Swedbank

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Swedbank Economic Outlook

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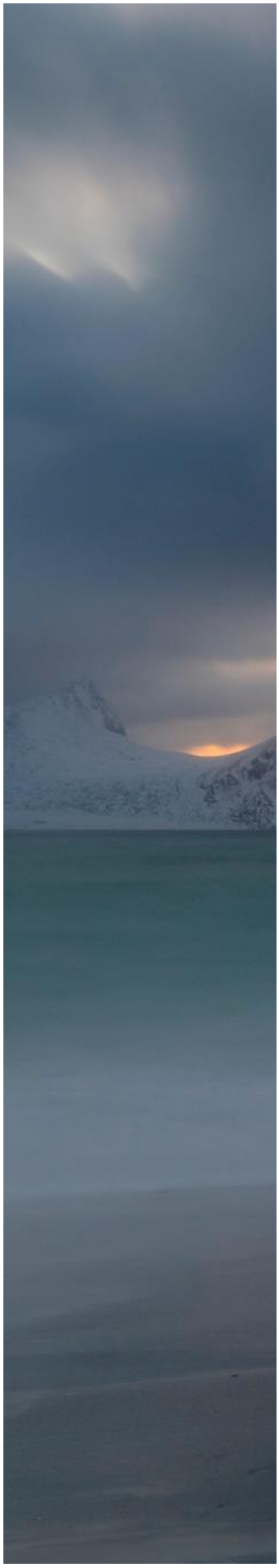


When the party's over

In the wake of the highest inflation seen in decades, central banks have globally increased policy rates in a front-loaded, synchronised and aggressive manner. Inflation is now showing signs of retreating, and central banks have reduced the pace of the rate hikes but are maintaining a hawkish stance. They will keep raising policy rates for part of this year to bring inflation closer to the target and prevent it from becoming sticky. Central banks cannot risk implementing a less restrictive monetary policy too early, as this would risk yet another policy mistake. Hence, the central-bank policy pivot will have to wait and stagnating economic growth will be the outcome.

Growth has, so far, been surprisingly resilient, but a downturn in the global economy is inevitable and is creeping closer. In our home markets of Sweden and the Baltics, economic growth during 2022 turned out stronger than expected. Favourable weather conditions, i.e., a mild winter, lower energy consumption, and fiscal support have postponed the economic downturn in Europe. In the US, the labour market and consumption have shown resilience.

"Central banks cannot risk loosening monetary policy too early"

However, the cost-of-living crisis, higher interest rates, worsened terms of trade, high energy costs, and other factors will cause economic growth to stagnate during 2023.

Next year, when inflation has declined and economies have been stagnating, central banks will start to cut interest rates and move monetary policy into less restrictive territory and to neutral levels. Helped by the reopening of the Chinese economy, lower inflation and improved cost-of-living conditions will improve economic growth somewhat.

The outlook is uncertain, and the risks are plentiful. Globally, the full impact of the synchronised and aggressive central-bank hikes could worsen the outlook even further in the near term, and even jeopardise the recovery in 2024 if the impact is greater than anticipated. Furthermore, inflation could prove to be stickier, which would require additional hikes by central banks. This would risk deepening and lengthening the economic downturn. The Chinese reopening could fuel inflation in Western economies through energy and commodities. In the geopolitical arena, many risks, such as a worsening of the war in Ukraine and the China-Taiwan situation, could also tilt the outlook for the worse. China might also get the party going again, and result in higher global growth.

Mattias Persson
Group Chief Economist

"Central banks will start to cut interest rates and move monetary policy into less restrictive territory in 2024"

5.0%

GDP growth
in China 2023

3.20%

10-year US government
bond yield
December 2023

3.50%

Riksbank
policy-rate peak
in June 2023

1.6%

Swedish inflation
by December 2023

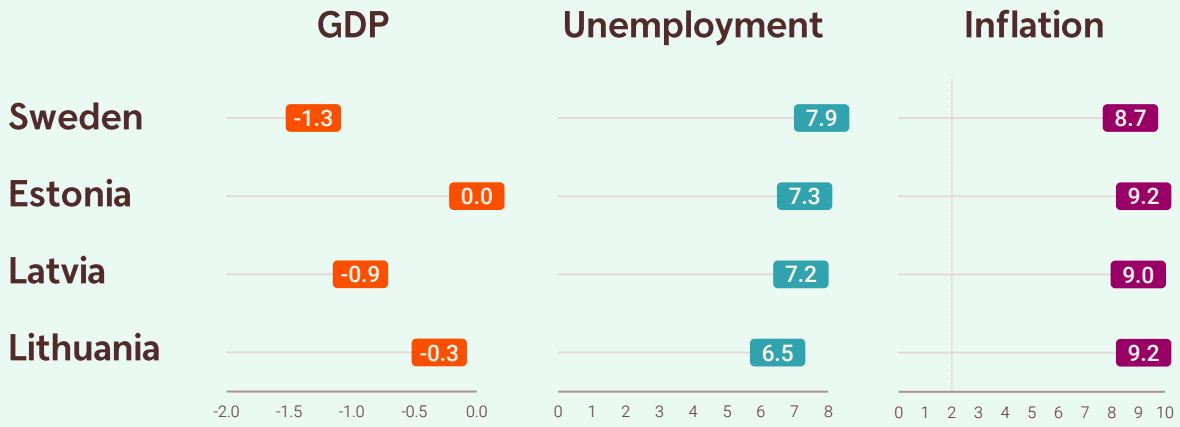
June 2023

The end of this
rate-hiking cycle for
central banks

1.12

EUR/USD
June 2023

2023 Outlook



Global Outlook

1. **Global growth** will take a hit this year as firms and households struggle with high energy bills and interest rates.

2. The energy crisis will drag down the **euro area** to stagnation this year. However, the outlook is less dark than we foresaw during the autumn, as energy prices have come down and many economies, not least Germany, have proved resilient. The **US economy** will also face stagnation on the back of higher interest rates. **China** has reopened, and a strong growth rebound is expected for this year.

3. In both the US and the euro area, **inflation will fall** substantially **in 2023**. This is partly due to base effects, but also to lower demand. Lower commodity prices, lower freight prices, and large inventories within the retail sector also suggest reduced price pressures ahead.

Financial Markets

1. Both the **Fed** and the **ECB** are expected to raise their policy rates during the first half of this year and to postpone rate cuts until 2024.

2. **Government bond yields** have declined since the start of the year. We expect a gradual decline also ahead as inflation fades, growth slows, and also, later, central banks soften their approach. However, **German yields** are expected to largely stay at current levels due to loose fiscal policy and the ECB's ending its quantitative easing.

3. An improved risk sentiment is expected to weaken the US dollar and strengthen the euro during the forecast horizon. The **Swedish krona** and **Norwegian krone** are expected to appreciate somewhat, beginning in the second half of this year.

Sweden

1. The Swedish economy is **slowing markedly**. Both household consumption and housing investments will drag down growth this year as a consequence of **sensitivity to the high rates**.

2. The labour market remains resilient, but the situation will worsen when **employment-intensive industries**, such as trade and construction, are **affected**.

3. The Riksbank will continue fighting inflation in the near future, and we expect the **policy rate to peak at 3.5% in June**. Inflation will fall this year, leaving room for a less contractionary monetary policy in 2024 and some **economic recovery**.

Baltics

1. **GDP** started shrinking at the end of last year, and some weakness is likely to persist, at least during the first half of 2023; a larger **fallout** remains **unlikely.**

2. **Inflation peaked** in the autumn and is on a steep downward path. Although rapid wage growth is likely to continue, we forecast that annual inflation will **drop to** low **single digits by the end of 2023.**

3. Real household income, **consumption,** and exports are likely to stagnate or shrink slightly this year, before **recovering in 2024.**

Global economy faces near-term pain

A downturn in the global economy seems unavoidable. While the US and Europe struggle with higher interest rates and inflation, China is suffering from a severe COVID outbreak. A gradual recovery in the global economy is expected later this year, but the pace is set to be unimpressive.

The darkest time is now

The global economy faces a challenging start to the year. High interest rates and inflation are weighing on the US and euro-area economies. Meanwhile, China continues to struggle with its lacklustre economy and, more recently, a severe COVID outbreak. It is indeed hard to see what could drive growth in the near term, and macroeconomic outcomes for the first quarter are expected to be dire.

Softish landing

Looking back at 2022, many economies proved surprisingly resilient to the twin shock of higher inflation and interest rates. However, the party will soon come to an end. We still expect that stricter monetary policy, which typically works with long lags, and inflation will weigh on the real economies this year. However, inflation has started to come down in the US, and we expect it to decline rapidly there and in the euro area this year, which implies only that the pace of worsening will ease. Prices will continue to rise from the current high levels, thereby eroding purchasing

Swedbank's global GDP forecast

Annual % change	2021	2022F		2023F		2024F	
US	5.9	2.0	(1.8)	0.4	(0.2)	1.2	(1.5)
Euro area	5.3	3.3	(3.0)	0.2	(0.0)	1.1	(1.4)
Germany	2.6	1.9	(1.4)	0.2	(-0.8)	1.0	(1.3)
France	6.8	2.5	(2.5)	0.4	(0.5)	1.2	(1.3)
Italy	6.7	3.8	(3.3)	0.4	(0.2)	1.1	(1.2)
Spain	5.5	5.3	(4.6)	1.1	(1.3)	1.3	(1.6)
Estonia	8.0	-0.4	(0.5)	0.0	(0.0)	3.0	(2.5)
Latvia	4.1	1.6	(2.8)	-0.9	(0.0)	2.6	(2.9)
Lithuania	6.0	2.4	(2.0)	-0.3	(0.0)	1.8	(2.1)
Sweden	5.1	2.9	(2.7)	-1.3	(-1.1)	0.9	(1.0)
United Kingdom	7.5	4.0	(3.4)	-0.9	(-1.1)	0.9	(0.5)
China	8.1	3.0	(3.5)	5.0	(4.5)	5.0	(5.0)
Global GDP (IMF PPP weights)	6.1	2.8	(2.8)	2.0	(1.8)	3.1	(3.2)

Previous forecast in parentheses.
Sources: IMF & Swedbank Research

power even more in many countries. Hence, we continue to see the US and the euro area stagnating this year, and a modest recovery beginning next year. We are revising the outlook for China up this year, as the reopened economy is expected to start gaining a footing this spring.

Inflation expected to fall as fast as it rose

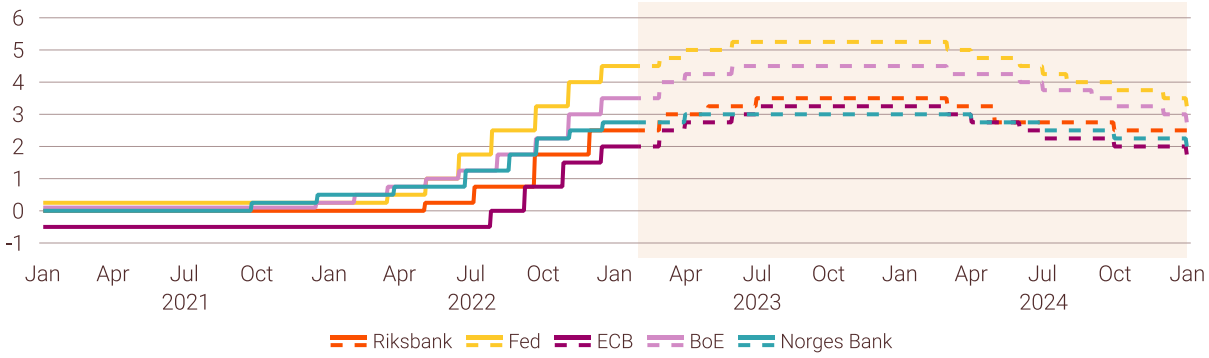
Two extraordinary shocks--the pandemic and the Russian war on Ukraine--have pushed inflation up to exceptionally high levels across the world. However, much suggests that the peak of inflation is near. We forecast a relatively rapid fall of inflation in both the US and the euro area this year. In fact, the inflation journey downwards started already this past autumn in the US, and plenty of indicators suggest that this encouraging trend will continue. The outlook for inflation in Europe is more uncertain and more heavily influenced by the energy crisis. However, in recent months, natural gas and electricity prices have fallen markedly, and the peak of inflation was probably at the turn of the year. Strong base effects will also drag down inflation this year. Also, the aggressive monetary policy tightening will squeeze demand and price pressures substantially going forward. In about a year, we forecast that inflation in both the US and the euro area will be lingering around 2%.

