The Baltic Outlook

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Macro Outlook

The Baltic Region

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Abbreviations

CB – central bank
CEE – Central and Eastern Europe
CSBL – Central Statistical Bureau of Latvia
ECB – European Central Bank
EIER – Estonian Institute of Economic Research
EP – Eesti Pank (central bank)
ESO – Estonian Statistical Office
EU – European Union
HBM – Hansabank Markets
LaB – Latvias Banka (central bank)
LDS – Lithuanian Department of Statistics
LiB – Lietuvos Bankas (central bank)
MoF – Ministry of Finance
NFA – net foreign assets
REER – real effective exchange rate

Summary

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Estonia, Latvia and Lithuania will maintain their position as the fastest growing economies in the EU – we expect the Estonian economy to grow 8.1%, that of Latvia 8.8% and that of Lithuania 6.8% this year. Growth will slow down slightly next year, but the growth level will still be extraordinarily high compared with the rest of the EU – we expect the Estonian economy to grow 7.4%, the Latvian by 7.6% and the Lithuanian by 6.5%.

Economic growth in the Baltic countries is mostly based on fast developing exports – growth rates are clearly over 20% p.a. -, which gets support from domestic production, regional integration and transit, and also from the advantages of the EU accession. But strong support to economic growth also comes from domestic demand, especially in Latvia and Lithuania. Unemployment is declining fast in all countries and employment is up, wages are growing rapidly as are state allowances, and household borrowing. –All this adds something to household incomes and supports consumption. However, there are risks related to the very fast decline in unemployment and rapid wage growth – too excessive a growth in salaries might undermine not only the competitiveness of companies but also the whole economy. It is also true that bigger incomes tend to support imports more than domestic production, and add strength to price growth. The ability of companies to cope with the changing labour market is very important for long-term developments – flexibility in changing production, and the readiness to shift from one production structure and technology to another are becoming more and more important as the number of working age population is about to decline in near future. We have discussed this theme in our special theme "Long-term Outlook on Labour Supply in the Baltics".

The other important risk factor, which - differently from labour market – is more like next years risk, is inflation. Although a significant part of price growth is caused by the global growth in energy prices, there are other factors also: some EU accession-related factors can still be seen in inflation figures (mostly in food prices), and demand is pushing prices up. The latter is most strongly represented in Latvia. Our inflation expectations for Estonia and Latvia have increased – we expect price levels to grow by 4.7% and 8.3%, respectively this year and by 4.2% and 6.7% next year. Our expectations are slightly low for Lithuania as – to our surprise - price growth has been relatively modest there and the authorities have (so far) effectively prevented various regulated prices growing. Consequently we expect prices in Lithuania to grow by 2.7% this year and 2.8% next year.

Strong inflation is threatening the euro aspirations of all three countries – the dynamics of Estonian and Latvian inflation indicate that both countries can barely fulfil the Maastricht inflation criteria (Estonia in spring 2006, Latvia in spring 2007) and Lithuania will have serious problems. We have discussed themes related with the Maastricht inflation criteria in our special topic "Concerning Some Aspects of the Maastricht Inflation Criteria". The inflation and other criteria are discussed as in previous *Outlook*s in "The Road to the Adoption of the Euro".

Summary of forcast	**2003**	**2004**	**2005f**	**2006f**
Economic growth				
Estonia	6,7%	7,8%	8,1%	7,4%
Latvia	7,2%	8,3%	8,8%	7,6%
Lithuania	9,7%	6,7%	6,8%	6,5%
Inflation (GDP deflator)				
Estonia	2,1%	3,1%	4,7%	3,9%
Latvia	3,6%	7,2%	8,3%	6,7%
Lithuania	-1,1%	2,8%	6,5%	7,5%
Current account, % of GDP				
Estonia	-12,1%	-12,7%	-10,2%	-8,0%
Latvia	-8,2%	-13,1%	-11,2%	-10,8%
Lithuania	-6,8%	-7,7%	-8,0%	-8,5%

General Assumptions

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World Economy

- Global economic growth is expected to decline this year and next – mostly because of slower economic growth in the USA and China. The slowdown is caused by high oil prices but the growing differences in the global economy are also playing a very important role. Despite the slowdown we can hardly talk about recession – growth will remain above or close to the potential level. Economic growth in China is expected to slow because of smaller investment activity, but growth in the USA will be affected by weaker private consumption. Economic growth in Russia will remain modest – growth in private consumption is not enough to grant higher than 5-5.5% growth in whole economy. Inflation will remain above 10% and processes bearing long-term risks will deepen in the Russian economy.

