

8 December, 2016

# Baltic Sea Report

## Half-hearted reforms will not raise competitiveness and boost growth

- Mind the risks to long-term growth
- Exports hold the key to future growth in the Baltics
- The services sector – stronger, smarter and more diversified

### Mind the risks to long-term growth

Russia has exited recession and now all the Baltic Sea region (BSR) economies are expanding, but growth is expected to be modest. The global rise of populism and anti-establishment moods, although promising fiscal expansion that may boost short-term growth, builds up risks of protectionism with a negative impact on long-term growth. Nurturing structural strength to improve competitiveness and reduce imbalances is critical for the BSR economies to maintain their reliance on exports as a key driver for growth. Smarter fiscal policies and smarter spending are needed to support long-term growth potential. The three Baltic economies have quite successfully overcome the sharp fall in trade with Russia by integrating closer into the EU and the rest of the world. The Baltic Sea index shows Sweden improving its already-high-standard structural strengths, while Latvia and Lithuania still have a mountain to climb to bring themselves to the region's average, which is Estonia's standing. Russia keeps drifting away from the rest of the region in terms of its institutional and structural qualities, which will keep weighing down on its economy.

### Exports hold the key to future growth in the Baltics

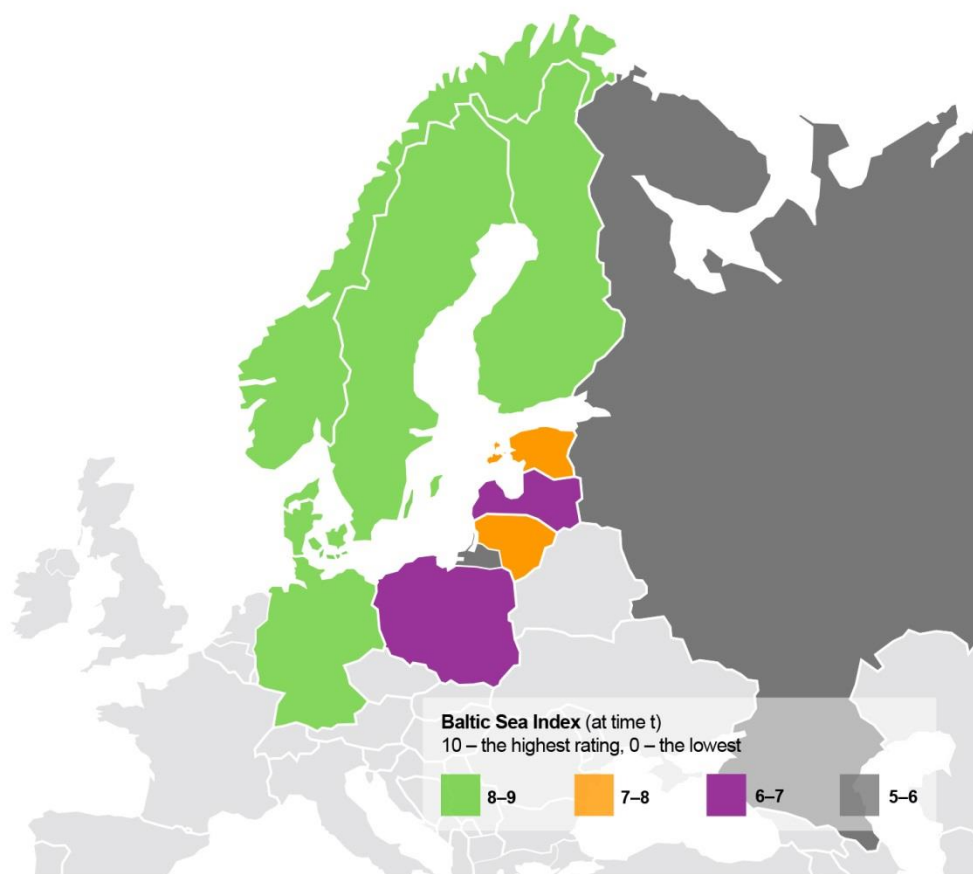
Although private consumption has been the main driver of growth lately, export performance holds the key to fast and sustainable growth in such small and open countries as the Baltics. Exports are recovering from the Russia shock. Diversification to other markets – predominantly the EU – has cushioned the losses from the Russian market, but it has not been enough to fully compensate for them. Exporters are trying new markets, but it remains to be seen if these markets can be retained. Exports will grow faster in the next couple of years as global goods prices recover and external demand improves. However, future growth is undermined by surging unit labour costs, which dent competitiveness. Expanding into new markets and increasing the domestic-value-added content of exports are crucial for raising the market share and boosting future growth. Even though the Baltics' exports seem quite diversified, export performance is closely linked to the success of a few big companies.

### The services sector – stronger, smarter and more diversified

As the Baltic countries are developing, the services sector is becoming an ever-more important player in their economies. This sector has demonstrated remarkable performance over the past decade, largely thanks to a rapid growth in exports of services. Although the rapid export growth, especially that of transport services and tourism, was temporarily interrupted by the Russian woes last year, most of the exporters have diversified away from Russia towards the EU, and the services sector is now re-emerging. There is still a lot of untapped potential for the services sector, both internally and externally, but the challenges to live up to it are mounting as well. The lack of a skilled labour force, flaws in the education system, insufficient investment levels, and the changing transportation strategy in Russia, as well as the protectionist winds from the West, may all affect negatively the future prospects of the services sector. However, at least some of the challenges can be tackled through smart in-house policies.



## The Baltic Sea region and Swedbank Baltic Sea index 2016



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

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## Introduction: mind the risks to long-term growth

Russia has exited recession and now all the Baltic Sea region (BSR) economies are expanding, but growth is expected to be modest. The global rise of populism, though promising fiscal expansion that may strengthen short-term growth, builds up risks of protectionism with a negative impact on long-term growth. Nurturing structural strength to improve competitiveness and reduce imbalances is critical for the BSR to maintain its reliance on exports as a key driver for growth. Smart fiscal policies are needed to support long-term growth potential. Russia keeps drifting away from the rest of the region in terms of its institutional and structural qualities.

**Global growth to remain subdued, but 3.3% in 2017 is not that bad for the global economy**

### Global environment: populism and anti-establishment moods rattle the old order

Global growth remains subdued and patchy, but GDP growth of 3.3%, which is our forecast for 2017, is by no means that bad for the world economy.<sup>1</sup> Developments vary much across the regions and countries. After a poor start of the year, growth in the US is firming up. The unemployment rate is low and wage growth is picking up. The US presidential election has brought expectations of a more expansionary fiscal policy, possibly pushing up US growth above our forecast of 2% in 2017. Expectations that inflation is finally back on track have lifted the long end of the yield curve. We expect the Federal Reserve (Fed) to continue its policy normalisation with a hike this December and another hike next year. The US dollar has thus strengthened. The euro area (and Europe overall) is lagging behind, but also slowly improving – in the third quarter of 2016, all economies were expanding. Euro area unemployment has slipped below 10%, the lowest in seven years. But the differences across countries are large – similarly to the US, Germany's business cycle is maturing, while few others are still experiencing hefty negative output gaps. Overall, there is a cyclical upswing in the euro area, and we expect its GDP to expand by around 1.5% next year. The ECB will begin to taper its asset purchases in 2017, but policy rate hikes should not be expected before late 2018 at the earliest. The Riksbank will continue its expansionary monetary policy, keeping interest rates at low levels throughout 2017.

Emerging-market economies had an early warning to fix their balances a few years back when the Fed started tapering its policies. Many have done well, but, recently, the stronger US dollar and steepening of the yield curve will put renewed pressure. Chinese growth is driven by domestic consumption, and its economic policies will remain supportive to keep its GDP growth around the target rate of 6.5%. Growth in India has disappointed, largely due to the nonperforming loans' problem, but its long-term outlook remains decent. The recession in Russia has ended, but, unless oil prices rise sharply and/or the US sanctions are lifted, growth will be only 1.5% in 2017. The Central Bank of Russia has started to cut its key rate.

**Populism is the new normal: more expansionary fiscal policy and more protectionism**

In our last year's report, we warned about the political implications of a fragile growth and noted the risk of populism rising. We did not go as far as to predict the Brexit vote, but the recent US presidential election was a clear game changer, showing that populism is the new normal globally. This does not mean that populists are to win every election, but it does mean that mainstream politics and economic policies are turning more national (i.e., inward looking and protectionist), thereby threatening the long-term prospects of global economic growth. In short term, fiscal policies will turn expansionary and mute the negative impact on long-term growth, but only temporarily, as debt levels are high and spending respite cannot run for long. Populism is likely to change the very fundamentals of the current growth model (most immediately, by impairing globalisation). And there is more to this than meets the eye. The source of populism is not only the period of slow post-crisis recovery; it is also about long-ignored undercurrents of income inequality, social mobility, digitalisation putting at risk large segments of jobs, labour skills, and ageing, among many other issues. All these challenges cannot be addressed by simply spending more and closing borders; they will need supply-side adjustments. How the growth model will change is still uncertain.

**Major free trade agreements have been shelved**

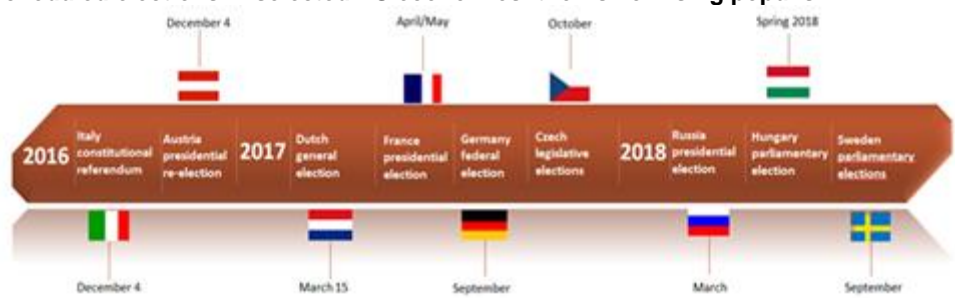
Donald Trump's propagated expansionary fiscal policy and deregulation raise expectations of a stronger short-term growth and higher inflation, bringing along a swifter normalisation of monetary policy. This may seem exactly what the US economy needs today, but if a fiscal stimulus and a tighter monetary policy are accompanied by protectionism (e.g., the TTIP is off the table, the TPP is unlikely to be ratified, existing trade agreements, such as NAFTA, could be renegotiated), the positive effects on US and global growth could be muted, if not reversed. More fiscal spending in a maturing US business cycle, unaccompanied by supply-side reforms, is likely to create bubbles rather than higher sustainable long-term growth.

<sup>1</sup> See our *Swedbank Economic Outlook*, November 2016, for details of short-term forecast [here](#).

## Forecast uncertainty has widened with negative risks to long-term growth

Uncertainty about the Trump administration's economic policy is high, and it is impossible to assign realistic forecast numbers to how that could affect the US and global growth, both short term and long term. We simply do not know what the policies will be. But what is clear is that, with higher policy uncertainty, forecast intervals have widened. Also in Europe – with many elections next year, rising populism and anti-establishment moods that reinvent all over again and again the stories of the EU and/or euro area falling apart. Though neither of these two geopolitical shifts currently seems likely to happen, it will raise uncertainty (i.e., high financial market volatility and spreads) and could delay long-overdue structural reforms, pushing towards a vicious cycle of weak growth and more populism. For the Baltic Sea region, a net exporter, higher uncertainty and the risk of protectionism mean the risk of less export and investment growth, and hampered long-term growth. With the global economy expanding, exporters will still see good opportunities to grow their exports, but, with policy uncertainty and the risk of protectionism, forecast intervals (especially for those small, open economies that are more export dependent) have widened and are tilted downwards.

### Scheduled elections in selected EU economies: the risk of rising populism



## In 2016, growth of the Baltic Sea region is stronger than forecast as Russia has exited recession earlier

### The Baltic Sea region: nothing more than modest growth

In 2016, the region's economy is doing better than we had forecast a year ago. Its GDP is to expand by 1%, above our forecast. This is due to Russia exiting recession a few quarters earlier than forecast (due to the base effects, however, it will still report a 0.5% drop for 2016 overall). The oil price recovery, orthodox monetary and fiscal policies, a cheaper rouble, and elements of import substitution have pulled Russia out of recession, but its recovery is set to be weak. We expect oil prices to rise but still to be much below the levels we saw just a few years ago (USD 67 per barrel of Brent at the end of 2017, and USD 71 at the end of 2018). The sanctions against Russia are still intact, limiting its access to capital. But most crucial, the key drags to growth, such as corruption, the poor rule of law, the massive state sector (70% of GDP), and the extractionary nature of its institutions in general have not improved.

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

	Average of 2004-2014	2015	2016f	2017f	2018f
Denmark	0.9	1.6	1.0 (2.2)	1.7 (1.9)	1.9
Estonia	2.9	1.4	1.3 (2.6)	2.4 (2.8)	2.5
Finland	1.0	0.2	0.9 (0.5)	0.8 (1.0)	1.1
Germany	1.3	1.7	1.7 (1.8)	1.4 (1.6)	1.1
Latvia	3.1	2.7	1.6 (3.3)	2.6 (3.0)	2.9
Lithuania	3.5	1.8	2.0 (3.3)	2.8 (3.0)	2.5
Norway	1.6	1.6	0.7 (1.1)	1.5 (2.2)	2.0
Poland	4.0	3.9	3.1 (3.5)	3.4 (3.5)	3.4
Russia	3.8	-3.7	-0.5 (-2.0)	1.5 (1.5)	2.0
Sweden	2.0	4.1	2.8 (3.3)	2.5 (3.6)	2.0
Baltic Sea region (PPP weights)	2.4	1.5	1.0 (0.6)	1.7 (1.9)	1.8
Baltic Sea region, excluding Russia	1.8	1.9	1.9 (2.1)	1.8 (2.1)	1.6

Source: World Bank, IMF, Swedbank Economic Outlook forecasts November 2016 (November 2015 forecasts in parenthesis)

If we exclude Russia, the region's other nine economies will pencil in 1.9% growth in 2016. All the economies are growing, but many have fallen short of the forecast. Norway reported a negative annual GDP growth in the third quarter, as the oil sector suffers from low prices; its mainland economy is doing well, and, with oil prices on the rise, we expect this to be its only negative GDP growth reading. Next year, we expect these nine economies to expand by 1.8% and by 1.6% in 2018. This will be a mixed bag, with some slowing and others speeding up. For instance, Germany is slowing as its business cycle is maturing and unemployment is at historic lows. Finland is just starting to recover from a long stagnation. Poland is to benefit from the EU funds' inflow and its populist government's support to already brisk household consumption. With Russia back to growth, all the region's countries will now grow, in total expanding the region's GDP by 1.7% in 2017 and 1.8% in 2018.



## Differences in business cycle create opportunities for businesses

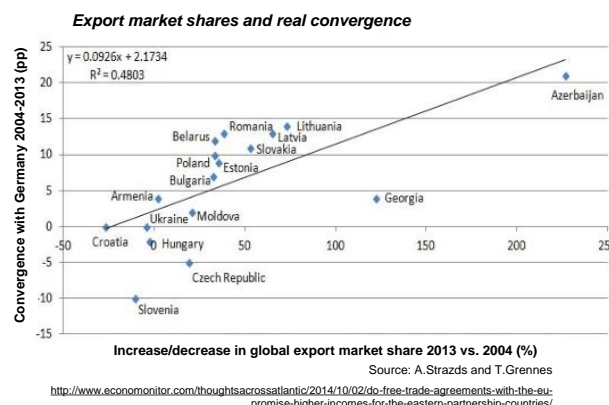
## Export-driven growth is the only model that can support fast and sustainable growth in the Baltics

## Fiscal policy should become smarter in supporting long-term growth

## Sweden to address housing and labour market imbalances

The different business cycle phases in the region are creating opportunities for businesses, but they also imply different political and economic policy agendas. In last year's report, we wrote "key risks are coming not from Russia or elsewhere, but from economically weak and politically fragmented Europe." Nothing much has changed. With slow economic growth and lingering social challenges, its massive geopolitical ambitions, and presidential elections in 2018, Russia's opportunistic policies will remain a key source of instability in the region. But with the rise of populism in the Western world, the key risk to growth and political stability for the region's economies lies in the damage that populism can do to the EU.

Swedbank's four home markets are facing multiple challenges. In 2016, growth in the three Baltic economies has been way slower than forecast. With the delay of the EU funds' inflow, investments have suffered. Consumption remains a robust driver of growth, but, with tighter labour markets, wage growth is exceeding that of productivity, building up headwinds for competitiveness. Unit labour costs have kept rising, pushing down export market shares. Research shows that the ability to raise market shares is critical for income convergence (see the chart to the right). So far, export performance is decent, and the fall of exports to Russia has been overcome by growth in other markets. The role of Russia has diminished, while integration with the rest of the world has deepened. The two in-depth sections later in the report analyse the track record, growth opportunities and challenges of the Baltic exporters. The widening of the Baltic economies' global reach is also seen in the foreign direct investment inflows – the share of the BSR investors is by far the largest (about 60%), but it has been shrinking as investors from other regions step in. With the populations shrinking (low birth rates, ageing, and emigration), export-driven growth is clearly the only model able to support sustainably fast income growth in the Baltics.



Populism will be a challenge also in the Baltics – we have just seen this in the outcome of the Lithuanian general election. Fiscal policies are to become more expansionary. With low public debt levels and good fiscal discipline (also enforced by the risk of forgoing the EU funds if spending slips out of hand), the Baltics could afford to spend more, but simply spending more will not help to prop up long-term growth. With the populations shrinking, growth will soon be driven only by productivity, which have been quite modest recently. Thus, we call for fiscal policies in the Baltics to turn smarter in supporting long-term growth potential, which now seems to have slid down to only about 2.5% per year. With the inflow of EU funds about to resume, short-term growth in the Baltics should pick up to about 2.5-3% in 2017 and 2018. Decent, but nothing stellar.

Growth has also fallen below our forecast in Sweden. Its growth is slowing from very high levels as the support from temporary factors fades. The slowing of growth will expose structural imbalances that have been built up. In the coming years, some of the main policy challenges will be supply shortages in the housing market and high levels of household debt, labour market mismatches, and the ability to integrate into the labour market the large inflow of immigrants. Growth is expected to slow to still good 2-2.5% in the next two years.

### Baltic Sea index: is the job never done?

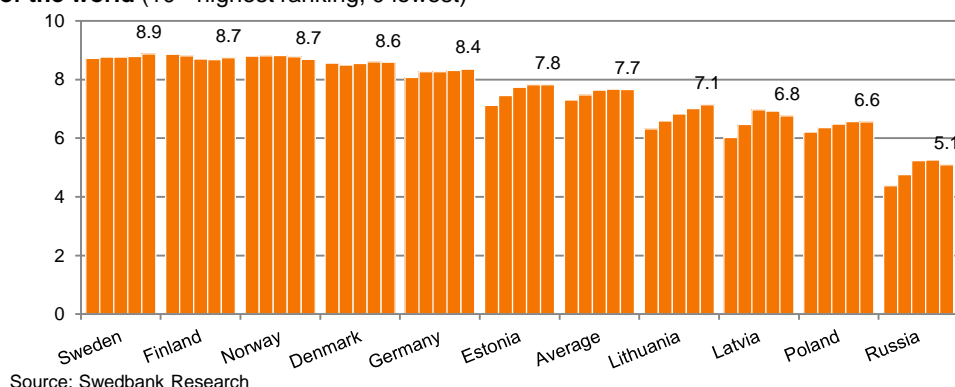
Since 2010, we have been publishing an index assessing the Baltic Sea region's structural competitiveness and institutional development: the Baltic Sea index (BSI). The region's countries are ranked in relation to each other and the rest of the world. Ten areas with underlying components are used as a basis for the overall index, which should serve as a good indicator of improvement in the business climate in relation to other countries. Countries are ranked from 0 to 10, where a rank of between 9 and 10 implies that in the selected area the country belongs in the top 10% in performance of all countries in the world. A country index is an average of all 10 areas. A regional index is an average of country subindices. The index allows to track a country's performance against others overall, and across 10 selected areas against others and its own past. If every country in the world were to improve at the same rate, our index and the country ranking would not change, because they measure comparative progress. The changes in countries' rankings indicate whether they have improved or slid backward. The index is slow to react to policy change as (i) reforms often are slow to take effect, and (ii) collecting internationally comparable data generates a measurement lag.