Central banks – higher for longer

We expect that many central banks, including the Fed and the ECB, will continue to raise their interest rates during the first half of this year. Thus, we now foresee policy rates to be higher for longer. The reason is that the central banks now seem eager to raise rates more. Inflation remains far above their targets – although it is expected to fall markedly this year – and labour markets are staying strong. It is also about credibility. Inflation has overshot targets as never before, and central banks will probably be more prone to erring on the hawkish side rather than stopping too early, especially since many of them, including the ECB, were late in taking away the candy bowl. Eventually, lower inflation and slowing economies will cause monetary policies to change course, and we forecast a series of rate cuts starting about one year from now. Both Norges Bank and the Riksbank are expected to largely follow the ECB, despite their economies being more interest-rate sensitive.

Central banks' policy rates - delayed reversal

Outcome and Swedbank forecast, %



Sources: Swedbank Research & Macrobond

Risks to the outlook

The forecast is surrounded by many uncertainties, not least regarding the development and consequences of inflation and monetary policy. In a stickier-inflation scenario, with even higher policy rates for longer, the real economy will certainly take a harder hit than in our baseline scenario. Such a scenario could materialise for various reasons. The energy situation in Europe remains strained, and a cold winter could pull up the price of natural gas and electricity again. Also, China's reopening could lift commodity prices in general, which would create global spillovers and add inflationary pressures.

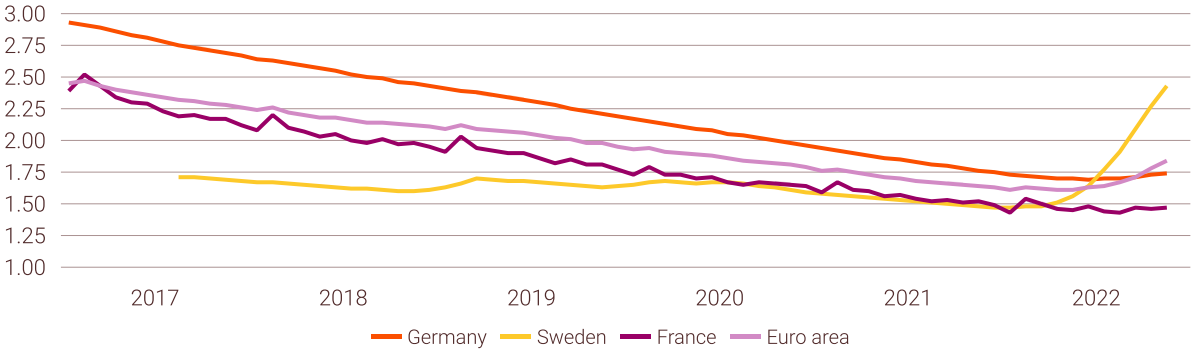
However, inflation could also decline faster than forecasted. The recent easing of supply-chain pressure, together with continued lower energy prices, could pull down price pressures faster than expected. In addition, high inventories in the retail sector in many countries might reduce retail prices.

Another downside risk relates to the adverse effects of the monetary policy tightening. Even if most economies seem to have been handling the rapid rise in borrowing costs so far, we could still be underestimating how much it will weigh on the economies in the years to come. Investments and consumption could take a bigger hit than expected, not least in interest-rate-sensitive countries like Sweden.

In addition to the risks mentioned above, we are not short of geopolitical risks, such as the Russian war on Ukraine and the relationship between China and Taiwan. An escalation of these risks could again imply harm to supply chains and, eventually, also inflation. There are also worrying indications of trade protectionism at the political level. For example, the US Inflation Reduction Act risks leading to a European response of more state support and "made-in-Europe" thinking. Although this could boost growth in the short term, the long-run negative effects of subsidies, export controls, and so on are well known.

The transmission mechanism differs across countries

Average mortgage rate (outstanding stock), %



Sources: Swedbank Research & Macrobond

Bond yields about to peak

Government bond yields rose rapidly last year. This year is bound to be different. Growth and inflation will come down markedly, which should put downward pressure on bond yields. And even though central banks will continue to raise their policy rates for some time yet, this has already largely been discounted by the markets. However, there are also counteracting factors at play. To a varying extent, central banks have stopped buying government bonds, which should put upward pressure on yields. Also, in Europe, fiscal stimulus could raise supply and yields. Overall, we foresee slightly higher bond yields in the near term, followed by a stabilisation or even small declines longer out.

The dollar should weaken – just not yet

Near-term economic headwinds, including hawkish central banks, will probably weigh on risk sentiment. This should imply that the trend from last year, with a strong US dollar, will hold for some time yet. The most recent US depreciation, likely due to a sustained lower inflation trend in the US and, thereby, lower expectations on the federal funds rate, will likely face setbacks. Later this year, however, as it becomes clearer that the trend of falling inflation can be sustained and as central banks soften, risk sentiment is expected to recover. Also, the Chinese recovery may stimulate the risk appetite. In this environment, we expect the US dollar to gradually weaken and the euro to appreciate.

The Scandinavian currencies had a rough year in 2022, with the Swedish krona and the Norwegian krone depreciating markedly. The main reason for the weaknesses was the overall small risk appetite that weighed on smaller, more illiquid, currencies. The continued depreciations since December 2022 seem to have been driven less by risk appetite and more by expectations that the Riksbank and Norges bank will be able to hike at the same pace as the ECB, due to their economies being more interest-rate sensitive.

We forecast that the Swedish krona and Norwegian krone will stay relatively weak during the first half of this year on the back of muted risk appetite, underpinned by inflation and the continued hawkishness of central banks. Later this year, however, as the central banks soften, risk appetite could resume, supporting the Scandinavian currencies.

United States – a softish landing

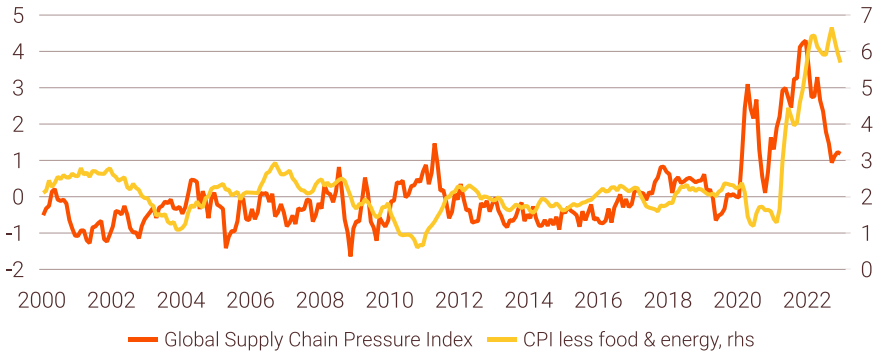
Inflation has started to come down, but from high levels, and the labour market has remained tight. The Fed will continue raising rates in the near term and wait until next year before cutting. Higher interest rates for a longer period are expected to put pressure on the economy. The downturn is, however, expected to be shallow.

Since peaking in mid-2022 at 9.1%, its highest level in 40 years, consumer price inflation (CPI) has fallen quickly to 6.5%. This was largely thanks to falling energy prices and, more recently, cooling food price inflation.

Excluding these components, underlying inflation has also declined recently due to a rapid reversal in core goods prices (particularly for vehicles) that is largely a result of the easing of supply-chain issues seen last year. Services inflation has, however, proved much stickier, not least housing. Inflation is expected to continue falling rapidly this year, but China's reopening constitutes an upside risk, particularly to energy and commodity prices.

Easing supply-chain issues point to receding inflation

Index (lhs); y/y % (rhs)



Sources: Swedbank Research & Macrobond

To combat last year's skyrocketing inflation, the Fed embarked on its fastest monetary-tightening campaign in several decades. The federal funds rate was raised by a cumulative 425 basis points (bp) to a range of 4.25–4.50%, and the balance sheet is being shrunk by up to USD 95 billion every month. Even though inflation continues to fall, it is still expected to be above the Fed's 2% target at the end of this year. This, combined with inflationary pressures proving to be more persistent than the Fed judged, suggests the Fed will be careful before being confident the inflation fight has been won. Therefore, we forecast that the Fed will hike rates by 25bp in February, March, and May, which will leave the fed funds in the range of 5.00–5.25%. A series of rate cuts will commence next year, when inflation will have come down markedly and growth will remain weak.

The Fed will hike to

5.00 - 5.25%

in May

Economic activity is likely to slow on a wide front due to the high inflation and the Fed's hawkishness. Moreover, the effects of the massive fiscal policy support enacted during the pandemic are waning, weighing on growth. We expect no major fiscal stimulus this year. The midterm elections resulted in a divided Congress, with the Democrats remaining in control of the Senate and the Republicans holding the House of Representatives.

The unemployment rate stood at 3.5% in December, a historically low level, and nonfarm payrolls are increasing at a robust, albeit slower, pace. However, employment in temporary help services has fallen since July, and fewer small businesses are planning to hire, according to survey data from the small business association NFIB, which indicates that labour demand is cooling and a broader slowdown in hiring is likely coming. In a

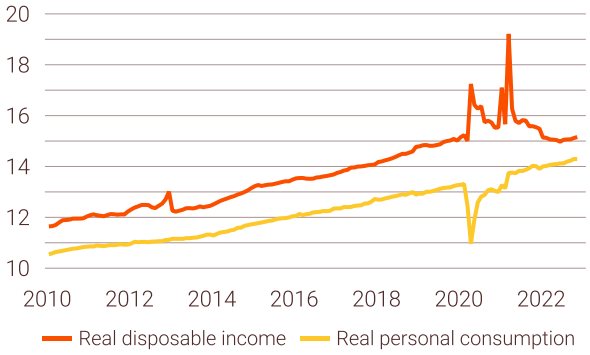
further sign that the labour market is becoming better balanced, the labour force participation rate picked up in December. The Fed should also be encouraged by the slowdown in wage growth, despite a still-tight labour market, and diminishing fears of a wage-price spiral. We expect that the unemployment rate will start to rise and wage growth continue to moderate as economic activity deteriorates this year.

While nominal wage growth has been high, real disposable income stagnated last year due to high inflation and interest rates. Despite this, real personal consumption expenditures held up extraordinarily well. To sustain a high rate of spending, households have run down on the large amount of savings they accumulated during the pandemic. At the same time, household debt, including credit-card borrowing, rose sharply last year. This will likely not be sustained forever however, which, together with a deterioration of the labour market, is why we expect a decline in consumption later this year. The housing market has not been as resilient towards higher borrowing costs and prices, leading to a sharp drop in home sales and construction activity; this is likely to continue for some time. Falling housing prices will also negatively affect consumers.

Signs of an imminent growth slowdown are mounting elsewhere. The Purchasing Managers' Index (ISM) is already showing contraction in both manufacturing and services, as well as recent large drops in new orders, production, and business activity, implying softer demand going forward. The Conference Board's Leading Economic Index (LEI) has been trending down since February 2022 and is currently down more than 5% compared to a year ago. We still expect the US to enter a recession this year, before rebounding to a still-below-trend growth next year. However, we expect it to be a relatively mild recession given that the economy has held up better than expected so far and that inflation will come down, and that, eventually, interest rates will be lowered. GDP is forecast to grow by 0.4% and 1.2% in 2023 and 2024, respectively.

Stagnating income but increasing consumption

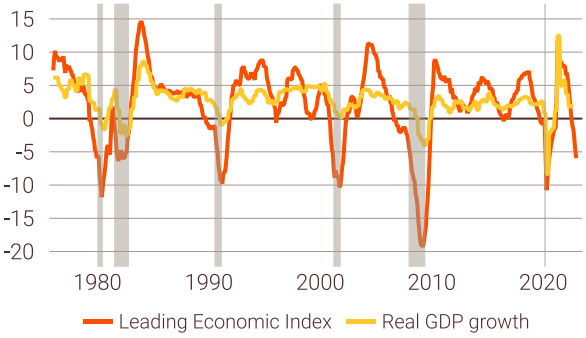
USD trn, 2012-chained



Sources: Swedbank Research & Macrobond

Leading Economic Index signals a recession

y/y %



Note: Shaded area represents recessions as determined by the NBER.
Sources: The Conference Board, Swedbank Research & Macrobond

Euro area – despite better-than-expected developments, rough path ahead

The economic outlook is murky. Even though the energy crisis does not seem to have dragged Europe into a deep recession so far, slowing global demand and continued monetary tightening will inevitably weigh on growth ahead. Inflation will decline rapidly this year, but the ECB will continue hiking rates until disinflation becomes undeniable and the side effects of higher interest rates painful.

Europe was expected to be in a recession by now. It was feared that gas shortages would lead to severe interruptions of industrial activity and sharply falling consumption. However, the energy systems proved to be more elastic than expected – substitution and saving significantly lowered gas demand without lowering output. Uncharacteristically warm weather and lower gas demand in China improved the situation further, and gas inventories are much higher than typical for this time of year.