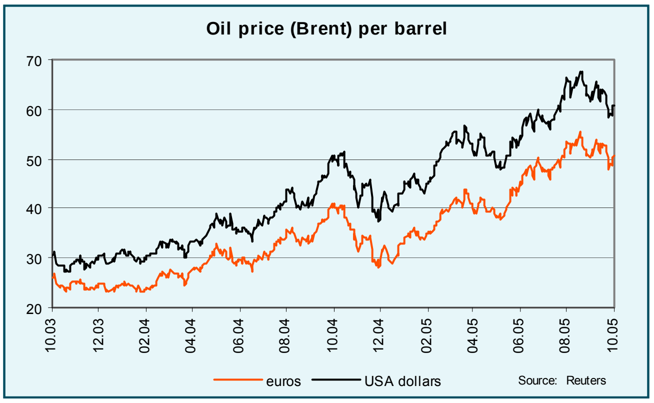
Global forecasts

	GDP				CPI			
	2003	2004	2005f	2006f	2003	2004	2005f	2006f
USA	2.7	4.2	3.5	3.3	2.3	2.7	3.2	2.8
Japan	1.4	2.7	2.2	2.1	-0.2	0.0	-0.1	0.2
Eurozone	0.7	2.0	1.3	1.8	2.1	2.1	2.1	1.9
Russia	7.3	7.1	5.5	5.0	13.7	10.9	12.5	10.8

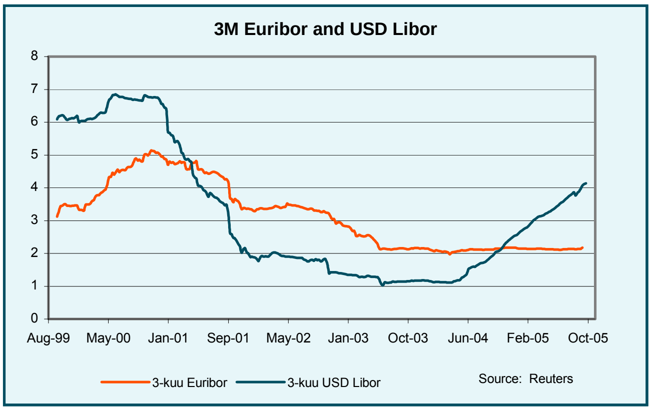
- The euro zone is one of the weakest regions for growth in world, but there are signs that after the setback at the beginning of the year, processes in the 2nd half of 2005 will be better. These hopes are tied to export growth and the strong financial stance of European companies, which should promote investment. However, growing unemployment keeps consumers unhappy and structural reforms are not advancing in euro zone. Growth is also jeopardised by high oil prices and the possible strengthening of the euro.

- Developments in new member-countries are only a bit better – EU accession caused a setback in growth rates in all Central European countries, however for now growth rates have strengthened modestly. The strengthening of national currencies hinders exports. However, domestic consumption has started to grow faster as inflation has remained modest. The Baltic countries are an exception compared to the rest of Europe. In non-EU countries growth is expected to slow because of weaker global growth.

- Markets expect that the Federal Reserve will increase interest rates a little this year and probably at the beginning of next. Interest rates in the euro zone have been stable for a long time and weak economic performance could support expectations of cuts. However, ECB rhetoric has became more hawkish, pointing to a possible increase in rates, as inflation is moving upward. The price of oil is increasingly having a strong effect on inflation and economic growth in the euro zone. However, if the ECB starts with an increase in rates in the 1st half of 2006, it is expected to be rather modest.



- Higher interest rates in the USA and continuous positive news strengthened the dollar last month, although basic factors (current account and fiscal deficits) still support a weaker dollar. We are of the opinion that if there are no important and meaningful changes in the economies of the USA and the euro zone (and we do not see them now), the dollar and euro will remain approximately in current band (i.e. 1.19-1.24).



