Activity in the Baltic Sea region is slowing – but now a foundation can be laid to elevate competitiveness

- We expect GDP in the Baltic Sea countries to shrink by 2.2% this year and that growth next year will be a modest 0.7%. The global recession, commodity prices and financial conditions are significant risks in the forecast.

- The German economy is slowing, with GDP expected to fall 4% in 2009. Export industry is being affected by the slowdown in global demand, and the recession is also cutting into domestic demand. The Nordic countries are slowing as well.

- With its relatively small imbalances, Poland is posting the strongest development in the region and is avoiding the recession thanks to a relatively strong household sector and the EU's structural funds, which could potentially raise GDP by just over 5% per year in 2007-2013.

- Declining commodity prices and shrinking access to international capital is exposing huge imbalances and leading to considerable downturns in the Russian and Ukrainian economies.

- Domestic demand in the Baltic countries is slowing significantly as imbalances are corrected. In Latvia, GDP will shrink by 15%, in Estonia by 8% and in Lithuania by 6% this year. Economic policies are focused on speeding up membership in the EMU.

- Despite that 2009-2010 is expected to be a period of very weak development, the Baltic Sea region continues to offer tremendous long-term potential for trade and investment. The convergence between new and old EU member states continues, but it won't happen automatically. Economic policies should therefore concentrate in the short term on softening the slowdown in demand and in the long term on strengthening economic competitiveness.

Cecilia Hermansson Jörgen Kennemar Magnus Alvesson
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## Economic conditions around the Baltic Sea

### March 2009

**Key financial ratios**

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth (%)</th>
<th>Inflation (CPI, %)</th>
<th>Current account balance (% of GDP)</th>
<th>Budget balance (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>4.8</td>
<td>0.3</td>
<td>1.5</td>
<td>-5.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>-3.6</td>
<td>-8.0</td>
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<td>-0.5</td>
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</tr>
<tr>
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<td>6.0</td>
<td>-3.0</td>
<td>2.0</td>
<td>14.1</td>
</tr>
<tr>
<td>Ukraine</td>
<td>2.1</td>
<td>-9.0</td>
<td>-3.0</td>
<td>25.2</td>
</tr>
<tr>
<td>Germany</td>
<td>1.0</td>
<td>-4.0</td>
<td>0.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>-1.3</td>
<td>-1.7</td>
<td>0.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Norway 2)</td>
<td>2.0</td>
<td>0.0</td>
<td>1.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Finland</td>
<td>1.0</td>
<td>-2.0</td>
<td>0.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>-0.2</td>
<td>-2.3</td>
<td>0.6</td>
<td>3.5</td>
</tr>
</tbody>
</table>

### GDP for Baltic Sea countries in total

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 (2.2)</td>
<td>-2.2 (1.4)</td>
<td>0.7</td>
<td></td>
</tr>
</tbody>
</table>

1. Annual average, actual GDP growth, not calendar-adjusted.
2. Associated “analysis country.” Statistics for the total economy, i.e., both the mainland economy and oil sector.
3. Percentage increase.
4. Ukraine is not included in regional growth. Weighted based on Swedish exports to these countries in 2005. The Baltic Sea region has also been calculated exclusive of Sweden.
5. The figure from the September 2008 forecast is in parentheses.
6. Forecasting work concluded on 23 March 2009.

Sources: National statistics, Swedbank’s own calculations.
Major imbalances create the need for adjustments

The financial crisis and recession are creating significant problems for the region’s households and businesses. Higher unemployment and shrinking incomes pose a huge socio-economic challenge after years of steady economic growth. The economic crisis is now having political consequences as well, having forced the governments of Latvia, Iceland and Hungary to step down.

We anticipate negative growth this year in every country in the region except Poland, which is less dependent on exports. The countries that built up the largest internal and external imbalances (e.g., Ukraine and Latvia) also face the greatest adjustments, followed by a lengthy period of weak economic growth. At the same time we are seeing that imbalances have already shrunk considerably: inflation is falling and current account deficits are lower.

The financial crisis is making the region’s countries more anxious to participate in the EMU and fairly quickly transition to the euro. For the Baltic countries, this is a reasonable goal. For Poland, however, there is good reason to consider delaying membership.

The EU offers a more secure macroeconomic environment for many countries in Central and Eastern Europe. Current account support and EU structural funds could ease instability and strengthen the economy. The EU also offers a meeting place to discuss economic policy, especially the danger of growing protectionism. For the Baltic Sea region, it is also important to continue the integration of the financial sector and the real economy. As the standard of living rises in neighbouring countries, Swedish businesses will see improved opportunities.

Global economy decisive for Baltic Sea countries

Since we published our updated Economic Outlook on 11 March, the dollar has declined in value in trade-weighted terms following the Federal Reserve’s decision to begin buying treasuries. Stocks have gained ground, bond yields have dropped slightly and oil prices have risen to slightly over $50 a barrel.

We have decided not to revise our global forecast due to these events, and reiterate our projection that global GDP will shrink by 0.5% this year and grow a modest 2% in 2010. Germany, which is an important Baltic Sea country, has been revised downward by one percentage point, to -4%, owing to the accelerating slowdown in industrial production earlier this year.

Considering the substantial decline in GDP around the world in the fourth quarter and shrinking industrial production, there are still significant downside risks in our forecast. On the other hand, there is also the possibility that monetary and fiscal stimulus measures will have a greater positive impact on the economy after the summer, when they have had the chance to work. We remain firm in our conviction that more resolute action is needed to alleviate the
problems in the US financial sector if the economic stimulus is to have a deep, lasting effect.

For export-dependent Baltic Sea countries, the global economy and commodity markets represent the greatest growth risks. We have assumed that oil will maintain an average price of $48 a barrel this year and $55 next year. We also anticipate that financial conditions will slowly improve, but that the process by which the global financial sector will shrink will impact investments, spending and trade for several years to come.

Baltic Sea region decelerates
Since the countries in the Baltic Sea region (with the exception of Sweden) grew by 3.6% in 2007, economic activity has slowed significantly. Last year GDP growth was only 1.1%, the lowest since the recession in 2001-2003. This was slightly over one percentage point lower than our forecast in September last year.

The economic picture for 2009 has now changed significantly. Our forecast last fall that the Baltic Sea region would reach growth of nearly 1.5% this year will not be met. On the contrary, GDP will shrink in line with other regions around the world. We expect negative growth of 2.2% will be followed by modest growth of 0.7% in 2010 as the global economy stabilises. Note that next year’s growth will also be low from an historical perspective.

GDP growth in the Baltic Sea region, excl. Sweden (annual percentage change)

Source: National statistics and Swedbank.

Growth in the Baltic Sea region is highly dependent on exports and is therefore affected to a fairly large degree by the global slowdown. Whereas growth in Poland and Russia receives significant support from consumer spending, exports and imports have a greater impact on growth, employment and public finances in the region’s other countries. Even relatively strong countries in Eastern and Central Europe, such as Slovenia, Slovakia and the Czech Republic, are strongly dependent on exports, which account for between 70 and 90% of their GDP. Of more importance to how these countries are affected by current economic conditions is the extent to which

The global economy, financial sector and commodities are the growth risks in the region

The Baltic Sea region’s GDP is shrinking, as is Sweden’s

The size of the imbalances is decisive to economic development
domestic imbalances have built up, since they create greater exposure to the global financial crisis.

**The Baltic region’s countries and their exports as % of GDP**

<table>
<thead>
<tr>
<th>Country</th>
<th>Exports as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>72</td>
</tr>
<tr>
<td>Lithuania</td>
<td>59</td>
</tr>
<tr>
<td>Denmark</td>
<td>54</td>
</tr>
<tr>
<td>Sweden</td>
<td>54</td>
</tr>
<tr>
<td>Latvia</td>
<td>47</td>
</tr>
<tr>
<td>Norway</td>
<td>47</td>
</tr>
<tr>
<td>Germany</td>
<td>47</td>
</tr>
<tr>
<td>Ukraine</td>
<td>45</td>
</tr>
<tr>
<td>Finland</td>
<td>44</td>
</tr>
<tr>
<td>Poland</td>
<td>42</td>
</tr>
<tr>
<td>Russia</td>
<td>32</td>
</tr>
</tbody>
</table>

Source: National statistics and Swedbank.

**Imbalances shrink**

Until mid-2008 inflation was rising in many of these countries in pace with their economic overheating – from credit growth and wage increases – and the effects of high energy and food prices. Lower commodity prices and sharply falling demand are now mitigating inflation. This is clearly evident in the Baltic countries. In Russia, Ukraine and Poland, the slowdown in consumer prices is partially offset by weakness in their currencies, which is raising import prices.

**Inflation, annual increase in consumer prices (%)**

Source: National statistics and Swedbank.

We anticipate that inflation will continue to fall in all the countries, reaching negative levels in several of them, including Sweden. In Latvia, we expect consumer prices to begin falling next year, a major reversal compared with 2008. In Russia and Ukraine, inflation remains high at around 15-20%.
Current account balance as% of GDP

In the Baltic countries, current account deficits have grown to unsustainable levels after a period of strong capital inflows from foreign direct investment and bank loans. The deficits decreased last year when demand fell, and imports shrunk faster than exports. At the same time capital inflows are now falling as the global investment climate weakens, access to credit shrinks and a growing number of Baltic citizens move home, which is cutting into the foreign currency transfers sent home by migrant workers. In Latvia, which faces growing imbalances, the state takeover of Parex Bank required the support of the IMF and other EU member states. Ukraine has also received support from the IMF and other international institutions to meet its financing needs. In every regional country except Russia, current account balances will improve in 2009. In Russia, several years of surpluses have turned into a deficit due to lower oil prices and expansive fiscal policies, among other factors.

Financial indicators remain a concern

In the face of shrinking external financing, increased risk aversion and liquidity problems following the global financial crisis, the Baltic Sea region’s demand has been strongly impacted. In several transition countries, private foreign debt has risen substantially in recent years, and because many of the loans in the corporate sector were short-term, the problems were exacerbated when they couldn’t easily be renewed.

We still see no signs that lending has begun to shrink on an annual basis. On the contrary, it is still growing, though at a slower rate. In Poland, Ukraine and Russia, lending has increased in domestic currency, though this is mainly the result of the weaker currencies in these countries.

We are now seeing a major reversal in current account balances in the Baltic countries

Lending is still increasing in the Baltics
Since public debt in these countries is relatively low, it is instead the uncertainty to what extent the states have guaranteed private loans that is increasing the risk of defaults. Measured in terms of Credit Default Swaps, the risk is still considered high, especially in Ukraine. The rating institutes have cut their ratings as well. Standard & Poor’s, for example, has given Latvia a rating of BB+ and Russia a rating of BBB, while Lithuania was rated A+, Estonia A and Poland A-. As expected, Ukraine had the lowest rating, CCC+. All the countries have a negative outlook, except Poland, which has stable prospects.

A shrinking global financial sector is reducing demand for assets in emerging and transition economies. It is becoming harder to create demand for government, corporate and mortgage bonds, at the same time that loan syndication is decreasing. Portfolio and direct investments are falling due to the lower risk appetite, as well as poorer growth and financial conditions. As a whole, the situation is more difficult for countries starting out with large imbalances, which increases the importance of effective economic policies to strengthen confidence at home and abroad.