It is becoming increasingly likely that Europe might end the heating season with gas storages still more than 60% full. If this occurs, preparations for the 2023/2024 winter will become much easier. While gas prices have declined massively since the autumn peaks, energy systems remain strained. The terms-of-trade shock has dragged the economy into a current account deficit and will likely worsen the competitive position for manufacturers. As the energy situation has eased, business and consumer sentiment has stabilised. Activity indicators still point towards contracting economic activity, but pessimism has peaked. It's still likely that several euro-area countries will experience a shallow technical recession over the winter, but a wider downturn seems to have been averted. Because the end of 2022 was much better than expected, Germany saw the largest upward revision of its GDP forecast; growth this year is likely to stagnate but not contract.

Indicators still point towards a contraction, but pessimism has peaked

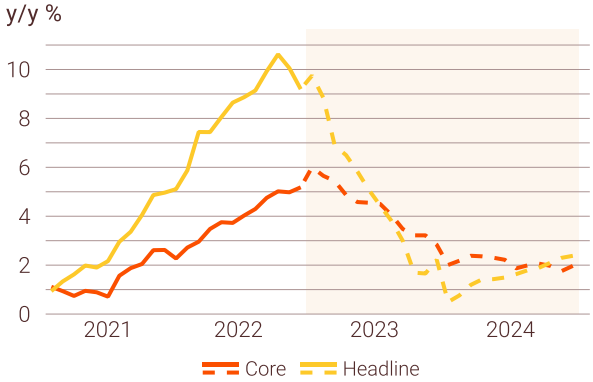
However, Europe is not out of the woods yet. Massive, coordinated monetary-policy tightening is slowing the global economy, export orders are falling, and yield curve inversions are flashing red. Manufacturing is suffering not only from higher costs but also from slowing demand. We are likely to see a divergence between sectors – energy-intensive production is still likely to suffer, while sectors such as defence and renewables will see a continued surge in demand.

Households' disposable income has largely been shielded from the energy shock by fiscal policy, but consumption will be muted. Policy tightening is set to hit housing markets this year, which should lead to lower consumption of durable goods.

Price pressures have started to wane. While current inflation is uncomfortably high, it will start to fall off rapidly in the second quarter of this year. Many of the pandemic bottlenecks have been resolved and natural gas prices have come down. These factors will contribute to strong goods disinflation in 2023. Core inflation will decline more slowly as higher wages

Inflation in euro area

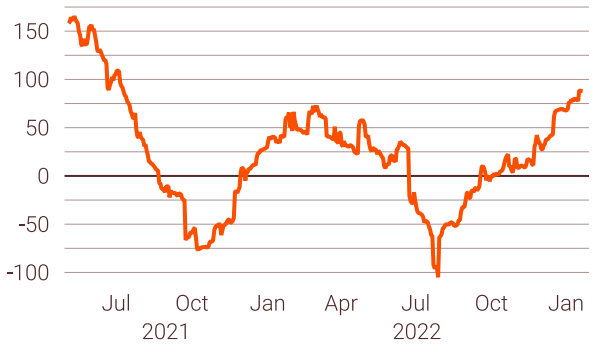
y/y %



Sources: Swedbank Research & Macrobond

Economic Surprise Index

Index



Sources: Swedbank Research & Macrobond

are passed on to consumers, but we foresee only a minor risk of de-anchored inflation expectations.

China's rapid reopening is a wild card for the European outlook. Higher Chinese growth – as we foresee beginning in the second quarter of this year – could materially improve the outlook for the exporting sector later this year. On the other hand, the reopening could also lead to upward pressures on commodity prices and even more policy tightening.

China's higher growth is a wild card for the European outlook

Overall, the near-term outlook has improved, while the medium-term outlook remains weak and highly uncertain. Energy remains a structural problem, and monetary policy is weighing on growth. The euro-area economy is expected to grow by only 0.2% this year and increase by a still-meagre 1.1% in 2024.

Peak hawkishness is near, but ECB's pivot will be delayed until early 2024

High inflation and economic resilience have encouraged the ECB to remain on a very hawkish path. We forecast that the ECB will increase interest rates by another 50 basis points (bp) in February, and that this will be followed by three consecutive 25 bp increases in March, May, and June. In our view, the deposit interest rate, at 3.25%, will be above the neutral rate of interest and sufficiently restrictive to dent housing-market activity and further dampen consumption. We forecast that, at the start of 2024 headline inflation will fall below 2%, and stronger deflationary forces cannot be ruled out; thus, the ECB, like many other central banks, will start cutting interest rates. We forecast six 25 bp cuts during 2024.

China – open for business

The pivot on COVID-19 policies paves the way for a strong economic recovery in 2023, led by a boost in household consumption. The recovery will also benefit from support to the ailing property sector. However, there are still some growth hurdles, especially long term.

Last year was dismal for the economy. Consumption and production were severely hampered due to the zero-COVID policy, the property slump weighed on overall economic activity, and China recorded its worst heat wave ever during the summer. The official GDP growth target for last year was set at "around 5.5%"; meanwhile, actual growth came in at 3%.

China's rapid reopening paves the way for a strong economic recovery in 2023

However, at the end of 2022 and the start of 2023, China removed its most severe COVID-19 restrictions and is, therefore, essentially fully open. An extreme surge in infections ensued, but there is some evidence that the first wave has peaked in several of the larger cities, such as Beijing and Shanghai. Increased traveling during the Lunar New Year holiday and the workers' return to work afterwards could mean that the spread picks up once again.

The zero-COVID U-turn happened both earlier and faster than expected. The resulting surge in cases will depress economic activity in the near term, and global supply-chains might become temporarily strained if a large amount of the workforce is away due to illness. Later, however, as virus worries and contamination fade, the removal of restrictions will entail a strong boost to the economy this year. Having been under strict restrictions for almost three years, there is a lot of pent-up demand, and households have accumulated a large amount of savings. The economic recovery will be led by increased household consumption, especially services. Globally, China's reopening is likely to be positive for sectors such as tourism and will boost commodity prices and imports due to increased demand. However, these effects should not be overestimated, given that the growth uptick will mainly stem from a kick-start of household consumption, not investments or a manufacturing boom.

Also, late last year, China announced a 16-point rescue package to support its property sector. While this marks another policy shift benefitting the economic recovery, it will take time for developer funding and investment to increase, given that this would entail a prior improvement in home-buying confidence and, by extension, sales. We expect that, as one of the few central banks that eased monetary policy last year, the People's Bank of China will continue to ease monetary policy early this year to continue supporting the property sector and stimulate growth.

The annual Central Economic Work Conference in December took a more pro-growth stance than in recent years' meetings. The meeting indicated that boosting domestic consumption will be a top policy priority in 2023, and that fiscal stimulus and monetary policy support will continue. The growth target for this year will be set in March, and we assume it will be

something akin to “around” or “above” 5%. This year, China is better equipped to reach such high growth, and we forecast that GDP will grow by 5%, with risks to the upside.

Not everything is rosy for the economic outlook, however. Net exports were one of China’s most important growth drivers during the pandemic, and the country enjoyed a record trade surplus last year; however, export growth is predicted to slow because of weaker external demand due to the global economic slowdown. Global geopolitical tensions are also heightened, and the US has imposed export controls on China’s access to advanced semiconductor technology. Structural challenges such as deglobalisation and an ageing population are weighing on long-term growth prospects.

How inflationary is the green transition?

This January, as they do every year, the world's elite gathered in Davos, perched at an altitude of 1,560 metres in the Swiss Alps. Yet, this time around, the beginning of the World Economic Forum 2023 was marked by muddy and dead-brown, grass-covered Alps – a clear message that climate change is getting harder and harder to ignore. To overcome climate change-induced challenges, a number of policy initiatives have been presented across the world – from the Inflation Reduction Act in the US to carbon-neutrality plans in China and a European Green Deal. Yet, as a side effect, these policies might also entail higher and more volatile prices.

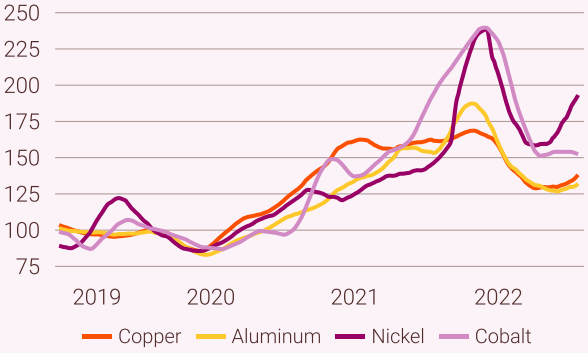
Greenflation is an inflationary demand shock

Greenflation is usually defined as an inflationary demand shock, which risks following from the green transition.[1] As companies go through the process of switching to low-emission technologies, decarbonising their products, the related greenflation stems from imbalances between demand and supply of commodities necessary for the switch. Many green technologies rely on minerals, and, therefore, the demand will keep rising. However, the supply is slow to adjust, which has already led to price increases of many minerals.

Given that all 27 EU member states agreed on a plan for Europe to become the first climate-neutral continent by 2050, with at least 55% of net greenhouse gas emissions to be cut by 2030 from the 1990 levels, the demand for low-emission technologies will continue to increase. Plans also include emissions trading for road transport starting in 2026, as well as expanded carbon pricing for aviation and maritime transport industries.

Selected metal prices

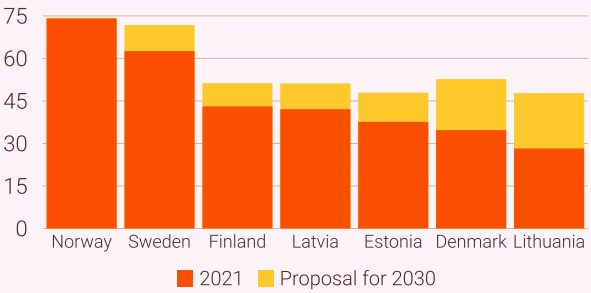
Index (2019=100)



Sources: Swedbank Research & Macrobond

Renewable energy and proposed 2030 targets

% of gross final energy consumption

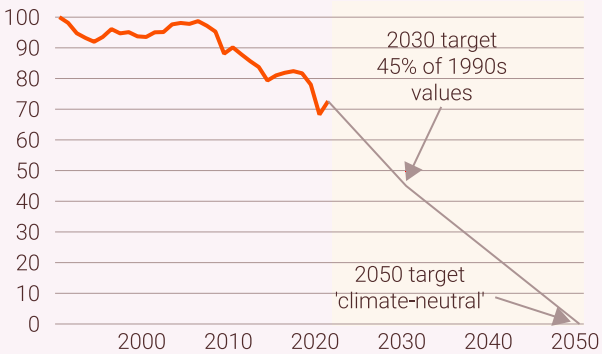


Note: National energy and climate plans submitted by EU member states, based on the EU overall target of 32%.
Sources: European Commission, Swedbank Research & Macrobond

[1] In addition to *greenflation*, one can also distinguish between *climateflation* – costs arising from extreme weather events, and *fossilflation*, costs related to dependence on fossil fuels. This was recently elaborated in a speech by Isabel Schnabel, Executive Member of the ECB.

CO2 emissions, EU

Index (1990=100)



Sources: Swedbank Research & Macrobond

EU Emission Allowances (EUA)

EUR/mt CO2, Futures price

Sources: Swedbank Research & Macrobond

In a survey of climate economists, the majority agreed that the global price of carbon should be at least USD100/t to reach net-zero emissions by 2050--a level that prices under the Emissions Trading System (ETS) have recently started to approach.

Hence, an increasing number of companies are adapting their activities and processes in order to lower emissions, while households are increasingly opting for greener alternatives such as electric vehicles or solar panels. Yet, most of these technologies require significant amounts of minerals.

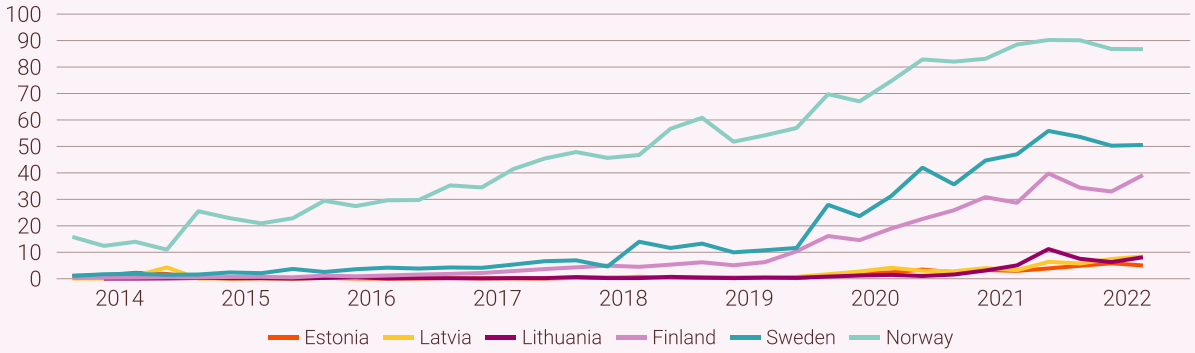
Green technologies increase the demand for minerals, but supply is constrained

One specific example would be an electric car, which contains about 200 kg of minerals such as copper, graphite, or cobalt, compared with about 40 kg in a conventional car. Despite this, raw materials represent only a small share of end-consumer prices (about 20% of a car). However, as the demand for electric cars increases, so does the demand for minerals; yet, supply is constrained in the short and medium term. Investments in new mining of these metals have partly been depressed by environmental, social, and governance reasons, as it would mean extended mining. The suppressed supply of minerals makes electric cars and other goods relying on minerals more costly to produce. Another example is the construction of solar and wind power plants, which use up to six times more copper than conventional power plants.