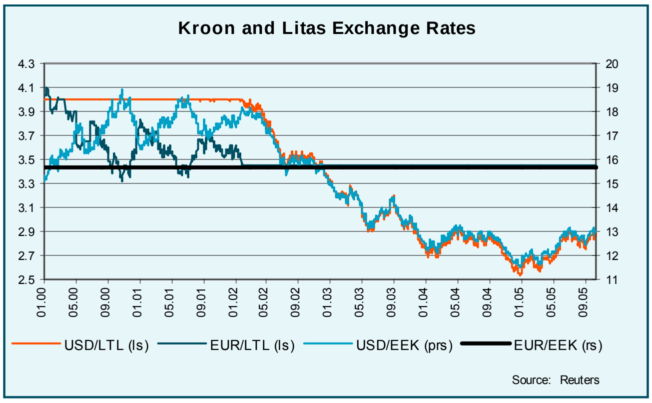
- The barely predictable price of oil has become the biggest risk factor for the global economy. Still the overall upward trend seems to persist. In the short-term (1-2 months), very large fluctuations might occur depending on many one-off factors (e.g. strikes, storms, political issues). In the medium term (up to 3 years) there are less and less optimists forecasting a decline of the price as the factors that are causing high price level – growing demand and shortage of capacities - will remain.

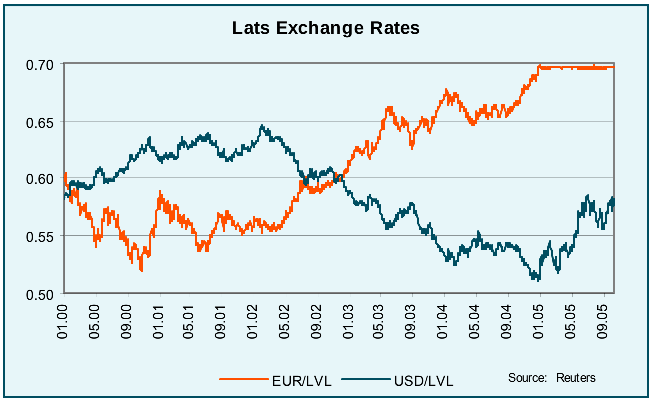
Domestic processes

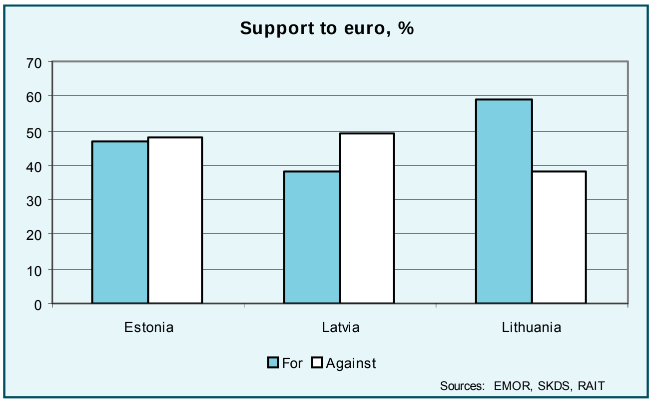
- Different election timetables have caused a somewhat different situation in domestic policy. Estonia has just ended the first phase of the new election cycle, Latvia is about to start preparations for general elections and Lithuania is having a short-term break. So we expect that the Latvian and Lithuanian governments will stay in place – though probably not without some trouble – and government policies will not change. There is a chance that the results of the local elections will not affect the Government in Estonia, but stability is far away.

- High inflation is threatening euro aspirations in all three countries, although Latvia and Estonia are in bigger danger. Governments have little chance to do something, particularly in Estonia and Lithuania, as they are running out of time and there are few ways to affect externally (oil) triggered inflation. We also see that the public is predominantly against the euro in Estonia and Latvia, which makes governments willingness to act more decisively weaker.