The region's structural qualities, as gauged by the BSI, have remained unchanged from the last year's reading (7.7). This means that the region has moved in line with the rest of the

**Countries with lower structural qualities are slow to improve...**

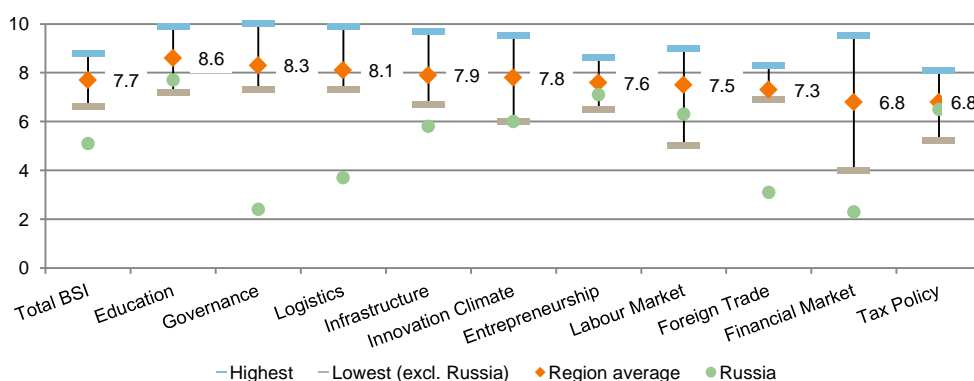
world. Three countries have seen their ranking improve (Sweden, Germany, and Lithuania), and three have seen them worsen (Norway, Latvia and Russia). The region ranks above the EU (7.5), largely owing to five areas: entrepreneurship, labour markets, tax policy, financial markets, and education. At the same time, the region ranks below the US (8.2), especially in financial markets, infrastructure, and logistics.

**Swedbank Baltic Sea index 2016 - ranking compared with the rest of the world (10 - highest ranking, 0 lowest)**



In contrast to last year, when most of the improvement came from those countries that rank below the regional average and had more catching up to do, this year it is only Lithuania that has inched up towards the region average (from 7.0 to 7.1; improvements in infrastructure, logistics, financial markets, and governance). Lithuania is the only country in the region that has been able to improve its ranking every year over the past five years (from 6.3 to 7.1). Estonia has retained its ranking of 7.8, while Latvia has slid from 6.9 to 6.8. The very recent improvements are likely to improve Latvia's position next year, but the current decline shows the lack of reforms, of which we had made clear notes in the previous reports. Sweden has risen from 8.8 to 8.9 (with a broad improvement in eight subindices and a slight reduction in education and foreign trade) and in all subindices ranks above the regional average.

**Swedbank Baltic Sea Index 2016**



**... the gaps are very wide and reducing them would boost growth**

**Russia keeps drifting away**

**Stronger economy means less pain and more gain**

The region's strength remains in education, governance, and logistics, where it ranks in the top 20% in the world. The key areas to improve are foreign trade, tax policy, and financial market diversity. Inadequate financial market development is a serious bottleneck for growth in the Baltic countries (especially in Latvia and Lithuania). Illiquid stock markets, the lack of private sector IPOs and floatings of state-owned enterprises (something that the Estonia now plans to do), and weak risk capital markets will be a drag on growth.

The key weakness comes from the region's uneven structural quality. Russia is the major outlier, e.g., see the massive spreads for the subindices of foreign trade and governance in the chart above. This year, there is also a massive fall in its financial market ranking – most likely due to the Western sanctions and recession. But the key gap for Russia, which our index fails to capture, is (geo)political risks. Unless those issues are resolved, Russia and the rest of the Baltic Sea region will drift apart.

What is the recipe for better growth of the Baltic Sea region economies in the times of rising policy uncertainty and risk of protectionism? Making their economies structurally more efficient and stronger is the solution that fits all seasons – in case of a downturn, they will suffer less; in case of an upturn, they will gain more.

*Mārtiņš Kazāks*

## Sweden: growth slowdown increases the need for structural reforms

Growth in Sweden is expected to slow from exceptionally high levels. This will increase the urgency with which to deal with growing structural imbalances. In the coming years, main policy challenges will be the rising housing prices, in combination with increasing household debt levels and the lack of qualified labour--together with the high unemployment rates among certain groups and the need to adapt to rapid demographic changes. Currently, however, Swedbank's structural indicators for Sweden show a benign situation compared with regional peers and the EU in general.

	Economic indicator	2004-2014	2015	2016f	2017f	2018f
<b>GDP per capita, PPP (2015):</b> 123% of EU 28	Real GDP growth, % (calendar adjusted)	2.0	3.9	2.8	2.5	2
	Consumer price growth, %	1.1	0.0	1.0	1.6	2.4
<b>Next parliamentary election:</b> September, 2018	Unemployment rate, %	7.5	7.4	6.9	6.6	6.6
	Nominal hourly wage growth, %	3.1	2.4	2.6	3.1	3.3
<b>Next municipalities election:</b> September, 2018	Current account balance, % of GDP	6.7	5.4	4.6	4.5	4.5
	General government budget balance, % of GDP	0.5	0.3	0.2	-0.2	0.1

Source: Statistics Sweden and Swedbank Research

**Strong growth, partly due to temporary factors,...**

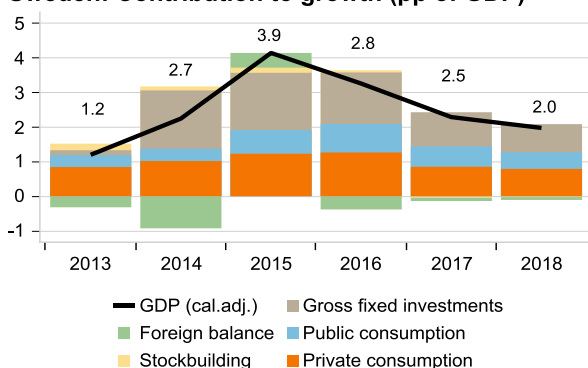
### Growth slowdown will increase risks from imbalances

The Swedish economy has expanded at strong rates in recent years due to both a strong underlying macroeconomic position and temporary factors. In 2015, real growth was 3.9%, preceeded by a 2.7% rate in 2014. These levels are among the highest in Europe. Although Swedish fundamentals are solid, the exceptionally high growth rates are also the result of temporary factors. Falling interest and tax rates, together with low inflation and solid employment growth, have led to strong growth in household disposable incomes. This has allowed for both increased consumption and savings. At the same time, an extended period of underinvestment in housing (since the banking crisis in the 1990s), together with strong household purchasing power, has generated a significant uptick in housing investments. Directly or indirectly, households have contributed to about two-thirds of growth in recent years. In addition, the weak Swedish krona has cushioned the export sector in these times of weak external demand, and the refugee inflow last year bolstered public spending.

**...will fade and expose structural imbalances**

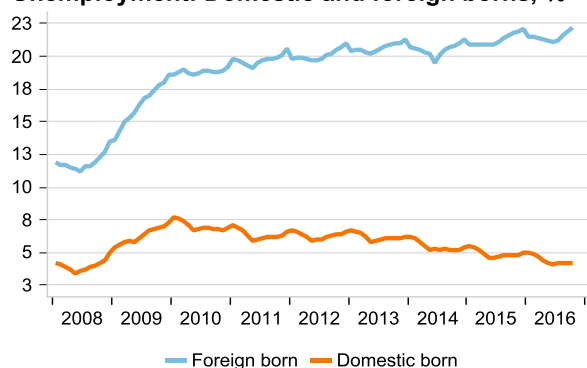
Looking forward, the impact of these factors will fade out, and we expect growth to slow, from 2.8% in 2016 to around 2% in 2018. This is not a cause for concern, but rather a slowdown to more sustainable levels, and it will be seen across all sectors. Policy support will be maintained, mainly through an expansionary monetary policy, and we do not expect a significant tightening of fiscal policy ahead of the general elections in 2018. The scope for fiscal policy expansion is also limited. The main political parties in Sweden have made a virtue of keeping the deficit in control, and, looking beyond the election, public expenditures are expected to increase mainly due to demographic trends. The Swedish National Audit Office, however, warned the government about underestimating public expenditures in coming years.

Sweden: Contribution to growth (pp of GDP)



Source: Macrobond and Swedbank Research

Unemployment: Domestic and foreign borns, %



Sources: Swedish Public Employment Service, Macrobond and Swedbank Research

External risks to the Swedish economy have increased. Swedish exports are growing but are to a large extent driven by services. Since 2010, exports of services have increased by 40% accumulated and account for more than one third of total export value. The

servicification of the business sector and new technology have boosted the market for services. However, Brexit is a downward risk since the UK is among the largest export markets for Swedish firms. Regarding exports of goods, growth has been significantly weaker, 13% accumulated during 2010-2016, partly due to a sluggish growth in global investments. Meanwhile, Swedish imports have been supported by strong domestic demand, and the surplus in the foreign trade balance has started to decline. From January to October 2016, the trade balance for goods shows a deficit of SEK 7 billion, compared with a surplus of SEK 15 billion for the same period last year.

We expect the Riksbank to continue to adapt to the low interest rates globally, primarily in the euro area. Although the Swedish inflation rate is picking up the inflation rate is not expected to reach the inflation target of 2 % during the forecast period. As a consequence, the repo rate will remain at negative -0.50% until early 2018 before rising to zero by the end of that year. Asset purchases will be extended, while tapered, through the first half of 2017.

Apart from external uncertainties, the main risks arise from the growing domestic imbalances, which need to be dealt with over the coming years.

### Significant structural challenges have been built up

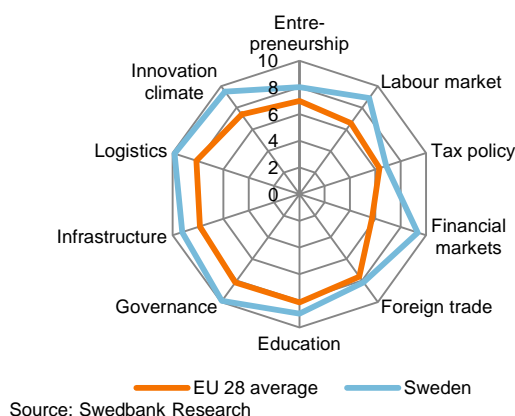
The Riksbank has repeatedly warned that the Swedish housing market is functioning poorly, with rapidly rising prices and household debt. The Financial Supervisory Authority has announced additional macroprudential measures to rebalance housing demand and supply. Minimum amortisation requirements on new mortgages became effective in June, and during the autumn housing prices and credit growth have started to decelerate. Annual repayments on mortgages of at least 2% will be made on loans until they reach a 70% loan-to-value ratio, and thereafter annual repayments of at least 1% will be paid until loans reach a 50% loan-to-value ratio. Swedbank's affordability index suggests a decreasing affordability for new house purchases, in particular for apartments in the larger cities. There is, however, a risk that imposing too-harsh measures might induce a too fast price decline. At the same time, since credit growth is still faster than that of disposable income, debt continues to grow as a share of disposable income (180%), although the debt-to-total-assets ratio has declined (26%). On the supply side, housing starts have increased significantly in recent years but still remain below demand. To mitigate the risks, additional supply-side reforms are needed, such as more transparent, standardised, and timely municipal land sales and planning procedures. Investments in infrastructure is a priority to improve the flexibility both for the housing and labour market and the government has increased the expenditures on infrastructure for the coming years.

The Swedish labour market is performing well but faces long-term challenges. Unemployment has declined and job growth has been robust since the financial crisis. At the same time, we are seeing an increasingly divided labour market, where two dividing lines run: between those with at least a secondary education and those without, and between those born in Sweden and those born abroad. Of these two, education is the more important factor. Soon, 80% of the unemployed will be concentrated in vulnerable groups, including those with little education (compulsory school or less), those born outside Europe, and the disabled. As a result, unemployment among those with lower education has risen to 20%, similar to that for workers born outside the EU. This imbalance could become more severe in coming years as the recent influx of refugees, many of them with little education, enters the workforce. For employment to continue to grow at a rapid rate, it will have to be easier for those furthest from employment to be able to find work. High collective-agreed wage floors and similarity of wages across sectors limit the scope to create jobs suitable for absorbing the skills mix of the unemployed. Reforms to create a more smoothly functioning housing market would make it easier for newly arrived immigrants to integrate. Reforming the housing market is also important for companies to be able to recruit the skilled workers they need. Capacity constraints due to the lack of labour are negative for growth.

### Compared with peers, Sweden needs to strengthen tax policy and education

In Swedbank's Baltic Sea index (BSI), Sweden maintains a strong position in comparison with regional peers and has improved in most of the subindices in recent years. Overall, Sweden ranks just below Norway and has improved the most (relatively speaking) in areas such as financial markets, labour market, and entrepreneurship. Also, in comparison with the wider

### Sweden vs EU28 average 2016



### Housing and household debt

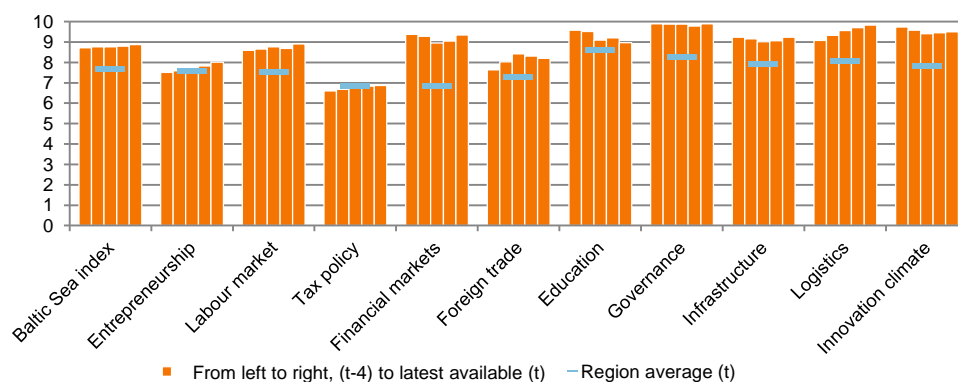
### Mismatch on labour market

### Sweden on top in a regional comparison



group of EU28; Sweden ranks well. However, there are also area of weaker performance. Notably, the slide in the ranking of education is continuing this year from the very sharp decline in 2015. Currently, Sweden ranks below Finland, Norway, and Denmark in education. There has also been a slide in foreign trade, and, although tax policy shows a slight improvement, this area still lags behind regional peers and is only slightly better than the EU 28 average.

**Sweden: Swedbank Baltic Sea index 2016**



*Jörgen Kennemar*

## Estonia: new government seizes the reins

According to Swedbank's index, the overall business environment in Estonia stayed at last year's level – the Baltic Sea region's average. The recent change of government is an opportunity to accelerate structural reforms. However, too much stimulation of the economy and the deterioration of public finances could increase potential risks.

	Economic indicator	2004-2014	2015	2016f	2017f	2018f
<b>GDP per capita, PPP (2015):</b> 75% of EU 28	Real GDP growth, %	2.9	1.5	1.3	2.4	2.5
	Consumer price growth, %	3.9	-0.5	0.1	2.6	2.4
<b>Next parliamentary election:</b> 2019	Unemployment rate, %	9.3	6.2	6.9	7.2	7.5
	Gross nominal wage growth, %	8.2	6.0	7.5	5.0	4.5
<b>Next municipalities election:</b> October 15, 2017	Current account balance, % of GDP	-5.0	2.2	1.1	0.2	-0.6
	General government budget balance, % of GDP	0.5	0.1	0.3	-0.6	-0.2

Source: Eurostat, Statistics Estonia, Bank of Estonia and Swedbank Research

### Estonia's economy sends mixed signals

We expect the Estonia's economy to grow by 1.3% in 2016, and by around 2.5% in 2017-2018.<sup>2</sup> This is below Estonia's potential growth rate, estimated at around 3%. There have been some capital-intensive sectors which have been hit by different negative shocks (lower energy prices, smaller transit flows). When rising energy prices start supporting the shale-oil industry, better access to cheaper Nordic electricity will continue suppressing domestic electricity production. Also, trade flows with Russia are expected to remain depressed.

At the same time, the labour market shows signs of overheating: the unemployment rate has decreased, participation/employment rates have grown substantially, the number of job vacancies has risen to the pre-crisis level, and average wage growth has exceeded productivity growth for several years. Wages have increased more than the general macroeconomic development of the economy would have suggested, as finding suitable labour is becoming increasingly difficult for Estonian employers.

Although we expect the unemployment rate to increase slightly in 2017-2018, this is mostly "technical" - a result of a reform that motivates people with disabilities who were previously inactive in the labour market to look for jobs. At the end of October, 5,000 people with reduced working ability were looking for jobs through the Estonian Unemployment Insurance Fund. As many of them might find it hard to find suitable jobs, the unemployment rate is expected to grow in 2017-2018.

Demographic changes add pressure to the labour market and public finances. Estonia's working-age population has decreased by around 7,000 people per year during the previous ten years, on average (2007-2016). Between 2004 and 2015, Estonia lost around 20,000 people because of external migration. Recent estimates by the European Commission and the United Nations show that the number of the 15-64-year olds will decrease from 854,000 in 2016 to 700,000 by 2040, and to 600,000 by 2060. Estonia's population is also ageing. The median age grew from 32 years in 1960 to 42 years in 2015. This is due not only to the low birth rate and emigration, but also to greater longevity. During the past 25 years, 64-year olds' life expectancy increased by 3.5 years (1989-2014). Growing social and health care costs mean less room for public investments to enhance the state's competitiveness.

With the legislation currently in effect, the retirement age is being gradually raised to 65 years by 2026. A reform proposal suggests raising the retirement age also after 2026 – to 68 years by 2057. This could still be too little – in order to maintain the current ratio of persons employed to pensioners, the retirement age should be 70 in 2040, according to the Ministry of Finance.

As Estonia's rate of natural population increase is negative and emigration has exceeded immigration (except in 2015), the current living standards can be sustained by either facilitating immigration or lifting productivity. Estonia applies annual quotas for short-term labour migration, up to 0.1% of the population (1,317 permits are allowed to be issued in 2016). Certain cases and countries are exempt from the limit. The residence permit regulations are gradually being relaxed to facilitate the immigration of qualified specialists.