A related example of greenflation is in the manufacturing of steel. Steel is widely used in, e.g., buildings, vehicles, and wind turbines. However, manufacturing steel produces more CO_2 than any other heavy industry and composes around 25% of Europe's industrial emissions. To reduce the carbon footprint of steel manufacturing, companies are switching to using "green hydrogen" produced with fossil-free energy. In doing so, one can reduce CO_2 emissions by up to 95%. So far, though, it is about 30% more expensive to produce green steel using green hydrogen, rather than using hydrogen produced by fossil fuels. This will likely impact the final consumer prices of goods with steel as a component. If the electric car in the previous example is manufactured using green steel, greenflation accumulates.

New electric vehicle registrations

% of total



Sources: Swedbank Research & Macrobond

Although it's not an easy task, efforts have been made to calculate the potential extent of greenflation. The studies use different assumptions and are not fully comparable; however, they all find that price effects will be limited (especially compared with the current high-inflation setting) if the transition is not delayed.

Reducing emissions by 25% from current levels, in accordance with the goals of the Paris Agreement, could increase near-term global inflation by 0.1 to 0.4 percentage points a year compared with a baseline, according to calculations by the IMF.

Given that about two-fifths of all supply-chain emissions could be avoided with affordable and available measures, such as circularity, efficiency, and renewable power, the World Economic Forum, together with the Boston Consulting Group, finds that end-consumer prices would increase by only 1-4% in the medium term as a whole, if companies also focus on efficiency and circularity. Other studies are also in line with these estimates and highlight fiscal policy design to alleviate potential pressure on households.

Larger inflationary impulse if the transition is delayed

However, the IMF calculations find that delaying the transition (reducing emissions starting in 2027 instead of 2023, but by the same total amount by about 2030) could make the inflationary impulse as much as three times stronger, which would correspond to a global inflation increase of 0.3-1.2 percentage points annually. The larger inflation impulse reflects the additional costs of having to reduce emissions more rapidly. Persistently higher greenflation would make economies more sensitive to other inflation shocks and could shift how policymakers see the inflation target, which is usually set at 2%.

Moreover, greenflationary pressures can be largely unequal between countries, mainly reflecting different starting points in terms of energy use, proportion of fossil fuels in the consumption basket, and regional production capabilities. In terms of greenflation, the transition will likely hurt more the countries that have more catching up to do in order to reach the 2030 and 2050 targets.

Like the rest of the world, the Nordic and Baltic countries need to significantly increase their renewable energy capabilities. Although the required capacity increase is smaller in Norway and Sweden, significant costs may arise. In Norway, the transition from an oil- and natural gas-producing country could be expensive, as the country will no longer be able to count on fossil revenues. In Sweden, the prolonged underinvestment in the electricity grid, as well as record-long permission processes for wind turbines, risks increasing the greenflation pressure.

In the Baltics, investments in renewable energy are lagging, compared with the Nordic countries. Lithuania lags the most; there, renewable energy constitutes less than one-third of total energy consumed, meaning that many renewable energy projects will have to be completed in order to reach the targets.

Sweden – the belt tightens

The Swedish economy is slowing markedly. We expect household consumption to fall along with purchasing power. Construction starts will decrease by more than half, partly as a result of higher interest rates. The labour market remains resilient, but the situation will worsen when employment-intensive industries, such as trade and construction, are affected. The Riksbank will continue fighting inflation in the near future. Fiscal policy is tightening. Inflation will fall this year, leaving scope for a less contractionary monetary policy in 2024 and some economic recovery.

The economy is slowing markedly in the first half of the year

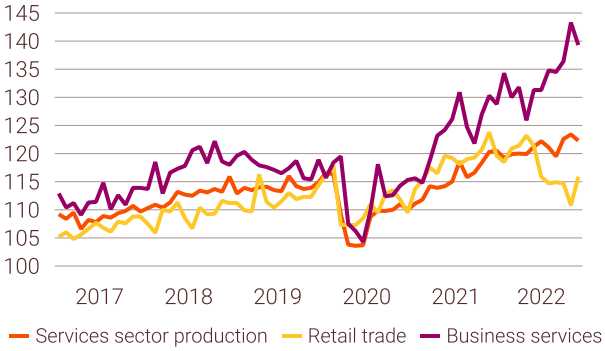
Despite high inflation, rising interest rates, and great uncertainty, the Swedish economy grew faster than expected in 2022. Above all, it was the business sector's investments and inventory buildup that were a surprise. The pace of investment has increased rapidly in several industries, with total investments reaching a historically large share of GDP in the third quarter. Services output continued to grow last year, although with significant differences between industries. While sales in retail fell, business services, e.g., continued to grow strongly. Despite this, the outlook is gloomier, which is reflected in deteriorating expectations for the business sector together with highly pessimistic expectations for households. We expect a clear decline in more industries and a significant deceleration in the Swedish economy during the first half of this year.

Households have only just started tightening their belts; more to come

Even though the labour market has been resilient so far, high inflation and rising interest rates will entail a decrease in household purchasing power. This year, purchasing power is expected to fall significantly as unemployment rises while inflation and interest rates remain high. Electricity support payments will not help ease the burden on households until February and later in the spring.

Major difference across services sectors

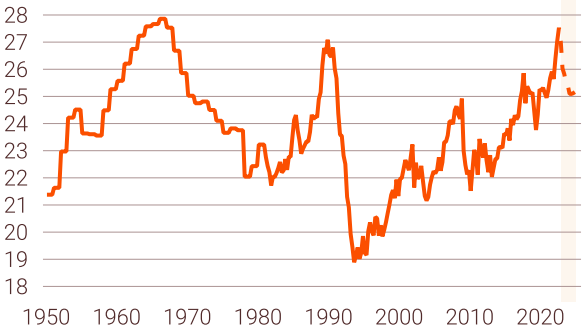
Index (2015=100), sa



Sources: Swedbank Research & Macrobond

Investment share largest in decades

% of GDP



Note: Annual data 1950-1980 and quarterly data from Q1 1981.
Sources: Swedbank Research & Macrobond

In addition, households' expectations on their own finances are highly pessimistic, while they perceive the risk of losing their own jobs as higher than before. The fact that households have never been as sensitive to interest rates as they are now also means that higher interest rates are more rapidly impairing households' ability to consume. This is due to a long-term sharp increase in households' debt-to-income ratios, with a high proportion of households having adjustable-rate mortgages. An analysis by the Riksbank shows that a rate hike will have twice as much effect on consumption today as it had 15 years ago.[2]

Purchasing power is deteriorating faster for interest rate-sensitive households

Household consumption was already developing weakly last year, despite services consumption holding up well. However, when this winter's high electricity bills and loan payments begin to have an impact, we expect households to tighten consumption even more. Uncertainty regarding the amount and timing of electricity support payments will fuel increased caution, especially during the first half of this year. Throughout the rest of the year, household caution will continue, in turn weighing on the durable goods trade such as home furnishings, consumer electronics, and building materials. In the future, households are also expected to cut back on restaurant visits and travel. Overall, we expect household consumption to fall 1.5% this year, which is slightly more than in our previous forecast. As purchasing power improves in 2024, when inflation is lower and new wage agreements are in place, consumption will recover somewhat. Although consumption is falling this year, incomes are plummeting even further, indicating an increased need for households to dip into their savings.

A stabilising housing market when interest rate uncertainty subsides

The housing market chill is expected to continue as long as there is uncertainty about how high mortgage rates will go; overall, housing prices are expected to fall 20% from the previous peak in February 2022 before bottoming out in the first half of this year. According to our forecast, we expect the Riksbank to make its final cut for now in June, with a peak in adjustable mortgage rates also being reached. The uncertainty will then subside, and buyers will begin returning to the housing market, resulting in more transactions and a stabilisation of the price picture. Given the fact that the Riksbank is expected to start cutting the policy rate in 2024, at the same time as housing investment fall back sharply, housing prices can be expected to begin rising somewhat, although we are probably several years away from the previous peak seen in February 2022. However, it cannot be ruled out that prices will fall farther if mortgage rates rise more than expected, or through changes in household mortgage terms, e.g., through significantly higher requirements in calculations of discretionary income.

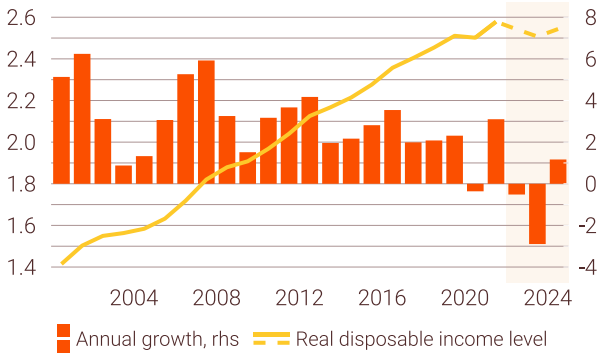
20%

housing price drop from peak to bottom

[2] Sveriges Riksbank (2022), Economic Commentary, *How has the impact of the policy rate on consumption changed when the debt-to-income ratio has risen?*

Very weak income growth this year

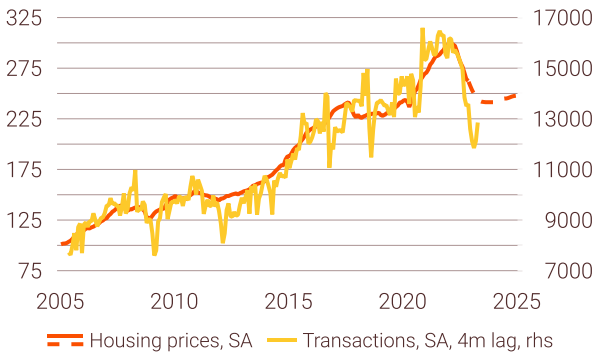
SEK bn, y/y % (rhs)



Sources: Swedbank Research & Macrobond

Prices to stabilise as uncertainty fades

Index (2005=100), number per month (rhs)



Sources: Swedbank Research & Macrobond

GDP will shrink this year, but recover somewhat in 2024

Housing investment is falling sharply in the wake of increased construction costs and interest rates, together with reduced demand. Construction starts are expected to decline by more than half from the high levels in 2021, while renovations are also anticipated to decelerate significantly during the forecast period. The development of business investment, excluding housing investment, is, however, more uncertain. In the Swedish National Institute of Economic Research's November survey, companies state that the pace of investment is expected to slow in 2023 compared with 2022; however, among industrials, more companies state that investments are still expected to rise. Unionen's Industry Survey also shows that the indicator for investments is falling, but expectations of future investments have not been downward-adjusted as much as, e.g., sales and order intake. While the surveys show that investments in increased capacity are falling, investments in efficiency and in research and development are expected to be prioritised. In addition, large, ongoing investment projects in several industrial companies are expected to gear up more next year (e.g., SSAB, Boliden, and Volvo Cars). All in all, we expect that, although business investment will fall slightly in the coming year, the downturn will be significantly limited compared with previous economic downturns. However, companies are expected to cut back on inventory buildup going forward, negatively contributing to GDP growth.

Construction starts fall to

25,000

Exports have been unexpectedly resilient, especially services exports, which grew by nearly 8% in volume terms last year. Given that the global outlook is somewhat less gloomy than it was in October, we expect the slowdown in Swedish export growth to be somewhat more muted.

Government consumption fell in 2022 at constant prices, partly as a result of lower consumption in the Swedish regions after high levels during the pandemic, together with rising costs. Compared with the other Nordic countries, Swedish public consumption has recovered significantly more slowly after the pandemic. We expect consumption to accelerate in the coming years, but at a somewhat slower pace than in our previous

forecast. However, the development is remarkably uncertain, not least as reflected in large differences across forecasters.

Overall, we expect Swedish GDP to shrink by 1.1% this year in calendar-adjusted terms and to recover slightly during 2024, when GDP will instead grow by just under 1%.

The labour market is cooling down

As the economy slows, the labour market is also expected to face a cooldown. Retail and consumer durables, and restaurants and hotels, as well as the construction sector, are sectors that will be hit particularly hard. These are also industries that have many employees, and layoffs are expected given the weaker demand. During the autumn, the number of bankruptcies and notices of layoffs increased, and we expect a gradual deterioration in the labour market. The labour force is expected to grow somewhat more slowly, roughly in line with the population. As the demand for labour, not least in the services sector, decreases, unemployment is expected to rise. All in all, we expect an increase in unemployment from the bottom level of about 7% to just over 8%, which corresponds to an addition of about 75,000 unemployed people.

