same time, the region ranks below the US (8.4), especially in financial markets, innovation climate, and infrastructure.

Similarly to last year, most of the improvement comes from those countries that rank below the regional average and have more to catch up. But improvement did not come from all of them. There were improvements in Estonia, Lithuania, and Poland, but the BSI inched down in Latvia and was flat in Russia. The Nordics and Germany retained their earlier rankings.

The region’s strength remains in education, logistics, and governance, where it ranks in the top 20% in the world. The key areas to improve (as before) are foreign trade, tax policy, and financial market diversity. The key weakness comes from the region’s uneven structural quality; however, in many cases this is because Russia is an outlier (e.g., see the massive spreads for the subindices of foreign trade and governance in the chart above). We already warned in our Baltic Sea Report 2014 that integration with Russia and the rest of the region is set to decrease, following the annexation of Crimea and the new geopolitical landscape. Even if in some of the BSI areas Russia’s rankings have improved (tax policy and infrastructure) and some scores are not far away from the region average (entrepreneurship and tax policy), political risks override many of the gains. Russia clearly demonstrates that it has different values, but different values mean a different business environment and different risks. Our index fails to capture such political differences. Russia looks good on paper, but not in real business life. For the rest of the region to minimise a negative impact from Russia and improve its own global competitiveness, the best policy is to integrate closer among themselves, and especially to bring up those countries that are lowest ranked and to become more open by searching globally for other export markets.

And this is happening, both in trade flows (e.g., the double-digit fall in exports to Russia in the Baltics has been replaced by growth in other markets) and structurally. The average spread for the region, excluding Russia, has decreased from 3.3 points last year to 3.1 in the BSI subindices in 2015. These countries are becoming more similar. Yet there is more to do, and the going now gets tougher. Progress in countries that are catching up with the average has slowed, and there is a lack of progress for the most advanced economies. There is something to think about and to do for everybody.

Mārtiņš Kazāks
Lija Strašuna
Sweden: Growth boost from migration

We estimate a significant short-term growth boost from the large refugee inflows, but the medium-term effects will depend on the political capacity to implement difficult reforms. Growth will increase by approximately ½ percentage point per year in 2016 and 2017, and unemployment will drop by 1 percentage point due only to migration. However, if the employment levels among the foreign-born do not improve, unemployment will rise fast, and growth, in particular in per capita terms, will stagnate. Our Baltic Sea index shows only minor changes, and Sweden remains one of the top performers in the region.

<table>
<thead>
<tr>
<th>Economic indicator</th>
<th>2003-2013</th>
<th>2014</th>
<th>2015f</th>
<th>2016f</th>
<th>2017f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>2.0</td>
<td>2.5</td>
<td>3.2</td>
<td>3.3</td>
<td>3.6</td>
</tr>
<tr>
<td>Consumer price growth, %</td>
<td>1.3</td>
<td>-0.2</td>
<td>0</td>
<td>1.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>7.4</td>
<td>7.9</td>
<td>7.3</td>
<td>6.5</td>
<td>6.4</td>
</tr>
<tr>
<td>Gross nominal wage growth, %</td>
<td>2.1</td>
<td>2.9</td>
<td>2.5</td>
<td>3.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>7.1</td>
<td>6</td>
<td>6.1</td>
<td>5.6</td>
<td>5.3</td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>0.5</td>
<td>-1.7</td>
<td>-1.1</td>
<td>-1.3</td>
<td>-1.4</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden, Swedbank

Long-term effects from migration depend on reform capacity

Sweden finds itself in an exceptional situation. The refugee crisis in Syria has led to the largest immigration wave to Sweden in modern times. Related fiscal spending could boost Swedish GDP by between ½ and ½ percentage point in 2016 and 2017, and unemployment will drop much faster than it otherwise would have. This, in turn, is expected to worsen the mismatch in the labour market and could increase the wage drift. Public finances will come under greater pressure, and the government’s net borrowing requirement is expected to increase further, while the strains on the municipality finances will increase. For monetary policy, the growth spurt is welcome. Inflation will get nudged higher, and the Riksbank may have to change direction as soon as next year.

In the medium term, the impact on the Swedish economy is much more uncertain. The integration of the new arrivals and non-natives in general, and in particular into the labour market, will be critical to the long-term impact on the Swedish economy. Two stylised scenarios can be painted. In a negative scenario, the employment level for foreign-borns remains at today’s low level, and the average time to get a job remains at seven-eight years. Integration costs will increase, while unemployment rises as the new arrivals begin to seek jobs and thus join the labour force. Growth, in this scenario, slows in 2018-2020. Social and political tension would also increase, with unknown negative effects on the economy. In a positive scenario, meanwhile, reforms would improve the integration of the newcomers into the labour market. If employment rates among the foreign-born can be raised towards the same levels as native-borns, a positive scenario could become a reality, with beneficial impacts on growth and public finances.

It’s worth noting that the people coming to Sweden seeking asylum are relatively young. Data from 2014 indicate a mean age of about 25 for new arrivals, compared with 40-45 years for natives. The current wave of refugees is presumably also relatively young. This is an opportunity to remedy the worsening demographic developments with an increasing dependency ratio and could give the Swedish economy a big and lasting boost. Whether this potential can be tapped and benefit the economy and public finances in the form of jobs, growth, and increased tax revenue depends on the extent to which, and how quickly, the refugees are integrated into the labour market and find jobs. One challenge is the varying level of skills and education of the recent arrivals. Employment rates among those with less than a highschool education, compared with those with a higher education.

Expansionary economic policy despite a booming economy

Despite the expected expansionary shift in fiscal policy, the Swedish central bank, the Riksbank, is not likely to revise its monetary policy trajectory in the short term. The Riksbank has announced additional bond buying for an equivalent of SEK 65 billion, which means that the Riksbank this summer will hold about 35% of the outstanding stock. Depending on action by the European Central Bank, there is also a possibility that the policy rate will be lowered further, although that is not in our main scenario. However, should the Swedish...
krona strengthen substantially, we do expect the Riksbank to act in order to protect the inflation expectations.

Growth in the Swedish economy has come in recent years to rely to an increasing extent not only on strong household finances, but also on growing household indebtedness. Lower taxes and interest costs, in combination with solid growth in job creation, have boosted household consumption. At the same time, years of underinvestment in housing, together with low financing costs, have led to a strong pickup in prices for housing, in particular in the larger cities and in university towns, and subsequently to rising household indebtedness. Thus, imbalances and vulnerabilities are increasing, and macroprudential policies to contain these risks will be in focus in the next years’ economic policy debates. We expect measures to be implemented relating to mandatory amortisation of mortgage loans, limits on loans-to-income ratios, and possibly a phaseout of interest rate deductions.

As a consequence of the stronger household sector, the Swedish economy has since the financial crisis gone through a structural transformation in which the services sector has been growing in importance, while manufacturing has been declining. Export performance has deteriorated, and productivity has slowed, but Sweden does not in these respects stand out among its peers. Sweden’s performance is rather a consequence of the structure of its export industry’s heavy reliance on investment goods and on product related to mining; sectors that have been slow to regain speed in the global economy. Instead, a diversification of the economy towards the services lesson the dependence on exports and creates opportunities for a more diversified labour market, where both low- and high-skilled service sectors jobs have increased in recent years.

However, further labour market reforms will be high on the reform agenda, despite the relatively good performance in recent years. On the one hand, signs of shortages in specific sectors have become more ominous, with, in particular, the construction sector having difficulties in recruiting qualified labour. On the other hand, low-skilled labour, not least young people and recently arrived immigrants with no advance degree, are experiencing difficulties in finding jobs. Thus, the Swedish Beveridge curve has been shifting out in recent years. The challenges will be mounting over the medium term next, when the recently arrived refugees enter the labour force.