### Estonia's business environment still at the Baltic Sea region's average

According to Swedbank's Baltic Sea structural index, the 2016 overall business environment in Estonia has stayed at last year's level. Estonia's index also remains at the Baltic Sea region's 10-country average. Estonia ranks below Sweden (which had the highest score),

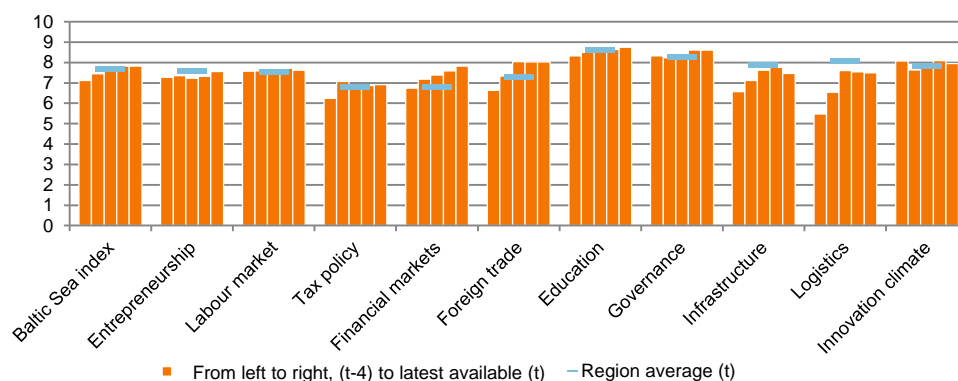
**No improvement in  
business environment,  
according to  
Swedbank's index**

<sup>2</sup> Swedbank's November forecast does not include any planned policy changes of the new government.

Finland, Norway, Denmark, and Germany, but above the EU28 average, Lithuania, Latvia, Poland, and Russia (which had the lowest score).

Estonia's business environment has stayed as business friendly as last year, receiving 7.8 points on a 10-point scale, both in 2015 and 2016. Out of the 10 areas we consider most important for business, three domains improved compared with the 2015 index: entrepreneurship (minority shareholders were more protected<sup>3</sup>), financial markets (easier access to loans and better regulation of the securities exchange<sup>4</sup>), and higher education and training (higher enrolment in secondary and tertiary education, but also better education-quality indicators<sup>5</sup>).

**Estonia: Swedbank Baltic Sea index 2016**



Source: Swedbank Research

The innovation climate received slightly lower scores in this year's index than last year. This happened because the World Economic Forum's Executive Opinion Survey 2013-2014 estimated that the Estonian government's purchasing decisions fostered innovation less than in previous years. The labour market index was lower, as labour participation in Estonia in 2014 remained below labour participation in the Scandinavian countries and in Germany. However, Estonia's labour force participation rate has increased substantially since 2014. Infrastructure subindex received a lower score in 2016 because Estonia is lagging behind best performers in this area, especially in the field of arranging competitively priced shipments.<sup>6</sup>

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

Tax policy requires additional efforts in Estonia, as this area received lower scores than other subindices. In the area of tax policy, the effective tax rate of enterprises as a share of profit is higher in Estonia than in the high-income countries of the OECD (49% in Estonia versus 41% in the high-income OECD countries).<sup>7</sup> Higher labour taxes are a result of the income tax exemption of reinvested earnings, which has shifted the taxation of corporate profits to labour. If the reduction of the corporate income tax proposed by the new government would be implemented, the corporates' tax burden would ease and consumption taxes would be raised.

#### **New government plans to carry out expansionary fiscal policy**

Estonia's political landscape changed in mid-November. The liberal Reform Party, which had been in the ruling coalition for the past 17 years, was pushed into opposition. A new coalition was formed between the centrist, social-liberal Centre Party, which had been in the opposition for the past 16 years, and the Reform Party's previous two smaller allies, the Social Democrats and the national-conservative Pro Patria and Res Publica Union. The new coalition has a slight majority in the parliament (27+15+14=56 seats, out of the total of 101).

<sup>3</sup> This subindicator measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain, as well as shareholder rights, governance safeguards, and corporate transparency requirements that reduce the risk of abuse; according to the World Bank's Doing Business indicator.

<sup>4</sup> According to the World Economic Forum's Executive Opinion Survey; 2013-2014 weighted average.

<sup>5</sup> According to the World Economic Forum's Global Competitiveness Index.

<sup>6</sup> According to the World Bank's Logistics Performance Index.

<sup>7</sup> The total tax rate measures the amount of taxes and mandatory contributions borne by the business in the second year of operation, expressed as a share of commercial profit. *Doing Business 2017* reports the total tax rate for calendar-year 2015. The taxes included: profit or corporate income tax; social contributions and labour taxes paid by the employer (for which all mandatory contributions are included); property taxes; turnover taxes; and other taxes (such as municipal fees and vehicle taxes).

The new coalition's parties would be supported by 50% of the voters, if elections would take place tomorrow (according to the latest Kantar Emor's poll, carried out in October 2016).

The new coalition started working on Nov 23, 2016. The coalition's main economic policy target is to decrease economic inequality. The new coalition plans to

- reduce the corporate income tax on "regular" dividends from 20% to 14%;
- increase the monthly tax exemption (nontaxable amount) of lower-income individuals and abolish the tax exemption of people with higher wages;<sup>8</sup>
- cancel the previously planned decrease of the social tax rate by 1 percentage point;
- expand public investments, build more public rental houses, and develop defence infrastructure;
- sell the minority shares of some public companies;
- impose a one-off registration fee on cars, depending on engine power;
- introduce a bank levy on financial institutions;
- limit the mortgage interest deduction and deposit interest income;
- augment the planned excise taxes on light alcoholic drinks and natural gas, and introduce a tax on sugary drinks;
- increase spending on agriculture and public transport; and
- lift the wages of teachers and cultural workers.

While there are some good ideas on the table (lower the corporate income tax and sell parts of public companies), the coalition government's plans are, in general, too expansionary. The planned increase of the monthly tax exemption of individuals is a good idea, but the scale of the planned tax cut is too big. The current monthly tax exemption is 15% of the average gross wage. The government has proposed to lift it by 2018 to around 40% of the average gross wage for the majority (around 85%) of wage earners. Lowering the corporate income tax rate of "regular" dividends from the current overall income tax rate of 20% to 14% is a good idea as well, but the expected positive net effect of the lower tax – in the range of EUR 50-100 million a year – could be overestimated.

Estonia's economy does not need a new overambitious public spending program, when the labour market has already overheated and investments of the general government are already expected to grow by one-fourth next year. Fuelling the already-high growth of domestic demand could trigger a too-high growth of wages, consumption, and construction volumes; this, in turn, could lead to a deterioration of the competitiveness of the exporting sector, as production inputs get too expensive. Although the current level of Estonia's general government deficit and debt are low, the ageing society, the shrinking labour force, and the decline in the inflow of EU funds (currently at around 2% of GDP), will increasingly pressure public finances; therefore, conservative fiscal planning is needed in order to avoid an onerous debt burden in the future, when the number of taxpayers is expected to be substantially smaller than now.

The current plan envisages spending the financial buffers the previous government had envisaged for the following years to keep the fiscal budget structurally balanced in the medium term. The new coalition plans to use this buffer to raise teachers' and cultural workers' wages. While teachers need higher salaries, raising teachers' average salary from the current 100% of the average salary of the whole economy to 120% of the average salary by 2019 means that the average salary of teachers would grow by around 11% a year for three years in a row, according to Swedbank's forecast. However, the government should not support the already strong wage pressures in the labour market.

*Liis Elmik*

<sup>8</sup> Increase the monthly tax exemption (non-taxable amount) of private individuals from the current 170 EUR a month in 2016 to 500 EUR a month for lower-income households and abolish the tax exemption for people whose gross wage is higher than EUR 2,100 a month.



## Latvia: a steep mountain to climb

Patchy external demand, wary confidence, insufficient investment, subdued credit demand, and structural weaknesses (e.g., in education, health care, and the judicial system) have dented Latvia's economic growth in recent years. Growth in 2016 has slowed close to stall speed, but with the EU funds and a rising corporate credit cycle, short-term growth is about to pick up. Long-term growth potential has a low ceiling, but the economy can do much better by unlocking pockets of higher growth – productivity, efficiency, and smart fiscal policy.

	Economic indicator	2004-2014	2015	2016f	2017f	2018f
<b>GDP per capita, PPP (2015):</b>	Real GDP growth, %	3.1	2.7	1.6	2.6	2.9
64% of EU 28	Consumer price growth, %	5.0	0.2	0.0	2.5	2.0
<b>Next parliamentary election:</b>	Unemployment rate, %	12.1	9.9	9.5	8.7	8.3
October 6, 2018	Gross nominal wage growth, %	10.3	6.9	5.0	5.5	5.5
<b>Next municipalities election:</b>	Current account balance, % of GDP	-7.1	-0.8	0.5	-1.3	-3.1
June 3, 2017	General government budget balance, % of GDP	-2.8	-1.3	-0.9	-1.1	-1.1

Source: Eurostat, Central Statistical Bureau of Latvia and Swedbank Research

### Policy mistakes lead to a sharp fall in investments and job loss in construction

On the surface, it is boring and calm. There are no issues with macroeconomic imbalances, the economy is grinding on: the fiscal stance is good, the current account has moved into a slight surplus, inflation is low (pulled down by global deflationary pressures for commodities, while prices of services that mainly depend on local factors show a healthy 2% rise), exports are recovering from the Russia shock and report single-digit growth, the unemployment rate is at 9.5% and inching down, and wages are growing moderately. The Ministry of Finance estimates that the output gap is about to be closed next year (which is likely), but the European Commission views that it has already been closed for years (which we doubt).

Yet, growth this year has been disappointing. A year ago we forecast GDP in 2016 to grow by 3.3%, but the first nine months have produced only 1.4%. The third quarter's annual growth was just 0.3%. Some of this weakness is self-inflicted. The administrative framework for the EU funds' inflow has been late to come into operation, and 2016 has been a dry year for investments. Gross fixed capital formation is down 24% in the first three quarters against that of a year ago. Construction has shed 10'000, or 14%, of its jobs, as the sector's output is down 20%. Some of the weakness is due to external factors. Most notably, Russia's redirection of its trade flows to its own ports, aiming to cease its transit via Latvia by 2020, has started to bite – this year, the transport and storage sector has employed on average 2'700 fewer people than a year ago, and railway cargos were down 17% in the first ten months this year. While it is unlikely that the Russian transit will dry up fully, the volumes are set to shrink, and finding replacement flows will be very tricky. With flows falling, the previously planned large investment projects for the railway's east-west direction and ports are likely to be brought into question, which would shrink the future investment pipeline. The looming delay in the EU funds and slippage in transit flows were known well in advance, but economic policies were not adjusted early on.

On the positive side, large falls in activity have been contained within construction and the transit sector, while the rest of the economy – especially the export segment – is growing, albeit moderately. Jobs shed in construction and transit (and recently in retail and wholesale, as slow sales growth along with wage pressures have pushed for productivity improvements and job cuts), have been absorbed by other sectors, and total employment has been fairly stable, at just below 900'000 this year. With the EU funds' framework by now largely in place, and EUR 650 million (2.5% of GDP) about to flow in, the lowest point in investments seems to have been passed, and growth should pick up from here. This will return growth to construction, which is set to create more jobs than will be shed by the transit sector. Labour market will tighten, pushing up wages and consumption. After seven years of deleveraging it should finally gear up the credit cycle (the corporate sector pencilled in timid credit growth this summer; households are set to continue deleveraging into 2018), pushing the economy into the next phase of the business cycle, with a positive output gap slowly starting to open up. Next year, GDP growth is expected to pick up to 2.6%, but this depends on the breadth of the EU funds' absorption and a robust upturn in the corporate credit cycle. With the global rise in populism and numerous elections in the EU, which are likely to raise uncertainty and dampen confidence, it will be an uphill struggle to reach that growth forecast.

### Wanted: supply-side reforms and a smarter fiscal policy

The uplift in the business cycle will raise GDP growth from the current lows, but this is unlikely to be a stellar and long-lasting run, since there are no ample pockets of slack and

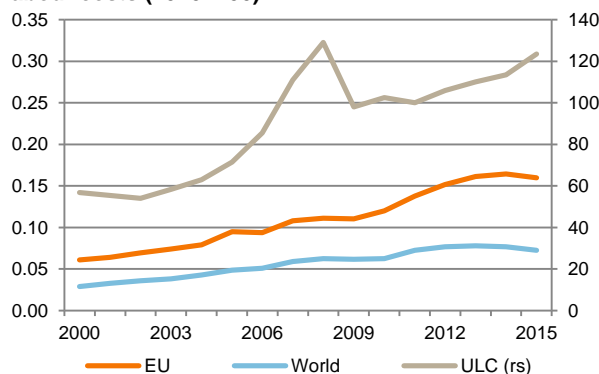
**A brief flirtation with stagnation: in 2016, growth sapped by adverse external shocks and inadequate policy response**

**In 2017, EU funds and corporate credit growth will lift the business cycle and boost short-term growth...**

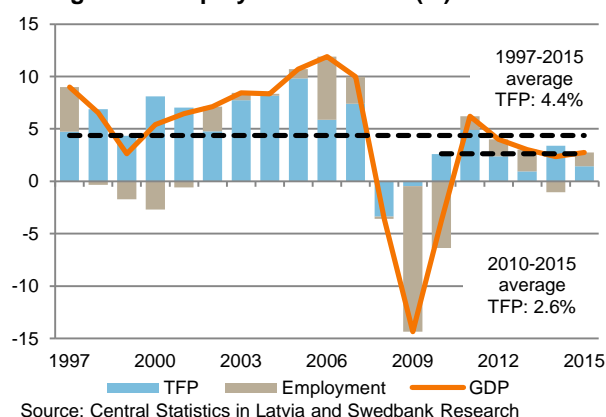
## ... but lack of reforms and demographic trends put a low ceiling on long-term growth potential

the current fundamentals set quite a low ceiling for long-term potential growth – about 2.5% per year. Latvia's population is shrinking (emigration and low fertility rates) and ageing. The population has decreased by 76'000, or 3.7%, in the past five years. Over the past decade, the share of people older than 50 has risen to 40% from 35%. Employment can still expand by a few tens of thousands via shrinking unemployment and raising participation (currently at 68%, its highest ever), but soon demographic trends (given no change in immigration policies) will take their toll, and falling employment will deduct from GDP growth. Then, GDP will grow only through productivity improvements, which in the past six years have averaged 2.6%. Unless broad supply-side reforms are implemented, with the convergence gap against the EU gradually narrowing, productivity growth will slip down further (see the chart below, which depicts the slowing of total factor productivity growth).

Latvia's export market shares (%) and unit labour costs (2010=100)



GDP growth: employment and TFP (%)



## Exports are the only source of fast and sustainable long-term growth

Going forward, certain sectors will put a drag on growth. Russia's redirecting its trade flows will shrink transit. Regulation will lead to downsizing in nonresident banking. This may have a further impact on residential real estate. The labour market tightening will lead to wage growth, which will not only support consumption, but could also dent competitiveness. Since 2012, wage growth has run above productivity growth, pushing up unit labour costs. Export market shares are stagnating (see the chart above). The role of exports as the main driver of long-term growth is being undermined. Experience (see the two special topics on exports of goods and services in this report) tells us that exporters are agile and able to grow in adverse situations, but support from productivity-enhancing governmental policies is critical.

Lingering periods of slow growth can induce hysteresis, i.e., unemployed labour loses its skills and forgone investment permanently depletes production capacity. Periods of slow growth lend support to populism, which makes it difficult to push for supply-side reforms, and politicians tend to slip towards fiscal expansion. For the time being, the political situation in Latvia is calm, and the municipalities' elections scheduled for June 2017 so far have made little stir in public debate. Opinion polls show that dissatisfaction with slow growth, however, is rising. The popularity of state institutions is low, and, as the October 2018 general elections near, we shall see populism rising.

## The new government aims to revive reform zeal, but so far with limited success

In February 2016, the government was reshuffled (the coalition did not change), and Māris Kučinskis assumed the Prime Minister's office. The government has set out five priorities – strengthen economic growth, implementing reforms in education and health care, improving the demographic situation, and strengthening defence. Mr Kučinskis has been vocal in support of supply-side reforms, promising a stable tax policy (while setting a target for tax revenues to GDP at 33% by 2020, up from the current 29%), improving the business environment and insolvency process, downsizing the bureaucracy, combatting the grey economy, and promoting fair competition. All the right things, but so far with limited success. In July this year, Latvia joined the OECD. As a condition for joining, certain reforms were implemented – e.g., in public sector governance--but the results are still to be seen. After years of dithering, reforms in school network and teachers' pay have resumed. The World Bank has been commissioned to audit the tax system to make it simpler and more growth friendly, and to reduce income inequality and cut down on the grey economy. Based on the audit, the government has promised to produce its long-term view on the tax code changes in April 2017. The Prime Minister's repeatedly stated aim of sustained GDP growth of 5% per year, though, is still a very distant target.

## Fiscal policy has turned more expansionary, but it should get smarter

Meanwhile, fiscal policy already has turned more expansionary. The Law on the 2017 Budget sets out a 7% rise in expenditures, which is by far the fastest increase since the boom years of the mid-2000s. This is way above forecast GDP growth. The key mistake would be to raise revenues from the legal economy at the expense of shielding the grey economy, to which a big part of the voters are exposed. Such a choice would kill tax morale and backfire, lowering the ceiling for long-term growth. Even though fiscal policy has turned more expansionary and politicians most likely will be willing to spend every penny they can

find in the run-up to the 2018 general elections, there are no urgent concerns about fiscal sustainability. Public debt is at a reasonable 40% of GDP. But the key safeguard is the EU funds – if fiscal policy would get “too adventurous”, the European Commission would stop the funds’ inflow. Because this is 3-4% of GDP annually and impossible to substitute for by borrowing in financial markets, it therefore disciplines the parliament.

But spending more is not a recipe for growth. Throwing money into a system that does not work (e.g., health care, education) will not create sustainable growth. Smart fiscal policy – favouring productive investment, improved labour skills and health, and a transparent and efficient business environment – will create long-term growth. In the 2017 budget, there is still too much talk about the lack of funding and too little about how efficiently it is spent.

#### Structural and institutional strength: Latvia has a mountain to climb

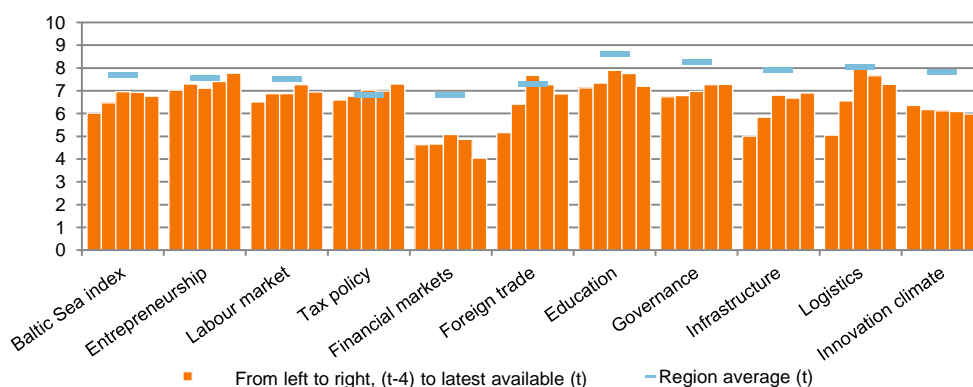
In our previous reports, we pointed out that politicians had been falling behind the curve, and that the post-crisis zeal for reforms had faded. This is very clearly seen in this year’s Swedbank Baltic Sea index (BSI), which measures an economy’s structural and institutional strength. In the past couple of years, Latvian policymakers have been slow in carrying out reforms. The BSI for Latvia has worsened to 6.8 from 6.9 last year. Of the region’s ten countries, Latvia is ahead of only two – Russia and Poland. Of the ten subindices that we monitor, only three have improved (entrepreneurship, due to the reduced cost of starting a business, tax policy, due to improved online systems for filing corporate income tax returns and labour contributions, and infrastructure, due to quality improvements of trade and transport related infrastructure), and six have worsened.

