

Global and Baltic Macro Update and Outlook *2010-2012*

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- Global macro update: wobbly multi-speed global recovery, austerity and stimuli combined
 - More upbeat view on 2010 growth but less optimistic for 2011-12 than in Spring 2010 Forecast, inventory cycle driven growth coming to an end and timely well-coordinated structural reforms necessary to support further recovery
- The Baltics macro update: this year stronger than expected exports, higher inflation
 - Better than expected exports strengthen recovery, but it is unevenly spread and wobbly
 - Labour market improves and household optimism is up, yet some setbacks are expected towards the winter; skills mismatch increasingly important: structural long term unemployment to root in and wage pressures to rise
 - Deflation pressure weaker than expected, i.e. prices rise: good for government and companies, bad for households
- The Baltics macro outlook 2010-2012: faster recovery this year, slower growth in 2011-2012 depending on the continuation of reforms
 - GDP growth faster due to surprisingly strong exports recovery, but it will slow in 2011-2012
 - Employment has started/ about to start to rise gradually, CPI deflation period is over while core inflation dynamics not that certain yet
 - Risks to the forecast dominated by:
 - Globally: uncoordinated and wrong policy response, weak governments, protectionism
 - Locally: election paralysis, shift in policy direction, reform fatigue

Part 1

Global update:

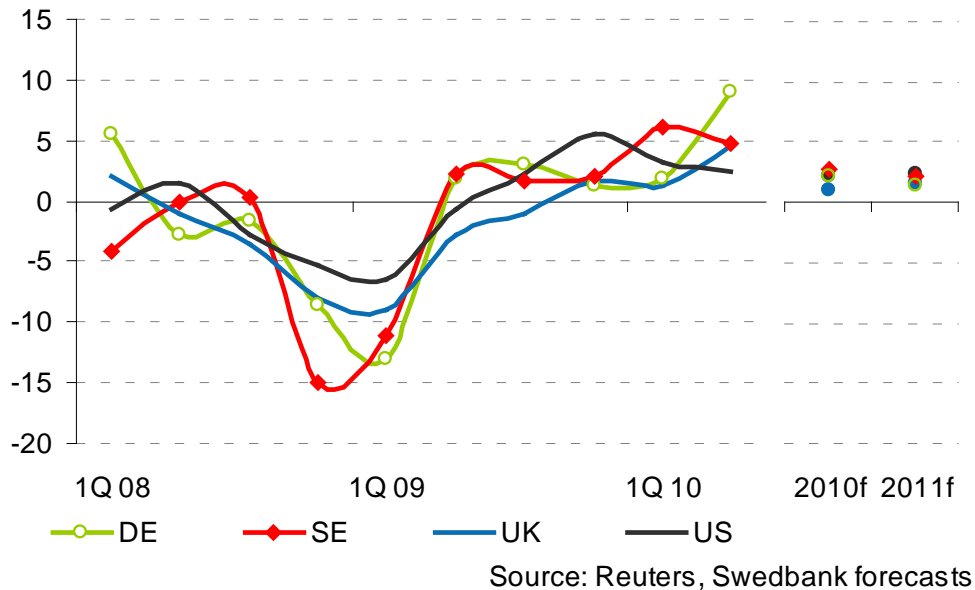
*Current situation and outlook for 2011-12
(comparing to Spring 2010 Forecast)*

Global economy: so far somewhat better than expected but a wobbly multi-speed recovery

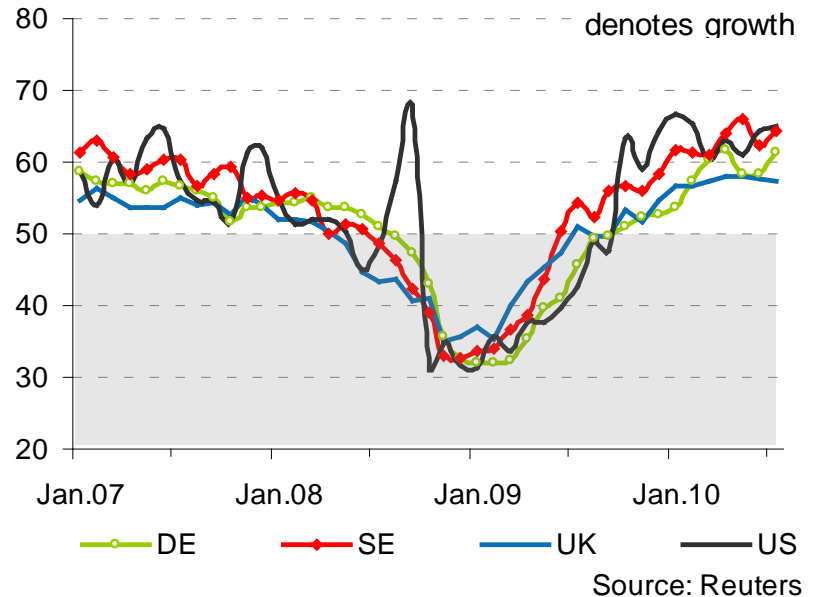
A recent flow of good though volatile data, multi-speed recovery globally and within EU, some surprises on Germany vs. USA growth... but inventory cycle boost running to its end

Optimism has improved, world trade volumes risen... yet further advances are hard coming as optimism seems to flatten out or even retreat in some cases

GDP, annualized qoq growth (sa)