- The adoption of the euro will, however, remain the main theme in economic policy, as will inflation, which is now a factor in euro adoption. Although Lithuanian inflation is showing a rising trend there is still the possibility of fulfilling the inflation criteria. Estonian inflation however, has reached a level, which makes it practically impossible to fulfil the current criteria by spring 2006. Latvian inflation, which is mostly triggered by demand, could be influenced by a more strict fiscal and monetary policy, however it is hard to expect Government activity in that respect. Elections are one problem for Estonia and Latvia, which makes it impossible to make unpopular decisions. It is also important to notice that most of the possible policy measures will also end in slower economic growth. We have discussed inflation and euro related themes in our special part.







Elections shedule	
Estonia	
Presidential	September 2006
General	March 2007
Local	October 2009
Latvia	
Presidential	March 2007
General	October 2006
Local	March 2008
Lithuania	
Presidential	June 2009
General	October 2008
Local	February 2007

Estonia

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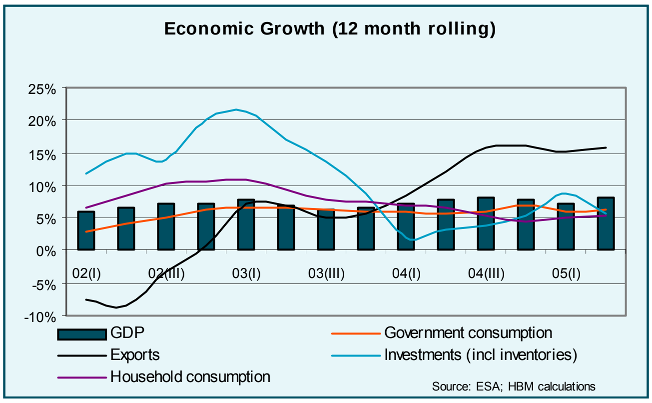
Recent Economic Developments

According to revised statistics, the Estonian economy grew by 7.8% in 2004 (the previous figure was 6.2%). The growth strengthened in 2005 and reached 9.9% p.a. in the 2nd quarter. The revised statistics point to different processes than those the previous figures did, and hence our forecast has changed significantly. The economic growth is driven by exports, while domestic demand has been growing slower than the economy (at ca 5.5% p.a.) for several years already. The strengthening of inflation after EU accession has continued, although now other factors have joined the previous triggers. As a result of this, annual consumer price inflation reached 4.9% in September. The trade and services deficit has declined to 4.2% of GDP as exports are growing fast, while import growth has slowed. However the current account deficit is declining slowly (9.9% of GDP) – the profitability of foreign investments in Estonia is high and that creates significant income outflows (both actual and accounted). Consumer confidence is very strong, as it is supported by strong wage growth, tax cuts, bigger state allowances, and declining unemployment. Business confidence is also strong, although some sectors are benefiting more and others less from the current economic boom.



Assumptions

Our economic forecast takes into account the following processes and developments, which are characteristic of the Estonian environment.

- Instability in domestic policy will remain high, and it is about to increase – after recent local elections, others are on the horizon (presidential in August-September 2006, general elections in March 2007). Therefore the government will shy away from making unpopular decisions and economic policy will remain slightly supportive. However the current stalemate might diminish the number of both populist decisions, which might harm the economy, and also of important and necessary decisions. In short – no big changes are expected in the overall economic environment.
- The adoption of the euro will remain the most important target of economic policy, although rapidly growing inflation has significantly cut the likelihood of that in 2007. However we cannot rule out the possibility of politically motivated decisions in Brussels and Frankfurt, or of a more adequate interpretation of the inflation criteria (see special section). The possible "no" in spring 2006 and delay for one year, should not have any effect on Estonian credit ratings, as Estonia is fulfilling other criteria and high inflation is caused by factors which the Estonian authorities cannot influence.

Summary of the Forecast

We have totally revised our forecast due to new GDP figures and the different processes they reflect. We expect the Estonian economy to grow by 8.1% this year and ca 7.4% next year. Domestic demand is expected to strengthen to 6.8% in 2005, but then the process will slow slightly. Exports will grow by 16% in real terms this year, but here also a slowdown is expected. The balance of trade and services will improve considerably this year, as EU-accession-related distortions will recede. The improvement of the current account balance will be slow, as the high profitability of foreign investments continues to generate large income outflows (both accounted and real). The utilization of EU funds has so far been even weaker than our previous pessimistic forecast, so the effect of those flows on the current account will be minimal.