Effects on the Swedish economy of the refugee influx

<table>
<thead>
<tr>
<th>2016</th>
<th>2017</th>
</tr>
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<tbody>
<tr>
<td>Household Consumption</td>
<td>0.4</td>
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<tr>
<td>Government Consumption</td>
<td>0.4</td>
</tr>
<tr>
<td>Housing investments</td>
<td>0.05</td>
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<tr>
<td>Public investments</td>
<td>0.03</td>
</tr>
<tr>
<td>Imports (deduction)</td>
<td>-0.2</td>
</tr>
<tr>
<td>GDP</td>
<td>0.7</td>
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<tr>
<td>Employment level</td>
<td>35000</td>
</tr>
<tr>
<td>Unemployment</td>
<td>-1.1</td>
</tr>
<tr>
<td>Wages</td>
<td>0.2</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.2</td>
</tr>
<tr>
<td>General Government Budget Balance (% of GDP)</td>
<td>-0.6</td>
</tr>
<tr>
<td>Repo rate (bp)</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: Swedbank
Note: Net contribution to GDP

Sweden: Still top-ranked...

...but lags in tax policy and...

...entrepreneurship

Baltic Sea index – lost reform momentum needs urgently to be regained

Swedish growth

Households drive Swedish growth

Services grow in importance, manufacturing declines

Labour market reforms are key

Spending on migration and integration, SEK bn

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</thead>
<tbody>
<tr>
<td>Migration(Oct)</td>
<td>40</td>
<td>45</td>
<td>40</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
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<tr>
<td>Migration(July)</td>
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<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
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<td>10</td>
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<tr>
<td>Integration(Oct)</td>
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<td>45</td>
<td>40</td>
<td>35</td>
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<td>25</td>
<td>20</td>
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</tr>
<tr>
<td>Total(Oct)</td>
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<td>Total(Oct)</td>
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<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Swedish Migration Agency

Tax policy is the subindex with the largest improvement potential for Sweden. It’s primarily the taxation of small businesses that explains Sweden’s relatively unfavourable position. According to World Bank’s Doing Business, total taxation of medium-sized firms was 49.4% in 2015, which is significantly higher than average of 41.5% for the Baltic Sea region.

Another challenge is to improve in the area of entrepreneurship, in which Sweden has one of its lowest-ranking scores. Despite a small improvement, from 7.7 to 7.9, Sweden is still lagging behind Norway and Denmark, which have the highest rankings in the region, along with Lithuania. Many fear that the government reduction of tax subsidies for renovation and for household services in 2016 will dampen the creation of new companies and new jobs in the household services sector.
The discussion about the infrastructure has intensified after a long period of relative quiet, with several problems surfacing with the train traffic, partly due to lack of maintenance. Overall, the infrastructure ranking is still high compared with other countries, with a subindex of 9.0 that is unchanged from last year. Going forward, the growing urbanisation and investments in housing will increase the pressure to improve and increase investments in infrastructure.

The index for the labour market has picked up to 8.8 this year from 8.7 in 2014, the second-highest ranking in the Baltic Sea region. A higher labour force participation rate is the main driver of the improvement. Several structural reforms have been implemented in the Swedish economy during the latest decade to stimulate a higher participation rate and to raise the employment ratio. In particular, reductions in social benefits and lower income taxes introduced by the former right-wing government had a positive impact on the participation rate. The implemented labour market reforms focusing on reducing the thresholds and encouraging labour market participation through, inter alia, in-work tax credits, entry-level jobs, tax rebates for jobs related to the household services sector, and the halving of the restaurant value-added tax also had a positive impact on the foreign-born participation rate.

The big challenge going forward is the large immigration wave, which is now expected to amount to approximately 520,000 people during the years 2015-2019. This is about 200,000 more than the forecast in the summer. Reforms need to be carried out in terms of both a more flexible wage formation and more investments in education of the immigrants, primarily in the Swedish language, but also in “bridge” education to adapt current qualifications to Swedish standards.

The rapid population growth will also have a significant impact on the housing market. For the foreseeable future, residential construction will not reach the levels necessary to meet the population increase. On a yearly basis, 75,000 housing starts are needed by 2020, according to the National Board of Housing. This is far above the actual numbers that we have today—approximately 35,000. Swedbank foresees a substantial growth contribution from investment in housing in the coming years, but this will be limited due to capacity constraints, such as lack of labour and regulations. Well-coordinated steps to gradually increase land supply and strengthen the incentives to invest in residential construction, e.g., making additional reforms in the rental market, simplifying building regulations, and stiffening competition in the construction sector, would help ease supply-side restrictions.

The subindex for education is still on a high level at 9.2, a slight pickup from last year, but worryingly, the trend is downward. Since 2010, Sweden’s index has dropped the most of the Baltic Sea countries, and during the last year Sweden was ranked as number four. According to the OECD’s PISA (Programme for International Student Assessment) surveys, Sweden’s scores continue 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.

Uncertainty about labour supply and the education system could also worsen the climate for innovation. The ranking for expenditures for R&D in Sweden has gradually decreased since 2010; this also affects the quality in scientific research institutions. At the same time, Sweden is very dependent on multinational firms, which accounts for a majority of the investments in R&D.

Sweden: Swedbank Baltic Sea index 2015

From left to right, (t-4) to latest available (t) – Region average (t)
Source: Swedbank

Jörgen Kennemar
Magnus Alvesson

Swedbank
Estonia: where’s a pit stop?

Estonia’s economic growth will remain below potential, as export demand stays relatively weak and consumption’s growth slows. Estonia’s business environment improved slightly for the third consecutive year in 2015, but more efforts are needed to increase competitiveness and productivity levels.

### Economic indicator

<table>
<thead>
<tr>
<th>Economic indicator</th>
<th>2003-2013</th>
<th>2014</th>
<th>2015f</th>
<th>2016f</th>
<th>2017f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>3.4</td>
<td>2.9</td>
<td>1.6</td>
<td>2.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Consumer price growth, %</td>
<td>-0.4</td>
<td>-0.1</td>
<td>1.6</td>
<td>1.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>9.6</td>
<td>7.4</td>
<td>6.6</td>
<td>6.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Real net monthly wage growth, %</td>
<td>-4.6</td>
<td>5.7</td>
<td>7.4</td>
<td>4.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>-6.3</td>
<td>3.1</td>
<td>5.6</td>
<td>2.8</td>
<td>0.9</td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>0.6</td>
<td>0.7</td>
<td>0.3</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
</tbody>
</table>


### Employment’s contribution to growth largely exhausted

Economic growth has been slower than expected in 2015, mostly due to smaller export volumes. In 2016-2017, economic growth is expected to accelerate gradually on the back of improving external demand. Nevertheless, Estonia’s economic growth rate will remain below potential and below the growth rates registered before the last economic and financial crisis. One of the reasons behind the lower growth is the fragile recovery of Estonia’s export markets. The economic crisis in Russia will continue next year, and the Finnish economy will face a weak recovery. Another reason is the lower-than-expected commodity prices (oil, metals, food); although these are a net positive for the whole economy, they depress production and investment volumes in certain sectors, i.e., agriculture, manufacturing and energy.

The main risk to the balanced, sustainable growth of Estonia’s economy stems from the high growth of wages, which have increased more than the general macroeconomic development of the economy would have suggested. Finding suitable labour is increasingly difficult for Estonian employers; therefore, wage pressures persist even as enterprises’ sales and profits have decreased. The labour shortage was perceived as the biggest business constraint by 18% of service, 17% of construction, and 14% of manufacturing companies surveyed in October 2015 by the Estonian Institute of Economic Research.

The working-age population is also shrinking fast – by around 9,000 persons, or 0.9% a year. This is adding pressure on the labour market and public finances. According to Statistics Estonia, Estonia’s population will have declined by another 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. With the legislation currently in effect, the retirement age is being gradually raised to 65 years by 2026.

As Estonia’s rate of natural population increase is negative and emigration exceeds immigration, current living standards can be sustained by either facilitating immigration or lifting productivity. The immigration restrictions for high-skilled labour are gradually being eased, although the inflow of foreigners faces strong resistance in some parts of the society, especially after the recent terror attacks in Paris.

Tensions on the labour market might ease a bit next year, though. Employment is expected to fall. A few export-related sectors have been struggling with low demand and output prices (agriculture, energy, and certain sectors of manufacturing). Also, a state reform will free up some labour in the public sector. The reorganisation of the social benefits system for the disabled will force around 40,000 persons to enter the labour market in the coming years.

In Estonia, economic growth has been driven by domestic demand, especially private consumption, for the past three years. As we expect the real growth of net wages to decelerate and employment to decline in 2016-2017, the growth of private consumption should slow in the coming two years. Therefore, if exports and investment do not take over the supporting role, economic growth will slow considerably.