Purchasing managers' index



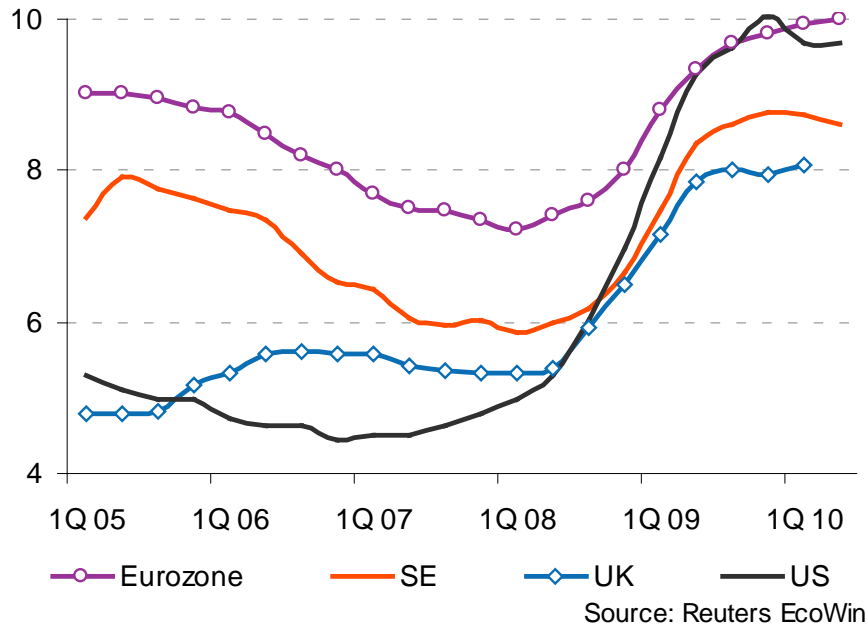
Global economy: structural issues to be addressed and policies better coordinated globally... with different country agendas!?



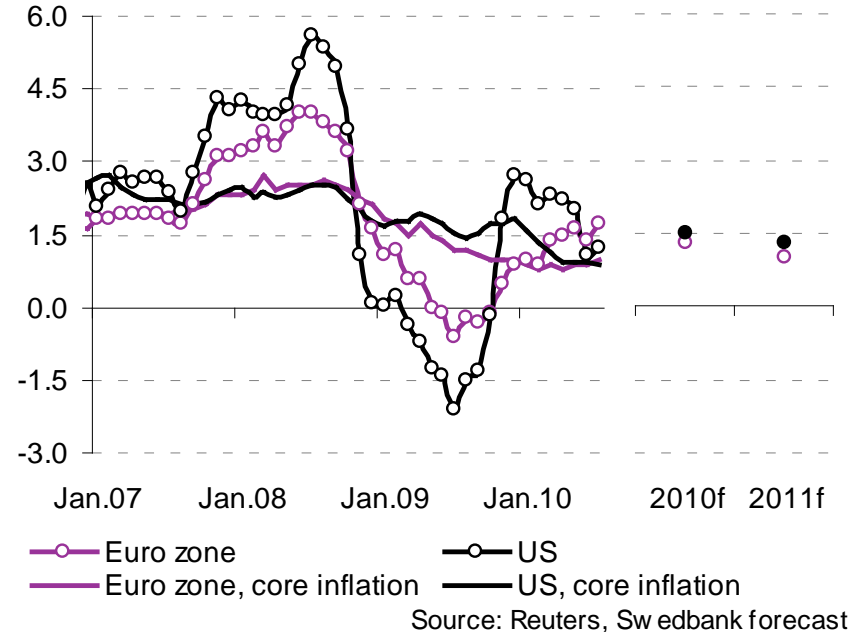
Albeit unemployment has edged down, the risk of jobless recovery remains, structural change difficult to come through as governments have weakened, but global policy response is poorly timed and coordinated

Commodity prices up, risks of bubbles. Core inflation slows to very low levels and deflation risks, while remote, become more likely. This keeps interest rates low, but raises the risks of impotent monetary policy

Unemployment rate, % (s.a.)



CPI annual growth, %



Global economy: *base scenario more upbeat on 2010, while less optimistic on 2011-12... just muddling through?*

- Base scenario: muddling through (50% probability)
 - Better growth in 2010 and slower 2011-12, i.e. weak and erratic growth, low inflation, low interest rates
- Main forecast drivers and assumptions:
 - **Multi-speed recovery** with emerging markets contributing the most
 - **Restrictive fiscal policy**, austerity deepens while a further stimulus is possible in certain countries, policies poorly coordinated and mistakes in timing
 - **Low policy rates** throughout 2010 and 2011, increases in 2012 (additional QE not ruled out)
- The key negative forecast risks:
 - new instability in financial markets and financial institutions, public sentiment, ineffective economic policy, and debt restructuring in the private and public sectors, as well as political developments
- The key positive forecast risks:
 - faster improvement in labour market (improving confidence and domestic demand), stronger investments due to good corporate earnings