75,000

more people unemployed

Tough wage round paves way for higher wages

This year, new collective agreements and salary increases will be negotiated for approximately 2.2 million employees in Sweden. On 31 March, the industrial agreement expires, and a new agreement is being negotiated that will become the norm for the rest of the labour market. This time, the wage round is characterised by high inflation, falling real wages, a deteriorating economic outlook, and the lower levels in agreements reached in the wage round during the pandemic. Therefore, we expect tough negotiations that will result in shorter agreements than usual and a larger part of the total wage increase being paid in the beginning of the period. In countries such as Germany, Norway, and Denmark, wages have increased more than usual, which speaks for higher wage increases in Sweden as well. In our forecast, we expect total wage growth of 3.7% for both 2023 and 2024. Based on our inflation forecast, real wages will remain negative throughout 2023.

The industrial unions' contractual requirements include wage increases of 4.4%, the highest wage requirement in 20 years. The technology companies' counteroffer means salary increases of 2%, supplemented with a lump sum of SEK 3,000. Historically, negotiations have met just under 80% of industrial unions' demands, equating in this case to a level of 3.4%, while an average of the parties' bids comes to 3.2%. A level of this magnitude would probably not pose much risk of the Riksbank needing to raise interest rates higher, but rather a possible risk of the parties not agreeing. If the collective agreements expire without a new agreement having been reached, the peace obligation will cease, and the situation could then become messy, with mediation and the risk of labour conflict notices and strikes.

Despite the grim outlook for households and some sectors of the economy, we expect the deterioration in the labour market as a whole to be relatively mild and temporary. In 2022, despite the global uncertainty, the labour market strengthened, and employment increased at a rapid pace. At the same time, 2022 was a year of large labour shortages. These shortages are expected to moderate in the future in line with decreasing demand, but in several sectors, the demand for staff with the right skills will remain high. In the public sector, there is a lack of resources and available skilled workers, which limits the scope for increased employment in sectors such as health and social care. When inflation starts to fall and the Riksbank starts to ease monetary policy—and when growth turns positive—we expect a fairly rapid recovery in the labour market. In addition to the Swedish labour market's structural challenges relating to e.g. long-term unemployment and the supply of skills, the EU directive on adequate minimum wages poses a possible challenge in the long run. Depending on how the directive is implemented, and how the European Court of Justice interprets it in potential civil cases, the Swedish model could be challenged, which risks affecting employment negatively. The Swedish government has appointed a special inquiry, which is to make its report this summer.

Historically high inflation is starting to fall back

Swedish inflation remains high, and in December the annual rate of CPIF (CPI at fixed interest rate) rose to 10.2%. At the same time, the CPI, which also includes the rise in household mortgage rates, was 12.3% higher than in December 2021. Throughout 2023, inflation is expected to fall relatively quickly (see the box "Inflation is at its peak – why is it falling?" on page 28).

An important explanation can be found in electricity prices, which are lower than previously feared as a result of factors such as falling gas prices and reduced electricity consumption. There are also signs of some deceleration in the underlying inflation, with lower monthly price increases at the end of the past year. In the short term, however, inflation will be kept elevated by the weak Swedish krona, and by increases in rent and fees charged by tenant-owner associations, as well as by prolonged strong price pressure at the producer level.

Over the slightly longer term, we expect inflation to approach 2% again. A gradual decline in electricity prices means that CPIF inflation will fall below the 2% target in 2024, while underlying inflation, as measured by the annual rate of CPIF excluding energy, will exceed 2% over the entirety of the forecast period. However, inflation developments are likely to be volatile, and both upside and downside surprises are possible. As of spring 2023, wage increases will be higher than before, which could lead to slightly higher prices in the employment-intensive services sector. In addition, companies are suffering from high costs for energy, interest rates, and rents, which will presumably be transferred to consumers. However, weak demand limits the scope for large price increases and should instead mean some price declines, not least for durable goods.

Inflation is at its peak – why is it falling?

After an intense year of sharply rising consumer prices, Sweden and the rest of Europe have reached, or are close to, the inflation peak. The downturn in 2023 will likely be steep, with significantly lower inflation figures as a result. There are differing views on exactly how much lower inflation will be, but few are questioning the direction.

There are many indications that consumer prices will not increase at the same rapid pace as last year. An important explanation for last year's high inflation was the extensive supply disruptions and the strong demand situation that prevailed during the pandemic. Instead, in 2023, we expect high inflation and rising interest rates to throw a wet blanket over household finances. As household purchasing power erodes, so does the scope for new price increases.

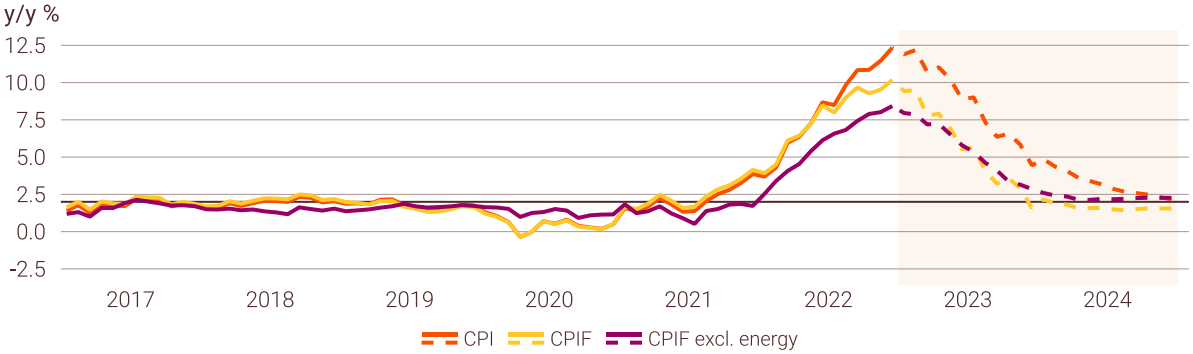
In parallel with the fact that households find it more difficult to handle higher prices, companies' costs are not rising to the same extent as before. On the contrary, global prices for raw materials and freight have fallen during the past six months. Supply disruptions have slowed and have depressed input prices. So far, companies have been able to raise prices against the background of both good consumer demand and rising costs, but in 2023 this will be more difficult.

Given that the rate of inflation consists of the price change over the past year, the percentage-price increase during each month of 2023 needs to be as large as in the corresponding month in 2022 to keep the inflation rate up at today's level. Lower monthly price increases, which seem most likely, will thus result in the gradual decline of the inflation rate.

Several factors could cause the decline in inflation to be both steeper and flatter. The general economic development plays a major role in both demand for inputs and, by extension, cost pressures, as well as for households' ability to absorb price increases. If growth holds up better than expected, it could also contribute to a more resilient labour market and higher wage growth. In an opposing situation, companies may need to move forward with larger sell-offs of durable goods in order to maintain market shares, especially if their costs return to pre-pandemic levels.

Other factors are more difficult to assess, but nevertheless important. The evolution of the war in Ukraine remains of great importance for inflation, especially via the impact on energy prices. In addition, China's reopening poses a risk factor; it could potentially generate stronger demand and upward pressure on commodity prices.

High inflation beginning to decline



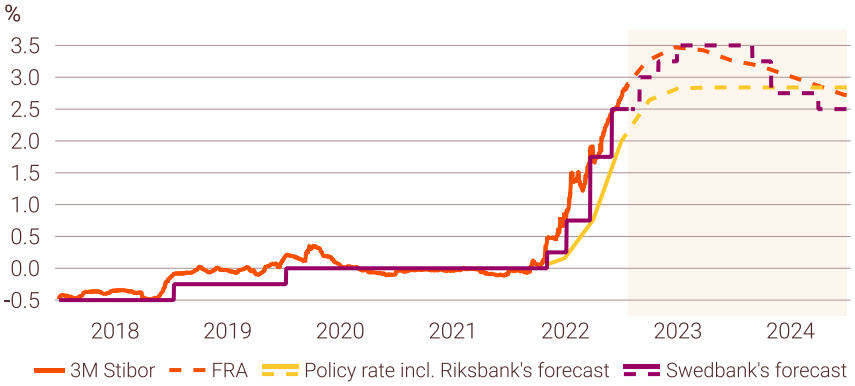
Sources: Swedbank Research & Macrobond

The Riksbank will hike in the near future, but soften next year

The high inflation means that the Riksbank will tighten monetary policy further during the first half of the year. Continued interest rate hikes from the ECB in the spring and a relatively weak krona mean that the Riksbank must show determination. We expect the Riksbank to raise its policy rate by 50 bp to 3% in February and by 25 bp in both April and June to 3.5%. The Riksbank's securities holdings, which increased sharply during the pandemic, will decline at a rapid pace during the next few years, further contributing to monetary policy tightening. As both activity and inflation decline, the Riksbank's monetary policy will fluctuate. Households are under severe pressure, and the need for a tightening monetary policy is waning. In just over a year, the Riksbank will therefore begin a series of interest rate cuts totalling 100 bp, which will ultimately result in a policy rate of 2.5%.

3.5%
policy rate

The Riksbank will hike now but soften in 2024



Sources: Swedbank Research & Macrobond

Tax cuts await in 2024

Fiscal policy is an important piece of the puzzle for future development. There are few signs of an expansionary policy, and the risk is rather that the policy will be too tight, given the economic downturn.

In December, the parliament decided on the budget for 2023, which was mainly in line with our forecast from October. The electricity support payment via Svenska Kraftnät's capacity fees, on the other hand, looks to be significantly less than we had expected, and will also be paid later. We now expect that SEK 55 billion will be distributed this year, of which just over SEK 20 billion relates to electricity support for households.

We also expect unfunded fiscal measures of an additional SEK 10 billion during the year, evenly divided between measures for households and state subsidies for the municipal sector. For households, we would like to see more targeted support for particularly vulnerable households, e.g., through larger housing allowances. The municipal sector faces sharply rising costs and a demographic challenge ahead, and, in addition to the state subsidies that were decided in the budget, we expect an additional SEK 5 billion required this year and next for the municipal sector to be able

to maintain the public welfare. For 2024, we assume total unfunded fiscal measures of SEK 30 billion, most of which are tax cuts announced in the Tidö Agreement (on earned income and pensions), but also transfers to households in addition to the abovementioned state subsidies to the municipal sector. We also expect that an electricity support payment will be paid in 2024 from capacity revenues; we expect, in line with the Swedish National Institute of Economic Research, that this will correspond to about SEK 35 billion.

The government budget balance will deteriorate slightly this year and the next, but this will be a noticeably small decline, given the economic situation. Maastricht debt as a share of GDP will be just under 32% of GDP in 2024, which is close to the lower end of the debt anchor.

Is higher inflation here to stay?

Inflation is currently historically high, and it is a global phenomenon. The large and rapid upturn in 2021-2022 is largely related to imbalances between supply and demand that emerged during the pandemic, including in manufacturing and transport. The expansionary monetary and fiscal policy, which was intended to support the economy during the pandemic, has also contributed. In addition, inflation received a further boost in the wake of Russia's invasion of Ukraine in February 2022, when energy prices skyrocketed as Russian gas taps were turned off. This has not only raised electricity bills for all households, but also increased the cost of production in industry and the food sector. Inflation is now expected to have peaked, and we forecast a sharp decline in the inflation rate in 2023. However, it is uncertain whether we will return to the period of low and stable inflation with accompanying low interest rates that characterised the pre-pandemic period. Although there are good arguments for this, inflation may instead become more volatile and probably also slightly higher in the future.

Over the past year, central banks have found reasons to focus more on supply rather than just demand parameters. In world markets, supply has been flexible for several decades, with increased world trade and cheap labour as China and the countries that were behind the Iron Curtain have opened up. Looking ahead, the supply side of the economy looks more challenging and is likely to have a greater impact on inflation. The pandemic and the war in Ukraine are reminders of this, but, in addition, we are observing several long-term factors that are likely to affect inflation developments.

Deglobalisation

The integration of world trade has taken a step back; barriers have increased, which will raise costs. In a recent survey from Business Sweden, more companies stated that they were moving sub-deliveries from China to Europe.

Demography

Until recently, the working-age population has been increasing in developed economies and in China and Eastern Europe. That trend has now reversed, and the working-age population is falling at a rapid pace. This means that the dependency ratio is increasing, as are labour shortages. This is likely to contribute to greater compensation in the form of higher wage increases, which will have an impact on inflation.

Climate change

Our planet is getting warmer. At the same time, the frequency of extreme weather, such as droughts and fires, as well as torrential rain and floods, has increased, a trend that is expected to persist. Extreme weather causes disruptions in the production of raw materials and food, as well as affecting transport and logistics. Ultimately, it may continue to affect inflation.