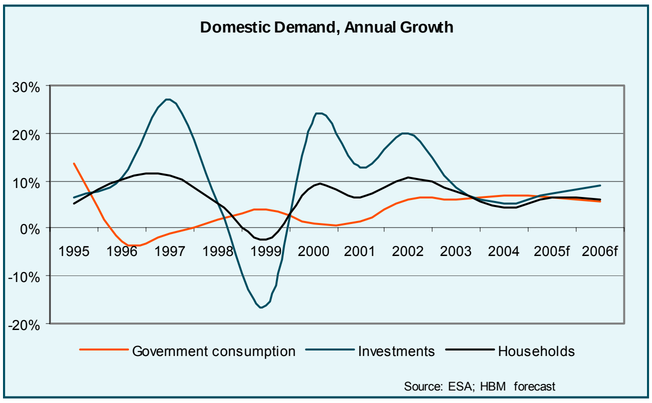
	2003	2004	2005f	2006f
Economic growth	6,7%	7,8%	8,1%	7,4%
GDP, mln EUR	8138	9043	10230	11420
GDP per capita, EUR*	6001	6693	7600	8500
Industrial production	11,1%	7,9%	9,5%	9,0%
Inflation (SKP deflator)	2,1%	3,1%	4,7%	3,9%
Consumer prices	1,3%	3,0%	4,2%	3,9%
Harmonized consumer prices	1,4%	3,0%	4,0%	3,9%
Producer prices	0,2%	2,9%	2,0%	1,0%
Unemployment (national definition)	10,0%	9,6%	8,0%	7,7%
Harmonized unemployment	10,2%	9,2%	7,6%	7,0%
Average monthly real wage	8,2%	4,6%	8,5%	8,0%
Exports of goods and services	9,0%	17,2%	19,0%	15,5%
Imports of goods and services	9,6%	16,8%	14,0%	13,0%
Balance of goods and services, % of GDP	-7,5%	-7,7%	-4,3%	-2,8%
Current account, % of GDP	-12,1%	-12,7%	-10,2%	-8,0%
Current and capital account, % of GDP	-11,6%	-11,9%	-8,7%	-5,8%
Inflow of FDI, % of GDP	10,1%	9,3%	27,0%	8,5%
Foreign gross debt, % of GDP	68,7%	81,2%	85,0%	86,0%
General government budget balance, % of GDP	2,6%	1,7%	1,0%	0,5%
General government gross debt, % of GDP	5,9%	5,4%	4,5%	4,0%

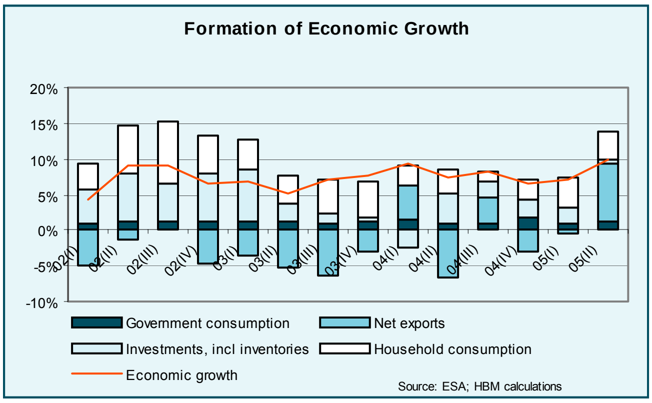
**HBM calculations; growth rates if not otherwise noted*