		2008	2009	2010f		2011f		2012f	
Real GDP growth, %	World	2.7	-0.7	4.2	(4.0)	3.6	(3.7)	3.8	(3.9)
	US	0.4	-2.6	2.8	(2.8)	2.2	(2.2)	2.5	(2.5)
	Euro zone	0.6	-4.1	1.0	(0.9)	1.1	(1.3)	1.6	(1.9)
CPI growth, %	US	3.8	-0.3	1.5		1.3		1.5	
	Euro zone	3.3	0.3	1.3		1.0		1.2	
Oil price, USD per barrel		35.0	62.0	78.5	(75.0)	82.0	(80.0)	90.0	
Policy interest rate	US			0.25 (end of year)		1.00 (end of year)		2.00 (average)	
	Euro zone			1.00 (end of year)		1.00 (end of year)		1.50 (average)	
EUR/USD exchange rate				1.30 (end of year)		1.22 (end of year)		1.20 (average)	

Source: National statistics and Sw edbank forecast (April 2010 forecast in parentheses)

Part 2

Baltics update:

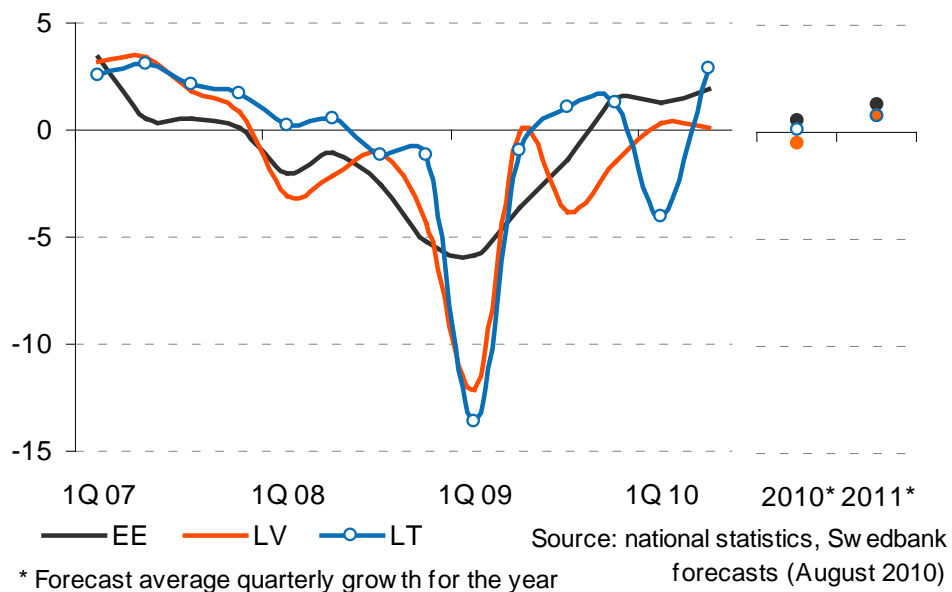
Current situation: what has changed since Spring 2010 Forecast

Economic activity: recent flow good of data raises 2010 forecast, i.e. along with global developments

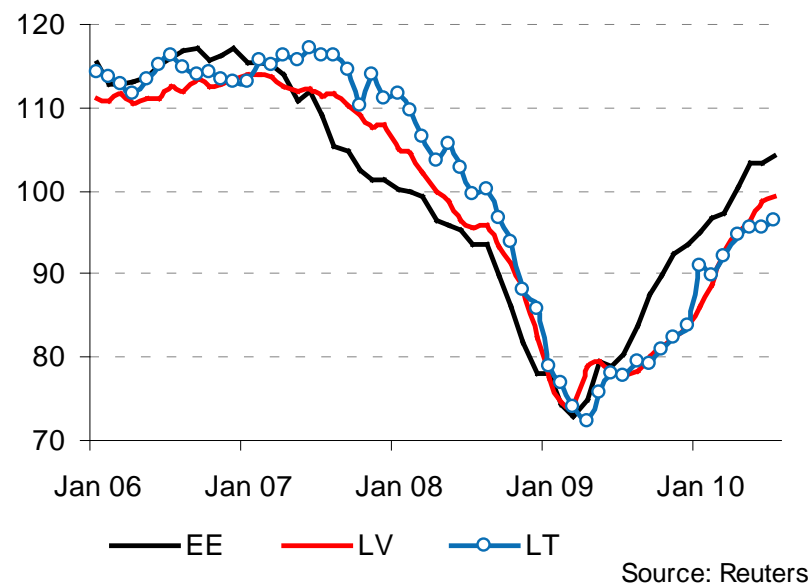
The low point of the cycle was in late 2009. Recovery is export driven, stabilizing household consumption. Strong upward data revision for EE. Recovery remains bumpy, uneven and fragile.

Strong run in optimism supporting growth, but it is likely to fall somewhat over the autumn due to seasonal and global slowdown reasons. Political cycle will also be important.

GDP, quarterly growth (s.a.)



Economic sentiment index, pts

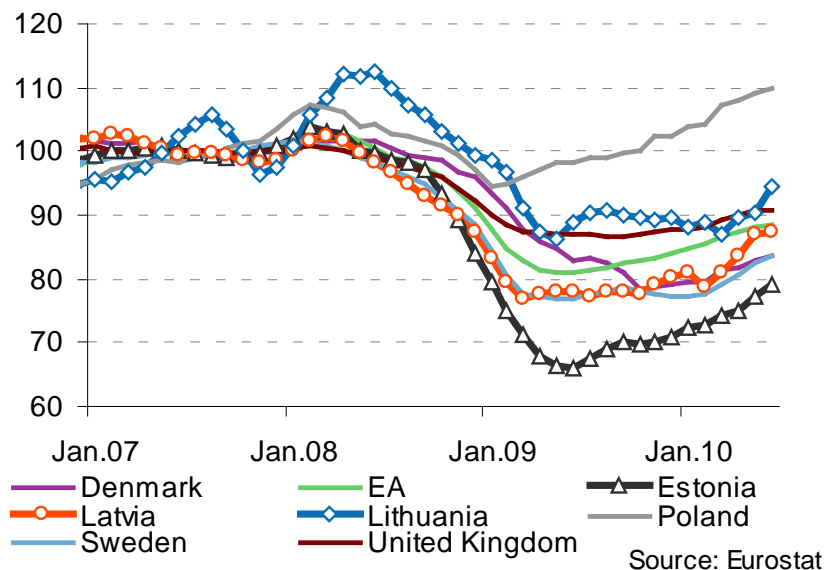


Manufacturing: *is the key driver of growth, responding to regional export demand*