Different views on currency policy

Interest rates in Estonia, Latvia and Lithuania are pegged (one-way) to the euro through their ERM II arrangements. Estonia and Lithuania have currency boards. Poland, Russia and Ukraine, on the other hand, have more or less fluctuating currencies, which have depreciated owing to the financial crisis and recession. The competitiveness of these countries has strengthened on a relative basis in pace with their depreciating currencies, while the Baltic countries saw their competitive strength fall, mainly in 2008, when inflation and wage growth exceeded that of their trading partners.

The fact that these fixed exchange rate systems, in combination with overly expansive fiscal policies and funding in foreign currency, have contributed to the overheating in the Baltics in recent years is one thing. What kind of currency policies they need now is another. The
problem in the Baltic countries hasn’t been insufficient export growth, but excessive import growth in recent years when fiscal policies were too expansive and wages and lending grew too quickly.

Real trade-weighted exchange rates (Index 100 = 1999)

Source: Reuters EcoWin

The benefits of a devaluation are the competitive boost and improved export opportunities it can provide. At this point, global demand is contracting, however, which reduces the impact of a devaluation. Instead, we have to consider the downside: inflation rises when import prices are higher. A devaluation could hurt demand via financial markets, while increasing the debt load for loans in foreign currency and the likelihood of more bankruptcies. Moreover, a devaluation in one country can lead to devaluations in its neighbours.

With current account balances rapidly improving on the heels of weaker demand and the resulting slowdown in imports – and because exports have remained stable for an extended period – the internal devaluations we are now seeing appear to be providing a needed restructuring to current account balances. Choosing an internal devaluation while continuing to back the goal of fast-track accession to EMU would seem to be the most effective alternative, especially given the export structure of these countries, current global demand and their desire to adopt the euro.

It is also interesting to note that with the EMU criteria as currently formulated, those countries that deflate their economies have better prospects of meeting them. Countries with deflation meet the inflation criterion. If they carry a low level of public debt relative to GDP (as the three Baltic countries do), they can surely keep their budget deficits below 3% in any given year. The current account problem, which is not as important a criterion but is still followed, also improves when countries devalue their currencies internally and imports fall faster than exports. It would seem to make sense that the criteria to participate in the EMU should account for several years of stable public finances and current account balances. At the same time it may be worth considering shortening the two-year period to participate in ERM2, since the currency markets rarely are steered by fundamentals. Furthermore, many transition economies have structurally higher inflation owing to faster productivity growth in tradeable
sectors than more mature economies (the so-called Balassa Samuelson effect). Though it isn’t for this reason alone that inflation is often relatively high in transition economies (competitive problems and inflation expectations are also factors), these aspects may have to be given greater weight in the criteria for euro membership. The alternative is that the countries delay joining EMU for many years until they have matured in this regard. If so, they would miss out on a bigger capital market and more stable macroeconomic environment.

The current financial crisis and recession make this the wrong time to reassess the Maastricht criteria. For the Baltic economies, it would be helpful if the current rules remain in place, which would allow them to fully participate in EMU faster and show that their internal devaluations were the right choice from a currency policy perspective. The Baltic countries can relatively quickly adopt the euro when looked at this way. For Poland, the goal is to participate in ERM2 this year and adopt the euro by 2012. We feel that Poland should not rush its accession to ERM2 and EMU. For one thing, there is a risk that fiscal policies could be overly tight during a recession. Secondly, there would be nothing wrong with a few more years of untethered exchange rates while the economy converges with the EU average.

The EU’s importance to Eastern and Central Europe

For Eastern and Central Europe, the EU and EMU provide greater security in the form of the underlying macroeconomic stability the EU offers and because of the strong political commitment to the region. The economies of the new members are converging with those of older members, a process that continues despite the financial crisis and recession.

The EU has agreed to expand the fund to support current account problems from €25 billion to €50 billion. When instability arises, the problem will be handled country by country, instead of trying to collectively support the entire region. There will also be better opportunities to discuss and discourage competitive devaluations and protectionism, even though it isn't clear yet how much pressure the group will be able to exert. While countries stand behind anti-protectionist rhetoric, tension invariably arises when action is required. The recent announcement by French automaker Renault to move some of its car production from Slovenia back to a suburb of Paris is one example.

Slightly over half (52%) of the EU’s structural funds are targeted for new member states, while Greece, Portugal and Spain are receiving 22%. The remaining resources (26%) go to the least developed of the EU’s other member states. Poland will receive, together with about 20% co-financing, €108 billion in 2007-2013, corresponding to slightly over 5% of its annual GDP. Absorption of these EU funds was relatively weak during the previous stage (2004-2006). Latvia and Lithuania used only 30%, while Slovenia tapped 50% of its allocated funds. The incentive to use EU funds is likely to increase during the recession. Moreover, because of the focus on infrastructure, the environment and energy, there is likely to be demand for the funds.
Competitive strength means everything

The process of converging toward the EU average has gone relatively quickly for Eastern and Central European countries in recent years as the new member states have gained greater access to capital markets and attracted large volumes of direct investment. We cannot expect further convergence to be quite so “automatic” in the years ahead. Reforms and effective economic policies will be critical.

For Russia and Ukraine, which are not EU members, the need for institutional change and structural reform is even greater than for the Baltic countries and Poland, which have undergone more extensive reforms since EU membership. Still, there is room to reduce bureaucracy and corruption in all these countries.

Infrastructure investments can be critical to the speed of the convergence. For Poland, it is also important to strengthen incentives for labour market participation. All these countries must increase their investments in education, research and development. Looking beyond the crisis, we can expect to see a newfound understanding of how the geographical map is being redrawn and how strong the expansion is in Asian countries, for example. The Baltic Sea region has every opportunity to be more competitive through increased trade, more direct investment and research cooperations. Improving value-added in production is a strategy every country should support.

The convergence is no longer automatic

Institutional reforms and …

… the labour market as well as infrastructure investments would improve competitiveness

Swedish exports by Baltic Sea country, % of total exports

Source: SCB and Swedbank.

The Baltic Sea region still accounts for 40% of Swedish exports. Slightly over 80% is to the other Nordic countries and Germany, with exports gradually increasing to Poland, Russia and the Baltic countries. While the financial crisis and recession are hurting export opportunities for Swedish companies, there is every reason to see the investments in these markets from a more long-term perspective. In the Baltic Sea region, there are markets that are growing due to the convergence and gradually rising standards of living. Production costs will be slashed, primarily for wages and premises, at the same time that the labour supply will ease. There are many challenges facing the Baltic Sea region, but opportunities as well.

Cecilia Hermansson
Russia: Dwindling cash reserves

Population: 141.6 million
GDP per capita 2007: USD 14,400
Government: Market-oriented coalition
Prime Minister: Vladimir Putin
President: Dmitry Medvedev
Next parliamentary election: 2011
Next presidential election: 2012
Average GDP growth in last five years: 7.0%
Average inflation rate in last five years: 11.3%

Summary

- Now that global oil prices have stabilised, turbulence in the Russian financial market is expected to ease. Russian reserves are still quite significant despite last year's interventions in the currency market and expectations of expansive fiscal measures. The biggest macroeconomic risk in 2009 is that oil prices will again fall, resulting in a further outflow of foreign capital and higher external funding costs.

- We expect GDP to shrink by 3% in 2009 before rising 2% in 2010. Domestic demand will slow and wage cuts will become more commonplace as unemployment climbs. With a fiscal expansion, we expect the budget deficit to reach 5% of GDP in 2009, but monetary policy will be tightened to stabilise the exchange rate, leading to higher interest rates.

- Government control will be further centralised and strengthened as the business sector comes under increased pressure. With selective stimulus measures and direct lending to financial institutions, the state will increase its influence in the private sector. Russia is also expected to flex its financial muscles in the neighbouring region, increasing its influence but causing greater uncertainty for foreign investors.

Consequences for companies

- Companies active in Russia or that sell to Russia face considerable challenges in 2009. Consumer spending and demand are retreating, access to capital will remain uncertain and jittery global financial markets could further weaken the rouble.

- There are also opportunities being created in Russia. The competitive situation will improve as foreign investment slows and local companies feel pressure from having taken on excessive debt. Moreover, labour costs will fall and access to qualified workers will improve. As more emphasis is placed on local businesses and their profitability, tax pressures should ease in the years ahead. A large fiscal stimulus package is expected to increase public investment and contribute to important infrastructure projects, which could create business opportunities.

- In the longer term, Russian business faces a major structural transformation. The impact of falling exchange rates and shrinking...
foreign capital will change conditions for Russian business and international investors. The process by which domestic production shifts to the consumer market will be gradual, but will create opportunities to locate more production in Russia to both satisfy the domestic market and for exports. Factors such as widespread corruption, an unpredictable justice system and limited freedom of the press will affect foreign investors and delay diversification.

Economic crisis is further centralising political power

The state’s – and thus the government’s – influence over the economy has grown considerably in the aftermath of the global financial crisis. A large slice of Russian businesses and the financial sector faced an acute liquidity crisis last fall. The state’s huge currency reserves were tapped for rescue measures and as liquidity support for selected companies and sectors. Its remaining domestic reserves, estimated at 12% of GDP, are still substantial, however. The state’s expanding role in the economy is likely to continue as part of crisis management efforts.

The oligarchs (the politically connected businessmen who built huge sums of wealth during the first privatisation wave) have seen their power and assets shrink. Many are deeply in debt and had to turn to the state for emergency loans to avoid bankruptcy. In the process, the state became a direct and indirect owner in an increasing number of strategic sectors such as finance, energy, metals and telecom.

The political coexistence between Prime Minister Putin and President Medvedev appears to be splitting at the seams. Medvedev has long been regarded as a temporary stand-in for Putin. The economic crisis raises the political stakes for Putin, who is only marginally responsible for economic policy. Medvedev has kept a distance and criticised the pace of the crisis management efforts. Putin, for his part, continues to maintain a high profile in foreign policy, an area traditionally regarded as part of the president’s mandate.

Growing economic discontent among the populace could also have far-reaching political consequences. With growing unemployment and reduced or unpaid wages, there is a risk that political protests against the authoritarian leadership could spread to the masses. Russian authorities have previously clamped down on liberal opponents and critical journalists. Growing political dissatisfaction could lead to a tougher stance with more reprisals and even more authoritarian measures by the current regime.

The economic slowdown notwithstanding, Russian has become more active in terms of foreign policy. With its strong stance against expanded NATO membership and the weakness of Western economies, it appears at this point that Russia has stopped NATO’s expansion. It also seems that it is closer to its goal of halting the installation of a US missile defence against Iran. President Barack Obama has signalled that he is prepared to negotiate, but at the same time is demanding that Russia support the U.S.’s Iran policy.
Russia has also strengthened its positions in the neighbouring region. The war in Georgia led to international protests, but they quickly died out. Instead, more countries in Caucasus are seeing Russia as an alternative to Western-oriented institutions. With its substantial financial resources, Russia has shown itself to be willing to provide financial support, but on terms that differ from the IMF or World Bank. Countries in Caucasus and Eastern Europe are also dependent on Russia for their energy supplies and because of extensive labour migration. The gas conflict with Ukraine late in December shut off deliveries, and many countries in south-eastern Europe suffered a direct energy shortage.