All but the tax policy subindex fall behind the region averages. The largest gaps are those for financial markets, infrastructure, and innovation climate. The financial markets subindex has worsened sharply over the past two years. The banking union does provide security, but fragmentation in the European financial markets has grown. Latvia has few alternative financing sources to banks. The inadequate financial market development is a serious bottleneck for growth. The government has just passed legislation easing the tax burden for start-ups (which will be helpful to improve innovation), but the weak development of venture capital and the hard time companies are having raising capital will weigh down on their growth. Too much dependence on the EU funds as a source of investment is a risk, particularly post 2020, when the current budget period ends and less funds will be available. With the current underdeveloped financial markets, it will be impossible to substitute for the EU funds shortfall by means of the private sector. The education subindex has been falling behind, and one of the reasons is the weakening results in math and science. Closer co-operation between vocational education and employers must be built. Improving adult participation in learning would help to keep them in the labour market longer. Most of the measures to be improved are well known, but it takes forward-looking politicians to do it.

**Latvia’s structural strength indicators fall behind those of key competitors**

**No silver bullets or unique reform recipes, only hard and unpopular work**

Latvia: Swedbank Baltic Sea index 2016



Recent structural improvements are not seen in the index yet due to the measurement lag, but other countries have not been sitting on their hands either. To boost productivity and incomes, Latvia can gain from closer cooperation and integration with the rest of the region. Improving Latvia’s structural and institutional qualities would make such gains easier to achieve.

*Mārtiņš Kazāks  
Agnese Buceniece*

## Lithuania: closing window of opportunity

This year's growth was weaker than expected and is likely to pick up somewhat in the coming years. However, potential GDP growth is weak and further convergence towards the EU average now largely depends on the ability to introduce structural and, in many cases, unpopular changes. We see actual progress and rays of hope for further improvements in some areas, but risks in others at a time when a breakthrough is needed.

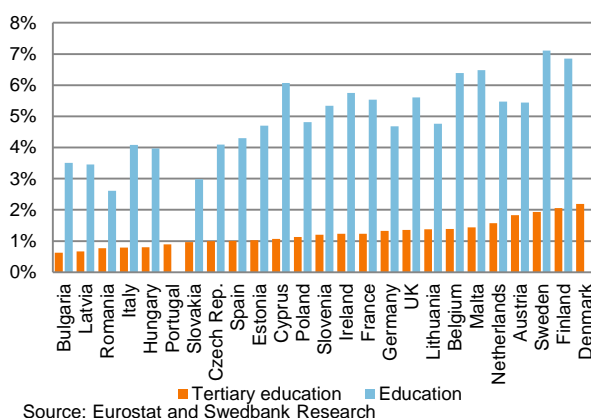
	Economic indicator	2004-2014	2015	2016f	2017f	2018f
<b>GDP per capita, PPP (2015):</b> 74% of EU 28	Real GDP growth, %	3.5	1.8	2.0	2.8	2.5
	Consumer price growth, %	3.5	-0.9	1.0	3.0	2.5
<b>Next parliamentary election:</b> October 11, 2020	Unemployment rate, %	10.7	9.1	8.0	7.4	7.2
	Gross nominal wage growth, %	7.7	5.4	7.8	6.5	6.0
<b>Next municipalities election:</b> February, 2019	Current account balance, % of GDP	-4.7	-2.3	-0.6	-0.5	-1.2
	General government budget balance, % of GDP	-3.4	-0.2	0.0	-0.8	0.5

Source: Eurostat, Statistics Lithuania and Swedbank Research

### Do not worry about slowing growth... for now

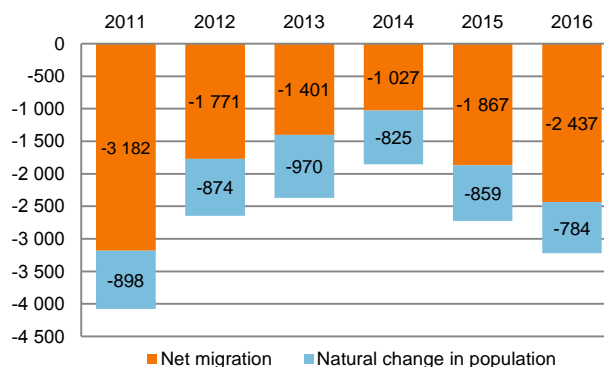
Economic growth has been slowing throughout 2016. The main factors weighing on growth this year will be short-lived, and growth will accelerate in 2017. However, Lithuania might start lacking growth drivers in the medium term. Purchasing power of households returned to the pre-crisis level this year, but further growth will be limited by weaker employment growth potential and a pick-up in inflation. At the same time, rapid wage growth will limit an increase in exports unless productivity growth is lifted significantly above the current levels. Now that Lithuania's GDP has reached 74% of the EU average, further convergence has become more challenging but not less needed, as emigration has intensified and investment decisions must be made facing rising global risks. There is no time to postpone productivity-enhancing reforms and start planning public finances in a longer time perspective, as the window of opportunity for making a breakthrough is closing. However, there is a lack of reassurance about implementation of the necessary policies in the still-vague policy agenda of the new government. It is to be hoped that not enough time has passed to forget the previous crisis lessons and the newly emerged political power will restrain from short-sighted policymaking, because raising social spending is just as easy as it is dangerous if not accompanied by less popular, but essential, structural changes.

General government spending, % of GDP



Source: Eurostat and Swedbank Research

Average monthly change in number of inhabitants



Sources: Statistics Lithuania and Swedbank Research

**Immigration  
procedures eased  
further--now to attract  
start-ups and highly  
qualified labour force**

### Some progress is seen, but risks are there

As of next year, immigration procedures will be further eased for those workers from "third countries" who are highly qualified and needed in the Lithuanian labour market.; Lithuania became the first country in Central and Eastern Europe to introduce a start-up visa, which creates a separate immigration procedure for a start-up business. In addition, foreign students will no longer be obliged to get a work permit and will be able to start working part-time from the first year of their studies. The number of immigrant workers from third countries (mainly Ukraine and Belarus) rose to 14,600 in the first three quarters of this year - 2.4 times more than during the same period a year ago. More than 80% of these workers are truck drivers, followed by workers that are in scarce supply in sectors such as manufacturing, construction, trade, and hotels and restaurants. It is expected that the easing of immigration procedures will partly address the lack of a qualified labour force in the IT sector.



**Some progress in reducing the shadow economy...**

National budget revenues this year are 4% higher than planned despite weaker-than-expected GDP growth. This is partly explained by the very strong labour market and household consumption growth. However, the shadow economy most likely decreased as well as various indicators show that smuggling and tax evasion has declined partly due to intensified efforts by Lithuanian government institutions. However, last year Lithuania was still among the six worst performers in the EU and had a shadow economy amounting to 26% of GDP, therefore large untapped resources remain in this area.

**...but a lot of potential to increase efficiency of the public sector**

Despite some positive changes, there is still a lot of potential to increase the efficiency of the public sector. The number of employees per one square meter, in at least some of the public sector institutions, is a few times higher than in the private sector. The share of employees in the public sector is about twice as large as in OECD countries. The number of hospital beds per inhabitants and the number of teachers per student are too high. The return on equity on Lithuanian state-owned enterprises assets, which are worth almost EUR 9 billion, is a few times lower than that in the private sector.

**Ambitious political agenda but lack of sustainable measures to address structural issues so far**

The largest party (the Lithuanian Peasant and Greens Union) in the new coalition government put forth some radical economic policy proposals, such as having the state own bank and pharmacies, creation of a state-owned monopoly of alcohol retailers, and restricting the concentration of ownership in the retail trade sector, during the election campaign. However, now it looks increasingly unlikely that these measures will be implemented. Reducing poverty, emigration, and the too-large public sector, and improving education, social security, and the health care system are all said to be the priorities of the newly appointed Prime Minister, but the lack of concrete, sustainable measures to address these structural issues remains a problem. However, some of the proposals might result in improvements. For example the new government plans to eliminate the Ministry of Energy and to transfer two other Ministries (Agriculture and Environment) from Vilnius to Kaunas, which should encourage regional development. Cutting down on the number of public institutions with potentially overlapping functions could improve the efficiency and quality of governance, as well as save some public finances. Spreading the ministries across the country could reduce regional differences, but this should not come at the cost of weaker or more cumbersome cooperation between government institutions. We think that the greatest potential for savings, efficiency, and progress lies in the further development of e-governance – too many institutions and processes rely on bricks and paper.

**Government should abstain from raising income taxation...**

More worrisome are some suggestions by the leader of the Peasant and Greens Union to introduce progressive taxation, beginning at EUR 1,000 gross monthly wages. The idea was rejected later by other members of party's parliamentary group, incl. the new Prime Minister, as ineffective and untimely. Progressive taxation would not increase budget revenues significantly, as the share of high wage earners is too small, and it would be a negative signal for foreign investors and the qualified labour force—both of which Lithuania lacks.

We believe that one of the most effective ways to reduce income inequality and the unemployment trap is to further lower the taxation of low-wage earners. The budget plan prepared for the next year, which will still have to be reviewed by the new government, includes a more substantial increase in the nontaxable income threshold, from EUR 200 to EUR 310. The "social reform" ongoing until recently, a part of which is the greater flexibility of labour market regulation, also included lowering social security contributions paid by employers by 1 percentage point each year for 12 years. Lower labour taxes would have a positive effect on wages and employment. It is not clear if this will be included in the new government's program, as it was not mentioned in the Lithuanian Peasant and Greens Union election programme, and there are plans to postpone the implementation of the "social reform."

**...and concentrate on education to reduce income inequality**

In the longer term, the most effective way to lower poverty and inequality depends on the quality and efficiency of the education system. There seems to be underinvestment in some areas and overinvestment in others. Public sector expenditure for education as a percent of GDP is close to the EU average and even higher than that for tertiary education; however, educational outcomes are unsatisfactory. Even though the employment rate of tertiary-education graduates is higher than the EU average, companies face additional costs because there is a divergence between competences of graduates and actual labour market needs. Moreover, only 65% of those holding bachelor's degrees (either from university or nonuniversity studies) are employed according to their qualifications. Some students lack motivation and seek only the degree, while the best motivated and most talented sometimes suffer because of the limited resources left; meanwhile, teachers and professors earn inadequate wages. Even though the total number of teachers is too high and their wages are too low, and even though there are too many uncompetitive higher education institutions, the Peasant and Greens Union believes that the current system of "money following the student," which has at least partly encouraged universities to be more efficient, should be abandoned because this has led to a decline in the number of universities and schools in the more remote regions.

**Some progress, but still among four worst performers**

**Largest improvements in logistics and financial market development**

**The perception of access to loans has finally improved**

**No progress in areas where reforms are needed most**

### Baltic Sea index – some areas are screaming for reforms

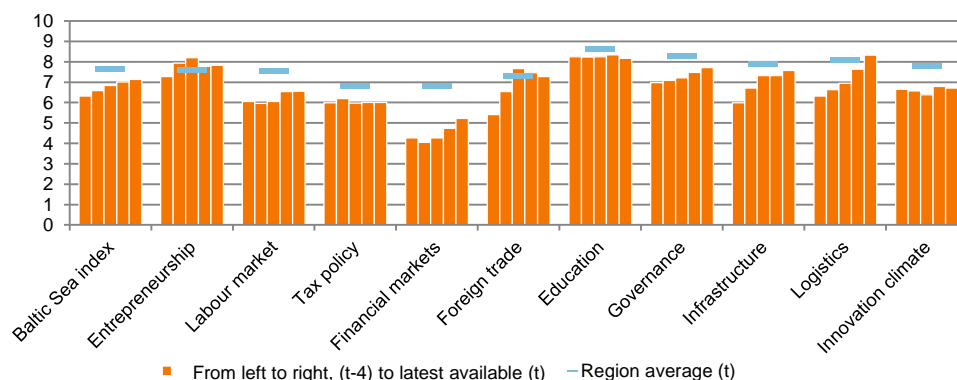
Lithuania's Baltic Sea index (BSI) continues inching upwards, but at a very slow pace – it has increased only marginally, from 7.0 a year ago to 7.1. This has prevented the country from moving upwards in the rankings – it was still among the four worst-performing countries in the region of ten countries. Only Latvia, Poland, and Russia scored lower than Lithuania. The country's BSI continued to score below the region's average, with the largest gaps in the areas of financial market development, innovation climate, and the labour market.

Nevertheless, there have been some improvements in a few areas. Since last year, Lithuania's logistics and financial market development subindices have improved the most, compared with other region's countries. The score for the logistics subindex has even overshoot that of the region's average. This increase resulted from improvements in the customs procedures, the competence and quality of logistics services, the ease of arranging shipments and their timeliness, and the ability to track and trace consignments. These advancements have been also reflected in the recent surge in Lithuanian exports of freight-forwarding and logistics services (see the in-depth on services).

Meanwhile, the financial market subindex, still the weakest point in the country's BSI, has increased due to a better evaluation of the soundness of banks, and even more to an improvement in access to loans, which is now perceived by the respondents to be similar to that before the recession. A crowdfunding law was passed this year and is likely to facilitate the emergence of fintechs in this area and the availability of alternative sources of capital for small and medium-sized enterprises (SMEs). Regarding the availability of venture capital, other countries in the region performed better than Lithuania and thus pushed it lower in the rankings. The lack of venture capital funding in Lithuania may be an important factor limiting the creation and expansion of start-ups; however, the situation will most likely improve as the country moves closer to the technological frontier. The governance subindex has improved somewhat, mainly due to a better perception of corruption, the control of corruption, and the rule of law in Lithuania. As a result of improved quality of trade and transport related infrastructure, the infrastructure subindex inched upwards as well, but still remained below the region's average. These are for the most part improvements achieved since last year.

Unfortunately, in most of the areas requiring urgent reforms, such as the labour market, tax policy, and education, as well as the innovation climate, we have seen no tangible progress. The low level of investment and the shrinking labour force are already dampening potential economic growth and may thus start limiting further income convergence. There is a risk that the implementation of the labour market liberalisation reforms, passed by the previous Seimas, will be postponed by the new government or even reversed. This would not only hurt employment and wage growth prospects, but also send a negative message to investors (an unstable and unpredictable economic policy). Easing the burden of labour taxation is another area requiring immediate attention – the recent rather symbolic increases in the nontaxable income threshold are insufficient to reduce emigration. Boosting the growth of productivity and potential GDP also requires an overhaul of the education system, focussing more on the quality of education instead of quantity. Education reform is also a prerequisite for improving the innovation climate and bringing the country's economy up the value chain. More than ever, the country's future competitiveness and prosperity depend on these reforms, but it is still unclear whether the new government will dare to take the risk of being unpopular.

**Lithuania: Swedbank Baltic Sea index 2016**



Source: Swedbank Research

**Vaiva Sečkutė**  
**Laura Galdikienė**  
**Nerijus Mačiulis**

## Exports hold the key to future growth

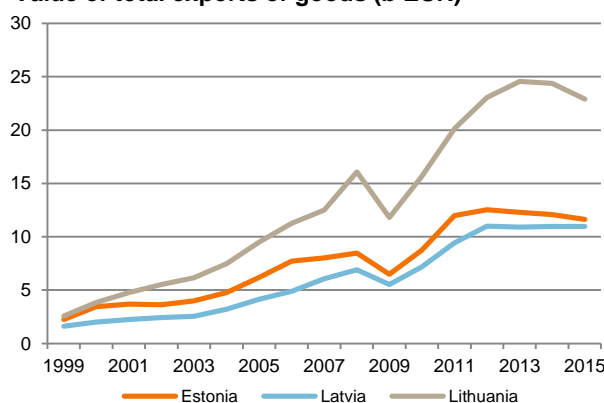
Although private consumption has been the main driver of growth lately, export performance holds the key to fast and sustainable growth in such small and open countries as the Baltics. Exports are recovering from the Russia shock, and they will grow faster in the next couple of years as global goods prices recover and external demand improves. However, future growth is undermined by surging unit labour costs, which dent competitiveness. Expanding into new markets and increasing domestic value-added content of exports are crucial for raising the market share and boosting future growth.

**The Baltics exported themselves out of the recession, but the advantage of internal devaluation faded out soon**

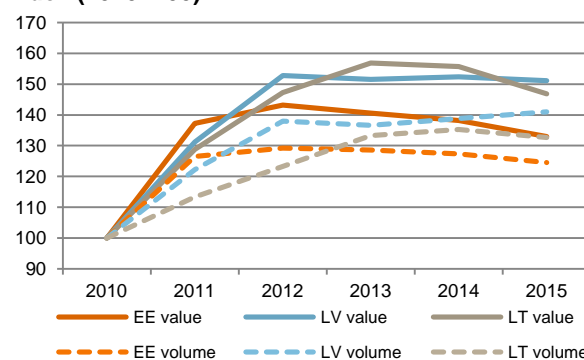
### Long-term growth in the Baltics driven by exports

The Great Recession that struck the world in 2008 did not spare the Baltics. It exacerbated the internal imbalances that had accumulated during the boom years (2000-2007). Exports of goods (both value and volume) fell sharply in 2009 and deepened the recession in the Baltics. However, the internal devaluation brought exporters back on their feet rather quickly. As elsewhere, exports were already rebounding strongly the following year, and the value of goods exports returned to its pre-crisis peak in late 2010-early 2011. In fact, the Baltics exported themselves out of the recession. A couple of years later, as the impact of internal devaluation faded, and, on the back of external shocks (e.g., the Russian food embargo), the growth of exports significantly slowed and turned negative in Estonia and Lithuania.

Value of total exports of goods (b EUR)



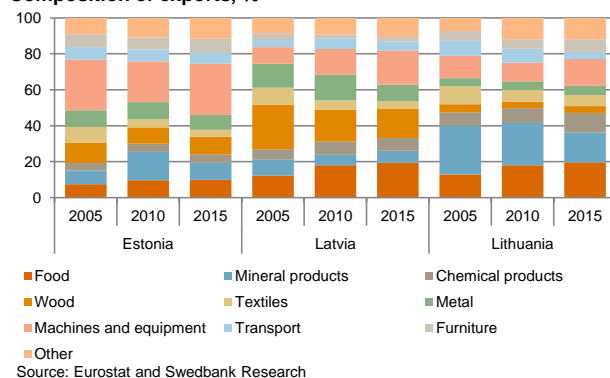
Exports of goods: value and volume index (2010=100)



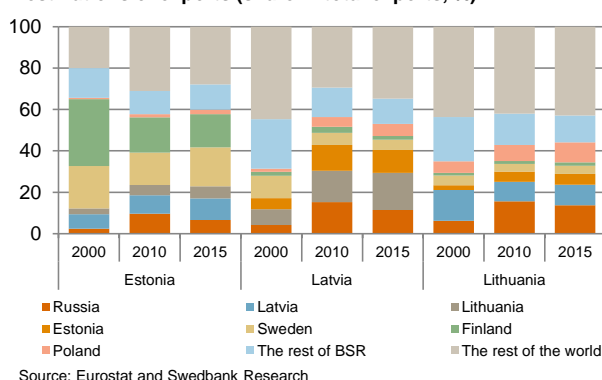
**Russian geopolitical and economic crisis had a negative impact on Baltic exporters**

Lithuanian exports of goods demonstrated greater resilience than their Baltic peers, but in 2014 this growth also halted. A sharp fall in exports to Russia – one of the major export destinations for the Baltic countries – has been especially painful. Russia's military aggression in Eastern Ukraine and the annexation of Crimea in early 2014 resulted in the imposition of international sanctions against Russia. Russia responded by imposing an embargo on certain food imports from the EU and other countries in August 2014 and plunged into recession on the back of falling oil prices. The sharp depreciation of the rouble made Baltic goods less competitive. The weakness in the global economy, anaemic recovery in the EU, and falling energy and other commodity prices have also contributed to the meagre export performance. The changes in the export value of goods have been largely driven by the fall in prices.