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1 Estonia’s potential growth rate is estimated at around 3%. The current negative output gap, when actual output is less than what an economy could produce when it is most efficient – that is, at full capacity, is expected to close in a few years’ time. A negative gap means that there is spare capacity, or slack, in the economy due to weak demand.

2 Insufficient demand remained the most important business constraint for 48% of service sector’s companies, 64% of construction, and 60% of manufacturing enterprises.
More investment is needed to lift productivity
Economic growth could be based on either more labour, more capital, or higher productivity. Since the last economic and financial crisis in 2008-2009, Estonia’s economic growth has largely relied on higher employment. Between 2011 and 2015, the number of employed grew by 36,000 persons. This has been a result of lower unemployment, from one side, and a higher participation rate, on the other. However, as employment is expected to fall in 2016 and 2017, the contribution from accrued labour will disappear. Therefore, economic growth needs to rely more on growing investment volumes, which would not only lift the amount of capital in the economy but also increase productivity.

Enterprises’ investment volumes decreased in 2014 and will also fall in 2015, according to our forecast. The business sector’s investment volumes are affected by the completion of one big energy project, Auvere power plant, which is expected to start operating in the first quarter of 2016. The total cost of the plant is EUR 640 million. If one excludes the energy sector, business sector investments would have grown in 2014. Smaller investment volumes in electricity production will also drag down enterprises’ investment volumes in 2015. Investment volumes are expected to start rising again in 2016-2017, when foreign demand will pick up and current idle production capacity will diminish.

Investments in technology are needed, as Estonia’s catching up with the EU’s average productivity levels has slowed in recent years. In 2014, Estonia’s labour productivity amounted to only 63% of the EU28 average, based on purchasing power standard (PPS) per hours worked. Estonia lagged behind most of the countries in the EU, excluding Bulgaria, Romania, Latvia, and Poland.

Elections did not change the main economic policy agenda
The March 2015 parliamentary elections were won relatively narrowly by the liberal Reform Party, which got 30 seats out of the 101 places available in the parliament. The main opposition party, which has been in the opposition for the past 15 years, the centrist Centre Party, got around the same amount of seats (27 seats) as in the 2011 parliamentary elections. The Centre Party’s support numbers have been relatively stable in recent years and unaffected by the long sickness leave of its leader, the mayor of the capital city, Mr Savisaar, or by the current corruption investigation, as a result of which the court has temporarily shelved him.

The Reform Party and its two previous coalition partners, the national-conservative Pro Patria and Res Publica Union and the Social Democrats, received fewer votes than in the 2011 election. The voters expressed their dissatisfaction by shifting votes to two recently formed parties. As a result, the two new parties got 15 places in the parliament in total. One of the new parties is the conservative Estonian Free Party, founded in 2014; the other is the national-conservative Conservative People’s Party, founded in 2012.

After the elections, the Reform Party formed a coalition with its ex-coalition partners, the Social Democrats and the national-conservative Pro Patria and Res Publica Union. The coalition has 59 seats in the parliament in total. The long-debated coalition agreement set the goals for the next four years. These goals represent a shift a bit to the left from the usual liberal economic policies. The coalition agreement promised more social transfers to children and lower-income-households and marginally lower labour taxes, financed by substantially higher excise taxes. The coalition is currently supported by less than 50% of the voters, if elections were held tomorrow (by 49%, according to the September TNS Emor’s poll, or by 38%, according to the November poll by Turu-uuringute AS).
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 third consecutive year in 2015. Estonia’s index remains at the Baltic Sea region’s 10-country average. Estonia ranks below Norway (which has the highest score), Sweden, Finland, Denmark, and Germany, but above the EU28 average, Latvia, Lithuania, Poland, and Russia (which has the lowest score).

Estonia’s business environment improved marginally from the previous year, by 0.1 point, to 7.7 points in 2015. Out of the ten areas we consider most important for business, five domains improved. The biggest achievements were recorded in the areas of financial markets, governance, innovation climate, and infrastructure. The financial markets indicator climbed because the soundness of banks and the regulation of financial markets improved (according to the World Economic Forum’s executive opinion survey).

Governance received higher scores because of improved corruption ratings and better rule of law. Due to all the ongoing corruption investigations in Estonia (of the port, railway, and the capital city government), corruption could be more widespread than many anticipated during the compilation of these indices in 2014. The innovation climate progressed in Estonia as the availability of scientists and engineers and the quality of scientific research institutions improved. Infrastructure ratings rose because the quality of roads and railroad infrastructure improved, available airline seat kilometres increased, and the electricity and telephony infrastructure was strengthened.

Estonia is ranked high globally in the areas of education, governance, and innovation climate. Good scores have been received globally in the areas of secondary and tertiary education enrolment, and quality and quantity of education. Governance has received a high rating in Estonia because of its strong, transparent, and efficient institutions and low corruption levels. In the area of innovation, Estonia has made a strong commitment to advance its technological readiness.

Logistics remains the main business bottleneck in the country, according to our index. Assessment of the logistics sector is based on the World Bank’s logistics performance indicator, which, in turn, relies on a worldwide survey of logistics operators (global freight forwarders and express carriers), providing feedback on the logistics “friendliness” of the countries in which they operate and those with which they trade. According to the survey, Estonia has room to improve in the following areas: timeliness of shipments; the ability to track and trace consignments; the competence and quality of logistics services (e.g., transport operators and customs brokers); and the ease of arranging competitively priced shipments. However, one needs to remember that the regional average in this area is the best in the world. According to the World Bank’s index, in 2014, Germany was ranked as the best in the world, Sweden as the 6th, and Norway as the 7th.

The entrepreneurship climate could also be improved. Swedbank’s entrepreneurship subindex is based on the Doing Business report, in which Estonia received relatively low scores in the categories of the strength of minority investor protection and the recovery rate. According to the World Bank’s Doing Business questionnaire for corporate and securities lawyers, in Estonia, shareholders are less protected from undue board control and entrenchment, and minority shareholders are less able to sue and hold interested directors liable for damage. As to the second category, according to another World Bank questionnaire for local insolvency practitioners, the recovery rate by secured creditors through reorganisation, liquidation, or debt enforcement proceedings is relatively low in Estonia.

Estonia: Swedbank Baltic Sea index 2015

<table>
<thead>
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<th>Area</th>
<th>Latest available (t)</th>
<th>Region average (t)</th>
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<tr>
<td>Baltic Sea Index</td>
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<tr>
<td>Entrepreneurship</td>
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<td>Infrastructure</td>
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<td>Logistics</td>
<td></td>
<td></td>
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<tr>
<td>Innovation climate</td>
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</tr>
</tbody>
</table>

Source: Swedbank

Notes:
1 Latest update from 2014.
Latvia: policymakers, move on

Latvian GDP growth is close to its potential pace of about 3%, which is slower than before. Yet, it seems quite likely that growth might temporarily exceed the potential, with the credit and investment cycles picking up and labour market continuing to heat up. To enhance potential growth and reduce possible overheating risks, productivity should be boosted, but policymakers are behind the curve; this can also be seen in the disappointing developments in our Baltic Sea index.

### Economic indicator
<table>
<thead>
<tr>
<th>Economic indicator</th>
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<th>2014</th>
<th>2015f</th>
<th>2016f</th>
<th>2017f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
<td>3.8</td>
<td>2.4</td>
<td>2.4</td>
<td>3.3</td>
<td>3.0</td>
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<tr>
<td>Consumer price growth, %</td>
<td>5.2</td>
<td>0.6</td>
<td>0.3</td>
<td>1.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>11.7</td>
<td>10.8</td>
<td>9.9</td>
<td>9.2</td>
<td>8.3</td>
</tr>
<tr>
<td>Gross nominal wage growth, %</td>
<td>10.8</td>
<td>7.9</td>
<td>6.7</td>
<td>4.1</td>
<td>3.6</td>
</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>-7.6</td>
<td>-2.0</td>
<td>-1.4</td>
<td>-2.7</td>
<td>-4.1</td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>-2.8</td>
<td>-1.6</td>
<td>-1.6</td>
<td>-1.2</td>
<td>-0.9</td>
</tr>
</tbody>
</table>

Source: Eurostat, CSBL, Swedbank

### Moving towards the next phase of the business cycle

Looking back one year ago, when we published Baltic Sea Report 2014, very little has changed in our storyline. Latvia’s growth has slowed, largely in line with our forecasts a year ago. Potential growth is estimated at about 3%, which is lower than before. This is explained, first, by geopolitics and by permanently slower growth in Russia after it recovers from the current recession. Second, productivity growth is slow, and, with the labour supply diminishing, it becomes increasingly difficult to sustain the previous pace of economic growth. Without productivity-enhancing policy changes, growth going forward will thus be slower than during the recovery in 2010-2013. At the same time, we believe that the output gap has been closed by now (i.e., the economy is operating close to its potential) and might now be marginally positive; this implies that Latvia is entering the next phase of the business cycle. It seems increasingly likely (although we have not included it in our base scenario yet) that growth might temporarily exceed 3% in 2016-2017, due to a number of factors coinciding.