The energy transition

Economies are switching to fossil-free energy. The expansion of renewable energy is in full swing. At the same time, investments in the traditional energy mix are declining sharply. There are many indications that, during a period when we are transitioning and expanding renewable energy, we are likely to see higher and more volatile energy prices.

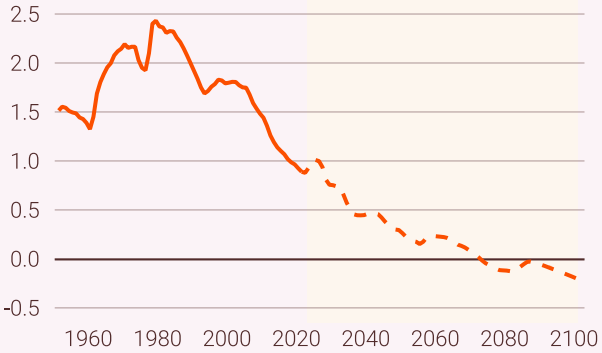
All of these factors are likely to affect the development of inflation to a greater extent in the future and lead to higher volatility, with sudden supply shocks possibly occurring more often. Another way to describe this is that the supply curve of goods and services risks becoming more inelastic.

However, there are also factors that could counteract and limit inflation risks. Technological development is progressing, with rapid automation of production and increased use of artificial intelligence, etc., which will dampen inflation. World trade and, thus, global competition will remain strong, and economic policy can also be adapted. Through economic policy that makes supply as flexible as possible and increases productivity, e.g., in the labour market, upside risks can be mitigated.

How inflation and interest rates will ultimately be affected by these changes is difficult to predict, but several factors suggest that the period of long-term steady and modest inflation, together with extremely low and stable interest rates, is behind us. This will place increased demands on central banks, and monetary policy is likely to vary more than what has become customary. The last few years have provided a renaissance for inflation- and interest-rate analysis, and there are reasons to believe that this trend will continue into the coming years.

Global working-age population growth

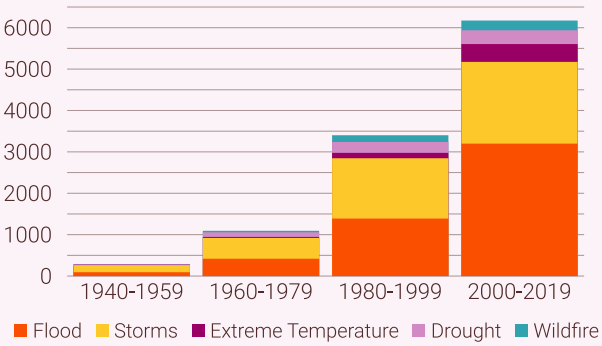
% y/y, 15-64 years, incl. UN projections



Sources: Swedbank Research & Macrobond

Extreme weather events globally

Number



Sources: Swedbank Research & Macrobond

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Baltics – under the weather

Despite better-than-expected developments in the energy markets and euro area economy, a recession in the Baltics still remains likely. GDP has been shrinking in Latvia and Estonia since the middle of 2022 and probably also contracted in Lithuania at the end of last year. Inflation is retreating rapidly, but the damage has been done – an average price jump of one-fifth last year has eroded purchasing power and will dampen domestic demand this year. Weaker global demand and, possibly, lower cost competitiveness are likely to take the wind out of the export sails.

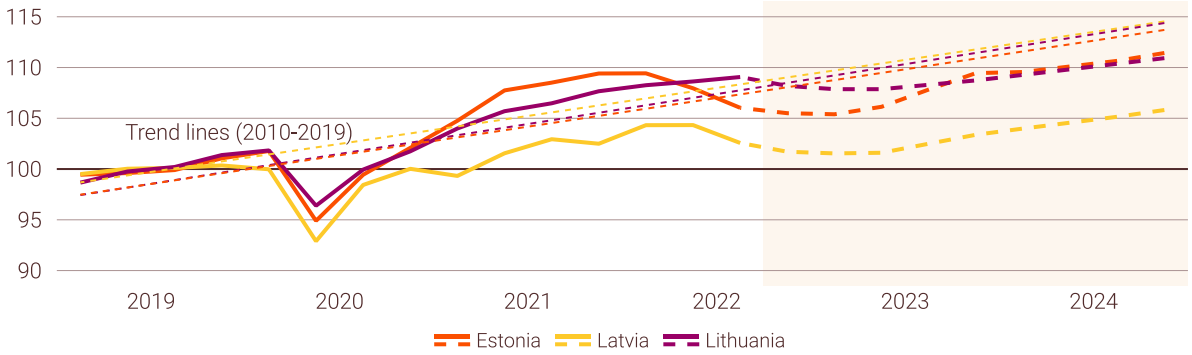
With the outbreak of war in Ukraine, we turned more pessimistic about the prospects of the Baltic economies; yet, they have proven largely resilient to the shocks from the East. Some sectors were hurt more than others, but to a large extent new suppliers were quickly found, and exports were diverted into other markets. Exports continued growing throughout most of last year, and household consumption eased only slightly in the second half of 2022. Yet, this does not mean that we are out of the woods – domestic demand weakness is likely to linger throughout this year, while exports are likely to stagnate or shrink this year before recovering in 2024. Higher interest rates and weaker household confidence have already negatively affected the housing market. In Estonia and Lithuania, the number of transactions has already fallen to pre-pandemic levels, and housing affordability has fallen to the lowest level in a decade. Although housing prices have been relatively stable, the downward pressure is likely to persist throughout this year.

GDP is likely to shrink somewhat or remain unchanged this year, before recovering in 2024

All in all, GDP is likely to shrink somewhat or remain unchanged this year, but a larger fallout remains unlikely – private sector financial leverage is low, there are no large structural imbalances, and countercyclical fiscal policy cushions external shocks. We expect GDP to decline below the long-term trend this year and start recovering by 2-3% in 2024. Admittedly, it is not clear to what extent the rapid increase in wages and energy costs has

Gross domestic product

Index (2019=100), sa, constant prices



Sources: Swedbank Research & Macrobond

dented exporters' competitiveness – this was not a problem during recent years, but weakening global demand may expose structural weaknesses. Businesses' own assessment of their competitiveness, especially outside the EU, has declined recently.

The Baltic countries were among the first to quickly cut all energy ties with Russia and find new natural gas, electricity, and oil suppliers. Yet this rapid transformation came with strings attached – inflation increased to levels not seen in a quarter of a century, the highest in the EU. It related not only to energy prices, as the increase quickly escalated into higher prices for most manufactured goods and services. The relatively high dependence on imports of other goods and commodities from Russia meant that securing alternative suppliers quickly also led to price jumps for those imports. Finally, strong domestic demand also contributed to the quick and full transfer of increases in input costs to final consumers.

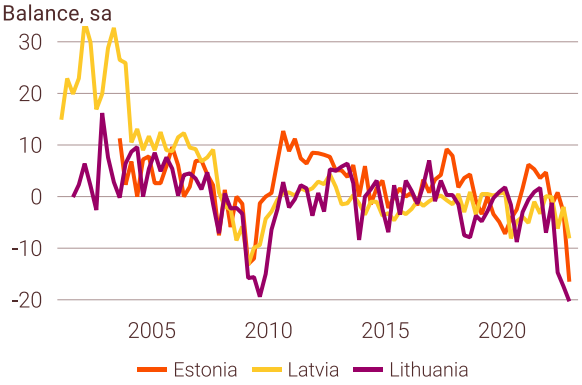
Inflation peaked in the autumn and is expected to decline to low single digits by the end of 2023

Yet, as the external price pressures and demand are ebbing, so is inflation in the Baltic countries. Inflation peaked in the autumn of last year and is expected to be on a sharp downward trend this year. We forecast that annual inflation will decline to low single digits by the end of 2023 and remain subdued throughout the forecasting horizon. Admittedly, wages are continuing to increase rapidly, not least because of the hikes in minimum wages, and may still push prices of many services upwards. However, sticky inflation is becoming less likely – the eroded purchasing power and weak domestic demand are likely to put a lid on price increases this year. We would not be surprised if prices of some goods even decline somewhat this year.

In addition, a more negative economic shock is likely to be avoided thanks to the countercyclical fiscal policy – which, although quite divergent across the Baltic countries, helped cushion the negative effects of the energy crisis. Investments in many sectors are likely to be subdued this year, but public investments in infrastructure and private investment in energy production and efficiency are likely to continue growing.

Competitive position outside EU

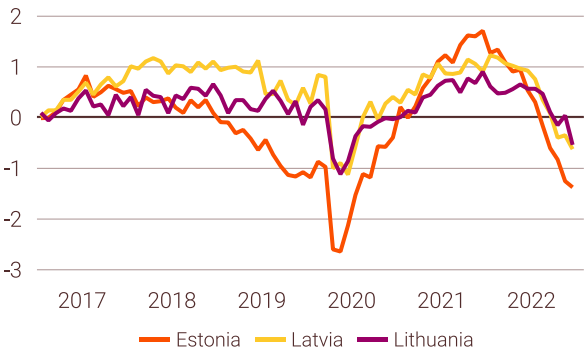
Balance, sa



Sources: Swedbank Research & Macrobond

Export orders in manufacturing

0 = long term average (since 2000)



Sources: Swedbank Research & Macrobond

Estonia – already in recession

The Estonian economy contracted in 2022, and this year we expect stagnation. Inflation is slowing, and unemployment will pick up slightly, while nominal wage growth will remain robust. In 2024, the economy will show moderate growth, and inflation will drop to more normal levels.

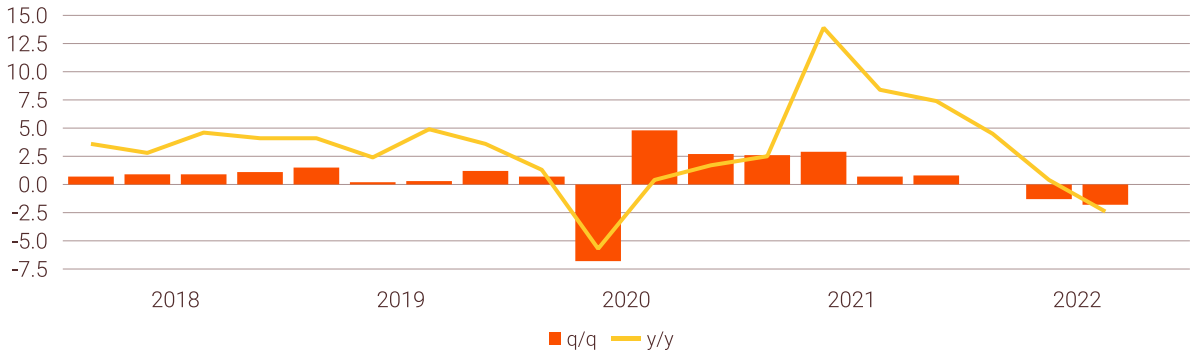
The impact of the coronavirus crisis on the Estonian economy was relatively mild, and the recovery was robust. However, the growth momentum reversed abruptly last year. We estimate that GDP contracted by 0.4% in 2022. Excluding the worst period of the corona shock in 2020, economic sentiment has dropped to a level last seen in the third quarter of 2009. The value added by roughly half of the economic activities declined in the first three quarters of 2022, and agriculture made, by far, the largest negative contribution. It is difficult to understand why an activity whose share in GDP has shrunk to close to zero makes up most of the decline of the total economy. We expect that both the value added by agriculture and GDP will be reviewed and updated.

Growth momentum reversed abruptly last year

The Estonian economy has declined since the third quarter of last year in an annual comparison; we project that the contraction will continue in the first half of 2023 as foreign and domestic demand weaken. Private consumption and exports of goods and services will stagnate this year. The strong growth momentum and contribution from the economic activities that have recovered from the corona crisis – especially accommodation and food services, arts and entertainment, administrative services, and transportation – will gradually fade. However, we expect that the opportunities for economic growth will improve in the second half of the year, and that annual GDP in 2023 will remain at the previous year's level, in real terms. Slowing inflation will result in a recovering purchasing power, while the expected improvement of foreign demand will favour local enterprises that participate in the export-sector value chain. Although we expect that Ukrainian refugees will contribute less to the Estonian economy than local residents, their large number will add to the creation of value added and to final consumption.

