# Baltic economic instability threatens to spread to Sweden

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Deepening economic problems in Latvia are threatening to spread throughout the region. The Baltic state, which received an IMF bailout worth approximately €7.5 billion at the start of the year, has revised its economic figures for 2009 downwards, forecasting an 18 percent contraction this year. On June 3, the government failed in its bid to sell state debt, raising concerns in financial circles that Riga may be forced to devalue its currency, the lat.

Latvia's central bank has been compelled to spend more than €200 million since the start of June in order to defend its sliding currency. Since the beginning of 2009, around €850 million have been expended to ensure the maintenance of its trading band with the euro. The lat is in a fixed exchange rate with the euro in line with Latvia's plans to adopt the European currency in the coming years. But without additional support from the IMF, devaluation seems inevitable. Torbjörn Becker of the Stockholm School of Economics stated, "They've invested a lot of political capital to maintain their fixed exchange rate, but in the long term it's unsustainable."

Devaluation would have a catastrophic effect on the Latvian population, faced with sharp price rises in the midst of a deep recession. Latvia's economy is set to suffer the worst decline of all 27 EU member states. Unemployment rose to 17 percent in April, with Standard & Poors projecting a jobless rate of more than 20 percent by the end of the year. The credit rating firm has threatened to downgrade Latvia's debt rating in the coming months.

To avoid devaluing its currency, the government, which came to power in the aftermath of mass protests earlier this year, is implementing budget cuts agreed on with the IMF including wage freezes and cuts to public services. The latest package, scheduled for passage on June 17, will be worth more than €500 million.

The IMF refused to grant Latvia the second instalment of its loan deal in March, since parliamentarians had stalled on proposed budget cuts in the lead up to recent local and European elections. With the elections over, the government is likely to press ahead.

Even with the implementation of deep cuts, it remains unclear whether the IMF will grant the next instalment of Latvia's loan. The current spending cuts will only bring down the budget deficit for 2009 to 9.2 percent of GDP, but the IMF has targeted a level of 5 percent as one of its conditions for providing support to Riga. Aidan Manktelow of the Economist Intelligence Unit pointed out, "There will still be an awfully long way to go to stabilise the economy. A further round of budget cuts is likely to be needed later in 2009, not to mention 2010."

The uncertainty over Latvia's economic future has provoked concerns in ruling circles throughout Europe. Joaquin Almunia, the EU commissioner for Economics and Monetary Affairs stated, "The end of the lat [currency peg] would create...very serious difficulty."

Any devaluation of Latvia's currency would likely trigger similar moves in neighbouring Estonia and Lithuania, as well as placing further pressure on the neighbouring Scandinavian economies.

Concerns are particularly acute in Sweden. Estimates suggest that Swedish-based banks have outstanding credits totalling 500 billion kronor (nearly €50 billion) to the Baltic countries. Particularly affected will be SEB and Swedbank, which between them have loaned nearly 400 billion kronor. Swedbank, SEB and Nordea together account for half of all banking business in Latvia. The danger for these banks is compounded further by the fact that many of the outstanding loans were made to Latvian customers in euros. In the event that Latvia is forced to devalue the lat, repayments for such loans will rise sharply, increasing the likelihood of defaults.

Swedish banks therefore reacted with relief to the proposed budget cuts, with shares in Swedbank, SEB, Handelsbanken and Nordea all rising. This followed on from heavy losses, with Swedbank shares having fallen by 15 percent and SEB stocks by 11 percent during trading on June 3. On June 8 the krona fell to one of its worst-ever exchange rates against the euro, with €1 worth 10.98 kronor. In the past two weeks, the currency has fallen by 2.5 percent and

1.7 percent respectively.

Already in the first quarter of the year, SEB suffered losses of 2.4 billion kronor while Swedbank lost more than 6 billion kronor. Nearly three quarters of Swedbank's losses were linked to the Baltic region and a further 1 billion kronor were lost in Ukraine, which also faces economic difficulty.

As early as last August, international financial circles were warning Swedish banks about their involvement in the Baltic area. The IMF stated that economic turmoil there could provoke a "credit crisis" in Sweden, an outcome that is looking ever more likely.

Swedish banks in Latvia are to be subject to police investigation, after reports that "aggressive" methods were used to collect money from borrowers. Latvian Prime Minister Valdis Dombrovskis told TT, "We're investigating certain methods when it comes to freezing companies' accounts and taking over their deposits, quite aggressively I might add."

While Latvia's economy presents the greatest cause for concern at present, neighbours Lithuania and Estonia face a similar recession. Estonia is projected to suffer an economic contraction of 15 percent this year, following first-quarter figures showing GDP down by 15.1 percent. The Tallinn government announced on May 21 a loan deal with Swedbank reportedly worth €50 million designed to stabilise state finances.

In Lithuania, forecasts suggest that credit portfolios at the main banks could shrink by up to 16 percent this year. First-quarter figures had economic output down more than 13 percent, its worst recession since secession from the Soviet Union in the early 1990s.

Ruling circles in Sweden are increasingly worried about the impact of recession on its banking system. At the end of last month, the Riksbank (Sweden's central bank) announced its intention to borrow 100 billion kronor of foreign currency from the Swedish debt office in order to boost its currency reserves. On June 10, the Riksbank announced plans to borrow a further €3 billion from the European Central Bank.

The Riksbank has extended a number of foreign currency loans to the banks since the onset of the economic crisis last September. In addition, it has entered into swap agreements with the central banks of three troubled states, Iceland, Estonia and Latvia. In a press statement announcing its plans for further borrowing, Riksbank governor Stefan Ingves declared, "We still need to be prepared for the eventuality that the financial crisis may be both severe and prolonged. This is why we need to strengthen the foreign currency reserve. This is part of our work to safeguard financial stability."

The Riksbank has also released its projections for the losses Sweden's banks are likely to face in the next period. Although it suggested that €16 billion of losses over the next three years could be handled by the banks, it said that actual losses could amount to much more. Its estimate €16 billion was based on "a number of risk factors" that could turn out to be much worse, which included a further deterioration of economic conditions in the Baltic countries as well as a longer world recession.

Any instability in the banking sector would immediately have an impact on state finances and on the population as a whole. While finance minister Anders Borg declared on June 3 that the banks had to take responsibility for their reckless lending in the Baltic, the reality is different. Sweden's right-wing Alliance government passed a package worth 1.5 trillion kronor to support the banking system last November.

While only Swedbank and SEB have received support thus far, this scheme will place the full burden of any banking crisis onto ordinary people.

State finances in Sweden have already suffered over the past year, with a budget deficit of more than 100 billion kronor forecast for 2009. In the event that the government is compelled to make more funds available to the banks, this will mean deep cuts to public services and social programmes.

The latest figures suggest a jobless rate of 11.3 percent next year, meaning that more than half a million Swedes will find themselves out of work.

Concerned over the potential economic and social consequences, Borg urged the IMF and the "international community" to step in and provide Latvia with sufficient credit to stabilise the situation. Even if such measures are agreed to, there remains the real possibility of Latvia being unable to meet its obligations.