First, the credit and investment cycles are likely to kick into gear. Capacity utilisation rates are high, – they inched down in 2015 in manufacturing, but is still largely at the 2004-2007 average of about 72%. With business confidence and external demand gradually improving, and with EU fund programmes from the current planning period hopefully opening for businesses towards the end of 2016, investment growth, relatively cautious so far, is expected to pick up. Given the past volatility, it can easily shoot up higher than the 7-10% per annum that we currently anticipate in the base scenario. Leverage levels are down to their lowest since 2005, when data became available, e.g., the loan-to-deposit ratio for nonfinancial institutions (NFIs) is at 1.7 and for households at 1 (2.4 and 1.3 in 2006, respectively). The debt-to-equity ratio of NFIs declined to 2 in 2013 from 2.9 in 2009 (2.1 in 2006), and most likely declined further in 2014. Credit demand and new lending are already growing, and it is likely that credit stock for NFIs will finally start growing next year. A sizeable monetary stimulus by the ECB will continue to put downward pressure on interest rates, which will remain very low in the coming years. The credit cycle in the euro area seems to have turned already, which can also support demand for borrowing/investing in Latvia.

### Slower-than-before growth, but a temporary boost in 2016-2017 is likely

### Credit and investment cycle likely to kick into gear

#### Credit demand for investments into fixed assets and gross fixed capital formation

Source: Bank of Latvia, CSBL

#### The unemployment and participation rates in Latvia and Riga, %

Source: CSBL

Part. rate: LV (rs) Unempl. rate: LV Unempl. rate: Riga

December 2, 2015
Labour market heating up

Second, the labour market is continuing to heat up gradually. The strong wage growth is boosted by rather high structural unemployment, the diminishing labour supply, emigration risks due to wage level gaps with more advanced EU countries (e.g., gross income per employee is at about one-fourth of Sweden's or one-third of Germany’s), and minimum wage hikes. The unemployment rate has fallen below 10% in 2015, i.e., back to the pre-boom levels of 2005, and the Bank of Latvia estimates it to be a natural rate of unemployment. In Riga and nearby municipalities, the unemployment rate was already 8% last year. Labour supply (population aged 15-74) is falling at about 1.5% per year through aging and emigration. There certainly is still potential to increase participation rates further (67.3% in the first nine months of 2015, up from 66.3% in 2014), but it is becoming more difficult. Emigration flows have diminished, and immigration has inched up (including emigrants returning); however, net flows are still negative and will remain so. Productivity growth remains outpaced by wage growth, thus putting competitiveness under pressure (which is already seen in the stagnating export market shares in the EU). Consumer price inflation remains close to zero, owing to lower commodity prices, but services’ prices (i.e., a proxy for nontradables’ prices) are growing steadily, by about 3% per year. So far, household consumption growth has been rather cautious (i.e., slower than income growth), but it might shoot up eventually, with consumer confidence improving and new lending for households growing.

Overheating pressures, but not as harsh as in 2006-2008

As a result, GDP growth might exceed its potential pace in 2016-2017, but this will not be sustainable. It should be emphasised that this would not be anywhere close to the overheating of 2006-2008. The Latvian economy (companies, households, government finances) is now much more resilient, balanced, and structurally stronger than it was then, and volatility will thus be much lower. It is more likely that overheating will be more visible in specific industries or areas (e.g., labour deficit for particular occupations or a lack of highly skilled labour, a varying speed of regional development – Riga vs. regions), but not so much in the economy overall.

Policymakers too slow to respond to overheating risks

Economic development is cyclical, so should something be done about it? Latvian policymakers are, unfortunately, behind the economy, and keep responding to economic challenges, e.g., overheating risks, rather slowly. While, during the past crisis there was no other way, but to act, currently, with the economy growing, there is neither a strong will nor pressure to implement reforms. If it is not about current developments, it is, unfortunately, outside the politicians’ horizon. So, one important message to the government and policy makers – do not treat the increase in tax revenues resulting from this higher-than-potential growth as something sustainable. Yes, this might help to balance the budget in the short term, but it does not help to fulfill cyclically adjusted (i.e., structural) budget targets. There have been slippages, with the budget deficit exceeding the plans for 2014 and, most likely, also 2015. If there are additional revenues from the stronger-than-potential growth, the government should use these to create reserves, as set in the Fiscal Discipline Law.

No major changes in political landscape

Given that the political cycle is turning and municipality elections are planned in mid-2017, politicians are likely to become more populist next year. Thus, 2015 is to a large extent a lost opportunity to pursue reforms. There have recently been recurrent public discussions/speculations about a possible change of government once the 2016 budget is approved by the parliament. It seems possible, but only time will tell. In any case, while some reshuffling in the government is possible, the current centre-right coalition is unlikely to change dramatically enough to alter the overall economic policy. The largest opposition party, Harmony Centre, which could alter some of the policies, is very unlikely to become a part of the ruling coalition.

Latvia’s institutional strength on par with Lithuania’s, but below Estonia’s

Policymakers are also behind the curve with respect to structural challenges, i.e., boosting the potential growth rate. Our measure of structural and institutional strength – the Swedbank Baltic Sea index (BSI) – was largely unchanged in 2014 after a notable improvement during the previous two years; this is something we warned of in last year’s Baltic Sea Report. In 2014, the BSI reached 6.8, retreating from 6.9 a previous year. This implies that Latvia ranks in the top 32% of the best-performing countries in the world. Latvia is now on par with Lithuania, but still behind Estonia (7.7) and the region average (7.6). There is some measurement lag in calculations of the BSI; therefore, the 2015 index results refer to reform progress (or rather lack of it) in 2013-2014. Even if there are improvements in some areas, competitors moved faster, and, thus, the relative position of Latvia either stayed unchanged (e.g., in innovation) or worsened (e.g., in financial markets). There are only two areas where Latvia managed to improve its positions relative to other countries – entrepreneurship (e.g., starting a business, registering property) and governance (e.g., rule of law, control of corruption).

9 For comparison, 72% in Sweden in 2014, which is one of the highest in the Europe.
10 This year two out of ten subindices are not updated (same value as last year) – foreign trade and logistics – as data are published biannually. This might change total BSI result for 2014 next year.
With policymakers behind the curve, the policy prescriptions remain largely the same as in the *Baltic Sea Report* a year (and, also, two years) ago. Yes, there have been improvements, but if we were to draw up a list of areas to focus on, we could largely copy-paste from the past years’ reports. The key is to boost productivity to reduce overheating risks in the labour market and to promote faster sustainable medium-term growth.

The BSI still shows the largest institutional gaps vis-à-vis the region average in innovation climate and financial markets. Both are crucial for productivity growth – innovation (and education) for necessary skills and ideas, and the ability to get financing to boost investments. Ease of access to loans, where Latvia scores poorly, is, besides other things, explained by the arguably decreasing, but still sizeable, grey economy – companies and households very often simply cannot prove that they have large enough income and equity to obtain loans from a bank. Alternative financing sources are developing, but rather slowly.

Lija Strašuna
Mārtiņš Kazāks
Lithuania: aging society, lagging reforms

This year’s growth was dragged down by weak exports and a deteriorating trade balance. Growth is expected to accelerate to 3.3% next year, partly due to fiscal stimulus and robust domestic demand. In the long run, however, an aging population, shrinking labour force, and lagging productivity are creating challenges for the competitiveness of the Lithuanian economy. Yet, the reforms needed to address these challenges have been insufficient.