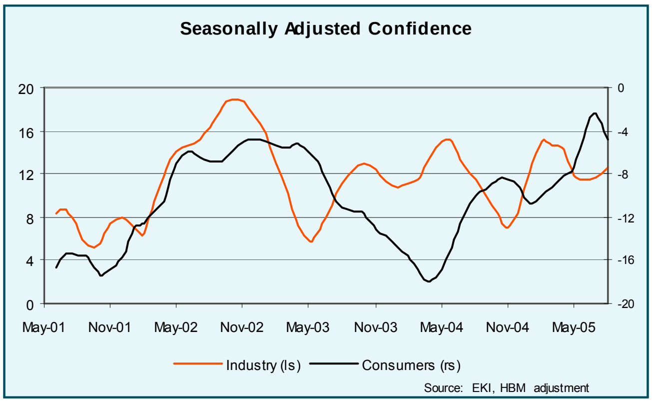
Still, we are more optimistic about next year's results. The capital flows into the Estonian economy will remain strong – in 2005 direct investments will dominate, while other types of investment will show outflows. As a result, Estonian net debt will not increase this year. This year's inflation will be 4.7% (CPI 4.2%) as oil and labour cost growth are prevailing; next year a slight slowdown is expected.

Economic Growth

HBM is expecting the Estonian economy to grow by 8.1% this year (the forecasted range is 7.8-8.3%) and 7.3-7.5% next year. Domestic demand will grow more slowly than the overall economy, but exports will advance by 20% this year and ca 15% next year. Despite rather weak results in the 1st half of the year, we expect that investments will grow ca 7.5% in the full year as inventories are expected to grow due to the start-up of new construction projects (actual inventories in companies will remain more-or-less stable). Household consumption growth will slightly slip from the level of 6.7%, but government consumption will grow faster than in the 1st half of the year. Domestic supply is about to grow significantly faster than it did last year, however next year's growth will be hindered by capital and labour capacity problems in some sectors. As unemployment has fallen very fast and the process is continuing, it might reach very close to the natural level of unemployment (our current estimates suggest ca 5-5.5%), which increases the risk of excessively fast wage growth. However, the very active work of companies in modernisation, efficiency and rationalisation is somewhat reassuring – we can talk about the next phase of economic restructuring now. The need to maintain competitiveness in global markets, where Estonia can no longer rely on cheap labour, is another reason for corporate investments.

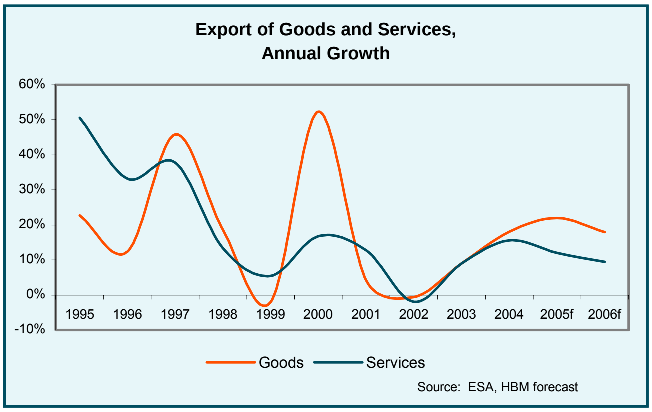






External Demand

Contrary to expectations, exports in 2005 have grown faster than in 2004 and hence we are forecasting over 19% growth for the full year (17.2% in 2004). But next year the growth will slow to ca 15%. Estonian foreign trade figures are still affected by the accession changes – the 1st half-year data are benefiting from the change of statistical method. Export flows are also being influenced by changed logistical flows in the Eastern Baltic Sea region. We see that the next 12 months' trade flows will bear a significant impact from those changes.



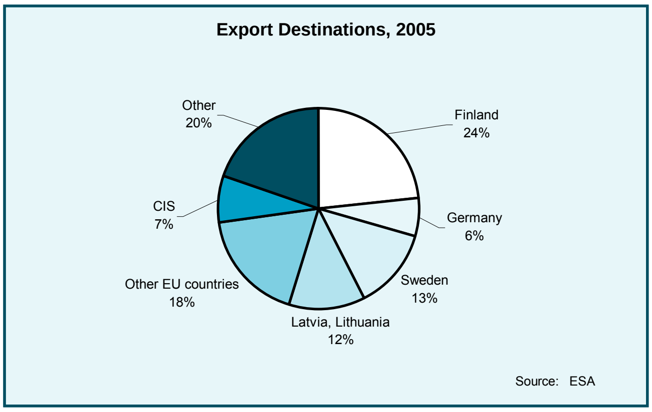
Merchandise Exports

The volumes of Estonian merchandise exports are dependent on domestically produced export goods and on the volumes of transit goods. Unfortunately existing statistics do not differentiate between them, but some brief conclusions are possible.