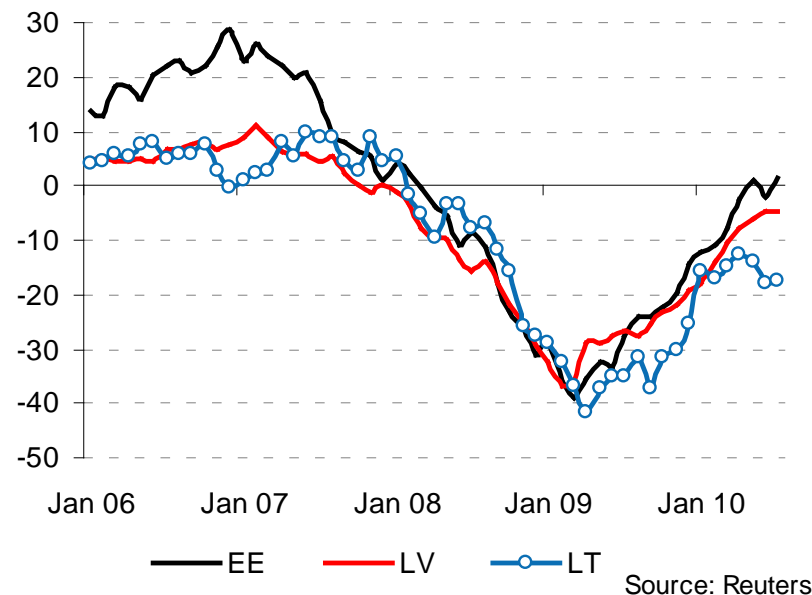
Good run of manufacturing recovery (e.g. 1H 2010 goods exports up by 21.3% yoy in EE, 24.9% in LV, 24.4% in LT). But it closely follows regional trends, i.e. will the exports run continue as the global economy slows?

Manufacturing confidence has recovered strongly, but how far will it go? Many leading companies run at close to full capacity, will there be new investments coming in?

Manufacturing output, 2007=100 (3M average)



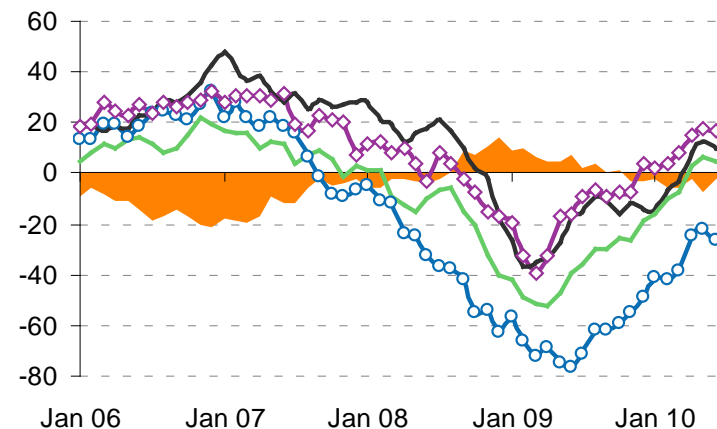
Manufacturing confidence, pts



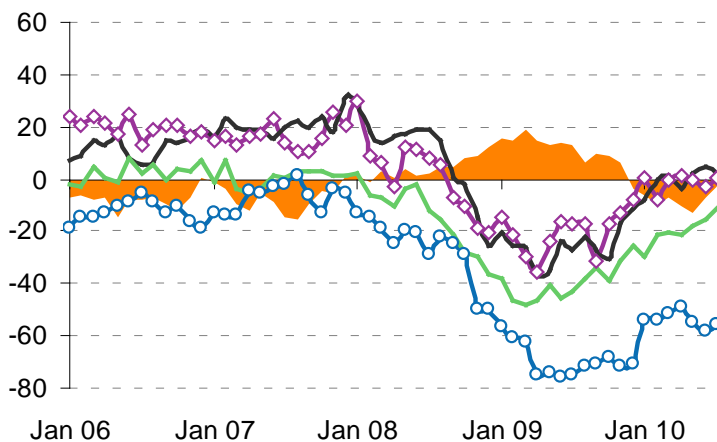
Manufacturing: a closer look at producer confidence

So far, so good: employment expectations up, so are selling price expectations, production expectations continue to increase as well. Confidence is by and large export driven and the share of exports in industry turnover has risen.