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<tr>
<th>Economic indicator</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, %</td>
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<td>3.0</td>
<td>1.8</td>
<td>3.3</td>
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<td>Consumer price growth, %</td>
<td>3.4</td>
<td>0.1</td>
<td>-0.8</td>
<td>2.5</td>
<td>3.0</td>
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<tr>
<td>Unemployment rate, %</td>
<td>10.9</td>
<td>10.7</td>
<td>9.3</td>
<td>8.1</td>
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</tr>
<tr>
<td>Current account balance, % of GDP</td>
<td>-5.7</td>
<td>3.6</td>
<td>-2.6</td>
<td>-2.8</td>
<td>-3.5</td>
</tr>
<tr>
<td>General government budget balance, % of GDP</td>
<td>-3.4</td>
<td>-0.7</td>
<td>-1.0</td>
<td>-1.5</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

Source: Eurostat, Statistics Lithuania, Swedbank

Economic growth rebounds... for now

Economic growth accelerated in the second half of this year and will continue accelerating in 2016, as export growth resumes and pensions, some public sector wages, the minimum wage, and the nontaxable income threshold rise. However, by 2017 we will see shrinking employment, as the labour force will continue contracting. A decline in the size of the working-age population and a rise in the share of dependants in coming decades will be one of the main obstacles to the attainment of comprehensive social security, adequate public sector wages, and, in general, sustainable public finances. A faster convergence towards EU is at risk, unless productivity-enhancing reforms are implemented. Lithuania needs to counteract a decline in the labour force, focus on its quality, boost investments, and implement a more efficient public sector in order to address future challenges to growth and competitiveness.

Population by age groups

Some small steps in the right direction

This year, a few public institutions agreed to cooperate in easing immigration procedures, making them less complicated and time-consuming. At the end of last year, the procedures for employing highly skilled foreign employees were eased; however, this applies only to employees whose wages will exceed the country average by at least three times. It is now possible to employ such workers in two weeks, but, obviously, this is an unnecessary high bar. Unfortunately, in other cases, getting an employment permit may take up to six months. There remains much uncertainty regarding the results of this initiative to ease immigration procedures, especially after the recent terrorist attacks in France. Moreover, public opinion in Lithuania regarding immigrants (and refugees, in particular) remains negative; therefore, further immigration easing is likely only after the next parliamentary elections.

Law easing the rigid labour market regulation, which is one of the biggest obstacles in Lithuania to a better investment climate and higher competitiveness, are now being prepared and awaiting their approval by parliament. The new labour code would ease the formalisation procedures for making, changing, or terminating an employment contract. In addition, more types of employment contracts would be introduced (part-time work, distance work, temporary work, project-type work, learning, work of unspecified scale, job-sharing, work for several employers, and apprenticeship work), and fixed-term contracts could be...
Labour taxes are set to decline slightly, but more progress is needed

Public sector efficiency remains a problem

Some small positive changes in education system and somewhat smaller shadow economy

Significant improvement in financial markets development, but it might be temporary

Applied more easily. The new code would also allow a more flexible regulation of work time. The notice period and severance pay would decrease from two-four months to one month (or to two weeks if the time of service is less than 1 year), and from one-six months (depending of the time of service) to one month for all employees with at least one year of service. However, some of these changes are very unpopular, especially among the trade unions, and parliament may be reluctant to pass the necessary laws before the elections, even though the Prime Minister hopes to have them passed by mid-January.

Some positive changes are being implement in the tax system as well. Even though the tax wedge on labour is close to the EU average, we consider that the labour force, especially low earners, is still taxed excessively. Taxes on labour could be partially replaced with taxes less detrimental to growth (e.g., property taxes). The ongoing “social reform,” a part of which is the aforementioned greater flexibility of labour market regulation, also includes lowering social security contributions paid by employers by 1 percentage point each year for 12 years. This would be accomplished by transferring the base part of the old-age pension to the state budget. We think that this would be sensible because the base old-age pension does not depend on the contributions to the social security insurance fund and, therefore, is not an insurance, but a state guarantee. This would allow labour taxation to be lowered, making Lithuania more attractive for foreign investments, and would have a positive effect on wage and employment growth. In addition to that „social reform“ includes the upper limit for social security contributions for wages exceeding the average wage by 5 times. It would be achieved in 6 years by lowering the limit from 10 times the average wage to 5 times the average wage. This is a welcome change since most of the social benefits are capped (at a much lower level). Another positive change is the rise in the tax-exempt income amount, which will ease the tax burden for low-wage earners. It will rise from EUR 166 this year to EUR 200 in 2016.

These changes in labour taxation are welcome but come at a price – the government needs to find other sources of revenue or, better yet, cut inefficient spending. The real estate tax was lowered from 1% to 0.5%, but the nontaxable threshold for real estate value was decreased from EUR 290,000 to 220,000. Nevertheless, the tax base is still very narrow, and, therefore, tax incomes will remain meagre. More extensive property (especially personal car) taxes and the abandonment of at least some of the income and value-added tax exemptions would ease the pressure on public finances and allow labour taxation to be lowered. The best way to deal with small budget revenues, however, would be to cut the size of the inadequately large public sector by eliminating some nonessential institutions and functions. This would also make public sector wages more adequate and more appealing to skilled graduates.

After a suggestion by the Ministry of Education, this year more universities started using minimum exam grade thresholds for school-leavers applying to universities. Until now, students with grades of only 0.5 out of 10 were admitted to some universities. This inevitably had a negative effect on the general quality of higher education and on the abilities of some of the graduates. Even though the bar was not lifted too high (it ranges from 1 to 3), this is a move in the right direction, because until now the education system in general was more focused on the quantity of graduates, rather than their quality. Also, a couple of large universities announced a planned merger – a welcome development that should followed by others (there are still more than 40 higher-education institutions).

Another positive change this year was the slight reduction in the size of the shadow economy. It is likely that stricter border control due to increased geopolitical risks also had an effect on smuggling. This can be seen from the number of smuggled cigarettes – their share has fallen from 29% last year to 20% in 2015 (according to the Nielsen “empty-pack” survey).

Baltic Sea index highlights too little progress

Lithuania’s Baltic Sea index has increased only marginally, from 6.7 a year ago to 6.8; moreover, Lithuania was among the four worst performing countries in the region of 10 countries. Only Poland and Russia scored lower than Lithuania. All of the subindices, except for entrepreneurship, are lagging behind the Baltic Sea region average, and the level of financial market developments is one of the weakest spots.

On a positive note, Lithuania has, among the region’s countries, improved its financial markets the most since last year. This was due to a better evaluation of the soundness of banks, which was extremely low in the previous year, and a greater perceived availability of venture capital. However, venture capital funds in Lithuania, which were partly financed by EU support, are likely to become less active next year as the period for support ends. Venture capital funds will still be able to invest the funds earned from current investments, but it is still likely that investments will decline. This might create additional challenges for the start-ups. Moreover, ease of access to loans remains low, as Lithuania is one of the 35% of countries in the world in which it is the hardest to get a loan.
Also, since last year, the subindex for innovation climate and governance has improved more significantly. The innovation climate has improved mainly due to higher company spending on R&D, as reported by the executive opinion survey of the World Economic Forum. In 2014, spending on R&D as a percent of GDP increased slightly, from 0.95% to 1.02%; however, in the region this exceeded only spending by Russia and Latvia, and was twice as low as the EU average. Governance has improved mainly due to a better perception of the rule of law; the control of corruption and corruption perception have also improved somewhat.

In many other areas, however, we saw no progress from the previous year, and some areas, such as tax policy and education, have shown no improvement for the past few years. Too-low foreign and local investments in the past, the rapidly aging population, and shrinking labour force will lower potential growth in Lithuania and put pressure on the social security system, unless structural reforms are implemented soon. Inevitably, there will be fewer employees and more dependants; therefore, it is very important that the labour force be more productive. This will not be possible unless the quality of education improves and the investment environment becomes more growth friendly. Actions in this latter area should include lower labour taxation, more flexible labour market regulation, a more efficient public sector, and a more up-to-date immigration policy. However, many of these reforms are unpopular, or their results lie too far in the future; therefore politicians lack the motivation to implement them, even though future competitiveness and prosperity depend on these reforms more than ever.
Income inequality and poverty: is a higher minimum wage the best answer?