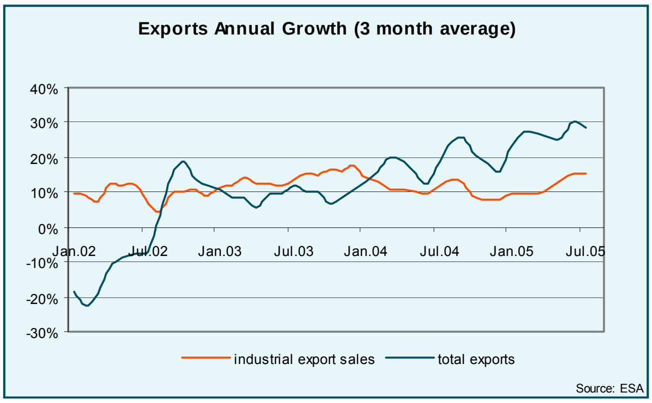
We expect Estonian merchandise exports to grow by approximately 22%, with much stronger growth in exports of Estonian produced machinery and equipment, and also of products of the chemical industry. Fairly strong growth is also expected in exports of products of the wood, timber, paper, publishing and furniture industries, while at the same time exports of food products will grow only a little and Estonian-produced textile exports will diminish. Exports of transit goods will be strong, because of both volume and price growth. The expectations for the next year are less promising – a higher comparison base and higher prices will cut growth rates. But we are more optimistic regarding Estonian-produced products.

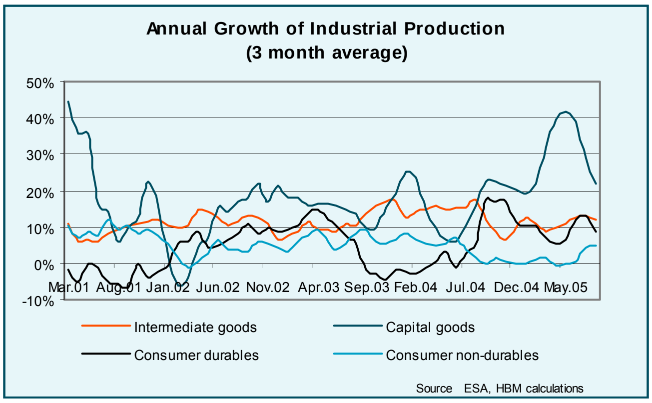
The transit business has changed its meaning in the last 12 months – instead of east-west cargo flows (mostly oil products) we now can add quickly growing cargoes from west to east and flows between north and south. The east-west transit is growing mostly because of bigger exports of Russian oil products – this is behind very strong Estonian export growth to the USA and Gibraltar, for example. Estonian ports and railways are benefiting from traditional transit. The rapid growth of oil prices is also behind stronger growth rates, but the more than tripling of exports and growth in imports of oil products of over 60% points not only to price, but also to volume growth.

Other transit flows (from west to east and between north-south) are harder to estimate. The strong growth of exports to Russia (80%) is hardly explainable only by bigger Estonian-produced exports – other EU countries have definitely played a part in it. The trading flows between Estonia-Latvia-Lithuania have grown extremely rapidly and we are of the opinion that it cannot be explained only by strong economic growth. We are more inclined to think that it is a reflection of the formation of a common logistic region, where bigger distribution centres are serving all three countries, sometimes also covering neighbouring regions of Russia (e.g. St Petersburg and Kaliningrad), and maybe even south Finland. The location of those distribution centres differs depending on goods and companies. We are of the opinion that the formation of such a region is one reason for the strong export growth to Russia.



Estonian-produced exports are also growing rapidly, although overall export growth exceeds that of local exports for the reasons mentioned above. The export sales of industries are growing generally faster than domestic sales or production. The exports of machinery, equipment, transport products, and chemical products are growing extremely fast and those industries are mostly dependent on external demand. In Estonian manufacturing, which is highly dependent on external demand, the fastest growing branches are those which gain most from exports – the production of capital goods has grown by 31%, the production of consumer durables by 9% and the production of intermediate goods by 12%.