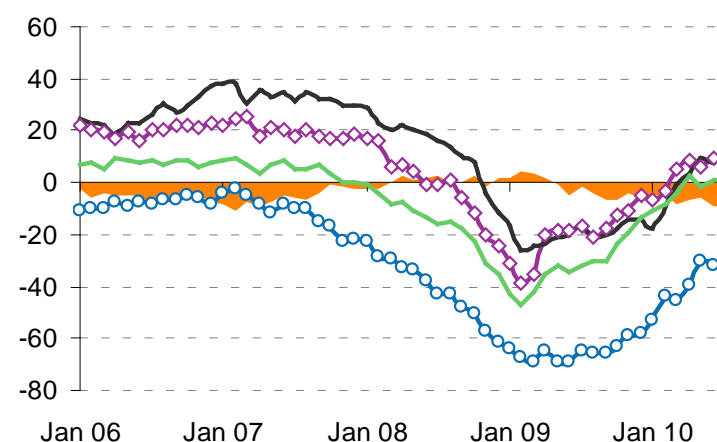
EE manufacturing confidence, pts



LT manufacturing confidence, pts



LV manufacturing confidence, pts



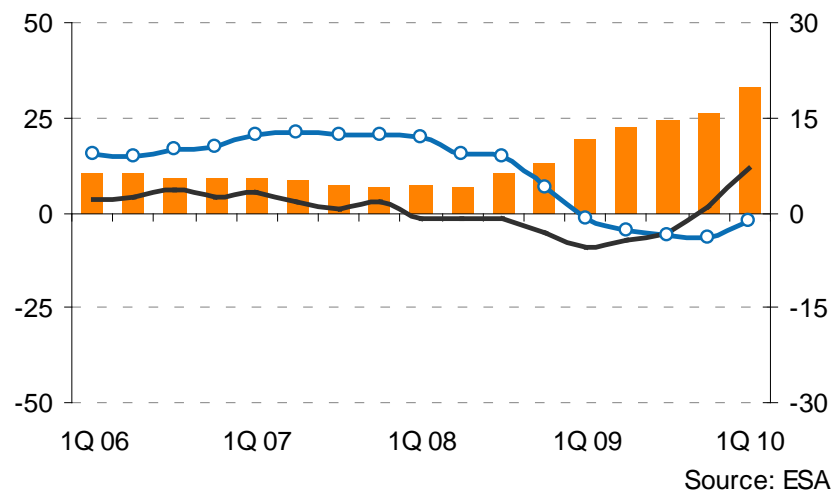
■ Assessment of stocks of finished products
◆ Production expectations for the months ahead
— Employment expectations for the months ahead

○ Assessment of order-book levels
— Selling price expectations for the months ahead

Households: *labour market improves*

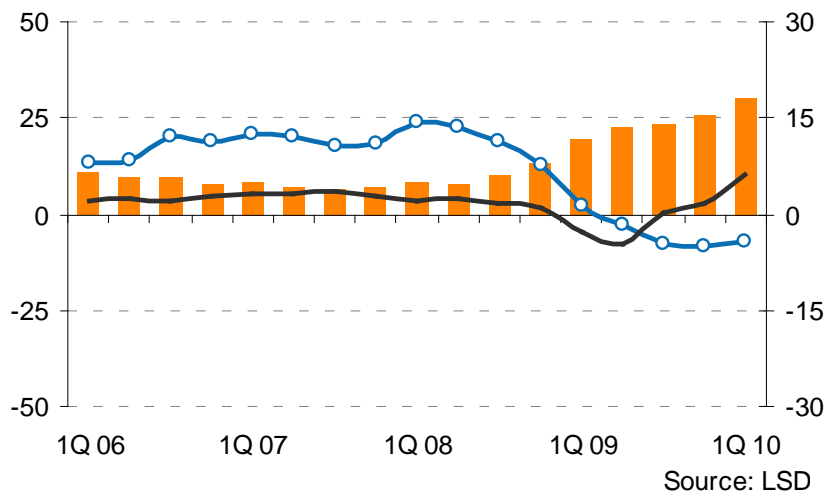
Unemployment retreats due to emigration, seasonality and weak job creation. In July registered unemployment was at 11.7% in EE (14.6% peak in March), 15.3% in LV (17.3%) and flat at ca 15.3% in LT (but note the methodology change there). Skills mismatch increasing, which gradually builds up wage pressures.