Estonian economy is in recession

y/y %, q/q % (swda), real



Sources: Swedbank Research & Macrobond

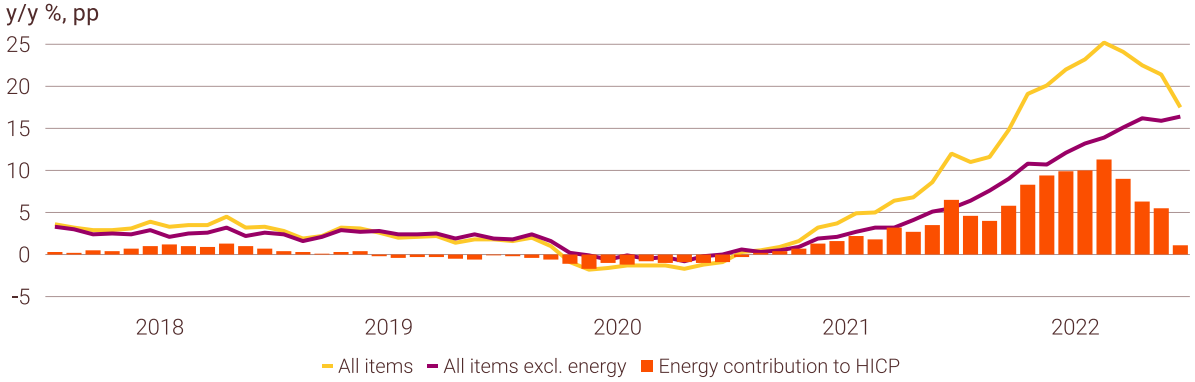
Weaker economic activity, falling household purchasing power, rising unemployment, and larger financing costs are reducing demand for various goods and services and helping ease price pressures. Consumers' inflation expectations have already moved downwards in recent months. The high base effect from 2022 will also help to bring down annual inflation figures. Price growth peaked already in August, primarily due to a decline in energy prices. However, inflation has become more broad-based, as the share of energy in total price growth has decreased. We expect consumer price inflation will slow gradually from close to 20% in 2022 to below 10% in 2023; it will decline to single-digit figures in the second half of this year. We project that inflation will drop to more normal levels, below 3%, only in 2024.

Inflation will decline to single-digit figures in the second half of this year

The slowdown in economic activity has affected the labour market only a little so far. The unemployment rate is still quite modest, if we exclude the Ukrainian refugees; employment is strong, and wage growth rapid. However, we expect that the demand for labour will decline in the coming quarters, as the downturn in the economy continues. The number of vacancies has already decreased. The unemployment rate will pick up, but will remain moderate, as we do not expect a deep or protracted economic recession. The layoffs are mainly expected in the manufacturing sector. The increase in unemployment should alleviate labour shortages somewhat. However, wage growth is expected to remain rapid, due to the shortage of skilled workers, higher minimum wages, wage increases in the public sector, and strong wage pressure from workers facing a large drop in their living standards. Although the economy will stagnate this year in real terms, it will expand rather robustly in nominal terms, which will enable the private and public sectors to increase wages.

Estonia will have general elections this March. The new government will take over the deficit budget, while spending will continue to exceed revenues this year. Although government debt remains well below the Maastricht requirements, it will increase. The tax burden is expected to increase a little, and plans to reshape tax policy, currently only in the discussion stage for some political parties, can be put on the table.

Decline in energy price growth slows inflation



Sources: Swedbank Research & Macrobond

Latvia – in a shallow contraction

The economy started 2023 in a recession, with weakening household consumption and exports. The first half of the year will remain downbeat, followed by a gradual recovery. Retreating inflation and the end of the expensive heating season should help improve private consumption. The export outlook will also start to recover as external demand picks up later in the year, but there are concerns about competitiveness.

Latvia's economy likely entered a mild recession at the end of 2022. Real GDP started to contract in the third quarter on a broad-based weakness in the producing sectors. The surprising rebound of manufacturing in November seems to have been a blip. The previously upbeat export expectations have sharply reversed on faltering external demand, and the October-November data point towards a significant slowdown in exports. Services sectors have held up better, still somewhat propped up by the release of pent-up demand. Household consumption even recorded a quarterly increase in the third quarter. It proved more resilient than expected and likely gave in only when the heating-season utility bills arrived. Households seem to have adjusted their services consumption down. We have revised our GDP growth forecast for 2022 down to 1.6% on the back of a larger-than-expected decline in the third quarter. We expect to see two more quarters with a contraction in GDP, followed by a gradual recovery in the second half of 2023. The economy will contract by 0.9% in 2023 and the ensuing, albeit unimpressive, rebound in demand will help boost growth to 2.6% in 2024.

Headline annual inflation has retreated only slightly from its September peak of 22.2%, and it ran at a still-high 20.8% in December. Weaker energy price growth and the provision of fiscal support helped to avoid a further increase in inflation. Core inflation continued to edge up and reached a new record of 10.6% in December. It is driven by second-round effects of earlier energy price increases and rising labour costs. A more favourable commodity price outlook and weaker demand should help bring goods inflation down further. On the contrary, services inflation will be stickier amid rapid labour cost growth. Inflation will likely average 9% in 2023, but end-of-year inflation will decline to around 2-3%. Inflation may be lower if the second-round effects subside faster than expected. It could also reach a higher level than our forecast if labour market resilience leads to larger-than-expected wage pressures or if the global commodity price rally – not least in energy commodities – resumes, led by Chinese demand.

End-of-year inflation will decline to around

2-3%

Entrenched labour shortages and the brevity of the recession should spare the labour market from damaging swings. The unemployment rate will likely increase by only about half a percentage point in the first half of the year and will start to come down again thereafter. Wage growth will remain rapid, supported by pay increases in the public sector and minimum wage hikes of 24% and 13% in 2023 and 2024. Over the past year, about 16% of workers received a minimum wage or less.

Nevertheless, the main drag on growth in 2023 will come from private consumption, which will contract by about 1%. Average real wages dropped by 9% in 2022 and purchasing power will continue to deteriorate throughout the first half of this year. The pent-up demand that boosted household spending last year is petering out, and the arrival of December utility bills proved to be a major shock for many. Higher interest rates will limit the consumption of durable goods and weigh on the housing market. On a positive note, the share of households with mortgages was only 14% in 2021 - one of the smallest shares in the EU. Government support to cushion the extreme price rise, social benefits, higher pensions, and the reduced savings rate will continue to limit the blow to consumption. Moreover, the inflow of Ukrainian refugees has helped to alleviate demographic problems, at least temporarily, adding to demand. Last year, Latvia's population increased for the first time since the country regained independence. Consumption will start to show signs of healing over the summer, as purchasing power crawls up and households get a respite from the winter-season utility bills.

Consumption will start to show signs of healing over the summer.

Housing market activity seems to have declined in the fourth quarter, and average apartment prices are flattening out. We expect some short-lived price correction of about 5% in 2023, led by the less-energy-efficient buildings on the secondary market. Following the 2008-2009 crisis, the uptick in housing market activity and housing prices has been more moderate than in the other Baltic states. Hence, price correction should also be smaller. Business investments will remain cautious, except for energy-related projects. Investment activity, mostly led by the public sector, will pick up in the second half of the year if we finally see the long-awaited acceleration in EU funds inflow.

External demand is expected to stall, as many trade-partner economies have entered a shallow recession over the winter. The meagre recovery in the euro area later in the year should support a slight rebound in exports and manufacturing. A proxy for external demand suggests growth close to 2% in 2024, which will create new export opportunities. Whether this will result in larger export volumes will depend largely on the resilience of Latvia's international competitiveness. This is currently heavily challenged because Latvia's labour costs and energy prices are growing more rapidly than that of many trade competitors. China's reopening may improve the export outlook if it pushes up demand for goods and global trade.

Export volumes will depend largely on the resilience of Latvia's international competitiveness.

Lithuania – more resilient so far, but not immune

Lithuania has been more resilient than the other two Baltic countries – we estimate that, despite the plethora of challenges, GDP grew by 2.4% in 2022. Although some of the biggest challenges seem to be behind us, the loss of purchasing power, higher interest rates, and weakness in export markets will dent economic activity this year. The good news is that price pressures are ebbing rapidly, and annual inflation is likely to drop to close to 2% by the end of this year.

Last year, net migration reached a record-high 72,000, or 3.3% of the labour force. Most immigrants came from Ukraine, but net migration of Lithuanians was positive for the third year in a row as well. This helped to fill job vacancies, which were at a record-high level at the start of last year. Unsurprisingly then, employment increased by more than 5%, and the number of employed persons hit the highest level in 15 years. Although real wages shrank by 6% last year, real household consumption increased by 1.3%, thanks to these positive demographic tailwinds and the booming labour market.

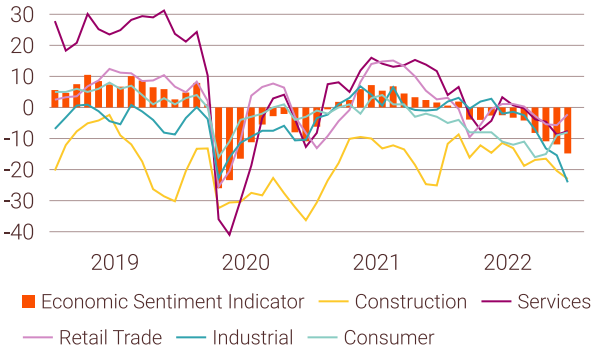
Employment increased by more than 5% in 2022

Average annual inflation reached 19.6% last year, but price growth ebbed during the autumn. In January, regulated prices of natural gas, heating, and electricity went up, which will temporarily push inflation somewhat higher; however, most other inflationary pressures are retreating rapidly. We forecast that average wage growth will ease to 9.5% this year, and increasing labour costs are likely to continue pushing prices of most services upwards. On the other hand, cheaper energy, commodities, and transportation costs are likely to cause prices of at least some goods to fall. Household consumption is likely to stay flat this year, and the lacklustre demand is also likely to put a lid on price increases.

The year 2023, however, is shaping up to be less rosy and upbeat. Although inflation is on a clear downward path, the damage has been done – household purchasing power has been eroded and will not recover this year. On top of this, we forecast that employment may shrink by more than

Ebbing confidence

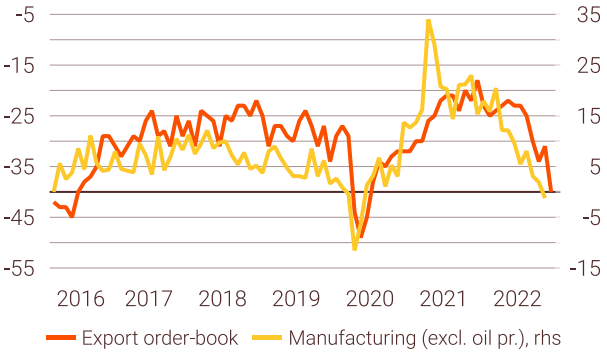
Balance, %



Sources: Swedbank Research & Macrobond

Manufacturing and export orders

Balance, y/y % (rhs)



Sources: Swedbank Research & Macrobond

2% this year. An emerging labour-market weakness is visible in the job vacancy figures, which fell to their lowest level in a decade (bar the brief blip in the early pandemic). An increasingly large share of businesses are saying that insufficient demand, not the labour shortage, is the main obstacle to expansion. Export orders have been declining sharply during the past few months, reflecting weakness in the Nordic countries and euro area. Although China's reopening may lift demand for capital goods produced in Europe, Lithuania barely trades with China, and no indirect positive effects are expected, at least until the second half of this year.

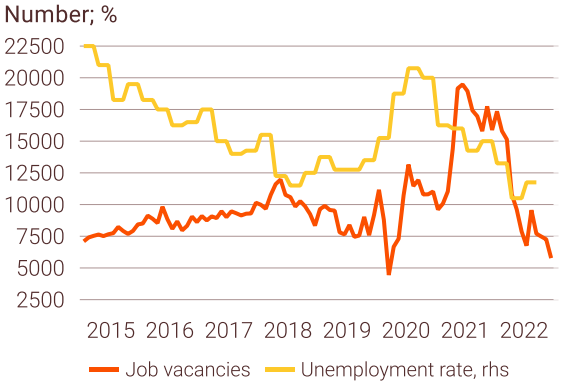
Household consumption is expected to stay flat, while exports may shrink somewhat

Investments are still likely to grow in 2023, thanks to public infrastructure development and the continued boom in private sector investments in renewable energy. The government has confirmed an expansionary budget, with a deficit of 5% of GDP, but the shortfall is unlikely to be as large, mainly due to moderation in energy prices (less funds needed to compensate households and businesses for energy costs).

High interest rates will continue to dampen residential real estate market activity, which we do not expect to recover before 2024. Downward price pressures will persist throughout this year, but sharper real estate price drops remain unlikely, given the relatively small unsold housing inventories and increasing number of inhabitants (in the biggest cities). Higher interest rates will dent some households' purchasing power, but the effect is likely to be mild – the ratio of household debt to income remains among the lowest in the EU, while less than one-fifth of households have a mortgage.