Income inequality may be both the consequence of underdevelopment and the cause of lower growth potential, as well as the general prosperity of the society. In terms of income inequality and poverty, Baltic countries are, not surprisingly, at the lower end of the European Union pack. Most recently, governments have responded by vigorously increasing minimum wages. Is this the best or only approach?

Poverty and material deprivation is more important than income inequality
In the post-global financial crisis period, an increase in inequality has been witnessed in the developed economies — economic recovery and gains have been increasingly concentrated among the high earners and capital owners. Different measures of income inequality tell the same story about the Baltics — income inequality here is among the largest in the EU, especially in Latvia and Lithuania. Yet, official statistics may be somewhat misleading, as there are plenty of households that have unofficial income. We argue that income inequality in itself is not always undesirable, especially if it is merit based and not the consequence of, say, smuggling, graft, nepotism, or other corruption. Thus, the major concern for government, especially in the Baltics, could be the level of poverty, not income inequality. The government should be happy as long as growing incomes of the top percentiles increase the prosperity of the society and reduce the poverty of the lower percentiles.

There are many ways to measure income inequality, but most of the measures have drawbacks and can send a wrong message. For example, one popular measure, called the at-risk-of-poverty rate, shows that some 20% of the population in the Baltic countries is at risk of poverty. This compares with, e.g., 25% in Romania (the highest in the EU) and 16% in Luxembourg. But once you realise that the rate is calculated as “the persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income (after social transfers),” you realise that it is nothing more than a measure of income inequality.

The data on material deprivation — another measure of poverty — indicate that there has been remarkable progress since the EU accession. Things got worse in 2009 and in 2010, but material deprivation is down again and already below the pre-crisis levels. Official data suggest material deprivation levels are the lowest in Estonia, which stands very close to the EU and EA average. Yet this measure of poverty is not perfect, either.

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10. The Gini coefficient of equivalised disposable income measures income inequality on a scale from 0 to 100, where the higher ratio refers to higher inequality.
11. The persons with equivalised disposable incomes below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income (after social transfers).
12. Severely materially deprived persons have living conditions severely constrained by a lack of resources, and they experience at least four out of the nine following deprivations items: cannot afford i) to pay rent or utility bills, ii) to keep home adequately warm, iii) to face unexpected expenses, iv) to eat meat, fish, or a protein equivalent every second day, v) a week holiday away from home, vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone.
Minimum wage is fine, as long as it does not destroy too many jobs

A rising awareness of income inequality has added momentum to the minimum wage debates. Arguably, an increase in the minimum wage could improve the well-being of low-income households and, therefore, boost consumption, economic growth, and the general well-being of the society (due to, e.g., lower crime rates). It can also boost government revenues, if it forces employers to legalise a larger fraction of wages (smaller envelopes). At the same time, if the minimum wage is raised too fast, some low-skilled jobs could disappear and the unemployment rate might rise as a result. Simple economic reasoning and plenty of empirical evidence illustrate this.

For example, this is well demonstrated in a recent study by the IMF on minimum wages in 2,800 counties in China during the past eight years. The results show that a 10% increase in minimum wages lowers employment by 1%, on average. Of course, the results are nonstatic: they vary across industries and are sensitive to the average wage in a company. The study showed that, following a 10% increase in wages, employment would shrink by 1.8% in the first decile of firms (the lowest average wages), but the effect is three times smaller in the tenth decile of firms (highest average wages). Admittedly and not unexpectedly, increasing minimum wages has a greater positive impact on the average wage in lower-wage firms. Other studies show that younger people and the low-skilled are more vulnerable to potential job losses when the minimum wage has been raised.

Thus, the most important implication of this study is that one cannot analyse and set minimum wages without any reference to the average wage in the country/region/sector. Minimum wages, as a share in average or median wages, range from below 40% to over 60% in the OECD. In Europe, the level of gross minimum wages across the EU member states varied from 33% to just over 50% of average gross monthly earnings in 2014. In the Baltics, in 2014, the minimum wage, as a share in average earnings, was the highest in Lithuania and the smallest in Estonia. In all three countries, minimum wages are expected to grow faster than average wages in 2015, and in Estonia and Lithuania also in 2016, based on our forecast.

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13 See IMF working paper for more details here
14 See OECD Employment Outlook 2015 for more details here
15 For those persons working in industry, construction, or services. Gross monthly earnings cover remuneration in cash paid before any tax deductions and social security contributions payable by wage earners and retained by the employer, and restricted to gross earnings that are paid in each pay period. ‘Nonstandard payments,’ such as 13th or 14th month payments (except Greece, Spain, and Portugal), holiday bonuses, and so on are excluded.
Economists do not have one good recipe for an optimal level of minimum wage for any given country — it is always a trade-off between efficiency and fairness. Often, there is no country-wide minimum wage, and the agreement is negotiated between companies and trade unions (regional or industry based). But there are some clear guidelines that help to avoid the "road to hell paved with good intentions." The OECD argues that a "reasonable level of the minimum wage will inevitably be country-specific, and depend on the interactions of the minimum wage with other policies, as well as on the coverage of minimum-wage legislation, compliance, and macro-economic and labour market conditions."\(^\text{16}\) IMF research also finds that appropriate labour market reforms should be decided on a country-by-country basis, taking into account other policy objectives, including macroeconomic stability, competitiveness, growth, and unemployment.\(^\text{17}\)

When discussing the appropriate minimum wage level, other factors have to be taken into account as well. In Estonia, e.g., the minimum wage level is also directly linked to several social transfers and fees (i.e., minimum thresholds of parental benefits, sick leave compensations, and kindergarten fees). In Lithuania, some social contributions of the self-employed also are indexed to a monthly minimum wage. In Latvia, some administrative fines and minimum alimony payments are indexed to a minimum wage.

Furthermore, a runaway minimum wage can dent a country’s competitiveness. Minimum wage earners amount to a substantial share of workers, especially in Latvia and Lithuania\(^\text{18}\) (although this is partly a statistical gimmick, as many of them receive additional cash payments under the table). Nevertheless, excessive increases in minimum wages (+10% in Estonia, +3% in Latvia, and +16% in Lithuania, on average, in 2016) push up the average wage level – both directly and indirectly, when differentiation between skills and pay have to be preserved and companies are forced to increase wages for all employees, not only low earners. This effect is most visible when economies are close to full employment and employees have higher negotiation power. Thus, as a consequence, the gap between labour costs and labour productivity widens, which is a growing concern in the Baltics. Considering these drawbacks of minimum wage regulation, alternative measures against poverty and excessive income inequality should be considered.

**There is no one good recipe for everybody**

**Excessive increases in wages can squeeze competitiveness**

**Raising nontaxable threshold for low earners might be a better option**

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\(^\text{16}\) See OECD Employment Outlook 2015 for more details [here](#)

\(^\text{17}\) See IMF working paper for more details [here](#)

\(^\text{18}\) The proportion of employees being paid less than 105% of the national minimum wage was 14% in Lithuania, 12% in Latvia, and 5% in Estonia, according to the latest structure of earnings survey from 2010. For the sake of comparability, the scope of the survey was restricted to full-time workers aged 21 years and over, working in enterprises with 10 employees and more, excluding public administration, defence and compulsory social security. Moreover, monthly earnings exclude earnings related to overtime and shift work. Official national statistics show much larger shares of minimum wage earners. For instance, according to the State Revenue Service of Latvia, the proportion of workers receiving a minimum wage or less in Latvia was 29% in the first 9 months of 2015 (a bit less in Lithuania). However, this most likely is an overestimation – exact proportions of employees earning the minimum wage are not clear, as minimum wage earners often get the rest of the salary unofficially, i.e., “in the envelope”; which distorts statistics.
In the Baltic states, labour taxes in Latvia are somewhat higher than in Estonia or Lithuania, especially for lower-income earners.\footnote{See our newsletter on Latvia’s tax system for more details \url{here}} Net earnings of a minimum wage earner are smaller in Latvia than in Lithuania, although labour costs per one minimum wage worker are higher in Latvia than in Lithuania. Net earnings of minimum wage workers, adjusted for average price levels in respective countries\footnote{Differences in purchasing power parities (PPPs), according to Eurostat.} (indicated as purchasing power on the graph), are noticeably lower in Latvia than in Estonia or in Lithuania.