Global oil prices are critical to rouble, stability and growth

The global economic and financial crisis hurt Russia through the collapse of commodity prices and the increasing turbulence in international capital markets. The global price of oil, Russia's most important export, fell from a high of $138 a barrel to $34 a barrel at its lowest (Ural crude). A previously large influx of capital came to an end and foreign investors instead repatriated their capital. This led to a significant decline in external financing, but was compensated in part by state subsidies to banks and certain large companies. Growth in the last quarter is estimated to have fallen to 2.5%, compared with an average of 7.5% during the three previous quarters, while industrial production declined in the last quarter by slightly over 5% year-over-year.

Russia's financial markets have been hard hit by weaker global confidence. By early 2009 the stock market index had fallen by 75% from its peak and the perceived risk of non-payment of foreign debt (measured through credit default swaps) had skyrocketed. As a result, funding costs will rise and access to external credit will be limited. Oil prices and the financial crisis have also placed greater pressure on the rouble. The Russian central bank gradually devalued the rouble in fall 2008 and used a large part of its currency reserves to fight off speculation. In early 2009 the rouble had fallen in value by 30% against a basket of euro (45% weight) and dollars (55% weight) compared with early 2008. At the same time the value of international reserves had shrunk by nearly one fourth, from $480 billion to $387 billion.

The stabilisation of oil prices at around $45 a barrel in recent months has provided a respite for Russia’s stabilisation policies. The central bank has signalled that it intends to defend an exchange rate of 41 roubles to a euro/dollar basket as long as the price of oil does not fall below $30 a barrel. Despite that a large part of currency reserves and the stability fund have been used to defend the rouble and support banks and companies, there are still plenty of resources left.

For 2009, we expect GDP to fall by 3% before growing by 2% in 2010. Previously strong external demand has fallen off, and domestic demand has been weakened by lower real incomes. The government has announced additional fiscal stimulus measures. We expect the
budget deficit could reach 5% of GDP, compared with an estimated surplus of 4.1% in 2008. In our oil price projection for 2009, we anticipate a price of around $50 a barrel at year-end and that the rouble therefore will not weaken any further relative to its target rate.

Expansive fiscal policies will be balanced by tight monetary policy. Prime Minister Putin has promised financial support for large sectors of society through direct transfers, subsidies and tax cuts. In early 2009 the capital gains tax was cut from 24% to 20%, and the tax on small businesses dropped from 15% to 5%. Monetary policy serves as a support for exchange rate policy, but at the expense of higher interest rates and weaker development in the private sector. This will limit inflation pressures. We expect inflation of 15% in 2009, against 14% in 2008. Falling commodity and food prices, coupled with weak demand, are compensating for the effects of the exchange rate depreciation and expansive fiscal policies.

Consumer spending is expected to stagnate due to rising unemployment, nominal wage cuts, unpaid wages and tighter access to credit. Falling share prices (to the extent households have invested in equities) and housing prices will affect the willingness of consumers to spend. Russian households are not especially weighed down by debt, however, so consumer spending could quickly rise once the economy rebounds.

Although households have been hard hit by the economic slowdown, the situation is even more acute for small and medium-sized businesses. Their profitability in recent years was rooted in growing domestic demand, primarily for consumer goods, and rising external demand, especially for metals and other commodities. At the same time borrowing in foreign currency has increased. With quickly declining sales and limited access to new credit, their liquidity situation could become a big problem once these loans fall due. The state has shown itself to be willing to provide foreign liquidity to banks and large strategic companies. The extents to which the Russian state will expand its liquidity support, and the terms it will demand, remain uncertain.

The biggest macroeconomic risks in the years ahead are external. Oil prices are critical, although developments in global financial markets will also impact Russia’s access to capital for investment and consumption. This is dependent on confidence and the credibility of Russian economic policy.

The Russian growth model faces huge challenges in the years ahead. It is unlikely that economic policies will be able to fully replace external demand with a domestic fiscal expansion. Even Russian reserves are insufficient, and this would unnerve the financial market. Instead, there is likely to be a shift toward developing domestic businesses, which can better adjust to the lower cost structure that has resulted from the currency depreciation and wage cuts.

Greater diversification of the Russian business sector, and for companies active in the Russian market, will be necessary. To date,
production for Russian consumers has consisted of assembly operations, mostly of imported inputs. Value-added in Russian manufacturing has been low, particularly in companies established by foreign investors to focus on the growing Russian market. Now that cost structures have changed, there will be greater incentive to place more production in Russia and to a greater extent develop locally produced input goods.

The financial and banking sector will also undergo a structural transformation. Many Russian banks do not serve as traditional intermediaries between domestic savings and lending. Instead, companies increasingly look abroad to meet their borrowing needs. Furthermore, many of the banks are directly linked to the oligarchs and offer no traditional banking services to speak of. The growing shortage of foreign capital will force Russian banks to strengthen their capacity to take in deposits and improve lending productivity. To raise efficiencies and normalise the Russian financial market, a major consolidation of Russian banks and financial institutions will be needed.

Swedish companies operating in Russia usually maintain a long-term perspective. The drop in demand will keep pressure on margins, though the cost structure for production in Russia will be more favourable. At the same time they will have opportunities to strengthen their market position as competitors come under increased pressure and acquisitions become relatively inexpensive. Provided there is a willingness to take on risk, expansion in the Russian market will increasingly be at the production level, partly for the large Russian market, but also for exports with what is now a relatively inexpensive rouble.

Magnus Alvesson
Ukraine: Deepening crisis

Population: 46.4 million
GDP per capita 2007: USD 6,810
Government: Market-oriented coalition
Prime Minister: Yuliya Tymoshenko
President: Viktor Yushchenko
Next parliamentary election: 2010
Next presidential election: 2010
Average GDP growth in last five years: 6.4%
Average inflation rate in last five years: 14.7%

Summary

- The international financial crisis (and subsequent fall-off in trade and capital flows) and 50% decline in steel prices have exposed Ukraine’s imbalances and quickly led to a deep financial and economic crisis. The period leading up to the crisis was distinguished by the private sector’s increased reliance on borrowing in foreign currency, growing structural budget deficits, a spiralling current account deficit and weakening economic competitiveness.

- The political power struggle, with a presidential election scheduled in January 2010, is complicating reactions to the economic crisis. Unpopular, but necessary, economic decisions could be delayed or watered down.

- For 2009, there is a significant risk that the crisis could worsen, with increased capital flight, diminished confidence in the hryvnia, rising inflation and falling incomes. We expect GDP to shrink by 9% in 2009 and 3% in 2010, at the same time that inflation slows.

- In the medium term, Ukraine’s potential as an emerging economy still remains. The recovery will depend on the international economy, but also on the ability to resolutely implement the economic stabilisation programme.

Consequences for companies

- This year will see a major decline in economic activity, incomes and employment. Business opportunities will shrink for foreign companies that sell in Ukraine. Currency markets are creating uncertainty for companies that do business with Ukraine.

- For many companies located in Ukraine, the major economic slowdown in 2009 and 2010 poses huge challenges. At the same time the economic and financial crisis creates opportunities for those with patience. Production in Ukraine will become more competitive. Many of the bottlenecks, e.g., a lack of qualified labour, during the recent period of economic growth are disappearing. There will be opportunities for consolidation and higher market share. In addition, the government has revisited the process of privatising state-owned companies. The cost to invest in Ukraine is falling due to the weakness of the currency.
- Ukraine remains an economy with good development opportunities and a relatively well-educated work force. Trade potential is considerable in the east bordering Caucasus as well as the north facing the Russian market and westward facing the EU. Membership in WTO and the possibility of a free trade agreement with the EU could strengthen this position.

Political power play is undermining the ability to manage the financial crisis

The economic and financial crisis has worsened and aggravated the political split. In fall 2008 the three-party coalition broke down. New elections were announced, but cancelled after a court ruling. Instead, a new coalition was formed in which Prime Minister Tymoshenko again received support from part of the pro-presidential party OU-PSD and the less liberal Lytvyn Bloc. A no-confidence vote in March 2009 failed. Since another vote cannot be called within six months and an election cannot be held six months prior to a presidential election, it is likely the government will sit through the rest of the year.

Tension between the prime minister and President Yushchenko has grown significantly in recent months against the backdrop of the upcoming presidential election in January 2010. The current president’s approval ratings are so low it is considered unlikely he will be re-elected. Instead, the choice is between Prime Minister Tymoshenko and opposition leader Viktor Yanukovych, who draws support mainly from the Russian-speaking eastern sections of Ukraine. Tymoshenko must balance the need for economic crisis management and tighter fiscal policy with her desire to be elected president. President Yushchenko seems to be trying to undermine Tymoshenko to open the way for an ally as presidential candidate or, if Tymoshenko drops in popularity, to run as the only Western-oriented candidate against Yanukovych.

The need for serious economic crisis management is also affecting political stability. Former Finance Minister Viktor Pynzenyk was outmanoeuvred and stepped down due to a lack of influence in the negotiations with the IMF and in connection with the budget revision for 2009. The appointment of a new finance minister is dragging on. It is likely the IMF will require that one is in place with the mandate to negotiate a revised budget if the economic support programme is to continue. In addition, the IMF has demanded that the prime minister and president sign a joint declaration that they support the economic crisis policy. In the end, however, the manoeuvrability available to politicians will depend on the reaction of the people, and Ukraine has a long tradition of noisy protests that can lead to dramatic political change.

Rapid economic reversal

Ukraine’s economic imbalances have been built up over an extended period. Leading up to crisis, from 2002 to mid-2008, economic growth was driven by a major expansion in domestic demand generated by wage increases and capital inflows. High steel prices and subsidised
natural gas imported from Russia led to big profits, especially in the metals industry, but also in other energy-intensive production. Wages were driven up in other sectors, and Ukraine's competitive strength eroded. The credit expansion in the private sector, which grew more than 70% in 2007, also drove the demand boom. Many borrowers, both households and businesses, took out loans in foreign currency at lower interest rates in expectation that the fixed exchange rate policy would hold. In mid-2008, about half of the total outstanding loan amount was denominated in foreign currency, mainly dollars. Fiscal policy weakened and structural outlays such as wages and pensions grew substantially. At the same time the large revenue increases were largely due to economic growth.

Because of previously favourable economic conditions and good profitability, many industries did not bother to rationalise or modernise to a significant extent. The subsidised gas price led to overconsumption of energy and inefficiencies. Generous lending terms created an expansion in many sectors that was unsupported by underlying earning capacity. In addition, the modernisation of the legal system, which dates back in large part to the Soviet days, has stagnated. Bankruptcy laws in particular are outdated and create a major stumbling block for the structural transformation now needed.

International crisis is hitting Ukraine hard

When the global financial crisis broke out in mid-2008, it had major consequences for Ukraine. With a fixed exchange rate policy and large imbalances, the economy was highly vulnerable to external disruptions. Two factors in particular came into play: the drop in global steel prices (which fell to half of what they were in the summer of 2008) and the collapse of international capital flows. The crisis worsened due to Ukraine’s dispute with Russia on gas deliveries, which led to their shut-off, though also to a global shortage of trade credits, which sent demand for Ukrainian exports even lower. The government initially reacted by introducing capital controls on foreign currency and limiting bank withdrawals. In March 2009 import duties were adopted as well to strengthen the external balance.