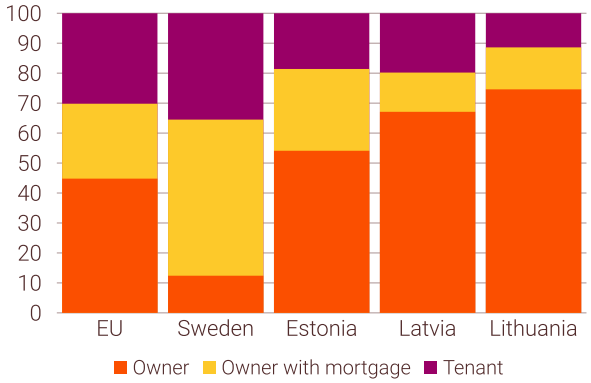
Household debt-to-income ratio is among the lowest in the EU

Job vacancies and unemployment



Sources: Swedbank Research & Macrobond

Distribution of population by tenure status



Sources: Swedbank Research & Macrobond

Appendix

Interest and exchange rate forecasts

	Outcome 2023 20 Jan	Forecast 2023 30 Jun	2023 31 Dec	2024 30 Jun	2024 31 Dec
Policy rates (%)					
Federal Reserve, USA (upper bound)	4.50	5.25	5.25	4.25	3.25
European Central Bank (refi rate)	2.50	3.75	3.75	2.75	2.25
European Central Bank (deposit rate)	2.00	3.25	3.25	2.25	1.75
Bank of England	3.50	4.50	4.50	3.75	2.75
Riksbank	2.50	3.50	3.50	2.75	2.50
Norges Bank	2.75	3.00	3.00	2.50	2.00
Government bond rates (%)					
US 2y	4.14	4.00	3.50	3.20	3.00
US 5y	3.56	3.40	3.20	3.10	3.00
US 10y	3.48	3.30	3.20	3.20	3.20
Germany 2y	2.56	2.70	2.50	2.10	1.90
Germany 5y	2.20	2.20	2.00	2.00	1.90
Germany 10y	2.13	2.20	2.10	2.10	2.10
Exchange rates					
EUR/USD	1.08	1.12	1.10	1.10	1.12
EUR/GBP	0.87	0.88	0.86	0.85	0.85
EUR/SEK	11.17	11.00	10.50	10.30	10.30
EUR/NOK	10.71	10.40	9.90	9.80	9.80
USD/SEK	10.30	9.82	9.55	9.36	9.20
USD/CNY	6.78	6.70	6.50	6.50	6.50
USD/JPY	129.9	120.0	115.0	115.0	115.0
NOK/SEK	1.04	1.06	1.06	1.05	1.05
KIX (Trade-weighted SEK)	125.4	122.9	118.7	116.6	116.2

Sources: Swedbank Research & Macrobond

Swedish interest rate forecasts (%)

	Outcome 2023 20 Jan	Forecast 2023 30 Jun	2023 31 Dec	2024 30 Jun	2024 31 Dec
STIBOR 3m	2.86	3.60	3.50	2.75	2.50
Government bond yields					
2y	2.53	2.50	2.30	2.20	2.10
5y	2.09	2.30	2.20	2.15	2.10
10y	1.85	2.15	2.15	2.15	2.10
Swap rates					
2y	3.15	3.10	2.80	2.55	2.50
5y	2.71	2.75	2.60	2.55	2.50
10y	2.59	2.55	2.55	2.50	2.50
Mortgage lending rates*					
3m	3.36	4.25	4.20	3.80	3.50
3y	4.05	4.20	3.90	3.70	3.50
5y	3.96	4.10	3.90	3.70	3.50

* Outcomes refer to December 2022
Sources: Swedbank Research & Macrobond

SWEDEN: Key economic indicators, 2021-2024

Annual % change unless stated otherwise	2021	2022F		2023F		2024F	
Real GDP (calendar-adjusted)	4.9	2.9	(2.7)	-1.1	(-0.9)	0.9	(1.0)
Real GDP	5.1	2.9	(2.7)	-1.3	(-1.1)	0.9	(1.0)
Household consumption	6.0	2.9	(3.7)	-1.5	(-1.3)	1.0	(1.1)
Government consumption	2.8	-0.2	(0.2)	1.1	(2.0)	1.8	(2.2)
Gross fixed capital formation	6.4	5.8	(4.9)	-3.2	(-3.6)	-0.9	(-0.8)
Change in inventories, contr. to GDP growth	0.3	1.3	(1.1)	-0.7	(-0.5)	-0.1	(0.0)
Exports of goods and services	7.9	4.4	(3.8)	1.0	(0.0)	2.7	(3.2)
Imports of goods and services	9.6	7.6	(7.5)	-0.4	(-1.0)	2.2	(3.1)
CPI (average)	2.2	8.3	(8.4)	8.7	(7.4)	3.2	(1.5)
CPI (Dec.-Dec.)	3.9	12.3	(12.1)	4.5	(2.3)	2.2	(1.5)
CPIF (CPI with fixed mortgage rate, average)	2.4	7.7	(7.8)	5.7	(5.1)	1.6	(1.2)
CPIF (CPI with fixed mortgage rate, Dec.-Dec.)	4.1	10.2	(9.9)	1.6	(1.2)	1.6	(1.4)
CPIF ex. energy (average)	1.4	5.9	(5.8)	5.5	(4.5)	2.3	(2.2)
CPIF ex. energy (Dec.-Dec.)	1.7	8.4	(7.5)	2.9	(2.6)	2.3	(2.3)
Riksbank policy rate (Dec.)	0.00	2.50	(2.50)	3.50	(2.75)	2.50	(2.25)
Unemployment (% of labour force, 15-74)	8.8	7.4	(7.3)	7.9	(7.6)	8.0	(8.2)
Labour force (15-74)	1.2	1.2	(1.1)	0.4	(0.1)	0.4	(0.1)
Employment (15-74)	1.0	2.8	(2.8)	0.0	(-0.2)	0.2	(-0.6)
Number of hours worked (calendar-adjusted)	2.3	2.3	(2.0)	-0.2	(-0.3)	0.3	(0.1)
Nominal hourly wage (NMO), whole economy	2.6	2.7	(2.8)	3.7	(3.7)	3.7	(3.7)
Household real disposable income	3.1	-0.5	(-0.8)	-2.9	(-1.8)	1.2	(1.6)
Household nominal disposable income	5.0	6.7	(6.3)	4.0	(4.0)	3.6	(2.8)
Household savings ratio, % of disposable income	15.5	11.8	(10.6)	11.4	(11.0)	11.6	(11.5)
General government budget balance (% of GDP)	-0.1	0.8	(0.8)	-0.3	(-0.1)	-0.7	(-0.5)
General government debt (Maastricht), % of GDP	36.3	31.9	(30.6)	30.7	(29.6)	31.9	(30.5)

Previous forecast in parentheses
Source: Statistics Sweden & Swedbank Research

ESTONIA: Key economic indicators, 2021-2024

Annual % change unless stated otherwise	2021	2022F		2023F		2024F	
Real GDP	8.0	-0.4	(0.5)	0.0	(0.0)	3.0	(2.5)
Household consumption	6.4	2.8	(3.5)	0.0	(0.0)	3.0	(3.0)
Government consumption	4.0	0.5	(1.0)	2.0	(2.0)	2.0	(2.0)
Gross fixed capital formation	2.8	-15.0	(-15.0)	4.0	(5.0)	7.0	(7.0)
Exports of goods and services	19.9	4.0	(3.5)	0.0	(0.5)	3.0	(3.0)
Imports of goods and services	21.0	4.5	(2.0)	-2.5	(-0.5)	3.5	(4.0)
CPI (average)	4.6	19.4	(18.8)	9.2	(8.9)	2.5	(2.0)
Unemployment (% of labour force)	6.2	5.8	(6.1)	7.3	(7.3)	5.9	(6.0)
Employment	-0.5	4.0	(3.2)	-1.1	(-1.0)	0.6	(0.5)
Gross monthly wage	6.9	8.7	(9.5)	8.5	(8.5)	7.0	(6.7)
Nominal GDP, billion euro	31.4	36.2	(36.6)	38.6	(39.0)	40.7	(40.9)
Exports of goods and services (nominal)	29.4	24.8	(22.7)	7.0	(6.5)	6.1	(6.1)
Imports of goods and services (nominal)	30.2	24.9	(21.9)	5.3	(6.4)	6.6	(7.1)
Balance of goods and services, % of GDP	0.2	-0.4	(0.2)	1.0	(0.2)	0.6	(-0.5)
Current account balance, % of GDP	-1.6	-0.4	(-0.2)	0.0	(-0.3)	-0.6	(-1.3)
General government budget balance, % of GDP	-2.3	-0.9	(-2.5)	-3.1	(-3.3)	-2.7	(-3.0)
General government debt (Maastricht), % of GDP	17.6	18.2	(18.6)	19.2	(19.4)	21.9	(21.9)

Previous forecast in parentheses
Sources: Statistics Estonia & Swedbank Research

LATVIA: Key economic indicators, 2021-2024

Annual % change unless stated otherwise	2021	2022F		2023F		2024F	
Real GDP	4.1	1.6	(2.8)	-0.9	(0.0)	2.6	(2.9)
Household consumption	8.2	7.3	(5.0)	-1.0	(-3.8)	3.4	(4.6)
Government consumption	4.4	2.2	(2.7)	-0.5	(1.7)	1.0	(2.0)
Gross fixed capital formation	2.9	0.7	(1.5)	1.2	(4.0)	5.8	(8.0)
Exports of goods and services	5.9	9.9	(6.0)	-0.3	(0.0)	2.9	(3.8)
Imports of goods and services	15.3	10.7	(8.2)	-1.2	(-0.5)	3.9	(5.8)
CPI (average)	3.3	17.3	(17.3)	9.0	(9.0)	2.5	(2.5)
Unemployment (% of labour force)	7.6	6.9	(6.8)	7.2	(7.0)	6.5	(6.3)
Employment	-3.2	2.6	(1.7)	0.0	(0.2)	0.8	(0.9)
Gross monthly wage	11.7	7.5	(8.2)	8.5	(8.5)	8.0	(8.0)
Nominal GDP, billion euro	33.7	39.9	(40.0)	43.1	(42.9)	45.5	(45.8)
Exports of goods and services (nominal)	17.9	29.2	(24.3)	-0.8	(3.0)	3.9	(3.3)
Imports of goods and services (nominal)	26.3	31.0	(28.3)	-3.7	(1.0)	3.9	(3.7)
Balance of goods and services, % of GDP	-3.4	-4.7	(-5.8)	-2.4	(-4.2)	-2.3	(-4.4)
Current account balance, % of GDP	-4.2	-4.9	(-5.9)	-1.9	(-3.9)	-1.6	(-3.7)
General government budget balance, % of GDP	-7.0	-4.7	(-7.2)	-3.0	(-3.8)	-0.8	(-0.8)
General government debt (Maastricht), % of GDP	43.6	41.4	(41.9)	41.0	(42.8)	40.1	(42.3)

Previous forecast in parentheses
Sources: Statistics Latvia & Swedbank Research

LITHUANIA: Key economic indicators, 2021-2024

Annual % change unless stated otherwise	2021	2022F		2023F		2024F	
Real GDP	6.0	2.4	(2.0)	-0.3	(0.0)	1.8	(2.1)
Household consumption	8.0	1.3	(1.8)	0.0	(1.2)	3.0	(2.5)
Government consumption	0.9	1.0	(1.5)	1.0	(1.8)	1.0	(1.0)
Gross fixed capital formation	7.8	2.0	(3.5)	2.5	(4.5)	5.5	(6.0)
Exports of goods and services	17.0	11.2	(8.5)	-0.5	(0.0)	3.5	(3.5)
Imports of goods and services	19.9	10.5	(11.5)	-2.0	(-1.0)	4.5	(4.0)
CPI (average)	4.6	19.6	(19.2)	9.2	(8.7)	2.0	(2.3)
Unemployment (% of labour force)	7.1	5.7	(5.6)	6.5	(6.6)	6.0	(6.0)
Employment	0.8	5.2	(1.1)	-2.4	(0.0)	-0.1	(0.6)
Gross monthly wage	10.5	12.8	(12.6)	9.5	(8.5)	7.0	(6.6)
Nominal GDP, billion euro	56.2	68.3	(68.2)	74.1	(73.6)	77.0	(76.7)
Exports of goods and services (nominal)	24.0	30.5	(27.0)	-2.0	(1.5)	4.0	(4.5)
Imports of goods and services (nominal)	34.1	41.0	(39.0)	-5.0	(2.0)	4.0	(2.5)
Balance of goods and services, % of GDP	4.5	-1.7	(-2.8)	0.9	(-3.0)	0.9	(-1.5)
Current account balance, % of GDP	1.1	-4.9	(-6.0)	-0.7	(-4.6)	-0.4	(-2.8)
General government budget balance, % of GDP	-1.0	-0.8	(-1.5)	-3.5	(-4.5)	-1.9	(-1.7)
General government debt (Maastricht), % of GDP	43.7	36.5	(37.4)	38.8	(39.1)	39.3	(39.2)

Previous forecast in parentheses
Sources: Statistics Lithuania & Swedbank Research

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