EE Labour market indicators



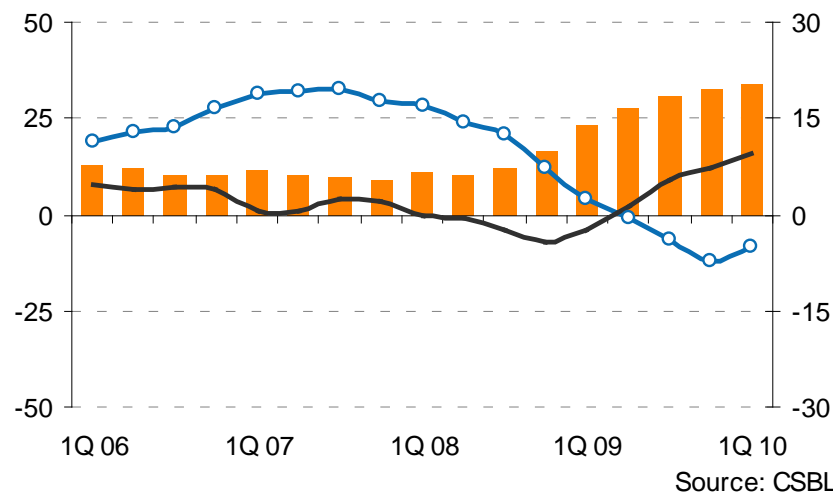
Source: ESA

LT Labour market indicators



Source: LSD

LV Labour market indicators

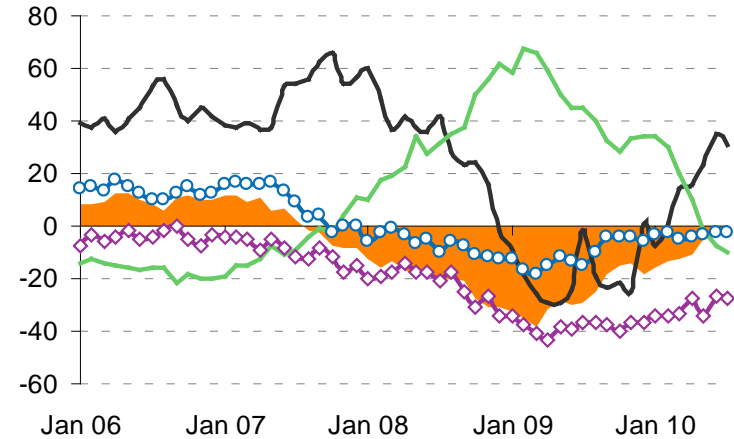


Source: CSBL

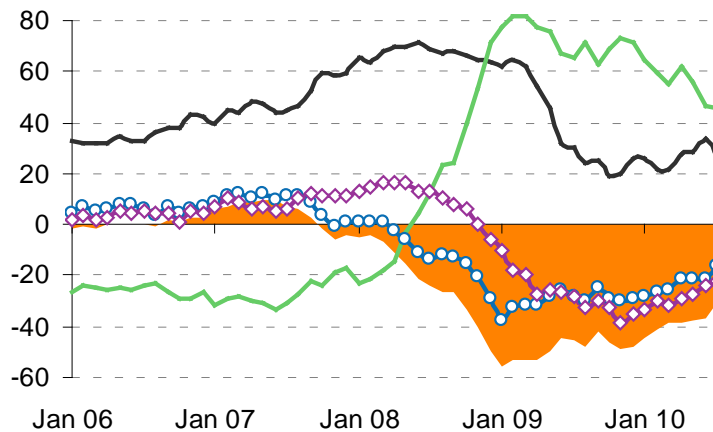
Households: *optimism is up, but setbacks are likely later in the year when unemployment inches up and political uncertainty rises*

Households expect their economic outlook to improve significantly with the sharpest gains in unemployment expectations. Yet, improvement in their financial situation expectations is less buoyant as, one of the reasons perhaps is rising prices (less so in LT)

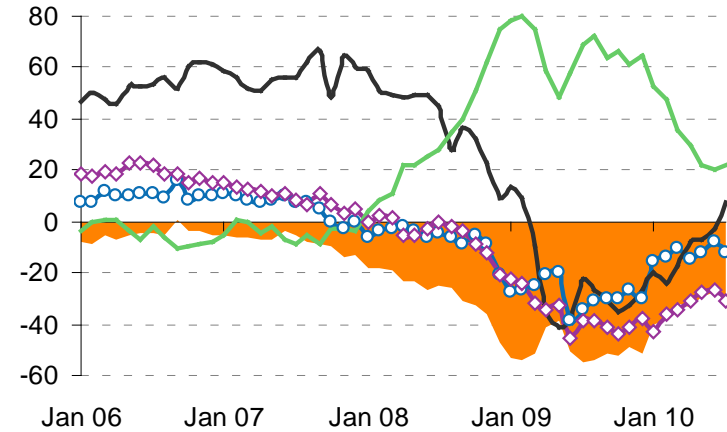
EE consumer confidence, pts



LT consumer confidence, pts



LV consumer confidence, pts



■ Total
◆ Major purchases over next 12M
— Unemployment expectations over next 12M

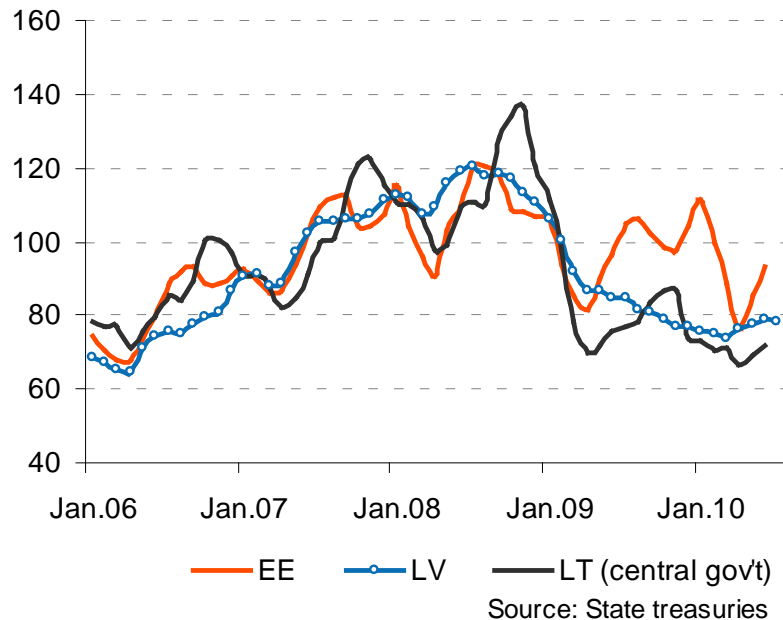
—○— Financial situation over next 12M
— Price trends over next 12M