The immediate impact of the crisis was a major decline in the exchange rate. Between May and December 2008, the hryvnia fell nearly 60% against the dollar. Even before the crisis, it had shown signs of overvaluation owing to high domestic wage increases and inflation. The weaker currency caused solvency and liquidity problems for many households and companies. Financial companies found themselves exposed to exchange rate risks, and many customers began withdrawing their savings. Certain large domestic banks were taken over by the authorities, at the same time that the banks now need capital contributions. The stock market was also hit hard, and in January had fallen by 80% year-over-year.

GDP quickly turned lower in the last quarter of 2008. For the full year the economy grew only 2.1%, compared with 7.9% a year earlier. Inflation peaked in the second quarter of 2008 at an annual rate of around 30%. During the last six months, inflation has slowed to an
annual rate of 21% as of February. Domestic demand slowed during the fourth quarter and household consumption decreased in volume by nearly 1% compared with a year earlier. In the labour market, wage growth has eased significantly, and average wages rose only 1% in the fourth quarter. Gross corporate investments fell by 6.5% during the same period and industrial production dropped 3.1%. External imbalances grew in 2008 and the current account deficit amounted to 6.2% of GDP.

International support for Ukraine’s crisis programme

In November of last year, Ukraine reached an agreement with the IMF on a $16.5 billion stand-by arrangement over three years. The World Bank and the European Bank for Reconstruction and Development (EBRD) will also contribute significant loan facilities. The principal aim of the programme is to stabilise the economy. The key elements are liquidity support for financial companies and an expanded deposit guarantee to stabilise the financial markets. An analysis was made of every bank to verify the need for additional capital. At the same time a framework was created to manage the growing debt burden of households and businesses. Moreover, the programme sought to adapt the economy to changing global economic conditions. The IMF required Ukraine to maintain a flexible exchange rate policy and use its money supply as a nominal anchor for economic policy. To keep inflation in check and remain competitive, it is important that Ukraine maintains tight fiscal and monetary policies and keeps public wage increases in check. At the same time the gas subsidies will be phased out. In December of last year, the World Bank granted a loan of $500 million to support the government's budget and the EBRD announced a €1 billion loan package, including to the financial sector. Both the EBRD and the World Bank have set as a condition that the government reaches agreement with the IMF, however.

After an initial payment of $4.5 billion was issued in December, negotiations between the IMF and Ukraine’s government have come to a standstill. The government has insisted on a significantly larger budget deficit than had been agreed to with the IMF, but is having difficulty finding outside financing. With an unfinanced budget deficit, inflation expectations would rise and pressure on the hryvnia would increase further. Prime Minister Tymoshenko has sought bilateral support in the form of loans in Russia and from the West.

Economy seeking a bottom

The macroeconomic risks in Ukraine in 2009 are considerable. The current situation is marked by political uncertainty and the market’s declining confidence in the Ukrainian economy. People will be hurt by significant real wage cuts or job losses, at the same time that the debt burden for loans in foreign currency will grow. There is a significant risk of further capital flight, which would put renewed pressure on the currency and growth.
We expect the crisis to worsen and GDP to shrink by 9% in 2009 and an additional 3% in 2010 before slowly recovering in pace with stronger global growth. Falling real wages and a growing debt burden will limit household consumption. We expect a decline in real terms of up to 15% and an even bigger decrease, 20-25%, in investments. Limited access to credit and weak growth in demand will force companies to cut back on everything but the most necessary expenditures. State investments will also be limited, and with falling revenues the budget deficit will rise to 5% of GDP. The external imbalance will be reduced through a slowdown in imports, which exceed the weak global demand for Ukrainian products. The current account deficit is expected to shrink to -1% of GDP. The exchange rate depreciation last year will increase pressure on inflation, but with falling demand we do not expect it to exceed 20% this year.

Ukraine’s short-term development is mainly dependent on the international economy. If global demand for steel and food products levels off and rebounds, the economic slowdown can be softened. More active international financial markets could provide a respite for Ukraine’s capital requirements and lead to more generous lending terms. Global confidence in Ukraine’s economic policies will depend in large part on the success of the negotiations with the IMF and whether the country can gain the support of the World Bank and EBRD. It is likely that direct loans from other countries will be required as well.

The risk of a default on foreign payments and government bankruptcy isn’t negligible. However, Ukraine has a relatively low national debt, at 20% of GDP, of which 15% of GDP is foreign debt. One uncertainty with regard to the state’s ability to repay is the extent to which implicit and explicit debt guarantees have been issued to private or state-owned companies. The private sector faces large debt repayments in 2009, a big part of which is from subsidiaries of foreign-owned companies. Although many of them also have problems in their home markets, we expect a significant share of these debts to be renegotiated. The decisive factor is whether the problems with the IMF programme can be resolved quickly and whether other financial organisations will again start issuing payments.

Companies in the financial sector will find lower demand both at home and in export markets. In addition, the debt burden is increasing at the same time that the availability of new credit will be very limited. For companies in the financial sector, credit losses will grow and the need for new capital will become acute. The number of bankruptcies is likely to rise significantly, which will fuel the economic downturn in the short term.

**Debts are a critical element in 2009**

**The number of bankruptcies in the private sector will grow**

**Structural transformation and diversification of the business sector will be needed**

Ukraine beyond the crisis

In the long term, the crisis will speed up the transformation of the business sector. The Ukrainian economy has been overly dependent on a few commodities and energy-intensive products, at the same time that a large share of domestic consumption has been satisfied with imports. Following the crisis, Ukraine will be better positioned to
compete internationally. Wages have declined, the exchange rate has been adjusted and trade flows have been facilitated by Ukraine’s membership in WTO. As in the previous crisis, there will be opportunities to speed up legislative reforms to create laws better suited to modern business. This could increase competition and efficiency. Furthermore, Ukraine remains a large market with a relatively well-educated workforce. The convergence with the rest of Europe will begin again. Bottlenecks such as a skills shortage will ease.

Sectors with high value-added will be of interest to companies. For Ukraine, with its extensive agricultural sector, this is especially true of food products, which can find markets locally as well as in the neighbouring region. The government recently announced it intends to liberalise the market for farmland and make it easier to consolidate small farms. Manufacturing may also have big potential given a new, more cost-effective wage structure. Acquisitions and new investments will offer cost advantages. The Ukrainian government is expected to re-launch its privatisation process, with state-owned enterprises in energy, agriculture and telecom perhaps ripe for sale.

_Magnus Alvesson_
Poland: Hopes rest with households

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<td>Next parliamentary election:</td>
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<td>Next presidential election:</td>
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Summary

- Poland is being affected by poorer export opportunities and tighter credit terms. Still, it has an opportunity to achieve marginal GDP growth this year with the help of the EU’s structural funds.

- The Polish government is anxious for the zloty to enter the ERM2 exchange rate mechanism this year, with full EMU membership by 2012. The risk is that fiscal policy will be held unnecessarily tight during the recession in order to qualify. If anything, the weaker currency could provide support during the slowdown. Quick accession won’t necessarily benefit the country.

Consequences for companies

- Domestic demand is expected to grow slightly despite the slowdown in export industry. Even with slower market growth, there are still relatively good business opportunities. In the long term, the large and growing Polish market offers considerable potential for companies in the countries around the Baltic Sea.

- Wage growth is slowing as unemployment rises. The labour shortage is also easing as migrant workers return home. Costs for companies with production in Poland are dropping from last year’s high level. A weaker zloty provides some support for exporters, but at the same time raises import prices and limits the decrease in inflation slightly.

- Expect the government to announce fewer privatisations, and others could be delayed. Foreign direct investment is decreasing from $18 to $14 billion. Still, the EU’s structural funds could help to maintain public investment, potentially creating big opportunities for Swedish companies as well.

- There is still strong demand for Swedish environmental technology companies in Poland. An energy alliance between Sweden and Poland could also generate business. Further, the Polish food sector continues to develop positively.

Politics focused on quick EMU accession

The government can be pleased that Poland has to date managed the global financial crisis and recession relatively well. After six years of rapid economic growth, the slowdown in 2008 was modest, at the
The same time that relations with the EU have improved. The new U.S. administration’s hesitation to place missiles in Poland (and Czech Republic) potentially could improve Poland’s relationship with Russia.

Prime Minister Donald Tusk and his party, Civic Platform (PO), have strong domestic support for their policies. If an election were held today, over half the population would vote for the sitting government, while the largest, and less EU-friendly, opposition party, Law and Justice (PiS) – led by President Lech Kaczyński’s brother, Jarosław – would receive the support of a quarter of the voters. Public opinion figures provide an indication of the possible outcome of the election in June this year when 50 Polish representatives are elected to the EU Parliament.

While Tusk represents a younger, more urbane, business-oriented and outward-looking Poland, Kaczyński has more traditional, conservative and Catholic values, at the same time that his politics lean Socialist. By setting himself apart from Kaczyński, Tusk has gained in popularity. The presidential election in October next year has already forced the prime minister to be less radical, since he has his sights on the presidency. The parliamentary election – scheduled for fall 2011 – coincides with Poland’s chairmanship of the EU. Consequently, it may be held earlier in the spring of that year.

To date, the government has been trying to reform the pension system, reduce bureaucracy and facilitate infrastructure investments. We have seen the pace of reform slow, but this could be partly due to the president’s veto, which stopped many of the government’s proposals. In the last half year, policies have focused on the economic slowdown and worsening financial markets:

- The zloty has lost 40% of its value against the euro and two thirds against the dollar since July of last year. Against the Swedish krona, the zloty has lost slightly over 20%. The central bank has intervened to prevent too much of a slide. Although the financial crisis is affecting the zloty, Poland's large government lending needs (up from $70 billion last year to $113 billion this year) may also be hurting the currency.

- In September of last year the government announced an aggressive target date to meet euro accession criteria. It hopes that the zloty will be pegged to the euro within ERM2 as early as this year in order to achieve the full membership in EMU 2012. A constitutional amendment may be needed before joining ERM2. It is uncertain whether there is a parliamentary majority to support membership. The opposition (and even the central bank) want to slow down. The government can decide whether to participate in ERM2 without parliament’s approval, but that could raise concerns about the zloty’s two-year period in ERM2 owing to the increased risk of speculation. The financial crisis makes it more difficult for the government to qualify for euro accession and stabilise the economy, particularly if the budget deficit exceeds 3% of GDP and automatic stabilisers aren’t given a chance to have their full effect.
Poland

- Polish banks are not directly exposed to toxic loans in the global financial system, but are affected by the reduced access to liquidity and falling real estate prices. Since about 60% of mortgages are in Swiss franc, the declining value of the zloty increases the risk of borrower insolencies. The government has issued a bank guarantee worth 40 billion zloty to ease the situation in the interbank market, and has issued 3.5 billion zloty to BGK Bank to limit the credit crunch, which is mainly hurting small and medium-sized businesses.

- Because companies have bought options to hedge against a stronger zloty, its substantial weakening instead has now left many of them at risk of bankruptcy. The losses reported by the hundred or so companies in question are estimated at 15 billion zloty. The government – through the Peasant Party’s deputy prime minister, Waldemar Pawlak – has announced that the options may be ruled invalid through legislation, though it is unlikely the prime minister will support this. Breaking existing contracts collectively in this way, rather than by the parties themselves, would weaken the investment climate.