In general, considering the low purchasing power of minimum wages, governments should aim to increase the nontaxable income threshold, preferably making the minimum wage tax free.\footnote{Nontaxable thresholds differ quite a lot across the Baltics (please see the graph above). Monthly tax allowances for dependants also vary: in 2016, from EUR 154, starting from the second child aged 17 or less, in Estonia; EUR 175 per child in Latvia; and EUR 120 per child in Lithuania. In Latvia and Lithuania the nontaxable threshold is gradually phased out for higher earners, making personal income taxation more progressive.} The government revenue losses would be tangible, but not unmanageable, at least partly. For instance, in Lithuania, it would cost around EUR 200 million, or 2% of the 2016 national budget. By the way, Lithuanian government expenditures in 2016 are forecast to increase by EUR 360 million compared with 2015, which means that it’s only a matter of priorities – the government can stimulate the economy by spending more, or by taxing less.

Finally, when it comes to measures against excessive income inequality (yes, we know, this is very subjective) and poverty, it’s not the lowest-hanging fruits that are the most nutritious. Treating the causes of the disease is more efficient than addressing the symptoms. Governments should therefore constantly strive to improve the quality and accessibility of education – in the broadest sense. Many recent studies show that preschool education (something that is often disregarded) plays crucial role in the development of cognitive skills. Accordingly, Lithuania is considering making preschooling compulsory. Financial literacy is another skill that should not be optional. For example, too often people resort to payday loans and turn their short-term financial liquidity problems into a financial abyss. Most important, governments should remember that, if they want to establish competitive economies and prosperous societies, their task should be to ensure the equality of opportunity, not the equality of outcome.

\textit{Nerijus Mačiulis}

\textit{Liis Elmik}
Taxes in the Baltics: which way forward?

New budget deficit rules, a moderate growth environment, repetitive calls for increased public spending, and a willingness to safeguard labour cost competitiveness will force the Baltic governments to improve their tax systems. A good tax system is neutral, fair, and growth friendly. To do that, the governments should improve their tax systems and clamp down on tax evasion.

Governments need to raise revenues and/or safeguard labour cost competitiveness

Latvia and Lithuania have been regularly running general government budget deficits. In the years prior to the 2008 crash, headline deficits seemed quite minor at less than 1% of GDP, but when adjusted for output gaps, structural (i.e., cyclically adjusted) deficits stood at a more sizeable 2-3% of GDP. With the ensuing recessions, budget deficits widened to close to double digits, but, with fiscal discipline and the economic situation improving, they have shrunk to about 1% of GDP. A few years back, new national Fiscal Discipline Laws and EU-wide regulations were put in place to hold down deficits. These new rules are stricter, as they aim for smaller structural deficits rather than simply setting a deficit ceiling at 3% of GDP, as was originally set out in the Growth and Stability Pact. And this is understandable, since budget deficits mean growing government debt and, thus, less resistance to recessions. From their lows of the pre-2008 crash (at 9% and 15% of GDP for Latvia and Lithuania, respectively) general government debts have risen to roughly 40% of GDP. This is still way below the 60% threshold of the Growth and Stability Pact, but there will be less room for manoeuvre when the next recession hits. Estonia, meanwhile, has been more disciplined – it has aimed for a balanced budget or a surplus, which has kept its government debt at only 10% of GDP.

There have been repetitive calls to raise public spending on defence, health, social issues, etc. With the GDP growth rate levelling off at a modest 3%, governments’ spending ability will lag behind their medium-term spending needs, particularly for Latvia and Lithuania. More efficient spending can free up resources without the need to raise more revenues – this must be done, but it is unlikely to provide large enough funding streams. One can terminate or limit some public services to shift those funds towards other needs – yet, this is politically very difficult. Thus, at the end of the day, it is about how to raise tax revenues. In Latvia and Lithuania, tax revenues hover around 28% of GDP, near the bottom in the EU (the EU average stands at 39%). For years, strategy documents in Latvia have set up as a target the raising of tax revenues to one-third of GDP, but no clear plan has been set out yet. Estonia already taxes around 32% of GDP, and these additional 4 percentage points not only give bigger spending power (e.g., Estonia meets the NATO membership requirement of 2% of GDP defence spending, while Lithuania and...
Latvia stand at about 1% each and aim to reach 2% in 2018), but also potentially allow for more flexibility in its tax system, giving it a “thicker wallet.”

But this does not mean that Estonia has fixed everything. There is a regional trend to cut labour taxes by shifting the tax burden towards consumption and property. For instance, Lithuania has set out plans to cut social security contributions by 1 percentage point every year for the next 12 years. It is arguable how fiscally possible such a massive cut is (i.e., it is still unknown how the government aims to compensate for the ensuing fall in tax revenues), but this plan shows the region’s mind-set. The European Commission is pushing for similar tax policy changes on a pan-European level. To safeguard their labour cost competitiveness, Estonians have sketched out a four-year plan to ease the labour tax burden (see the Estonian chapter in this report). They aim to compensate for the tax cut by raising excise taxes, but, with further labour tax cuts down the road, broader changes may be necessary. Estonia may not need to push tax revenues as a percent of GDP higher, but it is worthwhile to ask whether its tax system could be overhauled, also in view of its aging and decreasing population.

**Tax systems in the Baltics are quite similar, but Estonia taxes more efficiently**

The table at the end of this chapter reports major taxes and tax rates for the three Baltic countries as of mid-2015. There are some notable differences across countries, such as all income types are taxed at a flat rate of 20% in Estonia and at 15% in Lithuania, while Latvia differentiates tax rates by income types. There is a different split of social contributions between employers and employees, but the overall rates are quite similar. As to the value-added tax (VAT), there are different exemptions, but, again, the rates are quite similar. Perhaps the most interesting difference is that Estonia does not tax residential real estate (i.e., it taxes land but not buildings). The other two countries do, though very lightly. For instance, Lithuania taxes only very expensive property (i.e., with a cadastral value above EUR 220,000, and the cadastral value may sometimes be very far from the market value) and collects very little revenue therefrom.

The newest internationally comparable tax revenue data from Eurostat is only for 2013, but the key conclusions should still be valid since the tax systems have been relatively stable. So, how come Estonia collects more in tax revenues? The short answer is better tax administration and, perhaps, a smaller grey economy. For instance, with lower standard VAT rate (20% in Estonia vs. 21% in Latvia and Lithuania), Estonia manages to collect roughly 1% of GDP more in VAT revenues than its neighbours. Better tax collection ability is mirrored in its 16.8% VAT gap (i.e., a proxy for the share of tax evasion), which is about half that in Latvia and Lithuania (29.9% and 37.7%, respectively). Such estimates, of course, are latent and prone to estimate errors, but this massive gap does show the problem. Another major difference with Latvia is that Estonia collects more via social contributions, which, again, is an indication of the tax evasion problem (e.g., the Latvian State Revenue Service reports that nearly 30% of those employed pay taxes from incomes of around the minimum wage – a clear sign of tax evasion).

**What is a good tax system?**

One of the most comprehensive recent overviews of theories and evidence on tax systems in an open economy is by Mirrlees et al (2012). The Mirrlees Review defines a general framework for tax design, concluding that taxes should be viewed as a system, which should be neutral and socially fair. A systemic view means that one should view all taxes jointly as a comprehensive mechanism rather than individually. Individual taxes should not be changed without considering the impact on the whole tax system and the possible

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22 Study to quantify and analyse the VAT Gap in the EU Member States, available [here](#).

23 The Mirrlees Review summary is available [here](#).
distortions/inefficiencies such a change would create. It is not each individual tax, but the tax system as a whole that should achieve its desirable properties. For instance, making the overall tax system more progressive (i.e., raising taxes for the wealthier to support the less wealthy) does not require making each tax more progressive, as different taxes have different goals. A neutral tax system should treat similar activities similarly, thus minimising the welfare loss associated with distortion in behaviour due to taxation. A typical exception to this rule is consumption choices that have negative externalities or produce harm, e.g., the consumption of alcohol and tobacco. There is no specific degree of social fairness or progressivity (i.e., redistribution from the wealthy to less wealthy) that a tax system should aim for. The degree of progressivity is determined by the society’s preferences, and one should focus on how to benefit the less wealthy while minimising the loss in economic activity incentives of the wealthier.