Composition of exports, %



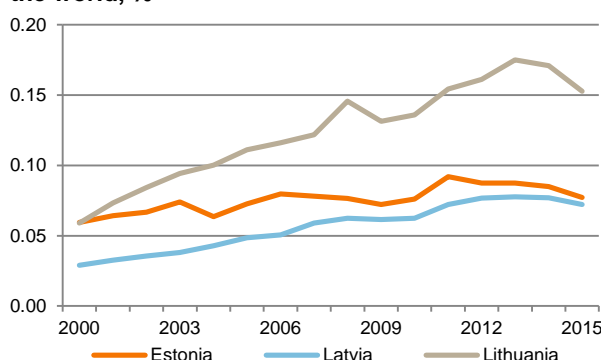
Destinations of exports (share in total exports, %)



## Export growth depends on goods prices, external demand, and competitiveness

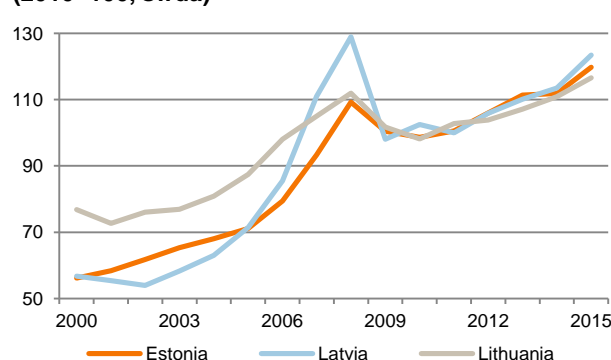
Consumption has been the main driver of growth in the Baltics lately. However, the population is shrinking, and consumption cannot contribute to fast and sustainable growth in the medium or long term in such small economies as the Baltics'. The Baltic countries are very open economies. The total exports of goods and services in 2015 accounted for 80% of GDP in Estonia and 77% in Lithuania. Latvia - with 59% - slightly lags behind its neighbours. Therefore, export performance holds the key to future growth. The value of exports will grow as global goods prices recover and external demand<sup>9</sup> improves. Demand from the main trade partners is expected to grow faster in 2017 and 2018 than in 2016, adding more opportunities for exporters. Demand is also likely to improve in Russia as it recovers from the recession (the effect will be stronger if Russia lifts its sanctions), as well as in the Baltics, as investment strengthens. At the same time, economic growth will slow in Germany, Sweden, and the UK. The balance of risks that foreign demand remains weaker than expected is tilted downwards. Surging unit labour costs are denting competitiveness and resulting in stagnant market shares, suggesting that export growth may be challenging.

**Baltic countries' export market shares in the world, %**



Source: IMF DOTS, Macrobond and Swedbank Research

**Baltic countries' unit labour cost index (2010=100, swda)**



Source: IMF DOTS, Macrobond and Swedbank Research

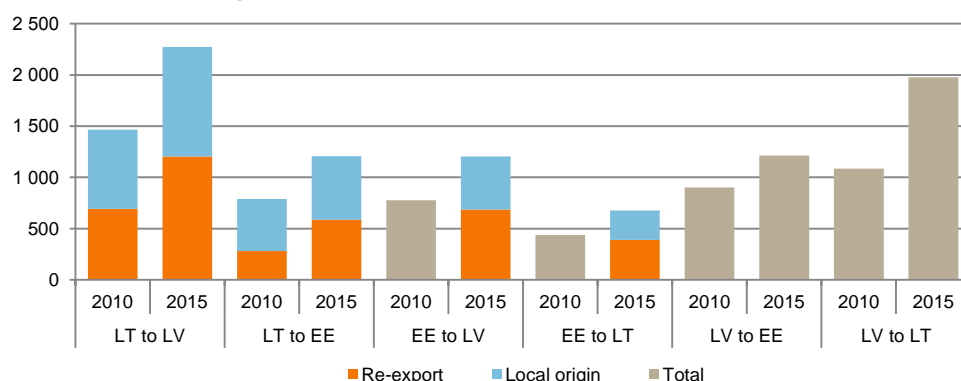
In the following sections, we look into exports of goods by destination, using the data on the value of exports. Volume data are available only at the aggregate level; hence, they are not suitable for a detailed analysis (partner/product dimension) and are not used here. The value data on total exports of goods are somewhat overestimated as they contain re-exports of goods (exports of foreign goods). Re-exports<sup>10</sup> account for about 30% of total goods exports from Estonia and Latvia, and about 40% from Lithuania. Detailed data on re-exports are not available for Latvia, and they start only in 2013 for Estonia. Thus, a comparable analysis of exports of domestic- (Baltic-) origin goods cannot be performed here.

## Export flows between the Baltics have increased; the share of re-exports is about 50%

### Re-exports form a substantial part of goods exports between the Baltic countries

A significant part of exports from Estonia, Latvia, and Lithuania remain within the Baltics. In 2015, the region absorbed about 15% of exports from Estonia and Lithuania, and almost 30% from Latvia. The importance of the Baltics as an export destination increased somewhat between 2010 and 2015. Slightly more than half of the exports of goods within the Baltics are made up of re-exports. The main reason, most likely, is that businesses treat the Baltics as a single market and use centralised logistics solutions.

### Nominal exports of goods within the Baltics, m EUR



Source: National statistics, Eurostat and Swedbank Research

\*Total if breakdown not available

<sup>9</sup> External demand developments are discussed in detail in the *Swedbank Economic Outlook* of November 2016.

<sup>10</sup> For Estonia and Lithuania, re-export data come from the National Statistics Offices; for Latvia, we use the Bank of Latvia assessment.



**Refined petroleum is the top export commodity from Lithuania; lower energy prices have dented the value of exports**

**Estonia mostly exports mineral products (electricity and shale oil) to Latvia**

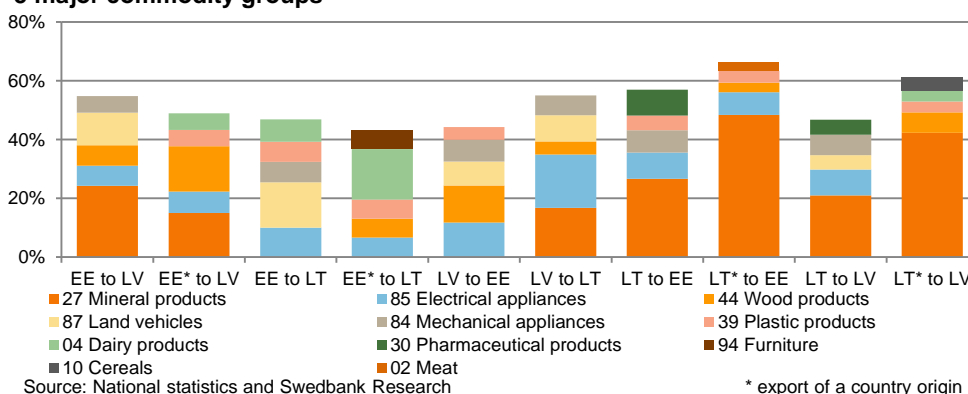
**Latvia mostly exports mineral products, and electrical and mechanical appliances to Estonia and Lithuania**

**Estonia mostly exports to Lithuania land vehicles, and electrical and mechanical appliances, as well as food and agricultural products**

Lithuania's exports of goods to the Baltics (and to the rest of the world) are dominated by locally refined petroleum. Nominal exports of this product category were growing between 2010 and 2013, driving total export growth. Between 2010 and 2015, the share of mineral products in the total value of Lithuanian-origin goods exported to Estonia reached, at its peak, about 80%, and to Latvia, about 55%. However, as oil prices slumped and the oil-refining company ORLEN Lietuva briefly cut its production volume in early 2014, the nominal value of exports of petroleum products to Estonia and Latvia – and also elsewhere – slumped, and their share in total exports of goods contracted to about 40% in 2015. The second-largest group of domestic-origin goods exported to the Baltics is food and agricultural products. This category was gradually growing between 2010 and 2013, but growth has slowed in recent years on the back of lower price and demand growth, as well as indirect effects from Russia's food embargo.

Mineral products – mostly electrical energy and shale oil – represent Estonia's most significant product group exported to Latvia. In 2015, this accounted for about one-fourth of its nominal exports of goods to Latvia. Between 2010 and 2015, this product group's export value increased by about EUR 135 million, or 85%. However, the value of exports fell in 2015, which can be mostly attributed to the price effect. Exports of electrical energy produced in Estonia had already started falling in 2014. In fact, the production of electrical energy has been falling across the Baltics as cheaper electricity has started flowing in from Scandinavia. Hence, during the last two years, Estonia's re-exports of electricity (mostly produced in Finland) replaced part of the Estonian-origin exports to Latvia. Nominal exports of wood and its products (almost entirely produced locally) have increased by almost EUR 60 million, or 240%, over the last five years, and their share in total exports has more than doubled (15% of local-origin exports in 2015). Until last month, Latvijas Finieris – the Latvian plywood company – imported veneer (used in plywood production) from its Estonian subsidiary, which contributed to the increase in wood exports from Estonia to Latvia. However, starting this November, Latvijas Finieris is producing plywood in its subsidiary in Estonia. Thus, the volume of wood exports to Latvia might decrease in the near future.

**Structure of exports of goods between the Baltic countries in 2015, 5 major commodity groups**



During the last five years, exports from Estonia to Lithuania increased by about EUR 240 million, with the largest share of growth coming from product groups with a large share (more than 50%) of re-exports, such as vehicles (personal cars) and machinery and appliances. These two product groups accounted for about two-fifths of nominal exports from Estonia to Lithuania. Food and agricultural products (mostly dairy) are the most significant local-origin export category. Most of Estonia's dairy exports to Lithuania is milk. However, in 2015, nominal exports of dairy products fell by 35%, or almost EUR 30 million. Some of the fall in value was due to lower milk prices, but the largest effect came from the embargo on food imports enacted by Russia. Estonian exports of raw milk to Lithuania fell abruptly in 2015, as Russia stopped importing most dairy products from Lithuania.

Between 2010 and 2015, exports from Latvia to Lithuania increased by about EUR 890 million, and from Latvia to Estonia by about EUR 315 million. Most of the increase occurred in product groups with large shares of re-exports. The largest contribution to exports of goods to Lithuania (EUR +265 million) was made by mineral products – mainly re-exports of petroleum products. The share of these goods in nominal exports from Latvia to Lithuania increased from 7% in 2010 to 17% in 2015. While this product group has accounted for the largest share in Latvia's exports of goods to Lithuania, it has taken a negligible share of exports to Estonia. In fact, over the last five years, mineral products have seen the biggest loss in value (EUR -20 million) of Latvia's exports to Estonia. Exports of machinery and equipment (mostly electrical appliances), which take up about 20% of nominal exports of goods to Estonia and Lithuania, as well as vehicles (large share is re-exports), have seen a large increase in value, both to Lithuania and Estonia. Food and agricultural produce, and especially wood and its products, are mostly locally produced. Latvia's wood and wood-

product exports to the Baltics demonstrated growth throughout the 2010-2015 period; these exports to Estonia were more pronounced (EUR +50 million, or about 50%).

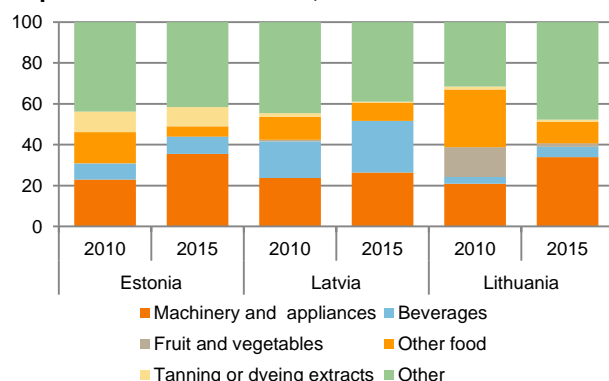
### Effect of Russia's embargo and the recession in Russia was partly cushioned

Exports of goods from the Baltics to Russia in 2010-2015 were dominated by machinery and appliances, tanning or dyeing extracts (from Estonia), beverages (from Estonia and Latvia), vehicles (from Lithuania), and fruit and vegetables (from Lithuania; mostly re-exports). The importance of the latter two product groups had decreased by 2015. The share of exports of milk and dairy products to Russia fell to zero in 2015 (in 2010, it was 7% for Estonia, 2% for Latvia, and 5% for Lithuania).

Reacting to Russia's aggression in Eastern Ukraine and its annexation of Crimea, the EU, along with other countries, imposed sanctions on Russia. In response, Russia introduced a ban on a range of food and agricultural-produce exports from these countries. This ban – in place since August 2014 – has already been extended twice, most recently until the end of 2017. Of the three Baltic countries, Lithuania was exposed the most to exports of the banned products. In 2013, exports (including re-exports) of embargoed goods amounted to 2.7% of Lithuania's GDP, while Latvia's and Estonia's exports of these items accounted for 0.2% and 0.4% of GDP, respectively. The numbers for the latter two countries are underestimated, however, as they reveal only the direct exposure. Latvia and Estonia, e.g., exported milk to Lithuania that it used to produce dairy products, such as cheese; Lithuania then sold these products to Russia. In 2015, Lithuania's exports of dairy products to Russia fell by about EUR 100 million, or 2% of its total exports to Russia, while exports of raw milk from Latvia and Estonia to Lithuania fell by about EUR 60 million (total).

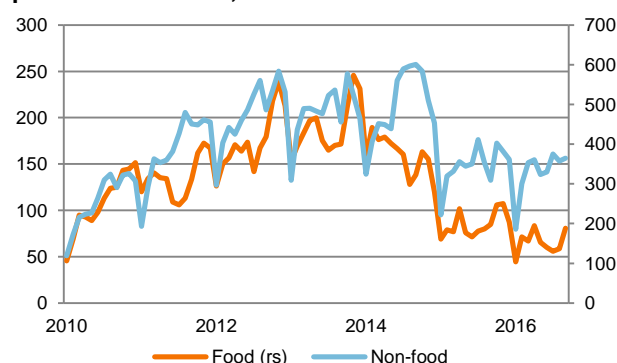
**Exports of embargoed goods amounted to 2.7% of Lithuania's, 0.2% of Latvia's, and 0.4% of Estonia's GDP in 2013**

Export structure to Russia, %



Source: Eurostat and Swedbank Research

Baltic exports of food and non-food products to Russia, m EUR

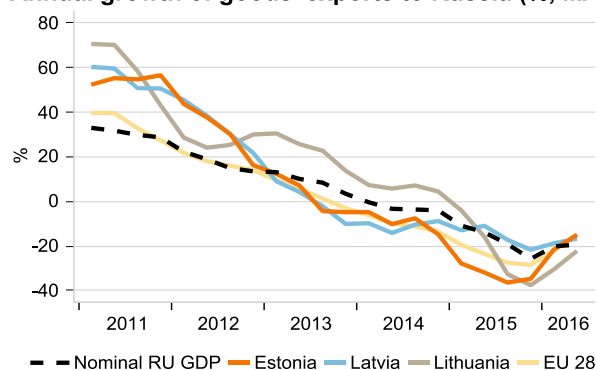


Source: Eurostat and Swedbank Research

**The embargo hit local milk and dairy producers the most. Resellers of vegetables and fruit in Lithuania took a hit as well**

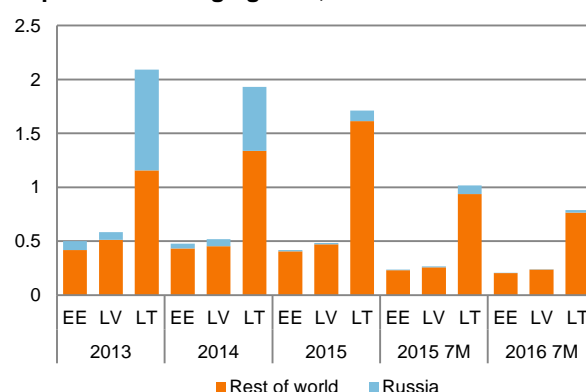
Across all three countries, Russia's food embargo affected the local producers of milk and dairy the most. The situation was especially grim for these producers because the negative effect of the sanctions was aggravated by the ending of the EU milk quota regime in 2015 and the record-low milk prices. Meat was the second-largest food category in Lithuania affected by Russia's import restrictions. These restrictions negatively affected exporters of fish from Estonia, and exporters of meat and fish preparations from Latvia. In addition to local-origin exports, the embargo also disrupted fruit and vegetable re-exports from Lithuania, which accounted for more than two-thirds of the loss in exports of food and agricultural produce from Lithuania to Russia over 2014 and 2015.

Annual growth of goods' exports to Russia (% MA)



Source: Macrobond and Swedbank Research

Exports of embargo goods, b EUR



Source: Eurostat and Swedbank Research

Even though Lithuania was one of the EU countries most dependent on the Russian market for embargoed goods, it has since 2013 diversified exports of those products to other markets more than the other Baltic countries. Since 2013, Lithuania has managed to

**The sharp rouble depreciation and economic crisis in Russia reduced the demand for exports**

**Between 2013 and 2015, exports to Russia decreased by 29-45%, and dependence on this market decreased substantially**

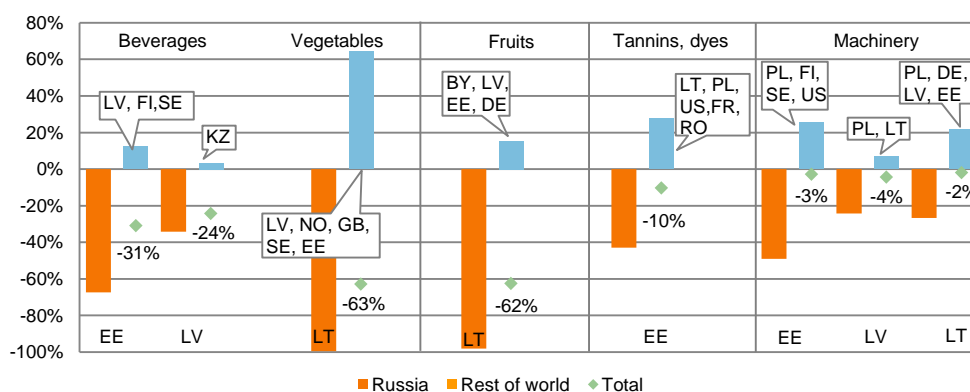
**Diversification towards other markets was not enough to fully compensate for the losses**

increase its exports of embargoed goods to other markets (excluding Russia) by almost 14%, while these exports have decreased by around 15% for both Latvia and Estonia (there is still a small share of embargoed goods exported to Russia, partly due to an imperfect selection of statistics for embargoed goods). However, this year, compared with 2015, exports of embargoed goods to other markets have shrunk rather significantly in Lithuania, mainly due to the rapidly contracting sales of fruits and vegetables, which are mostly re-exports. Exports of embargoed goods declined, but to a lesser extent, in Latvia (meat and fruit sales) and Estonia (fish sales).