- To date, the government has presented a fiscal stimulus package worth 91 billion zloty for 2009/2010, but at the same time ministries are slicing expenses to maintain some form of budget discipline. The government is trying to keep the budget deficit at around 2.5%, but that target is based on optimistic GDP projections. The central bank has cut its discount rate from 6% last fall to 4%. We cannot rule out further rate cuts, despite the weaker zloty.

Economy is cooling off

Even Poland can’t avoid the impact of the global financial crisis and tighter credit, as well as the global recession, which is hurting export opportunities. In the first three quarters of 2008, the Polish economy grew by 5.7% on an annual average, before GDP growth fell by 2.3% in the fourth quarter.

In February of this year, industrial production had decreased by nearly 15% year-over-year. The industrial slowdown contributed to an increase of slightly over 2 percentage points in unemployment since October 2008, from 8.8% to 10.9%. Wage growth in the private sector is slowing. It seems certain that domestic demand will decline as the export sector cools off. Despite the slowdown, Poland appears to have the strongest economy in the Baltic Sea region. There are several reasons why:

- Poland is entering the recession with relatively good fundamentals and without major economic imbalances. Household savings are relatively high, at around 9%, and their debt ratio was 30% of disposable income in 2007 (and mortgages nearly 10% of GDP). Public finances are also in reasonably good shape. Although the current account deficit has risen as a share of GDP, 5-6% is still lower than many other countries in Eastern and Central Europe. At the same time that foreign direct investment is shrinking, the EU’s...
structural funds (totalling €108 billion in 2007-2013 incl. co-financing, or slightly over 5% of GDP per year) could compensate for part of the fall-off and help to spur public investment (infrastructure, environment, energy, IT and healthcare).

- The weakening of the zloty provides some support for the economy, but because global demand is falling broadly, the effects on Poland’s competitive strength are limited in the short term. Exports are falling, but that is being softened somewhat by the weaker zloty. Imports are also declining due to the currency, as well as because of lower investments and falling exports.

- Consumer spending accounts for slightly over 60% and public spending nearly 20% of GDP. Relatively high domestic demand appears to slowing the decline that thus far has impacted industry.

- While household income is hurt by weaker wage growth and rising unemployment, there is a gleam of hope for those with jobs in the form of tax cuts and lower inflation. In addition, the incomes of pensioners and certain wage-earners are indexed. Real disposable income continues to rise, though not at the double-digit rates of recent years.

- Poland can avoid a serious domestic financial crisis. Although credit terms are tightening, lending is still growing and activity in the interbank market is gradually easing. Credit growth has continued to rise and on an annual basis amounts to slightly over 45% for households and nearly 30% for non-financial companies.

We expect GDP to grow by a marginal 0.25% this year and 1.5% in 2010. Household and public spending will support the economy while industrial activity declines. Investments are also falling in the aftermath of lower exports and capacity utilisation. The weak zloty and lower capital inflows will reduce the current account deficit.

The primary risks in assessing the economy for 2009 and 2010 are Poland’s ability to handle the financial crisis and the effects on domestic demand. Though household debt ratios are low, indebted households are still fairly vulnerable to a weaker currency, falling real estate prices and rising unemployment.

**Many structural challenges remain**

According to a survey by the Lisbon Council, Poland has made considerable progress to reach the targets of the Lisbon Agenda. The results have been especially good in terms of economic growth and productivity, while the labour market and human capital are developing relatively weakly. As a whole, Poland places second after Finland (Sweden ranks fifth).

The OECD has stated that productivity growth is now beginning to slow. The long-term challenge is to create a tax system that encourages participation in the labour market. The employment rate is low at 50%. To assist entrepreneurs and strengthen the business
climate, bureaucracy will have to be reduced, along with corruption and nepotism. Moreover, infrastructure investments will have to be accelerated. Perhaps the fact that Poland (together with Ukraine) is hosting the Euro 2012 football championship can be the catalyst needed to modernise roads and housing.

Cecilia Hermansson
Estonia: Better equipped for crisis

Population: 1.3 million  
GDP per capita 2007: USD 19,810  
Government: Conservative coalition  
Prime Minister: Andrus Ansip  
President: Toomas Hendrik Ilves  
Next parliamentary election: 2010  
Next presidential election: 2011  
Average GDP growth in last five years: 6.0%  
Average inflation rate in last five years: 5.7%

Summary

- The Estonian economy is expected to contract by 8% this year, driven by substantially lower domestic demand and deteriorating export opportunities. Next year we expect GDP to rise by 1% on average when the economy stabilises at a low level and the EU's structural funds contribute to growth.

- Increased risk aversion among foreign investors and debt restructurings among households and businesses are slowing the level of activity in Estonia.

- Euro accession in 2010 has taken on greater political significance in the aftermath of the global financial crisis, at the same time Estonia's opportunities to meet the Maastricht criteria have improved as imbalances in the economy rapidly decline.

Consequences for companies

- The deep recession is lowering costs for companies active in Estonia. Payroll costs will decline at the same time the labour shortage shrinks. Falling real estate prices will also mean lower rental costs.

- For foreign companies with sales in Estonia, export prospects will be limited as households reduce their spending and businesses slash investments. Long-term efforts to improve productivity will still create the need for efficiency-improving investments.

- The Estonian business climate ranks among the best of the new EU member states. New labour market legislation taking effect at mid-year will give the businesses greater flexibility in connection with new hires and layoffs.

Politicians becoming more crisis conscious

Prime Minister Andrus Ansip has long been accused of not taking the recession seriously enough. Now, however, he is stressing the seriousness of the economic situation, as was apparent on Estonia's independence day, 26 February. The overall objective is to keep the coalition between the Pro Patria and Res Publica parties – under the leadership of Mart Laar – and the centre-left Social Democratic party led by Finance Minister Ivari Padar from disbanding. The government
Estonia has managed to build a consensus, even if cost cuts have caused obvious friction between the ministries in question.

The deepening recession in Estonia has necessitated extensive cuts in the state budget for 2009 beyond those announced in December when the budget was adopted. In total, the savings correspond to 10% of the state budget. Cuts will be made on a broad front and will affect public employees, pensioners and the military. In an attempt to check the slump in exports, the government has decided to support exporters that have been hurt by a lack of credit.

How robust are Estonia’s finances?

Estonia is being impacted just as hard by the economic crisis as the two other Baltic countries. However, it is slightly better equipped, particularly in terms of its public finances. More stringent fiscal policies and more efficient government administration contributed to the cumulative surplus in public finances in 2000-2007. The surplus has been placed in a reserve (corresponding to 10% of GDP) and can be used if finances should deteriorate drastically. Latvia and Lithuania have no equivalent surpluses. This is probably one reason why public confidence in Estonia’s politicians and institutions is higher than in neighbouring countries.

The government feels euro accession is likely as early as 2010, assuming that inflation continues to slow as a result of weak demand and low commodity prices. In February, inflation was 3.4%, the highest level since June 2005. The biggest risk factor, however, is that the public deficit will exceed 3% of GDP, as the government has projected. At the same time government debt is less than 10% of GDP. EMU membership would give Estonian companies and households access to a considerably larger credit market.

The Estonian economy started decelerating in the second half of 2007 when lending growth gradually declined and the housing bubble burst. Since the global financial crisis escalated last year and access to credit worsened, the real economic effects have become clearer. At the same time optimism among households and businesses fell to record-low levels. GDP fell by an average of 3.6% in 2008. The biggest decline occurred late in the year, when it fell by 9.7% on an annual basis. The slowdown is being driven by major declines in consumption and investment. This is the first time since 1999, in connection with the Russian crisis, that the Estonian economy has shrunk. From then until 2008, the economy grew by total of 90%, as a result of which GDP per capita climbed to more than 60% of the EU average, compared with slightly over 40% ten years ago.

Debt restructuring and fewer foreign investments

Industries that previously accounted for a disproportionately high percentage of the production gains in Estonia, such as construction, trade and finance, are now reporting the largest declines. The global financial crisis and increased risk aversion among companies and financial players has slowed direct investment, which is choking domestic demand. As long as uncertainty in the global financial
market and the weak investment climate persist, they will constrict growth in small, open economies with limited capital markets such as Estonia.

At the same time Estonian businesses and households are adjusting their balance sheets to correct for the excesses built up during the overheated years 2005-2007. This would suggest consumer spending will further decline as households see their buying power diminish when wages are cut and unemployment rises. A shrinking global market for Estonian exporters, overcapacity and declining profitability are expected to lead to lower investments in 2009 and 2010. Estonia’s access to the EU’s structural funds could ease the economic slowdown. The loans from the European Investment Bank (EIB) are designed as co-financing.

As a whole, we expect Estonia’s GDP to fall by 8% in 2009. Next year the economy should stabilise at a low level, at the same time that the EU’s structural funds contribute positively to growth. We project that GDP will rise by 1% in 2010. There is a big risk that things could get worse, however, if the domestic market continues to weaken. Not until 2011 do we see better conditions for economic growth as the global economy rebounds and confidence in the financial market improves. Weak domestic demand and debt restructurings by businesses and households will keep the Estonian current account deficit in check. By the end of the forecast period, there could even be a slight surplus.

Increased flexibility when the world changes
Changing economic conditions demand greater flexibility. Although the Estonian labour market is already flexible from a European perspective, new laws will be introduced at mid-year to make it easier for companies to hire and fire employees. At the same time it is important that the social safety net is strengthened. Rapidly rising unemployment, which is likely to exceed 10% within a year, increases the need for a stronger social insurance system. The government has therefore decided to devote more resources to unemployment compensation.

The Estonian business climate continues to rank high in several international surveys, such as the Global Competitiveness Report. In the short term, Estonian companies will become more competitive as the domestic cost level falls and the labour supply expands. Increased investments in research and development to make the business sector more competitive are still important to long-term economic growth.

Jörgen Kennemar
Latvia: Facing an acid test

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Summary

- The global financial crisis and recession, combined with major imbalances, are making Latvia’s recession deep and protracted. We expect GDP to decrease by 15% this year and slightly over 4% next year, when consumer spending and investments fall broadly. Latvia’s export industry, where wood product exports weigh heavily, is being hurt by the weak global investment climate.
- We expect the Latvian government to satisfy the IMF’s guidelines and tighten fiscal policy during the forecast period, which will mean extensive cutbacks in public spending.

Consequences for companies

- Substantially lower domestic demand in 2009 and 2010 will limit export opportunities for Swedish companies with sales in the Latvian market.
- Trading companies, construction and the financial sector will be especially hard hit by the global financial crisis and debt restructurings under way in Latvia, at least for the next two years.
- Domestic costs are easing rapidly in pace with lower resource utilisation in the economy. Last year’s nominal wage hike of 17% on an annual basis will be replaced by a period of significant wage cuts in both the public and private sectors.

Major challenges face the new government

The deep economic crisis in Latvia had political repercussions in February when Prime Minister Godmanis was forced to step down. Besides internal opposition within the governing coalition, Latvian President Valdis Zatlers had been critical that sufficient measures hadn’t been taken to alleviate the crisis. At the same time Godmanis’ government has long been accused of corruption and despotism, which is why its public confidence is among the lowest in the EU.