Government: *fiscal stance improves, currently no threat to exceed 2010 budget deficit target*

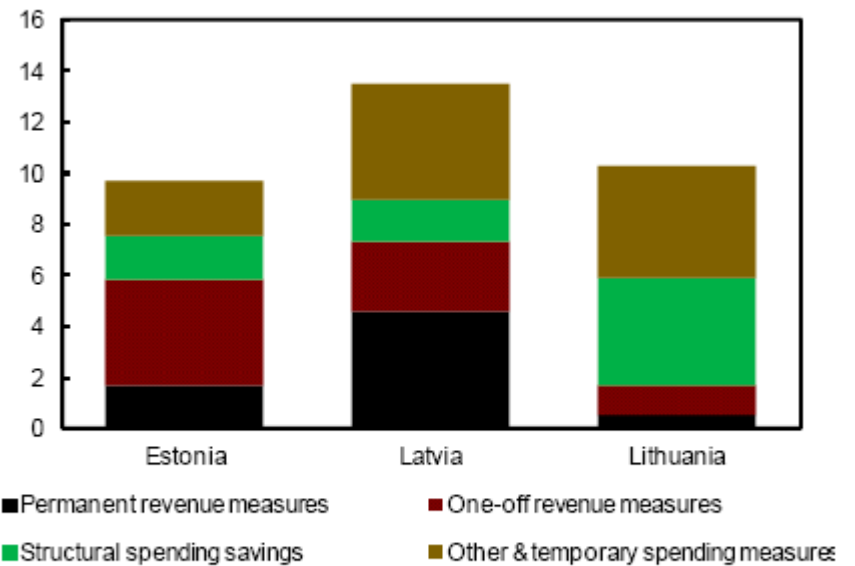
The sharp fall in tax revenues seems to have bottomed out, 7M revenues exceed the plan and there seems to be no risk to meet this year's deficit target without new additional consolidation measures

But further consolidation is still necessary as (i) many of the measures were temporary, and (ii) LV and LT structural deficits in 2009 were estimated at ca 7% of GDP (only ca 1% in EE)

Total tax revenues (3M average), 2007=100



Fiscal Adjustment in the Baltics, 2009-10 (Percent of GDP) 1/



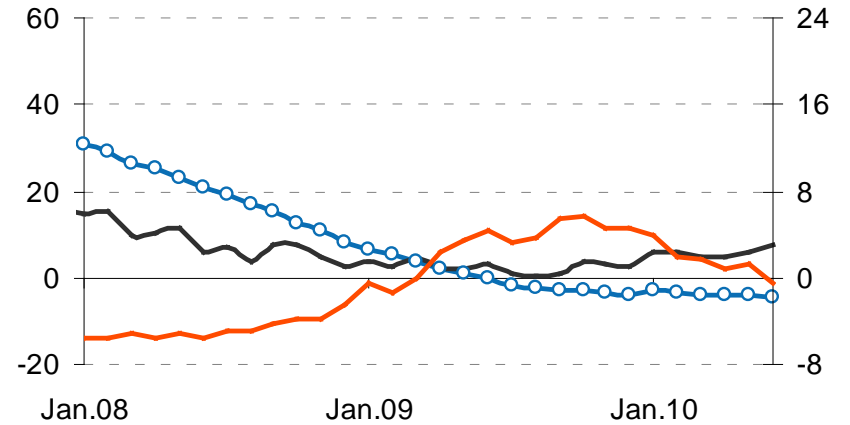
Source: IMF staff estimates.

1/ Measures implemented net of the impact of rate reductions in PIT and CIT or of spending increases. Gross adjustment was larger. For Estonia and Latvia, measured on a cash-basis; for Lithuania, on a ESA 95 basis.

Deleveraging: *as seen in textbooks... nobody said it's easy, but could have been worse*

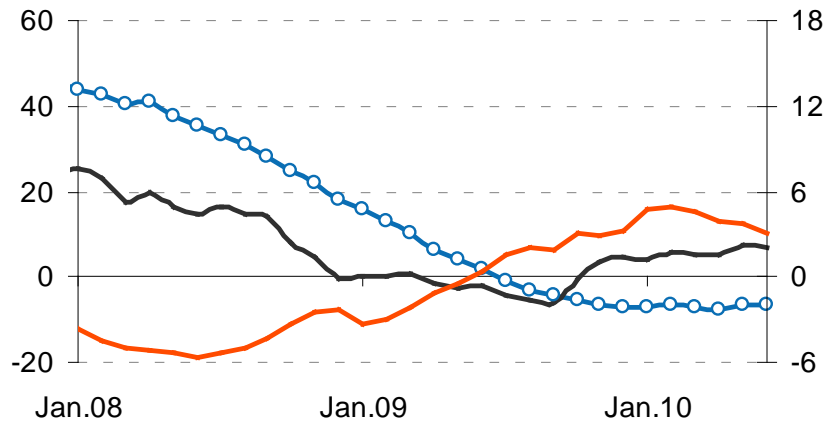
Dragging their feet... deleveraging grinding to the bone as credit stock shrinks, deposits are up (where do they get the money from?), and high real interest rates make it more painful. Effective credit stock reduction must be sharper, see e.g. NPL data.