However, as EU growth was weak during the period after the global financial crisis, Russia was an important market for some other nonbanned goods (see the graph below) in the Baltic countries. During 2010-2013, Latvia and Lithuania exported 17-18% of total goods to Russia, and the corresponding share in Estonia rose to 11% (it has now decreased to 11-13% in Latvia and Lithuania, and 6% in Estonia). Between 2013 and 2015, the value of total exports of goods from Estonia to Russia decreased by 45%; from Latvia, that value decreased by 29%, and from Lithuania, by 36%. However, among the Baltic countries, Lithuania in its exports to Russia most likely has the smallest share of goods produced locally – during the post-crisis period, this was less than 18%. Exports from Lithuania – except for refined petroleum products – have not decreased since 2013, as total exports have in Latvia and Estonia. Lithuanian-origin goods exports (except for refined petroleum products) have increased by 11% since 2013, as the affected sectors have not had a significant impact on the macro level due to their small size.

Moreover, Lithuania has managed to increase its exports (refined petroleum products excluded) of locally produced goods and re-exports to other markets by 17% and 18%, respectively, since 2013. This performance is better than Latvia's, where total exports of goods to other markets have risen by 3%; meanwhile, for Estonia these exports have been broadly stable since 2013. However, all the Baltic countries have managed to increase significantly their exports (except for dairy producers, who have suffered from lower prices) to other markets for those products, which were both heavily dependent on the Russian market and most significant for total exports. This has helped to cushion the losses from the Russian market, but the overall effect has still been negative, and exports have decreased. In some sectors, such as machinery producing, other markets have almost compensated for the losses in Russia. However, it has been more difficult for food (including beverages) exporters, except for meat sector companies in Lithuania. Exporters of Lithuanian vehicles have also suffered, despite diversification, due to the Russian economy's weakness.

**Exports of selected groups of goods, 2016 compared with 2013\***



Source: National statistics and Swedbank Research

\*Countries mostly contributing to growth in text box

**The Baltic countries have found demand for their exports predominantly in the EU countries**

**The EU is the major export market: more than 60% of exports from the Baltics go to the EU**

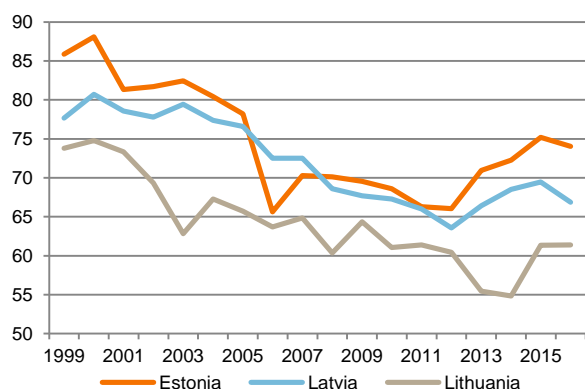
Although total exports from Estonia to other markets have fallen slightly since 2013, country has managed to diversify away from Russia rather significantly in selected sectors (see the graph above). However, as in Latvia and Lithuania, this has not been enough to compensate for losses in the Russian market in those sectors. All the Baltic countries have found demand for their exports mainly in other EU countries. However, there have been some exceptions. Last year, e.g., almost 40% of Lithuanian vegetables were exported to Egypt and India, and total exports of Lithuanian vegetables<sup>11</sup> have more than tripled since 2013.

#### Exports of goods to the EU and BSR have slowed

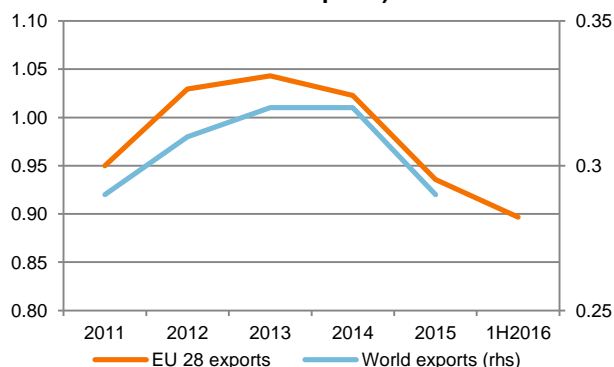
The EU is by far the most important destination for exports of goods from the Baltics. In 2015, it absorbed about 75% of Estonia's, 70% of Latvia's, and 60% of Lithuania's value of goods exports. The EU market was even more important to the Baltics before they joined the union, largely because in the late 1990s the share of exports to Russia in the total exports of the Baltics was very small, due to the Russian crisis in 1998. However, as exports to Russia recovered, the share of exports to the EU started falling (see the graph below). In

<sup>11</sup> Lithuanian vegetables this year amount to only half of total vegetable exports from Lithuania; the rest are re-exports.

recent years this trend has halted, on the back of decreasing dependence on the Russian market. An overwhelming part of the Baltics' exports to EU countries remain in the Baltic Sea region (BSR). In 2015, about 66% of total exports of goods from Estonia – and 54% from Latvia and 43% from Lithuania – went to the region, excluding Russia. The share of exports to the BSR countries has roughly followed the same trends as the wider EU share.

**Exports to the EU 28, % of total exports**


Source: Eurostat and Swedbank Research

**Export of goods of the Baltic countries (% of total EU 28 and world exports)**


Source: Eurostat and Swedbank Research

The most significant exports of goods from Lithuania to the EU are food and agricultural products (20%), mineral products (17%), and chemical products (12%). About one-third of all exports of goods from Estonia to the EU come from electrical and mobile communication equipment (e.g., Ericsson, exported to Sweden); food and agricultural products, and wood each take about one-tenth of the total value. The main products that Latvia exports to the EU are wood and wood articles (19%), and machines and equipment (17%). Food and agricultural products (16%) are also an important category.

Export flows to the EU slowed significantly in 2012. Lithuania's export growth had already turned negative in 2013, mainly driven by the fall in its exports of petroleum oils (the price effect). In 2015, Lithuania managed to significantly increase its exports of electrical machinery and equipment to Poland and Latvia, which helped growth to briefly turn positive. Nominal growth of Latvia's and Estonia's exports to the EU has turned negative only in 2016. The fall in energy prices was already negatively affecting Estonia's shale oil exports in 2015, but a very successful year for furniture exporters (mainly prefabricated houses) saved the export growth. The decline in Latvia's exports in the first seven months of 2016 was led by losses in exports of electrical machinery and equipment, and mineral products. The setback in export growth might not be temporary, given that the Baltic exporters are losing competitiveness. The share of exports from the Baltics in total exports from the EU has decreased somewhat recently (see the graph above).

#### Exports outside the EU, Norway, and Russia can be expanded further

The total value of exports of goods to other markets<sup>12</sup> is quite small. They accounted for 14-22% of total exports in 2015. The largest product groups delivered to this market are machinery and equipment (Estonia leading the way), mineral products (petroleum products from Lithuania and shale oil from Estonia), food (grain, especially from Latvia), and wood and its products (from Latvia and Estonia).

**Export growth will be limited as the Baltic exporters are losing competitiveness**

**The Baltics export machinery and equipment, mineral products, food, and wood products**

**Five largest export partners of the Baltics in other markets in 2015 (% of total exports of goods and top export category)**

Estonia			Latvia			Lithuania		
Country	%	Category	Country	%	Category	Country	%	Category
United States	3	Mineral products	Turkey	2	Iron and steel	Belarus	5	Fruit and nuts
China	1	Electrical equipment	Belarus	2	Instrument, apparatus	United States	4	Mineral products
Turkey	1	Iron and steel	United States	1	Electrical equipment	Ukraine	3	Mineral products
Canada	1	Mineral products	Algeria	1	Grain	Kazakhstan	2	Mechanical appliances
Japan	1	Wood and its products	China	1	Wood and its products	Saudi Arabia	1	Grain

Source: Eurostat and Swedbank Research

Between 2010 and 2015, the value of exports from Estonia to markets outside the EU, Norway, and Russia remained roughly the same, but it increased by about one-half from Latvia and Lithuania. Estonia's exports fell to CIS countries and Nigeria, while the largest increases were to India (electrical appliances, pulp of wood, and cork), Mexico (mobile phone equipment), and Togo (shale oil). Exports from Latvia increased the most to Turkey (metals, mechanical appliances), China (wood and its products), and the United Arab

<sup>12</sup> Other markets represent all the countries in the world except Russia, Norway, and the EU countries.



**Exporters are expanding into new markets, e.g., China, Mexico, North Africa, and the Middle East countries**

Emirates (electrical appliances); from Lithuania, exports increased the most to the United States (petroleum products), Belarus (fruit and vegetables), and Saudi Arabia (grain).

The Baltic countries have been trying to expand into new markets, e.g. the Chinese market (the share of exports to China is about 1% for Estonia and Latvia, and 0.5% for Lithuania). Estonia and Lithuania have mostly been selling mineral oils to China, but Latvia has been exporting wood. For example, food companies have big hopes for this market, but, apart from securing health certificates, country branding is crucial to gain the trust of local consumers. Grain producers have been very successful in expanding their exports to North Africa and the Middle East. Between 2011 and 2015, they managed to more than triple their export revenues from countries outside the EU. The share of grain exports in total export value (outside the EU) increased from about 1% in 2011 to about 7% in the first eight months of 2016. Estonia has expanded into Mexico with its mobile phone equipment.

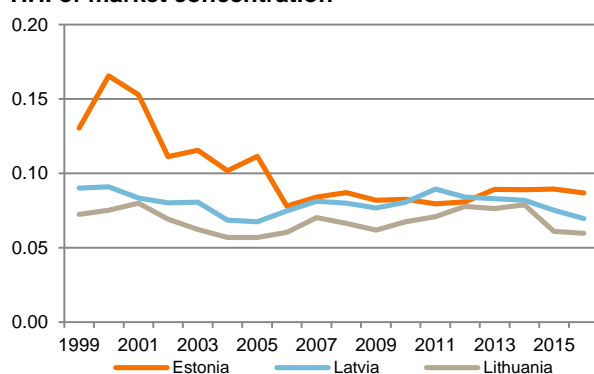
The value of goods exported to other markets is very volatile. Mineral products, metals, and cereal are commodities that are traded in the global market, and price fluctuations can be significant. In addition, these goods are often traded indirectly with the help of intermediaries, and the final destination of exports may vary from one year to another.

**Export market and product structure of the Baltic countries are quite diverse**

#### Product and market diversification

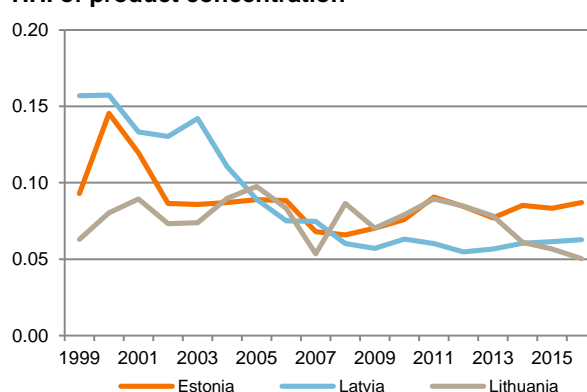
According to the Herfindahl–Hirschman index,<sup>13</sup> exports of goods portfolios in the Baltics are well diversified. Estonia and Latvia improved their product diversification quite dramatically in the first half of the 2000s. Estonia also managed to improve its market diversification and come closer to the level of Latvia and Lithuania between 2000 and 2006. Over the past decade, the concentration indices have been broadly stable in all three countries.

**HHI of market concentration\***



Source: Eurostat and Swedbank Research  
\*0-fully diversified, 1-no diversification

**HHI of product concentration**



Source: Eurostat and Swedbank Research

**However, export performance is reliant on a few big companies**

Even though the export portfolio in general is quite diversified, export performance is highly dependent on a few big companies, such as Ericsson (networking and telecommunications) in Estonia, Latvijas Finieris (plywood) in Latvia, and ORLEN Lietuva (the Māžeikiai oil refinery) in Lithuania.

*Agnese Buceniece  
Tõnu Mertsina  
Vaiva Šečkutė  
Siim Isküll*

<sup>13</sup> The Hirschman Herfindahl index measures the degree of concentration, both in terms of destination markets and product portfolio, and is computed as the sum-of-squared shares of each product (CN 2-digit level) or market in total exports.

## The services sector – stronger, smarter, and more diversified

As the Baltic countries are developing, the services sector is becoming an ever-more important player in their economies. This sector has demonstrated remarkable performance over the past decade, largely thanks to a rapid growth in exports of services. Although export growth was temporarily interrupted last year, now the services sector is re-emerging stronger, smarter, and more diversified. There is still a lot of untapped potential for the services sector, both internally and externally, but challenges to live up to it are mounting as well.

### Growing importance of the services sector – a sign of economic maturity?

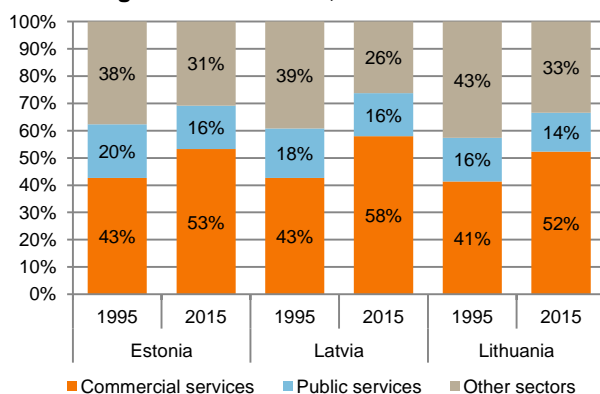
Over the last two decades, the value added in the services sector, as a share of total value added in the economy, has increased by 7 percentage points (p.p.) in Estonia, by 9 p.p. in Lithuania, and by 13 p.p. in Latvia, reaching 69%, 67%, and 74% in 2015, respectively. Meanwhile, the share of commercial services<sup>14</sup> increased even more over that period and accounted for more than half of the total value added in the Baltic economies in 2015 (see graph below). This transformation is nothing extraordinary – most of the developed and developing countries go through a similar decline in the relative size of agriculture and industrial production and an increase in that of the services sector.

One of the reasons explaining this structural shift towards the services sector is related to the fact that, as the standard of living improves, a larger share of consumer expenditures tends to be allocated to services. As incomes grow, the opportunity cost of time rises, which makes the in-house provision of services, such as housekeeping or child care, less attractive than purchasing those services in the market. Moreover, when incomes rise, consumers demand not only more, but also better-quality services, especially in education, health care, child care, travel, etc. This notion is supported by Baltic data. The fraction of consumer spending<sup>15</sup> attributed to services by an average Lithuanian, Latvian, or Estonian consumer has increased by more than 14 p.p. over the last two decades (see graph below). As real wages continue to grow, consumers in the Baltic countries will most likely allocate an ever larger share of their spending to services.

The importance of the services sector is growing...

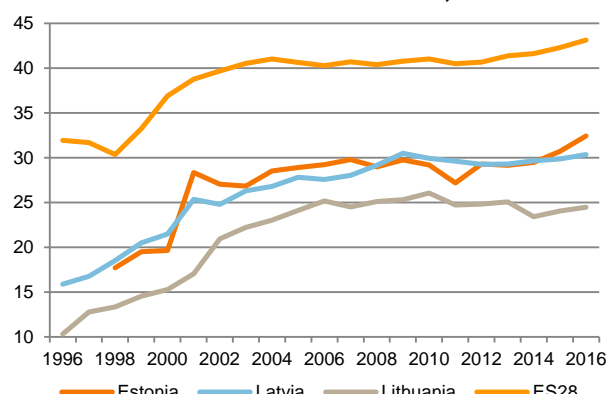
...due to increasing consumer demand...

Share of gross value added, %



Source: Eurostat and Swedbank Research

Share of services in consumer basket, %



Source: Eurostat and Swedbank Research

...and due to rising demand for business services

However, changing consumption patterns are an important but not the only explanation for the growing relative size of the service economy. Another explanation is related to the, as the OECD puts it, “changing business model where companies source intermediate services from specialised firms – both at home and abroad – as an alternative to in-house production.”<sup>16</sup> Due to the growing specialisation, companies have been outsourcing business services (e.g., advertising, accounting, legal, recruitment, IT, R&D, etc.) to specialised firms that can deliver them at lower cost and/or higher quality. This development

<sup>14</sup> Here we consider public administration, defense, education, human health, and social work as “public services.” The remaining services (wholesale and retail trade, transport, accommodation and food service activities, information and communications, financial and insurance activities, real estate activities, professional, scientific, and technical activities, administrative and support service activities, art, entertainment, and recreation, etc.) are considered “commercial services.” We will focus on commercial services here. “Other sectors” include industry, agriculture and construction.

<sup>15</sup> Measured as a consumer basket, constructed for inflation calculation purposes.

<sup>16</sup> OECD “Growth in Services. Fostering Employment, Productivity and Innovation,” Meeting of the OECD Council at Ministerial Level, 2005.

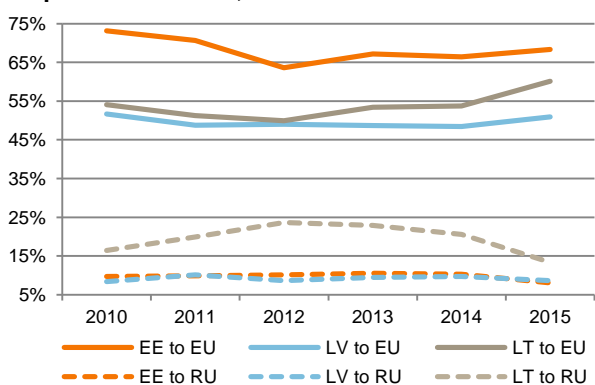
has been triggered by technological advances, increasing liberalisation of trade in services, and free movement of labour across the EU countries. The Baltic countries have been a clear beneficiary of this change – it has allowed them not only to increase the sales of services to local companies, but also to push up their exports.

## Exports have been an important driver of revenue growth of service companies

### Exports of services are recovering and turning towards Europe

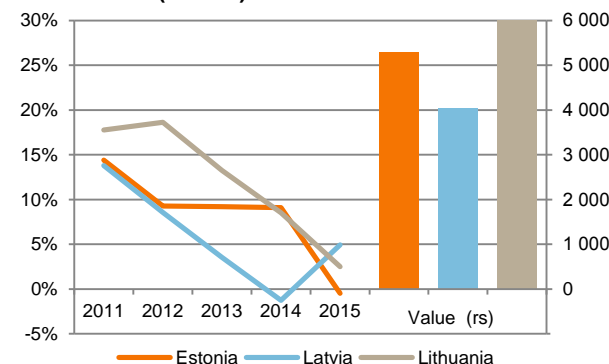
During 2005-2015, the nominal turnover of service companies<sup>17</sup> more than doubled in Lithuania and increased 1.9 times in Latvia and 1.7 times in Estonia. Exports have been an important driver of revenue growth of service firms, mostly due to the still-large labour cost advantage of Baltic companies – average wages in the Baltic countries are still around 3-5 times lower than those in the Nordic countries. During 2005-2015, nominal services exports doubled in Latvia and Estonia and increased by almost 2.5 times in Lithuania.