On 12 March, the Latvian parliament approved a new government (the fourteenth since the country’s independence in 1992) under the leadership of Prime Minister Valdis Dombrovskis from the New Era party, with former prime minister and president of the central bank Einars Respe as finance minister. The government is comprised of...
five parties, which together hold 64 of the parliament’s 100 mandates and therefore has a broader base than the previous government.

Critics feel that the risk of political disagreement between the governing parties could complicate or delay needed measures. The largest party in the government is already critical of how the EU’s structural funds are being used. A scheduled parliamentary election in 2010 could also complicate the governing alliance, with the risk that needed decisions will be delayed or watered down. A lack of clear boundaries between special interests and national interests has historically thwarted the political decision-making process, in which the business interests of oligarchs still play an important role.

Budgetary difficulties

The takeover in December of Parex Bank, the country’s second largest, proved to be a heavy burden for the Latvian state, making the need for liquidity acute. In the same month the IMF and EU agreed to €7.5 billion in loans, equivalent to about one third of the Latvian economy. The currency peg to the euro (Latvia is participating in ERMII) would remain unchanged. This will necessitate major spending cuts, with the goal being a budget deficit of 5% of GDP in 2009. Two thirds of the savings will be in the form of wage reductions in the public sector. The economic outlook for the Latvian economy has worsened since the start of the year, due to which the deficit is likely to exceed 5% of GDP. In its most recent forecast, the government expects a budget deficit of 7-8% of GDP. Additional savings are therefore required, which poses a big challenge for the new government. Negotiations with the IMF will soon continue. If they do not lead to an acceptance of larger deficits, there is likely to be growing speculation whether further cutbacks will be needed or other financing opportunities can be found.

Debt restructuring is worsening the recession

The Latvian economy’s expansion, driven by several years of strong credit growth and expansive fiscal policies, abruptly came to a halt in 2008 in connection with the global financial crisis and worsening international recession.

In 2008 GDP fell by an average of 4.6%. The downturn accelerated late in the year when GDP fell by as much as 10% on an annual basis. Rapidly rising unemployment, lower wage increases and debt restructurings are forcing households to cut back on their spending. Retail sales have fallen for the last year. The country’s collective investments fell by nearly 15% in 2008, although the decline in export volume was limited to a modest 1%. Falling domestic demand is helping to rapidly reduce the current account deficit, which reached nearly 10% of GDP at year-end 2008, compared with nearly 20% a year ago.

The huge debt build-up, which the private sector quickly created when foreign capital became available and asset values rose, will be followed by a period of extensive debt restructuring for companies
and households. Lower domestic demand will help to further trim the imbalance in foreign trade as imports shrink as a share of the Latvian economy from a record-high 65% of GDP during the overheated year of 2007 to just below 50% in 2010. This is a level Latvia hasn’t seen since the mid-1990s.

We expect GDP to fall by an average of 15% this year, with the biggest decline in relative terms during the first half year. The slowdown is being driven by significantly lower consumption as household incomes shrink and unemployment rises. Worsening global growth prospects, lower resource utilisation by businesses and shrinking profit margins will contribute to a further drop in investments in 2009.

In 2010 we expect the Latvian economy to contract by slightly over 4%. Household consumption is not expected to rise during the forecast period as incomes decline and unemployment rises. Lower industrial production and weak housing demand point to lower investment levels again next year, though certain productivity investments are expected. Rapidly slowing economic activity and growing unemployment will also reduce domestic inflation pressures. In 2010 we expect consumer prices to fall by an average of 4%.

Our forecast for 2009/2010 is that Latvia will lose nearly a fourth of its gross domestic product compared with 2007, an expansive year. We expect GDP in fixed prices to retreat to the 2004 level by the end of the forecast period. The decline increases the importance of creating the right conditions for stable, long-term economic development.

Economic policies will be decisive

Economic activity will be significantly lower in 2009/2010, increasing the importance of an effective economic policy. There is still a political consensus in favour of the currency peg to the euro and the goal of future EMU membership.

A devaluation would reduce costs for exporters. This would stimulate the export sector, which accounted for slightly over 40% of GDP in 2008, compared with an import share of 55%. The timing is unfortunate, however, in light of weak global demand, which is not expected to rebound until the end of the forecast period at the earliest. The net contribution from exports is also limited by increasingly expensive imports of key investment and input goods for Latvian production. For households and businesses with loans in foreign currency, a devaluation would mean significantly higher lending costs. This would leave them with less money to spend. Even though domestic demand is expected to remain weak in such a scenario, a devaluation would drive up domestic inflation, especially in the sectors of the economy where competition is lacking.

The other alternative is an internal evaluation, i.e., an adjustment of internal costs, which also can be a painful process. In addition to wage cuts in the public sector of up to 10-15% in 2009-2010, wages
in the private sector will come under pressure as companies are forced to adapt production to lower demand.

Economic policy isn't focused merely on the currency. Although Latvian exporters have gradually seen their competitive advantage shrink in recent years due to substantially higher payroll expenses and unsatisfactory productivity growth, exports still account for a relatively unchanged share of the economy. This indicates that Latvia's cost level isn't really a disadvantage. Studies show that Latvian exporters have actually gained market share in Europe. Substantial growth in imports, driven by a rapid debt build-up, large wage increases and overly expansive fiscal policies, has contributed to a significant increase in the current account deficit. These imbalances are now shrinking rapidly during the forecast period.

To avoid serious budgetary problems in the future, greater attention will be paid to improving efficiencies in the public sector. The establishment of budget and surplus targets would further increase manoeuvrability during economic fluctuations. To date, however, fragile coalition governments and special business interests have complicated the political decision-making process and affected public confidence in politicians. The Corruption Preventing and Combating Bureau (KNAB) therefore plays a central role in increasing transparency and strengthening domestic competition.

Efforts to improve the corporate climate to attract more foreign investment are also important in order to create stable macroeconomic development. Increased investment in research and development and productivity improvements to make businesses more competitive will still be one of the long-term challenges for Latvian businesses.

Jörgen Kennemar
Lithuania: Worsening recession

<table>
<thead>
<tr>
<th>Population:</th>
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</thead>
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<td>GDP per capita 2007:</td>
<td>USD 17,180</td>
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<tr>
<td>Government:</td>
<td>Centre-right coalition</td>
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<tr>
<td>Prime Minister:</td>
<td>Andrius Kubilius</td>
</tr>
<tr>
<td>President:</td>
<td>Valdas Adamkus</td>
</tr>
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<td>Next parliamentary election:</td>
<td>2012</td>
</tr>
<tr>
<td>Next presidential election:</td>
<td>2009</td>
</tr>
<tr>
<td>Average GDP growth in last five years:</td>
<td>7.0%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

Summary

- The Lithuanian economy is expected to shrink by 6% this year and 3% in 2010, driven by weaker domestic and foreign demand.

- Finding a replacement for nuclear power production will place a short-term strain on the economy, but in the longer term could stimulate growth as energy investments accelerate.

- Fiscal tightening will be a priority in 2009/2010, so that the government can maintain a deficit below the Maastricht target of 3% of GDP. The goal of the current coalition government is euro membership as soon as possible.

Consequences for companies

- A lack of capital is forcing Lithuanian companies to delay investments, reducing demand for capital goods such as machinery and equipment. Greater capital inflows from the EU's structural funds will create business opportunities, however.

- Its geographical location and transparent rules still make Lithuania an attractive market for Swedish companies.

- The corporate tax rate was raised from 15% to 20% in 2009 as part of a savings package the government announced to strengthen public finances as growth prospects deteriorated.

- The decommissioning of the Ignalina power plant at year-end 2009 will increase demand for energy efficiencies that are currently lacking. This creates greater demand for alternative and environmentally friendly energy sources that Scandinavian companies can take advantage of.

Politicians are facing the financial crisis

The Lithuanian government consists of four parties under the leadership of Prime Minister Andrius Kubilius. Despite a relatively weak parliamentary position – with only 80 of the parliament’s 140 mandates – the government has received support for the crisis package presented to parliament before year-end 2008.
The global recession and financial crisis are having a major impact on the Lithuanian economy. To avoid a budget deficit exceeding 3% of GDP, the Lithuanian parliament, Seimas, has approved a €1.5 billion savings package for the budget year 2009. The cutbacks in public spending are substantial and include wage reductions in the range of 10-15%, followed by a corporate tax hike (from 15% to 20%) and higher value-added tax. Households are being compensated partly through a reduction in the income tax rate from 24% to 20%. The austerity package will be followed by a stimulus package worth €1.2 billion for the private sector, which will be financed through the EU’s structural funds and loans from the European Investment Bank (EIB). Part of this stimulus package consists of emergency lending facilities for small and medium-sized businesses hurt by the global credit crunch. Measures are also planned to improve energy efficiencies in the housing stock. The government has clearly stated that it is not in need of emergency funding from the IMF, although the Lithuanian central bank feels it could be beneficial to formulate a preparedness plan should economic conditions worsen further.

The dismal economic signals in recent months, as well as widespread pessimism among businesses and households, could increase the risk of further austerity measures. Criticism of the government’s savings plans, particularly among public employees, may reduce opportunities for further spending cuts.

Attaining full EMU membership as quickly as possible has taken on greater political significance in 2009, particularly since the likelihood of meeting the Maastricht criteria as early as this year has increased. The government, led by Prime Minister Kubilius, has mentioned 2010/2011 as a likely date in several official pronouncements. The criticism that can be made of the timetable is that imbalances are being reduced while the economy is in recession. It is difficult to determine whether this will last when the economy rebounds.

Shrinking economy in 2009 and 2010

To date Lithuania's GDP has not shrunk as much as that of its two neighbouring countries. On average, GDP rose by slightly over 3% in 2008. This occurred despite that the economy slowed significantly during the last quarter, when GDP fell by 2% on an annual basis. The outlook for the next two years is gloomy. Lithuanian export industry, which has benefitted for several years from strong demand from the Russian market, is shrinking rapidly. This market accounts for 25% of Lithuania's total goods exports. Slowing Russian growth owing to lower oil prices and a significant depreciation of the Russian currency limits export opportunities for Lithuanian businesses. The fact that their next largest export market, Latvia, is in a deep recession is also a big disadvantage for Lithuanian companies.

Domestic demand has turned to the lower, exacerbated in recent months by the worsening global financial crisis and growing consumer pessimism. We expect domestic demand to continue to decline during the forecast period. In January, retail sales fell by slightly over 20% on an annual basis. Monthly statistics should be
viewed cautiously, but do not change expectations of lower spending as household incomes fall and unemployment rises. This marks a significant reversal for the Lithuanian labour market, which had been distinguished for several years by a major shortage and double-digit wage increases. The increase in unemployment to 9.8% in January can also be attributed to the fact that fewer Lithuanians are seeking employment elsewhere in the European market. In fact, more are returning home owing to a deteriorating labour market in other EU member states.

As a whole, we expect Lithuania’s GDP to shrink by 6% this year and 3% in 2010. There is still considerable uncertainty, however, with a risk that the slowdown could worsen. In its most recent forecast, in March, the government projected that GDP would drop by 10.4% in 2009, considerably higher than the previous forecast of 4.8%. A further decline in domestic demand is driving the slowdown, due to which the current account deficit will shrink throughout the period. The loss of energy exports when the Ignalina power plant is decommissioned will negatively affect the current account balance, however. The appreciation of the euro, low commodity prices and weak domestic demand pressures will reduce the inflation rate to around 5% on average in 2009 and 2.5-3% in 2010.