Apart from the general principles of the tax system described above, evidence suggests the following hierarchy of individual taxes with respect to harming growth (moving from most to least harmful): corporate taxes, personal income taxes, taxes on consumption, and taxes on residential real estate. Simple tax systems are preferred to complex ones, e.g., multiple exemptions make taxes less transparent, more difficult to enforce, and easier to evade. What way forward for the Baltic tax systems?

We highlight some major avenues available for improving the tax systems of the Baltic countries. To start with, all three need to reduce tax evasion, and it seems that, here, Latvia and Lithuania have more ground to cover. Cutting back on tax evasion would improve fairness, transparency, and the long-term competitiveness of the whole economy. Large-scale VAT fraud must be reduced. Latvia is introducing elements of a reverse VAT, but its efficacy is still to be seen. Estonia has recently seen good results in reducing smaller-scale VAT evasion by requesting that all transactions valued above EUR 1,000 be reported to the State Revenue Service. This May, the Lithuanian State Tax Inspectorate (STI) started implementing a “smart tax administration system”. So far, this is covering only 7,000 enterprises that are considered to be in a “risk zone.” The system allows the STI to follow business invoicing almost in real time and has greatly improved VAT collections – the VAT revenues from these companies have increased by 80% compared with the same period a year ago. Clamping down on the smuggling of excise goods – as Lithuania has recently done by improving its border controls – should be implemented by all countries. Making corporate reinvested earnings tax free could not only support investment activity by reducing investment cost, but also reduce the willingness to hide corporate profitability and, thereby, improve access to loans.

But it is not only administrative and criminal measures that can reduce tax evasion. Changing the way the overall tax system is designed can also help. For example, the taxation of residential real estate is impossible to evade (i.e., property cannot be hidden), it is progressive (i.e., more affluent individuals tend to have more expensive real estate), and increasing it has no direct negative impact on business costs and competitiveness. This policy choice was picked up in Latvia a few years back, but the tax revenues from so this source are small and could be used to a larger extent. Taxation of personal cars would also fit this description and is discussed in Lithuania. Increased revenues from such sources could be used not only to reduce tax evasion but also to shift tax burden away from labour to other tax bases that does less harm to economic growth.

Tax system’s social fairness should be ensured mainly via income taxes. For instance, instead of reduced VAT rates to improve access to certain goods and services for those with lower incomes, one should consider whether it might not be fiscally more efficient to forgo reduced VAT rates and provide such support via benefits targeted to specific social groups.

As to single earners, taxes are less progressive in the Baltics than in the EU on average (i.e., the slope of the tax burden for different wage levels is less steep than in the EU). Given that many EU countries aim to ease labour tax burdens, if the Baltic countries would decide to raise progressivity, they should do it more by lowering the tax burden for those with low incomes rather than by raising the income tax burden for those with high incomes. Introducing progressive personal income exemptions make taxes less transparent, more difficult to enforce, and easier to evade.

![Graph showing tax wedge on labour costs for a single earner with income 67%, 100%, and 167% of the average wage in the country, 2015](image)

* 2013 data for EU28 average

24 See, for instance, OECD
tax rates by increasing them for those with higher wages, to our view, would be a wrong choice. Given the still massive tax evasion problem, it would not only create motivation to move into the grey economy and thereby reduce fairness, but it would also undermine labour cost competitiveness. To raise tax revenues, Latvia and Lithuania could consider raising income taxes to the level of Estonia, i.e., to a flat rate of 20% for all income types. The current different tax rates for different income types in Latvia are potentially regressive, as those more affluent are more likely to have capital gains.

Mārtiņš Kazāks
Andrejs Semjonovs
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.

Contents and sources of Swedbank Baltic Sea Region index 2015

I Entrepreneurship
- Starting a Business
- Dealing with construction permits
- Registering property
- Protecting investors
- Enforcing contracts
- Resolving insolvency

Source: Doing Business (World Bank)

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

Source: World Bank and Global Competitiveness Report (World Economic Forum) and Conference Board TED

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

Sources: Doing Business (World Bank)

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

Source: Global Competitiveness Report (World Economic Forum)

V Foreign trade
- Market access
- Border administration
- Business environment

Source: Enabling trade index (World Economic Forum)

VI Education
- Higher education and training

Source: Global Competitiveness Report (World Economic Forum)

VII Governance
- Corruption perception index
- Rule of law
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Source: Transparency International and World Bank

VIII Infrastructure
- Infrastructure index (GCR)
- Trade and transport-related infrastructure

Report (World Economic Forum) and Logistics Performance Index (WB)

IX Logistics
- Customs
- International shipments
- Logistics competence
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- Timeliness

Source: Logistics Performance Index (World Bank)

X Innovation climate
- Innovation Input
- Innovation Output
- Capacity of innovation
- Quality of scientific research institutions
- Company spending on R&D
- Gov’t procurement of advanced tech products
- Availability of scientists and engineers

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

Swedbank Baltic Sea index 2015

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Contact Information

Swedbank Research
Olof Manner
olof.manner@swedbank.se
Head of Research
+46 (0)8 700 91 34

Macro Research
Magnus Alvesson
magnus.alvesson@swedbank.se
Acting Head of Macro Research
Head of Economic Forecasting
+46 (0)8 700 94 56

Olof Manner
olof.manner@swedbank.se
Acting Group Chief Economist
+46 (0)8 700 91 34

Harald-Magnus Andreassen
hma@swedbank.no
Chief Economist NO
+47 23 11 82 60

Tõnu Mertsina
tonu.mertsina@swedbank.ee
Chief Economist EE
+372 888 75 89

Nerijus Mačiulis
nerijus.maciulis@swedbank.lt
Chief Economist LT
+370 5258 22 37

Mārtiņš Kazāks
martins.kazaks@swedbank.lv
Deputy Group Chief Economist
Chief Economist LV
+371 6744 58 59

Knut Hallberg
knut.hallberg@swedbank.se
Senior Economist
+46 (0)8 700 93 17

Jörgen Kennemar
jorgen.kennemar@swedbank.se
Senior Economist
+46 (0)8 700 98 04

Åke Gustafsson
ake.gustafsson@swedbank.se
Senior Economist
+46 (0)8 700 91 45

Anna Breman
anna.breman@swedbank.se
Senior Economist
+46 (0)8 700 91 42

Cathrine Danin
cathrine.danin@swedbank.se
Economist
+46 (0)8 700 92 97

Martin Bolander
martin.bolander@swedbank.se
Senior Economist
+46 8 700 92 99

Sihem Nekrouf
sihem.nekrouf@swedbank.se
Economist, EA to Olof Manner
+46 (0)8 5959 39 34

Øystein Børsum
ob@swedbank.no
Senior Economist
+47 99 50 03 92

Helene Stangebye Olsen
hso@swedbank.no
Research Assistant
+47 23 23 82 47

Liis Elmik
liis.elmik@swedbank.ee
Senior Economist
+372 888 72 06

Siim Isküll
siim.iskuil@swedbank.ee
Economist
+372 888 7925

Lija Strasauna
lijas.strasuna@swedbank.lv
Senior Economist
+371 6744 58 75

Andrejs Semjonovs
andrejs.semjonovs@swedbank.lv
Economist
+371 6744 58 44

Vaiva Šečkutė
vaiva.seckute@swedbank.lt
Senior Economist
+370 5258 21 56

Strategy
Madeleine Pulk
madeleine.pulk@swedbank.se
Head of Strategy and Allocation
+46 (0)72 53 23 533

Anders Eklöf
anders.eklof@swedbank.se
Chief FX Strategist
+46 (0)8 700 91 38

Pär Magnusson
par.magnusson@swedbank.se
Senior Rate Strategist
+46 (0)8 700 91 38

Hans Gustafson
hans.gustafson@swedbank.se
Chief EM Economist & Strategist
+46 (0)8 700 91 47

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**Macro Research - Baltic Sea Report**

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