Exports of services, % of total



Source: Eurostat and Swedbank Research

Services exports: annual growth (%) and value in 2015 (m EUR)

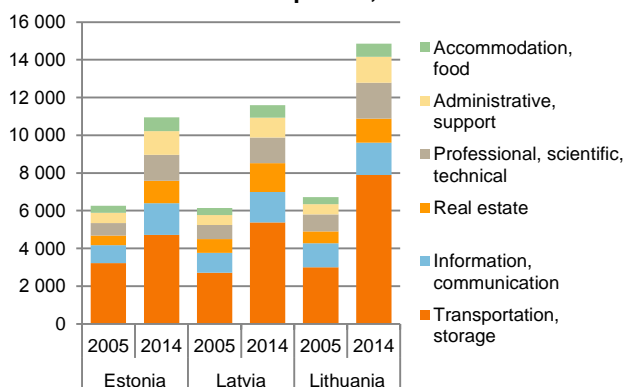


Source: Eurostat and Swedbank Research

## Export growth was temporarily interrupted last year by Russian woes

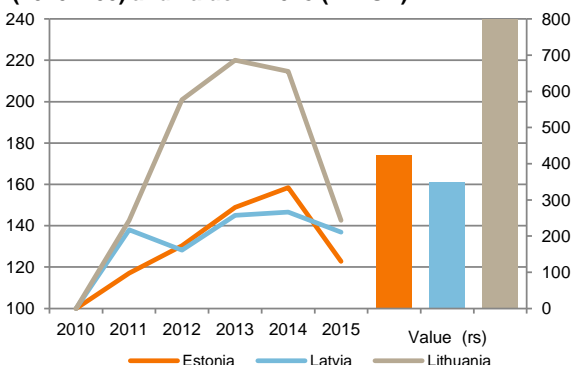
The rapid export growth was temporarily interrupted in 2015 in Lithuania and Estonia. This was largely caused by the worsened economic situation in Russia, devaluation of the Russian rouble and by the trade restrictions implemented by Russia<sup>18</sup> in 2014. Exports of services from the Baltics to their eastern neighbour declined in 2015, with Lithuanian and Estonian exports to Russia being hit worst (see graph below). Exports of transport services and tourism were most affected by the Russian woes. However, the first half of this year provides some reasons for optimism – annual export growth again turned positive in Estonia, and that in Lithuania accelerated to double digits. In Latvia, exports declined in 2014, largely due to shrinking exports of manufacturing and repair as well as of sea, road and rail transport services. However, despite rapidly contracting exports of construction services, the country's total exports of services returned to a growth path in 2015.

Turnover of service companies, m EUR



Source: Eurostat and Swedbank Research

Exports of services to Russia: index (2010=100) and value in 2015 (m EUR)



Source: Eurostat and Swedbank Research

## Latvian and Lithuanian exporters have diversified away from Russia towards the EU

In 2015, Latvia and Lithuania managed to compensate for the loss from shrinking exports to Russia with increased exports to the EU countries, and in the Lithuanian case, also to the markets other than the EU and Russia. Meanwhile, Estonian exports to the EU countries increased only marginally and did not compensate for the fall in exports to Russia and other non-EU countries.

<sup>17</sup> Commercial services, excluding wholesale and retail trade and repair.

<sup>18</sup> The ban on food products originating from the EU, as well as various other trade barriers, e.g., excessive scrutiny at the border checks, products no longer meeting the required standards, etc. has had negative effects on the exports of transport services.

**Exporters with close relations to the Russian market had challenging times last year**

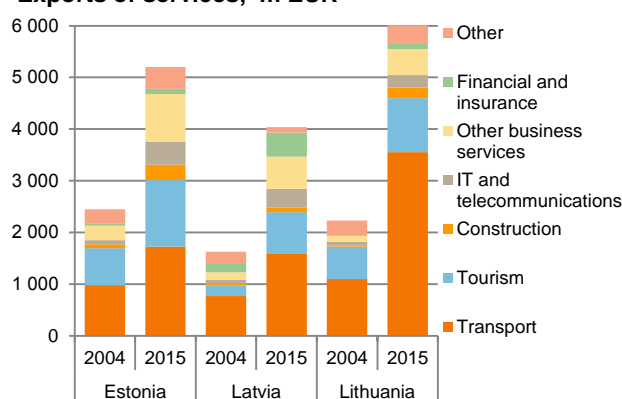
**Despite the hit from Russia, Lithuanian exports of road transport services remained strong**

### Russian woes - what doesn't kill you makes you stronger?

Some Baltic exporters, especially those closely related to the Russian market, e.g., operating in transport or tourism sectors, had challenging times in 2015. Exports of transport services, which make up the largest share in the export structure (see graph below), faced a decline in Lithuania after five years of very rapid expansion; so did they in Estonia and Latvia. In 2015, exports of tourism, another important component in the export structure, continued growing by double digits in Latvia, but contracted somewhat in Lithuania and remained stagnant in Estonia. However, not everything is as dark as it might seem – some companies diversified their export markets and emerged stronger than before.

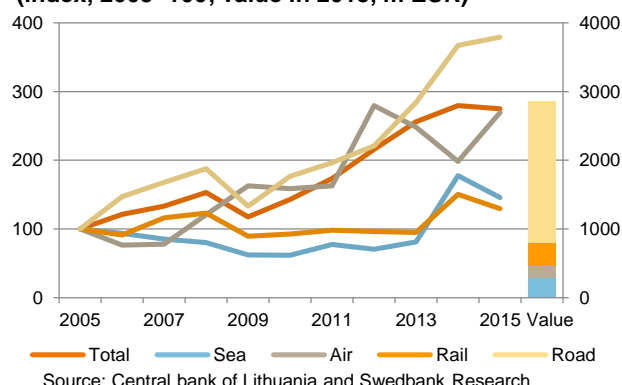
Although aggregate transport exports from Lithuania declined by 1.9% in 2015, the impact came mostly from contracting exports of sea and rail transport services, which inherently are less flexible in finding alternative sources of demand. Growth of road transport exports, which account for around 60% of all transport services exports, decelerated from double digits in previous years to 3.3% in 2015. Given that road transport services to Russia contracted considerably in 2015, the fact that exports of road transport services continued growing is fascinating. This was achieved largely by expanding exports of other road transport services, such as freight forwarding and logistics services. Recently, the export performance of road transport companies has improved even more.

**Exports of services, m EUR**



Source: National central banks and Swedbank Research

**Lithuania: Exports of transport services (index, 2005=100; value in 2015, m EUR)**



Source: Central bank of Lithuania and Swedbank Research

**Further expansion towards the EU market might be facing challenges**

**Latvian exporters of transport services have been facing multiple headwinds for a while**

**Latvian and Estonian transport companies had trouble finding new markets**

Lithuanian road transport companies demonstrated remarkable flexibility and ability to quickly replace the Russian market with the Scandinavian and Western European markets, despite the intensified competition among the road transport companies in Europe. In 2015, exports of transport services to the EU market, as well as those to other countries outside the EU and Russia, increased by almost 11%. However, the expansion to the EU market is not coming without risks. Due to protectionist moods, new requirements to pay the truck drivers minimum wages of the country they are working in, as well as other barriers to cross-border road transport, are emerging in some EU countries.<sup>19</sup> Moreover, the European Commission is revisiting the regulations of pay and work conditions for posted workers, which may reduce the competitiveness of Baltic transportation, construction, and other companies and undermine the further expansion of exports of these services. It is therefore very important to ensure that the interests of these sectors are represented at the EU level.

The situation regarding exports of transport services in the other two Baltic countries differs from that in Lithuania. Exports of transport services by Latvian companies declined marginally in 2015, but this was the third year in a row of decline. This situation was resulted by an unfavourable environment for the transport services in the region in general, i.e., the Russian recession and the sanction standoff, changes in the Russian transit strategy (for more see below), as well as the increased competition among the transport service providers in the region. The 15% decline of transport services exports from Latvia to Russia<sup>20</sup> in 2015 was not entirely compensated for by more rapid growth in other markets – exports of transport services to the EU remained unchanged (see graph below) and those to other markets than the EU and Russia expanded by only 2%. The decline in Latvian exports of transport services accelerated in the first half of 2016, largely due to a more rapid contraction in the exports of rail and sea transport exports.

Meanwhile, exports of transport services by Estonian companies declined by 5.9% in 2015, making the largest negative contribution to services exports growth. Estonian exports of

<sup>19</sup> Germany introduced a minimum wage that would apply to any employee working within country borders. Meanwhile, the new French law requires foreign transport companies to pay their drivers the French minimum wage when making deliveries in France and to appoint a representative in France.

<sup>20</sup> Russia accounted for around 8% of Latvia's total exports of transport services, but this share is most likely misrepresented, since many Russian companies are registered in other countries, e.g., Switzerland, which appears as the largest export market for Latvian transport services.

## The outlook for rail and sea transport service exports is not optimistic in the Baltic countries

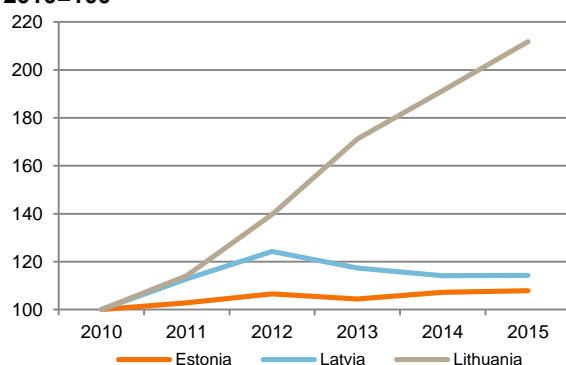
## Baltic tourism sector faced declining demand from Russia last year...

transport services were hit two ways - a sharp decline in exports to Russia and to other export markets outside the EU; meanwhile, those to the EU remained almost unchanged (see graph below). The situation deteriorated further in the first half of this year.

In general the outlook regarding exports of sea and rail transport services is not very optimistic in the Baltic region as Russia most likely will continue diverting its export flows away from the Baltic countries. Russia plans to stop its oil product exports via foreign Baltic ports by 2018 and to cease all other transit via the ports of the Baltics by 2020. It is unlikely that Russia will stop transit flows via the ports of the Baltic countries completely, but they will keep reducing them. Russian origin flows form nearly 80% of the total flows of the Latvian railways, thus, they will be affected negatively even if the Russian transit does not stop completely. Given that substitute flows are slow to come, we will most likely see decreasing exports of rail and port transport services in the Baltic countries in the coming years.

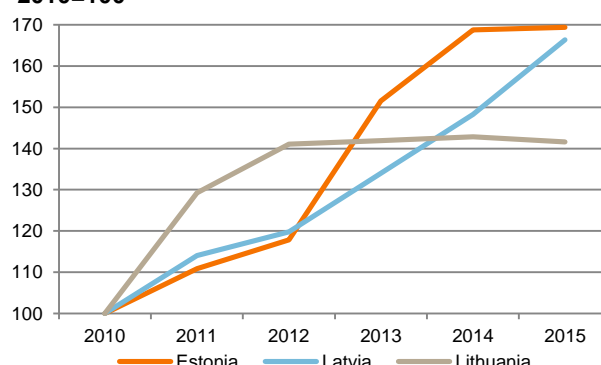
The transport sector was not the only one affected by the Russian woes. Due to the economic recession and the falling value of the rouble, Russians limited their travel to the Baltic countries in 2015. As a result, exports of travel services, or tourism, to Russia—one of the largest markets for the Baltics – declined by more than 24% in Estonia, by 19% in Latvia, and by almost 13% in Lithuania. However, the decline in demand from Russia was compensated for in all countries by increases in exports of tourism to other markets.

Exports of transport services to EU index, 2010=100



Source: Eurostat and Swedbank Research

Exports of tourism services index, 2010=100



Source: Eurostat and Swedbank Research

## ...but it was compensated by increases in demand from the EU and other markets

Lithuania was probably in the worst position to deal with this challenge, as exports to Russia constituted around a quarter of all Lithuanian tourism exports in 2014 – the largest share among the Baltic countries. Moreover, Lithuanian exports of tourism to countries other than Russia and the EU were hit as well in 2015 largely due to shrinking exports to Belarus – the largest export market for Lithuanian tourism services. However, the Lithuania attracted more tourists from the EU countries and almost entirely compensated for the losses in other markets. In the Estonian case the tourism sector expansion was directed more towards other than the traditional markets of Russia and the EU. In Latvia, the decline of Russian tourists went largely unnoticed – growth of total exports of tourism services accelerated to over 12% in 2015. This was largely due to large increases in exports of tourism to the EU countries, which was most likely boosted by the Presidency of the EU Council held in Latvia in the first half of 2015 as indicated by an uptick in business travels, as well as to other markets than the EU and Russia.

## Tourism sector in Lithuania and Latvia has most room for improvement

Estonia is the largest exporter of tourism services among the Baltic countries, but its remarkable performance was interrupted in 2015 when growth slowed considerably. Latvian exports of tourism have grown rapidly in recent years, but from relatively low base. Meanwhile, Lithuanian exports of these services have been stagnant for the past three years. This is not surprising, since Lithuania was ranked lowest among the Baltic countries by the World Economic Forum in its "Travel and tourism competitiveness report".<sup>21</sup> Improvements in areas where the country scores lowest, such as air transport infrastructure, tourism service infrastructure, and--the most important categories--the prioritisation of the travel and tourism industry by the government, effectiveness of marketing and branding to attract tourists, and execution of the country brand strategy, could help boost exports of tourism services in Lithuania. However, this year may mark a start of a revival of the tourism industry in Lithuania and Estonia, as exports of tourism started inching upwards in the first half of this year.

## Knowledge-intensive services are becoming more important players

Less knowledge-intensive services, such as transport and tourism, still make up the largest share in the export structure; however, knowledge-intensive ones are becoming more

## Exports of knowledge-intensive services are becoming more important

<sup>21</sup> Out of 141 countries, Lithuania ranked 59th, Latvia 53rd, and Estonia 38th. Read more here: [http://www3.weforum.org/docs/TT15/WEF\\_Global\\_Travel&Tourism\\_Report\\_2015.pdf](http://www3.weforum.org/docs/TT15/WEF_Global_Travel&Tourism_Report_2015.pdf)



important. Such factors as rapidly growing labour costs and wage regulation initiatives in the EU countries--as well as the changing transportation strategy in Russia and the less rapid growth of its economy--may start limiting the further expansion of exports of less-knowledge-intensive services, such as road and rail transportation, as well as construction. Higher-value-added knowledge-intensive services exports will become increasingly important--also because they tend to pay higher wages. Latvia and Estonia are leaders in this field, with financial services, insurance and pension services, telecommunications, and computer and information services, as well as other business services, accounting for around 36% and 28% of all service exports, respectively. In Lithuania, these services accounted for only around 14% in 2015.

**Business services exports: index, 2010=100 and value in 2015 (m EUR, rs)**



**Expansion of Latvian exports of financial services might slow**

However, Latvia stands out with its large exports of financial services.<sup>22</sup> This is related to its large non-resident banking sector, dominated by clients from Russia as well as other CIS countries. Although exports to EU countries expanded rapidly and those to non-EU countries shrank in 2015, the latter still accounted for around 68% of these exports (to compare, only 25% in Estonia), and those to Russia<sup>23</sup> continued to grow rapidly in 2015. It was generally a good year for Latvian financial services exports; however, annual growth has turned negative in the first half of 2016. The new anti-money-laundering legislation, which toughens the penalties for banks and their employees for violating anti-money-laundering regulations, as well as the deteriorated economic prospects in Russia, might slow the expansion of Latvian exports of financial services even more.

**Exports of business services have been expanding rapidly in all Baltic countries**

Despite the differences among the countries, there are a few categories of services exports that have been expanding rapidly in all three Baltic countries. These are telecommunications, computer, and information services, as well as other business services (e.g., professional and management consulting services, technical, trade-related and other). During the period 2005-2015, exports of IT and telecommunications services tripled in Lithuania and quadrupled in Latvia and in Estonia. Exports of other business services followed a similar path – quadrupling in Lithuania, tripling in Latvia, and expanding by 2.6 times in Estonia<sup>24</sup> during this period. Exports of these services continued to grow rapidly in 2015 in Latvia and Lithuania, but growth decelerated in Estonia. However, in the first half of 2016, the annual growth of exports of IT and telecommunications, as well as other business services, accelerated to double digits in all three Baltic countries.

**Non-EU countries are emerging as more important export markets for business services**

Exports have become an important source of income for business service companies in the Baltic countries, especially for the high-tech, knowledge-intensive ones, such as software publishing and data processing and hosting, as well as computer programming (see graph below). Regarding IT and telecommunications services, EU is by far the largest export market in all three Baltic countries. However, exports to non-EU countries are quickly catching up. In recent years, non-EU countries, such as the US, Norway, Russia, Singapore (for Lithuania), Hong Kong (for Estonia), and Switzerland (for Lithuania and Estonia), have emerged as more important export markets for these services.

**Shared-service centers in Lithuania have boosted exports of higher-value-added services**

There are a few reasons for the emergence of the knowledge-intensive services. One of them is related to the general increase in importance of IT and the growing world demand for such services. Another is related to the expansion in outsourcing and nearshoring activities by foreign companies due to changes in the business model. According to Invest Lithuania, the government agency for attracting FDI, Lithuania is emerging as one of the leaders in the region for nearshoring activities, as the last six years have been marked by the rapid expansion of business service centres in Lithuania (see graph below). Large,

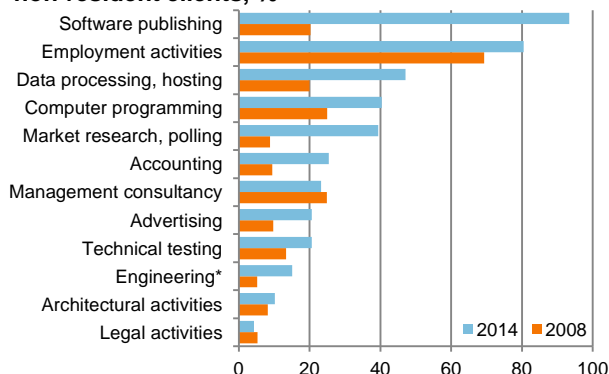
<sup>22</sup> In 2015, exports of financial services accounted for 11.6% of all exports of services in Latvia, while in Lithuania and Estonia, 1.7% and 2%, respectively.

<sup>23</sup> Russia's share in financial services exports expanded from 5.8% in 2014 to 10.2% in 2015.

<sup>24</sup> Among the Baltic countries, exports of IT and telecommunications services, as well as other business services, are still highest in Estonia, in absolute terms. To compare, exports of these services in Estonia are twice as large as those in Lithuania.

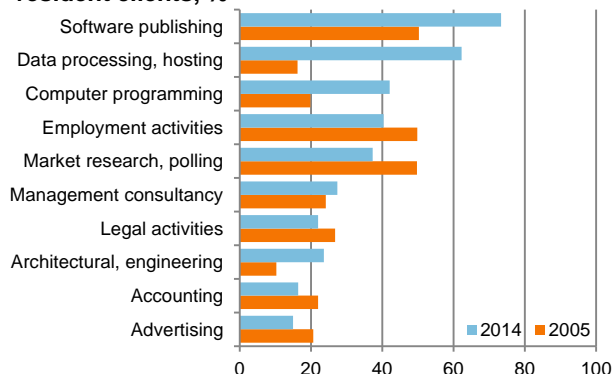
mostly Scandinavian and American, companies, operating in banking, insurance, finance, and IT, as well as other areas, have been moving part of their operations to Vilnius and Kaunas, the two largest Lithuanian cities.<sup>25</sup> This has not only boosted exports of higher-value-added services, but has also created lots of well-paying jobs; this, in turn, has increased demand for local services.