Major investment needs when energy production is reconfigured

On 31 December 2009 the Ignalina power plant will be decommissioned. Since nuclear power accounts for no less than three fourths of the country’s energy supply, there is naturally concern about future energy sources. To compensate for the loss, imports will rise substantially, with the risk of higher inflation and lower growth, even if the EU compensates for a percentage of the lost nuclear power through 2013. Estimates show that closing Ignalina will cause a 3% decline in GDP in 2010. It also makes Lithuania almost entirely dependent on Russian natural gas, which is unpopular among many Lithuanian politicians. A new nuclear power plant is planned in co-operation with the other Baltic countries, but it is still uncertain when one would be in place. An electric cable from Sweden and Poland is also planned, but is unlikely to be ready before 2012 at the earliest.

Efforts to improve energy efficiencies will take on a completely different light when Lithuania becomes an importer of electricity rather than an exporter. The risk of higher energy prices is increasing. Today energy efficiency is low. This is particularly true of energy consumption in housing built during the Soviet period.

Jörgen Kennemar
Germany: Slowing exports

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<tr>
<th>Population:</th>
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<tr>
<td>GDP per capita 2007:</td>
<td>USD 33,530</td>
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<td>Government:</td>
<td>Grand coalition CDU/CSU/SPD</td>
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<td>Horst Köhler</td>
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<td>Next parliamentary election:</td>
<td>September 2009</td>
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<td>Average GDP growth in last five years:</td>
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<td>Average inflation rate in last five years:</td>
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Summary

- Germany’s GDP is expected to shrink by 4% this year before stabilising next year (+0.3%). Even though it did not build up huge imbalances in the form of inflated housing prices and consumer debt, Germany is affected by the loss of growth opportunities for its export industry.

- Germany’s budget deficit as a share of GDP will near 4% this year and 5% next year due to the recession and stimulus package. The German government is trying to resist demands for further stimulus measures as the labour market and recession worsen.

Consequences for companies

- The slowdown in the economy is being driven by lower exports and investments. Germany’s huge manufacturing industry is shrinking, which also affects Swedish and other Nordic suppliers.

- With unemployment expected to near 10% next year, consumer confidence will be hurt and spending will slow. Incomes will trend slightly higher in real terms, however, so households are likely to increase their savings, which will also benefit from tax rebates. In a best-case scenario, retailers can expect stable or slightly declining sales.

- The government’s package incentivises car sales and, if nothing else, will temporarily halt the slide in demand.

- Domestic demand is also being affected by weak real wage growth in recent years due to a larger labour supply, outsourcing of production to low-cost countries and the weaker negotiating position of trade unions. Moreover, Germany’s labour productivity has decreased in recent years, which could be due to neglected IT improvements and relatively slow productivity growth in the service sector. There is room for investment here to increase potential GDP growth, which the OECD estimates at 1.5%, below the euro zone average (approx. 2.25% for EU11).

Politics, economy and structures

Germany’s economy is back in recession mode after five relatively good years. The downturn will be deeper and lengthier than other post-war recessions. In the 1970s and ’80s GDP shrunk by 0.9% and

The recession will be the deepest in decades
0.4%, respectively, and in 1993 and 2003 the declines were 0.8% and 0.2%. Last year the economy grew by 1.3%, but quarterly growth in the last three quarters was negative. We expect Germany’s GDP to shrink by 4% this year, at the same time that 2010 will also be a weak economic year with marginal GDP growth.

Germany’s economic slowdown should be viewed against the backdrop of the global financial crisis, which has slashed available credit and hurt future confidence, as well as the weaker market for German exports, which was also hurt by the rise in the euro last year. Moreover, a period of rising energy and food prices has cut into consumer purchasing power and consumption.

If imports are excluded, German goods exports account for slightly over one fifth of GDP. One of four workers is in the export industry. Because external order bookings have dropped by about 25% from a year earlier, export volumes are down as well. As capacity utilisation and corporate profits decline, so does the need for new investment. Construction is also being hurt by tighter credit terms and lower future confidence among real estate companies and households. Increased public spending will offset part of this, but is relatively small and will not begin in time to prevent the slowdown in investments.

Despite that households can now be happy with decent wage increases and lower energy prices, which allow them to buy more goods and services, they are less willing to spend because of growing uncertainty about their jobs and incomes. Within a year, we expect Germany to lose 750,000 jobs. The number of unemployed will exceed 4 million early next year, and unemployment is closing in on 10%. German households’ savings ratio will creep higher from the current level of around 11.5%.

What can economic policy achieve? The European Central Bank has cut its discount rate from 4.25 percent in October of last year to 1.5%. We expect the rate to drop to around 0.25% this spring and remain at that level until the end of next year. The interest rate differential between mortgage and corporate bonds on the one hand and government bonds on the other is gradually shrinking. The German government has announced its second stimulus package, amounting to €50 billion, or 2% of GDP. This includes infrastructure investments and tax cuts. The previous package also offers support for small and medium-sized businesses, increased tax deductions for households and lower taxes on new car purchases. The recession alone is creating a budget deficit of 1.5% of GDP, and with the package that figure will exceed 3% in 2009 and 4% in 2010. Though Germany’s budgetary situation is worsening, it is still better than the UK, Spain or France, for example.

German Chancellor Angela Merkel was initially criticised for not providing enough support for the economy or understanding the seriousness of the situation. CDU/CSU still enjoys relatively high public support, with around a third of voters, while the coalition party SPD would receive the support of 25% of voters if an election were held today. The party that has gained the most from the economic
crisis appears to be the liberal FDP, with slightly over 15% of the votes. Leading up to the parliamentary election in September, the parties are trying to strike a balance between stabilising the economy and at the same time showing the spending restraint.

The Bundestag has approved a new law giving the state the power to expropriate the shareholders of the lender Hypo Real Estate, which has received €102 billion and which the government now wants to nationalise to avoid a complete collapse. Reminiscent of the 1930s, the expropriation law is controversial in Germany, but applies only temporarily through June.

German Economic Minister zu Guttenberg is negotiating with GM on Opel’s survival. GM is awaiting US administration’s approval of an action plan, prior to which the German government cannot issue any guarantees, either. As with Sweden’s handling of Saab, there is a hope of finding new owners with a cohesive business plan for the automaker, which currently employs 25,000 people.

Cecilia Hermansson

Opel’s fate has not yet been fully negotiated
Finland: Export industry exposed

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<td>GDP per capita 2007:</td>
<td>USD 34,550</td>
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<td>Government:</td>
<td>Coalition between Center Party and Social Democrats</td>
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<td>Prime Minister:</td>
<td>Matti Vanhanen</td>
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<td>President:</td>
<td>Tarja Halonen</td>
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<td>Next parliamentary election:</td>
<td>2011</td>
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<td>Next presidential election:</td>
<td>2012</td>
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<tr>
<td>Average GDP growth in last five years:</td>
<td>3.3%</td>
</tr>
<tr>
<td>Average inflation rate in last five years:</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Summary

- Finland’s GDP is expected to contract by 2% this year before rising slightly by 0.5% in 2010. Falling domestic demand and a shrinking global market are driving the downturn in GDP, which is expected to be the most severe since the crisis of the 1990s.

- A fiscal stimulus plan with investments in infrastructure and education has been implemented to ease rising unemployment. Although a budget surplus will turn into a deficit in 2009/2010, Finland is still among the EU’s strongest economies.

Consequences for companies

- Finland is Sweden’s sixth largest export market. Lower business investments in 2009/2010 will mean less export opportunities for Swedish companies. On the other hand, the weakening of the krona against the euro – 18% since August 2009 – will give a competitive boost to Finnish companies.

- Finnish households are expected to tighten their purse strings in the next two years as the job market worsens, even if real disposable incomes rise as income taxes are cut and inflation declines. Retail and auto sales will be weak.

- Re-evaluating purchasing routines, production processes and sales channels will be an important part of strategic planning, particularly since the global growth outlook for 2009 and 2010 is unusually uncertain.

2009 and 2010 – two lost years

The global financial crisis and recession contributed to a 2.4% decline in GDP on an annual basis in the fourth quarter 2008. This is the first time since the crisis of the 1990s that the economy is shrinking. Exports accounted for the largest decline, at no less than 14% in terms of volume, twice as high as in Sweden. The Finnish export industry, where forest products weigh heavily, has been hard hit by lower global housing construction. The other major industrial sector, electronics, has managed significantly better. Import demand in several key export markets has fallen substantially, particularly the important Russian market, which is still the largest buyer of Finnish goods and services.
The appreciation of the euro may be a contributing reason for last year’s relatively large drop in exports, which is also causing business production and investment to fall. Consumer spending, which has grown by an annual average of 3% since 2000, fell by slightly over 1% in the last quarter of last year. This was a smaller decrease than in Sweden, however, where household consumption fell by as much as 3.3% on an annual basis. The dramatic events in the global financial markets and increased pessimism about the future have led to increased household savings in both countries.

The Finnish economy is basically strong, with a large current account surplus and budget surplus. As a result, there is room for fiscal stimulus measures if the economy should weaken further. The government has decided on a stimulus package worth €2 billion (1% of GDP) to offset the economic slowdown. The package includes infrastructure investments that will generate at least 25,000 new jobs, according to the government’s calculations. Educational programmes are being introduced to ease unemployment, at the same time the social insurance area is receiving more resources with open unemployment expected to rise.

In our most recent international economic forecast from 11 March, we predicted that global growth would be negative in 2009 and remain weak in 2010. As a result, Finland cannot expect a boost from the global economy. We expect weak global investment, particularly in housing, to hamper Finnish exporters in 2009. Low capacity utilisation in industry, 72% in the first quarter of 2009, compared with over 86% a year ago, and a slow global economic recovery point to a decrease in investments during the forecast period 2009/2010. Not until capacity utilisation rises are investments expected to increase, most likely in 2011.

Household income is being strengthened by the government’s income tax cuts, equivalent to €800 million, as well as low nominal interest rates and lower consumer prices. Consumer spending is being held back, however, by growing pessimism as the job market worsens. Households are therefore expected to increase their savings. As a whole, we expect the Finnish economy to shrink by 2% this year before rising slightly next year, though far below the country’s potential growth. Because of low resource utilisation in the economy, domestic inflation pressures should remain in check throughout the forecast period, which will also be reflected in nominal wage growth in 2009/2010.

Jörgen Kennemar
Denmark: Abrupt slowdown

| Population: | 5.5 million |
| GDP per capita 2007: | USD 36,300 |
| Government: | Liberal–Conservative coalition |
| Prime Minister: | Anders Fogh Rasmussen |
| Next parliamentary election: | by 2011 |
| Average GDP growth in last five years: | 1.7% |
| Average inflation rate in last five years: | 1.9% |

Summary

- The Danish economy reported a surprisingly large decline in the fourth quarter 2008, which is expected to continue in 2009. The housing market and consumer spending are impacting demand, while exports are being hurt by a shrinking market and the appreciation of the Danish krona against key export markets. For 2009, we expect GDP to continue to fall by 1.75% before turning slightly upward in 2010.

- A new referendum on EMU membership is likely in 2010.