EE credit and deposit growth (NFIs and households), real EUR interest rate on loans



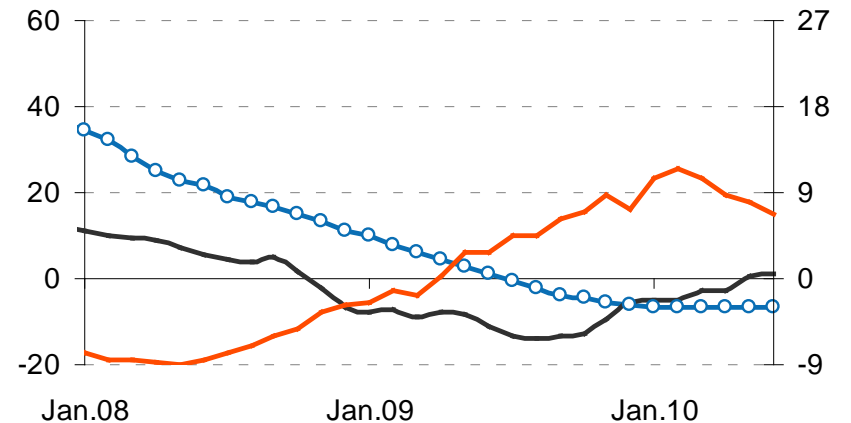
Source: EB

LT credit and deposit growth (NFIs and households), real EUR interest rate on loans



Source: LiB

LV credit and deposit growth (NFIs and households), real EUR interest rate on loans



Source: LaB

—○— Credit stock growth, % yoy — Deposit stock growth, % yoy — Average real interest rate, % (rs)

Note: interest rates are deflated by local CPI indices

Part 3

Baltics outlook:

*Outlook for 2011-2012: still muddling through but in a temporarily happier mood
(comparing to Spring 2010 Forecast)*

Base scenario: *stronger recovery in 2010, but somewhat weaker in 2011-2012*

Main storyline remains as earlier and any change in numbers is mainly due to stronger than expected global growth in 2010 and weaker global growth in 2011-2012 (**NOTE: all changes here relative to the Spring forecast, see next slide**)

- 1) **Stronger GDP growth in 2010, weaker in 2011:** a good run of exports is expected to weaken as the global economy slows
- 2) **Stronger exports and imports in 2010,** somewhat weaker or same as previous forecast in 2011; imports are predominately export driven, i.e. inventories. This may worsen current account balance
- 3) **CPI deflation is over,** driven by weak euro, external pressures (also via exports), admin price changes, euro accession etc.
- 4) **Higher unemployment in EE and LT, lower in LV** due to different turnout regarding job creation and activity rates
- 5) **Stronger household consumption in EE and LV** as wage bill improves, LT household consumption forecast as earlier

Note: IMF has cut optimum growth for LT and EE from 5-7% to 3-4%, which may perhaps be somewhat cautious, i.e. midway

	2008	2009	2010f	2011f
<i>GDP real growth, %</i>				
Estonia	-3.6	-14.1	1.5	4.5
Latvia	-4.6	-18.0	-2.5	4.0
Lithuania	2.8	-15.0	-2.0	3.0
<i>Jobseekers' rate, % of economically active</i>				
Estonia	5.5	13.8	14.0	12.0
Latvia	7.5	16.9	21.5	19.5
Lithuania	5.8	13.7	16.0	15.5
<i>Consumer price index growth, %</i>				
Estonia	10.4	-0.1	0.5	1.8
Latvia	15.4	3.5	-3.0	0.0
Lithuania	10.9	4.5	1.0	1.0
<i>Real net wage growth, %</i>				
Estonia	3.2	-5.2	-5.3	1.5
Latvia	6.3	-5.9	-8.0	2.0
Lithuania	10.1	-7.5	-5.0	0.0

Source: National Statistics and Swedbank

GLOBAL: uncoordinated and wrong policy response, weak governments, protectionism

- **Global/ EU demand** (positive/ negative): given that the recovery is exports driven, a new recession or sharp sustained slowdown will immediately shift the Baltic growth rates, incomes, employment, budget finances etc.
- **Global prices** (positive/ negative): global slip into deflation means more deflation for us in order to improve competitiveness, it would also make deleveraging longer and more painful; moderate inflation (including weak euro) would ease exports growth and deleveraging, and support recovery
- **Global financial markets uncertainty** (negative): poor asset quality for banks, prolonged stress in Southern Europe (e.g. Greek default in 2012/13 as their parliamentary elections approach) etc would raise sovereign and private debt refinancing costs for LV and LT

LOCAL: election paralysis, shift in policy direction, reform fatigue

- **Parliamentary/ municipal elections** (positive/ negative): postpone structural reforms and shift in policy direction if opposition parties come to power; but in LV after elections there is a long period to be brave, i.e. no elections
- **Reform fatigue** (negative): relay on temporary solutions, temptation to sit out as worst has passed
- **Euro adoption in EE** (positive/ negative): boost FDI in EE and the whole region, but may also result in some complacency in EE slowing structural reforms
- **Lack of investment in manufacturing** (negative): currently sector leaders run at close to full capacity and may not invest in new capacity as (i) lack of funding, (ii) had leveraged up at peak costs and still need to deleverage. It would cut export growth and slow recovery
- **Emigration/ immigration policy** (negative): will deduct from future growth
- **EU funds accession** (positive): boost domestic demand and perhaps export capacities

Thank you!