#### Lithuania: share of sales income from non-resident clients, %



Source: Statistics Lithuania and Swedbank Research

#### Estonia: share of sales income from non-resident clients, %

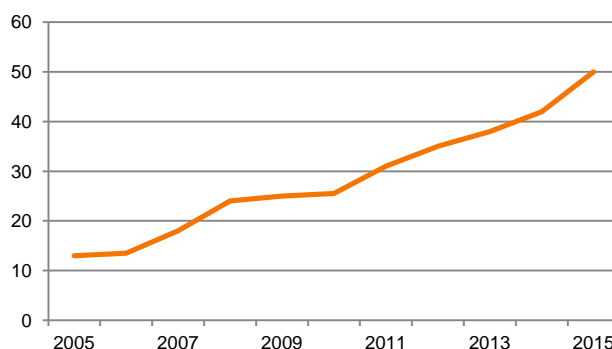


Source: Statistics Estonia and Swedbank Research

**There is a lot of potential for services, but challenges are mounting as well**

The Baltic countries still have a lot of untapped potential for developing the services sector – both internally and externally. However, challenges to live up to this potential are mounting as well. The lack of a skilled labour force, flaws in the education system, and insufficient investment levels, as well as the protectionist winds from the west, may all affect negatively the future prospects of the services sector. However, at least some of the challenges can be tackled through smart in-house policies.

#### Number of shared service centers in Lithuania



Source: Invest Lithuania

*Laura Galdikienė  
Linda Vildava*

<sup>25</sup> According to Invest Lithuania, only Krakow, Wroclaw, and Prague are ranked higher than Vilnius in the CEE region by the number of people employed in business service centers per 1,000 residents.

## Appendix: Swedbank Baltic Sea Index

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

### Contents and sources of Swedbank Baltic Sea Region index 2016

#### I Entrepreneurship

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

Source: Doing Business (World Bank)

#### II Labour market

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

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

#### III Tax policy

- Ease of paying taxes

Sources: Doing Business (World Bank)

#### IV Financial markets

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

Source: Global Competitiveness Report (World Economic Forum)

#### V Foreign trade

- Market access
- Border administration
- Business environment

Source: Enabling Trade Index (World Economic Forum)

#### VI Education

- Higher education and training

Source: Global Competitiveness Report (World Economic Forum)

#### VII Governance

- Corruption perception index
- Rule of law
- Control of Corruption

Source: Transparency International and World Bank

#### VIII Infrastructure

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

Sources: Global Competitiveness Report (World Economic Forum)  
and Logistics Performance Index (World Bank)

#### IX Logistics

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

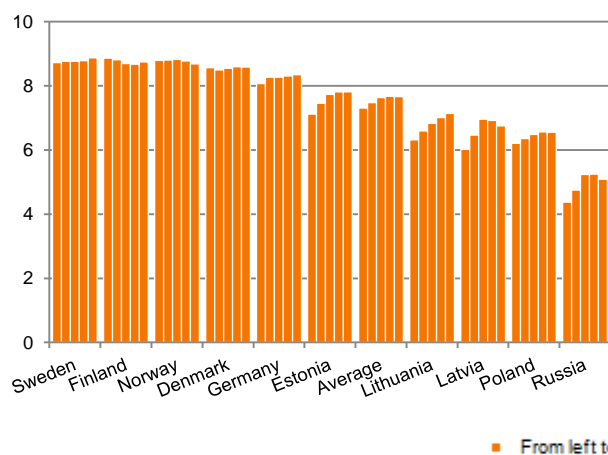
Source: Logistics Performance Index (World Bank)

#### X Innovation climate

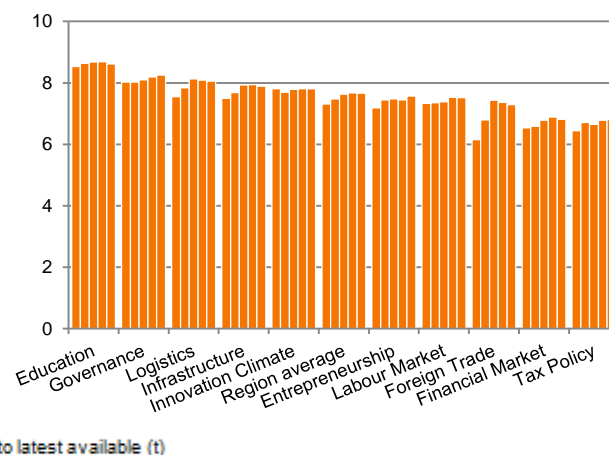
- Innovation Input
- Innovation Output
- Capacity of innovation
- Quality of scientific research institutions
- Company spending on R&D
- Gov't procurement of advanced tech products
- Availability of scientists and engineers

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

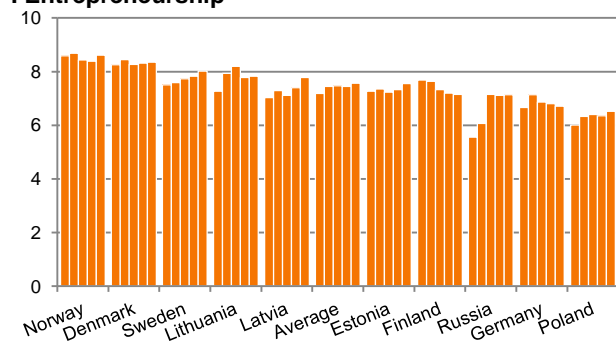
Swedbank Baltic Sea index 2016



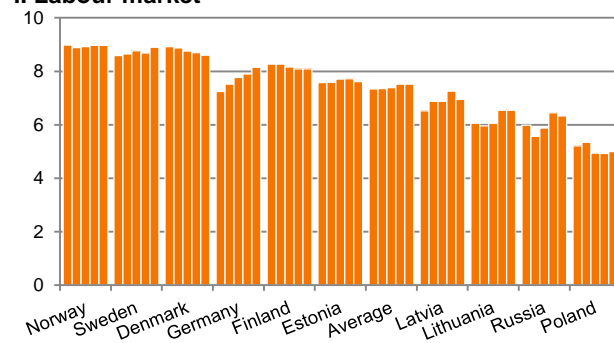
Swedbank Baltic Sea index 2016



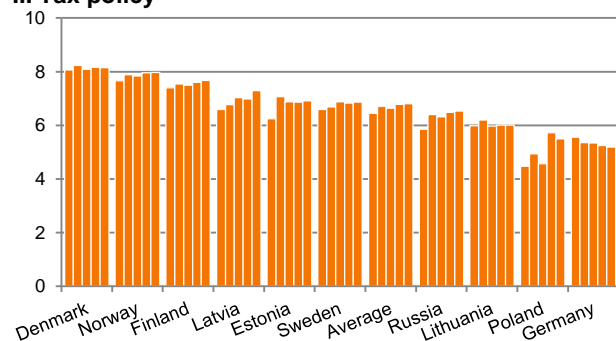
# I Entrepreneurship



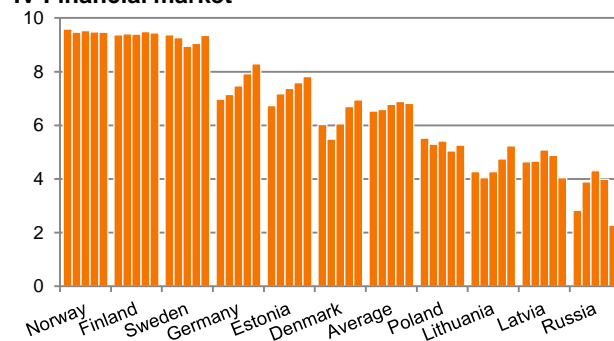
# II Labour market



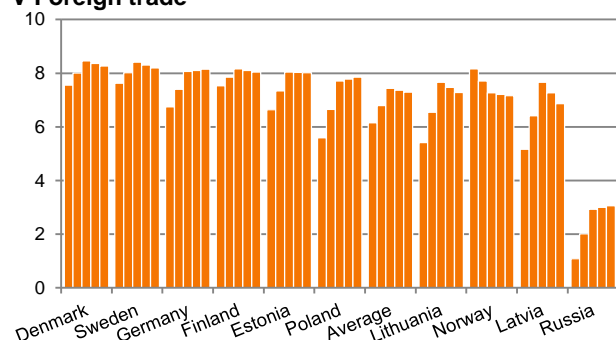
# III Tax policy



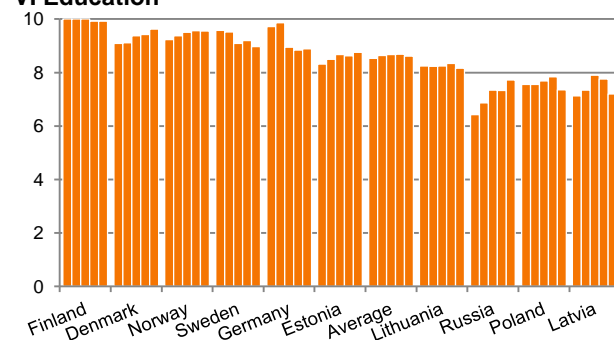
# IV Financial market



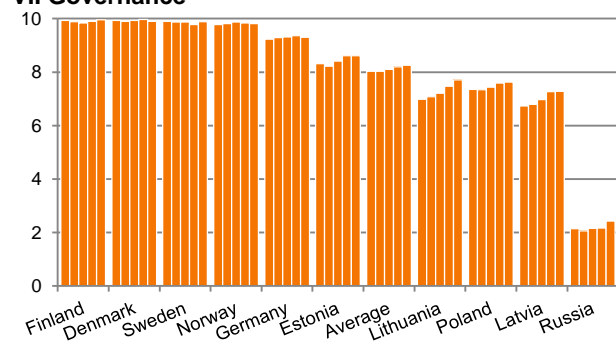
# V Foreign trade



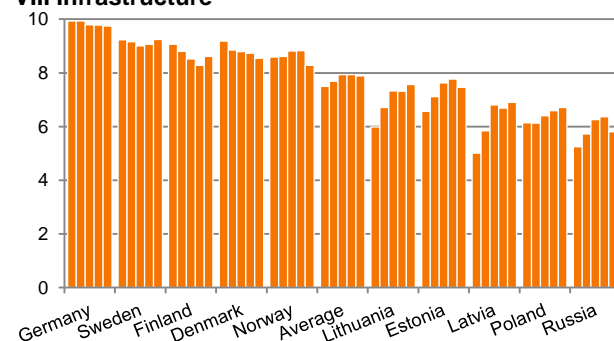
# VI Education



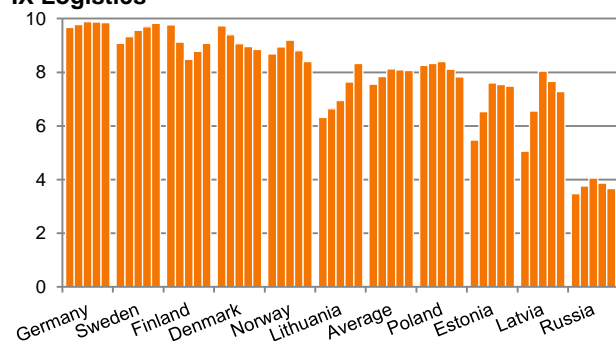
# VII Governance



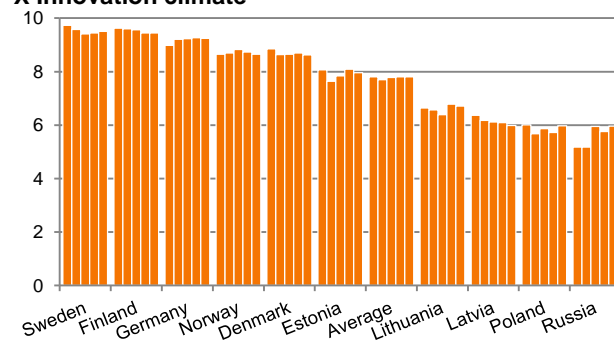
# VIII Infrastructure



# IX Logistics



# X Innovation climate



■ From left to right, (t-4) to latest available (t)

I Entrepreneurship	(t-4)	(t-3)	(t-2)	(t-1)	Latest available (t)
Norway	8.6	8.7	8.4	8.4	8.6
Denmark	8.3	8.4	8.3	8.3	8.3
Sweden	7.5	7.6	7.7	7.8	8.0
Lithuania	7.3	7.9	8.2	7.8	7.8
Latvia	7.0	7.3	7.1	7.4	7.8
<b>Average</b>	<b>7.2</b>	<b>7.4</b>	<b>7.5</b>	<b>7.4</b>	<b>7.6</b>
Estonia	7.3	7.4	7.2	7.3	7.6
Finland	7.7	7.6	7.3	7.2	7.2
Russia	5.6	6.1	7.1	7.1	7.1
Germany	6.7	7.1	6.9	6.8	6.7
Poland	6.0	6.3	6.4	6.3	6.5

II Labour Market	(t-4)	(t-3)	(t-2)	(t-1)	Latest available (t)
Norway	9.0	8.9	8.9	9.0	9.0
Sweden	8.6	8.7	8.8	8.7	8.9
Denmark	8.9	8.9	8.8	8.7	8.6
Germany	7.2	7.5	7.8	7.9	8.2
Finland	8.3	8.3	8.2	8.1	8.1
Estonia	7.6	7.6	7.7	7.7	7.6
<b>Average</b>	<b>7.3</b>	<b>7.4</b>	<b>7.4</b>	<b>7.5</b>	<b>7.5</b>
Latvia	6.5	6.9	6.9	7.3	6.9
Lithuania	6.1	6.0	6.1	6.5	6.5
Russia	6.0	5.6	5.9	6.5	6.3
Poland	5.2	5.3	4.9	4.9	5.0

III Tax Policy	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Denmark	8.1	8.2	8.1	8.2	8.1
Norway	7.7	7.9	7.8	8.0	8.0
Finland	7.4	7.5	7.5	7.6	7.7
Latvia	6.6	6.8	7.0	7.0	7.3
Estonia	6.2	7.1	6.9	6.9	6.9
Sweden	6.6	6.7	6.9	6.8	6.9
<b>Average</b>	<b>6.4</b>	<b>6.7</b>	<b>6.6</b>	<b>6.8</b>	<b>6.8</b>
Russia	5.9	6.4	6.3	6.5	6.5
Lithuania	6.0	6.2	6.0	6.0	6.0
Poland	4.5	4.9	4.6	5.7	5.5
Germany	5.6	5.4	5.3	5.3	5.2

IV Financial Market	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Norway	9.6	9.5	9.5	9.5	9.5
Finland	9.4	9.4	9.4	9.5	9.5
Sweden	9.4	9.3	9.0	9.0	9.3
Germany	7.0	7.2	7.5	7.9	8.3
Estonia	6.7	7.2	7.4	7.6	7.8
Denmark	6.0	5.5	6.1	6.7	6.9
<b>Average</b>	<b>6.5</b>	<b>6.6</b>	<b>6.8</b>	<b>6.9</b>	<b>6.8</b>
Poland	5.5	5.3	5.4	5.0	5.3
Lithuania	4.3	4.1	4.3	4.7	5.2
Latvia	4.6	4.7	5.1	4.9	4.0
Russia	2.8	3.9	4.3	4.0	2.3

V Foreign Trade	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Denmark	7.6	8.0	8.5	8.4	8.3
Sweden	7.6	8.0	8.4	8.3	8.2
Germany	6.7	7.4	8.1	8.1	8.1
Finland	7.5	7.8	8.2	8.1	8.0
Estonia	6.6	7.3	8.0	8.0	8.0
Poland	5.6	6.7	7.7	7.8	7.8
<b>Average</b>	<b>6.2</b>	<b>6.8</b>	<b>7.4</b>	<b>7.4</b>	<b>7.3</b>
Lithuania	5.4	6.5	7.7	7.5	7.3
Norway	8.2	7.7	7.3	7.2	7.2
Latvia	5.2	6.4	7.7	7.3	6.9
Russia	1.1	2.0	2.9	3.0	3.1

VI Education	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Finland	10.0	10.0	10.0	9.9	9.9
Denmark	9.1	9.1	9.4	9.4	9.6
Norway	9.2	9.4	9.5	9.6	9.6
Sweden	9.6	9.5	9.1	9.2	9.0
Germany	9.7	9.9	9.0	8.8	8.9
Estonia	8.3	8.5	8.7	8.6	8.8
<b>Average</b>	<b>8.5</b>	<b>8.6</b>	<b>8.7</b>	<b>8.7</b>	<b>8.6</b>
Lithuania	8.3	8.2	8.3	8.3	8.2
Russia	6.4	6.9	7.3	7.3	7.7
Poland	7.6	7.6	7.7	7.8	7.4
Latvia	7.1	7.3	7.9	7.8	7.2

VII Governance	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Finland	9.9	9.9	9.8	9.9	10.0
Denmark	9.9	9.9	9.9	10.0	9.9
Sweden	9.9	9.9	9.9	9.8	9.9
Norway	9.8	9.8	9.9	9.8	9.8
Germany	9.2	9.3	9.3	9.4	9.3
Estonia	8.3	8.2	8.4	8.6	8.6
<b>Average</b>	<b>8.0</b>	<b>8.0</b>	<b>8.1</b>	<b>8.2</b>	<b>8.3</b>
Lithuania	7.0	7.1	7.2	7.5	7.7
Poland	7.4	7.3	7.4	7.6	7.6
Latvia	6.7	6.8	7.0	7.3	7.3
Russia	2.1	2.1	2.2	2.2	2.4

VIII Infrastructure	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Germany	9.9	9.9	9.8	9.8	9.7
Sweden	9.2	9.2	9.0	9.1	9.2
Finland	9.1	8.8	8.5	8.3	8.6
Denmark	9.2	8.8	8.8	8.7	8.5
Norway	8.6	8.6	8.8	8.8	8.3
<b>Average</b>	<b>7.5</b>	<b>7.7</b>	<b>7.9</b>	<b>7.9</b>	<b>7.9</b>
Lithuania	6.0	6.7	7.3	7.3	7.6
Estonia	6.6	7.1	7.6	7.8	7.5
Latvia	5.0	5.8	6.8	6.7	6.9
Poland	6.1	6.1	6.4	6.6	6.7
Russia	5.3	5.7	6.3	6.4	5.8

IX Logistics	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Germany	9.7	9.8	9.9	9.9	9.9
Sweden	9.1	9.3	9.6	9.7	9.8
Finland	9.8	9.1	8.5	8.8	9.1
Denmark	9.7	9.4	9.1	9.0	8.9
Norway	8.7	8.9	9.2	8.8	8.4
Lithuania	6.3	6.6	6.9	7.6	8.3
<b>Average</b>	<b>7.6</b>	<b>7.8</b>	<b>8.1</b>	<b>8.1</b>	<b>8.1</b>
Poland	8.3	8.3	8.4	8.1	7.8
Estonia	5.5	6.5	7.6	7.5	7.5
Latvia	5.1	6.6	8.0	7.7	7.3
Russia	3.5	3.8	4.1	3.9	3.7

X Innovation Climate	(t-4)	(t-3)	(t-2)	(t-1)	(t)
Sweden	9.7	9.6	9.4	9.4	9.5
Finland	9.6	9.6	9.6	9.4	9.4
Germany	9.0	9.2	9.2	9.3	9.2
Norway	8.7	8.7	8.8	8.7	8.6
Denmark	8.8	8.6	8.6	8.7	8.6
Estonia	8.1	7.6	7.8	8.1	8.0
<b>Average</b>	<b>7.8</b>	<b>7.7</b>	<b>7.8</b>	<b>7.8</b>	<b>7.8</b>
Lithuania	6.6	6.6	6.4	6.8	6.7
Latvia	6.4	6.2	6.1	6.1	6.0
Poland	6.0	5.7	5.9	5.7	6.0
Russia	5.2	5.2	5.9	5.8	6.0



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