Consequences for companies

- Fiscal stimulus measures will provide a slight boost to private consumption, and infrastructure investments at the municipal level are expected to increase. Monetary policy, which is limited by the fixed exchange rate policy, is not quite as expansive as in neighbouring countries. Higher interest rates pose a risk for the housing market and could worsen the recession.

- Demand in Denmark will continue to fall in 2009, but the strong krone will give companies with sales in Denmark greater opportunity to gain market share. The Swedish side of the Öresund region will benefit from growing integration with Denmark.

Politics, economy and structures

Anders Fogh Rasmussen has led the Danish coalition government since 2001. Recently there has been talk whether he has his sights set on a top international position – within the EU or as NATO Secretary General. His most likely successor is Lars Løkke Rasmussen, the current finance minister. He has extensive political experience from the liberal Venstre party and, as finance minister, has gained a reputation as a tough negotiator with sharp elbows.

In Denmark, the global crisis coincided with the start of a slowdown in the economy after a period of high growth. Despite this, Q4 growth figures were surprisingly negative. GDP fell by 3.9% on an annual basis. For 2008 as a whole, GDP fell by 1.3%. The decline was driven predominantly by shrinking consumption and coincided with a major drop-off in inflation. In February inflation reached 1.7%, against 4.8% in August last year. The export sector has been hurt by the substantial appreciation of the Danish krone, particularly compared with the Swedish krona and the British pound. The major decline in housing prices in 2008 (-9%) is another sign of the quickly slowing economy.
In our assessment, economic conditions will remain fairly tough in 2009, with GDP falling an additional 1.75%. The slow economy and dramatic drop in demand are reducing inflation to 1.5%. With Denmark’s flexible labour market, we expect unemployment to rise rapidly. The housing market is the economy’s Achilles’ heel, and a further drop in prices could increase pressure on consumer spending.

The Danish government was quick to stabilise the financial sector. Danish banks incurred problems with large exposures to the domestic real estate market early on. The government introduced a guarantee fund to maintain confidence in the banks and offered liquidity support. At the same time the banks joined together to take over several smaller banks with solvency problems.

Danish monetary policy is restricted by the fixed interest rate against the euro and membership in ERM2. The national bank has therefore been forced to maintain higher interest rates than the ECB to defend the krone against the euro. After the ECB recently cut its main interest rate from 2.0% to 1.5%, the central bank cut the Danish discount rate from 2.75 to 2.0%. The interest rate differential, which is positive but shrinking, is placing further pressure on consumer spending and housing prices. Compared with other key export countries such as Sweden and England, the differential is even higher.

Fiscally, we expect a growing deficit that to some extent will affect consumer demand. The government recently reached an agreement with the Danish People’s Party to continue the tax reforms launched in 2004. The new package includes income tax cuts for low-wage earners, a “green” tax deduction and the option to withdraw surpluses from the pension system. This is expected to have a total impact equivalent to 0.5% of GDP. Financing the reforms, through higher fees on emissions and energy consumption, is being postponed to increase the stimulus effect in the short term. Discussions are also being held whether to expand investments at the municipal level.

The central economic question in Denmark is whether to adopt the euro. In the last referendum, in 2000, a majority voted to retain the krone within ERM2. The financial crisis has raised the question anew. Fogh Rasmussen has recently signalled that his government is prepared, once the Lisbon Treaty accepted by Ireland, to call for a new referendum, probably no sooner than 2010. The latest opinion polls show a slight majority leaning toward yes.

Danish businesses can expect a period of slowing demand and competitive weakness owing to several years of economic overheating, rapid wage growth and an overvalued housing market. The competitive strength of Swedish companies that sell in Denmark has risen significantly thanks to the weaker Swedish krona. Exchange rates also are helping border trade in the Öresund region and softening the blow on Malmö’s housing market. Border straddlers who live in Sweden and work in Denmark will see their disposable income grow.

Magnus Alvesson
Norway: Deceleration

Summary

- After several years of rapid growth, an economic slowdown is now being fuelled by global trends. Oil prices are critical to income and demand in Norway, although the drop-off in other export markets is having an adverse effect as well.

- The Norwegian economy stands strong in face of the crisis. The country has already launched a support package for the financial sector, cut interest rates at record speed and announced a fiscal stimulus package worth 2.4% of GDP. Against this backdrop, we expect the slowdown in the Norwegian economy to be relatively mild, with zero growth in 2009 and a slight upswing in 2010. Though on the decline, consumer demand will be offset by public spending and investment.

Consequences for companies

- Public spending is expected to increase significantly in Norway in the next two years. Infrastructure and environmental investments, in particular, may offer opportunities for Swedish companies.

- Investments in the oil sector are expected to be relatively unaffected by the slowing economy, and demand for input goods should remain stable.

- The boom in the consumer sector will subside after several years of very strong growth, especially for capital goods. For companies in these sectors, the priority will be to maintain market share in the years ahead.

Low oil prices and an imminent recession

The global recession coincided with an expected slowdown in Norway after several years of rapid growth. The labour, housing and consumer markets all showed signs of overheating. High oil prices contributed, but Norway’s competitive strength was also weakened by rising real exchange rates and high wage increases. The Bank of Norway tried to cool off the expansion and cut its interest rate to 5.75% as recently as October of last year. Fiscal policies were expansive, however, despite a budget surplus (including the oil sector) of 17.4% of GDP in 2007.

The Norwegian slowdown is being fuelled by global trends
In late 2008 there were clear indications of a rapid downturn. Housing prices fell by 7% in the third quarter year-over-year. The Norwegian krone followed oil prices lower, dropping 20% in the second half of 2008. At the same time inflation fell to 2.1% at year-end, against 5.6% in October. High interest expenses and rising unemployment strained households, and consumer demand began to slow in the third quarter before falling 1.3% on an annual basis in the fourth quarter. Mainland investments also fell, by 7.4%. Exports (excluding oil) fell by 7.2% (seasonally adjusted) between the third and fourth quarters, while imports correspondingly lost 10.9%.

Economic policy has quickly been reversed. The Bank of Norway responded to the rapid downturn in the economy by gradually, but quickly, cutting its key interest rate to 2.5%. The government has announced a fiscal stimulus package equivalent to 2.5% of the mainland GDP that is expected to generate 15,000 jobs. The package consists of transfers to municipalities, investments in public infrastructure and lower corporate taxes. Also included are investments in environmental improvements, e.g., subsidies for efficiency improvements and renewable energy. Moreover, a number of measures are being taken to ease the credit market and strengthen the financial sector:

- A program worth NOK 350 billion to facilitate bank lending,
- Two funds totalling NOK 100 billion to ease lending to households and businesses,
- Increased export credit options, and
- Proposals to use tax rules to improve corporate liquidity.

The Norwegian economy has entered the recession in good financial shape. The major cut in interest rates will soften the slowdown in consumer demand, and there is still room for further rate cuts. Fiscal measures are also available to stimulate the economy if the downturn is worse than expected.

Looking ahead, we expect the economic downturn to continue, but ease. For 2009, we anticipate zero growth before seeing growth of 1.5% in 2010. Though households will be less willing to spend, this will be partly offset by public spending. Housing and industrial investments are expected to retreat significantly, but the oil sector remains relatively stable, and public investments will grow significantly in both 2009 and 2010. The trade surplus will shrink as a result of the decline in oil prices, and demand for other Norwegian exports will be impacted by the global recession. While the declining Norwegian krone could signal higher inflation, slowing demand in the economy should lead to a relatively modest increase in 2009. Thanks to lower payroll costs, the Norwegian mainland economy will become more competitive after several years of weakening.

Magnus Alvesson
Sweden: Sharp fall, slow recovery

Population: 9.1 million
GDP per capita 2007: USD 36,590
Government: Moderate coalition
Prime Minister: Fredrik Reinfeldt
Next parliamentary election: September 2010
Average GDP growth in last five years: 2.8%
Average inflation rate in last five years: 1.7%

Summary

- The Swedish recession will be deep. We expect GDP to fall by 2.3% 2009, followed by a weak gain in 2010. The decline in GDP is being driven by lower demand both at home and in export markets. The weaker krona and stimulus measures by the government and Riksbank compensate to some extent. There is a big risk that the labour market will develop very weakly, which would impact overall demand.

- Economic policy has been expansive, and stabilisation measures for the financial sector have been implemented in quick succession. The repo rate has been cut from 4.75% in September 2008 to 1% in March 2009. Although the government has already announced additional measures in its 2009 budget, strong public finances will allow for further action if economic development is worse than expected.

Consequences for companies

- The recession is affecting every sector, especially companies active in export markets and cyclical industries such as construction. The downturn will affect workers as well as suppliers. Price pressure will make it harder to maintain profitability by shifting costs to consumers.

- Public spending and investments will offset the slowdown in the private sector to some extent. State infrastructure investments, including demand for services from the public sector, may offer business opportunities.

- The decline in the krona may provide some respite for sectors that are competing with imports and create opportunities to grow or maintain positions in export markets.
Global conditions are hurting the Swedish economy

Sweden followed the global economy into recession in the fourth quarter last year and was particularly hurt by falling demand for Swedish exports, which caused GDP to fall by 0.2% on an annual basis. Households in Sweden and abroad reduced their spending on capital goods, while investments stood firm initially. Net exports contributed to negative growth of nearly a half percentage point. The slowdown mainly affected the transportation and pulp industries, which fell by 16.8% and 7.9%, respectively, in the fourth quarter year-over-year. The construction industry remained fairly positive, reporting growth of 0.9% measured the same way. The electronics industry also grew throughout the year, posting a growth rate of 13.9%.

Competitive conditions in Sweden improved slightly owing to the declining value of the krona and slower wage growth. Companies have adjusted their cost structures by quickly cutting jobs and the number of hours worked. Inflation fell on an annual basis from 4.4% in September to 0.9% at year-end, at the same time the real exchange rate fell by 13% as of February 2009.

Economic policy-makers have been busy with measures to stabilise the financial sector and stimulate the economy through lower interest rates. A number of programmes were introduced last fall and this spring to strengthen banks and boost their confidence. Also, the Riksbank aggressively cut the repo rate to 1% from a peak of 4.75% earlier in the business cycle. There is still room for further cuts. As a result, the downturn in the housing market has probably slowed temporarily in expectation of a weaker labour market.

Fiscally, things are quieter. The government has clearly signalled that it is sceptical of rescue packages for individual companies or sectors. At the same time a total of SEK 41 billion (approx. 1.5% of GDP) was allocated to soften the crisis. Considering that Sweden’s public finances are good and its debt low, there is room for further stimulus measures if the economy continues to worsen.

The outlook for 2009 is weak. We expect GDP to fall by 2.3% with a slight upswing of 0.6% in 2010. Growth in household disposable income is still positive, but will be weakened by rising unemployment and wage pressure. Previously
announced tax cuts should compensate slightly, but a major boost from the global economy cannot be expected. We see exports continuing to fall in 2009.

Many Swedish companies will continue to cut costs in 2009. This will affect both competitors and suppliers. Price pressure will be weak, with limited opportunities for companies to increase profitability at the consumer level. The best business opportunities will be in connection with the public sector’s expansion. The infrastructure investments that have been fast-tracked to stabilise demand for many businesses in the construction industry could partly compensate for the decline in the housing sector. Service businesses associated with the public sector may also see a somewhat milder recession. The weakening of the Swedish krona could provide opportunities for expansion in economies where competition had previously been tight.

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