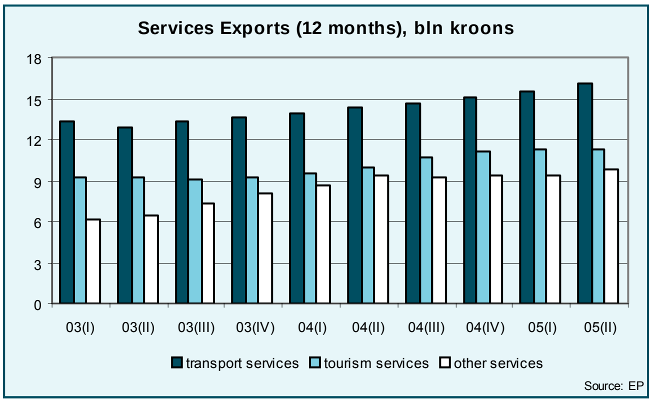




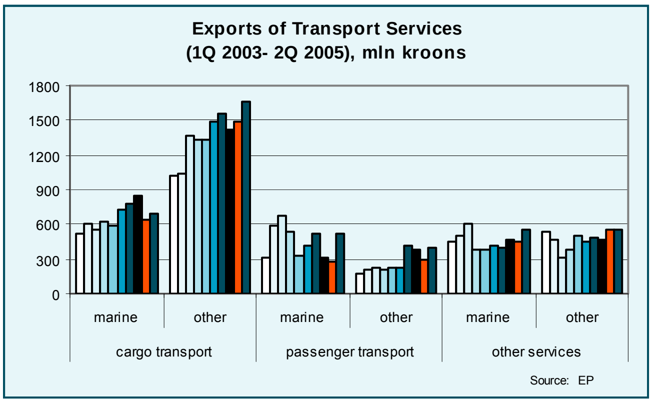
On the other hand, exports of textile and clothing products have grown marginally and even then it is mostly because of transit flows: sales of domestic companies have fallen, and particularly export sales (8% vs. 10-13%). The major reason is the loss in competitiveness due to growing production costs, but also the access of cheap Asian products to the EU market. The food industry has increased its export sales by 4-4.5% - milk and meat products are the major product items alongside drinks. Despite very unfavourable developments in the 1st half of the year – a storm in the Baltic Sea countries, which caused prices of timber to drop, and a long-term strike in the Finnish paper industry – or maybe because of those processes, the exports of the Estonian timber, paper and furniture industry have grown strongly. We are of the opinion that early investments, which have allowed volumes of more valuable products to now be increased easily, might be behind the good developments in the sector. Estonian producers increased their use of cheaper imported timber from Latvia and Sweden, where the storm damage was the worst and hence the supply and shortage of capacity are the biggest.

Exports of Services

Exports of services will grow relatively modestly this year – 11-12%. There are several reasons to expect slower growth, but the major one is the slowdown in tourism services exports, which has been caused by the very high comparison base. We maintain the opinion that Estonian services exports are underestimated in official statistics, especially the exports of tourism services: the number of foreign visitors, payments by non-residents and turnover statistics in service and retail companies suggest bigger growth rates. It seems that part of the tourist consumption in Estonia is reported under Estonian household consumption, which means that the latter is slightly overestimated[1].



As the number of Finnish shopping tourists has stabilised after the sharp increase last year (there is a real chance that the figure will start to decline soon), we do not expect strong growth in the revenues from shopping tourism starting from the 3rd quarter. Tourists from other EU countries and Russia, who are spending more money because they are staying longer, will largely compensate for the decline of the Finnish share in tourism. The building of the Saaremaa harbour (expected to open in spring 2006) should promote tourism.



Transport services (incl. supporting areas) have a more than 40% share in the whole range of exported services and they have grown by close to 14% this year. That growth rate points to a long-term growth trend. However we maintain our cautious position because of the high risks in the business. We expect that growth will slow slightly because of the higher comparison base, however we also see couple of causes that might quicken the growth in the sector.

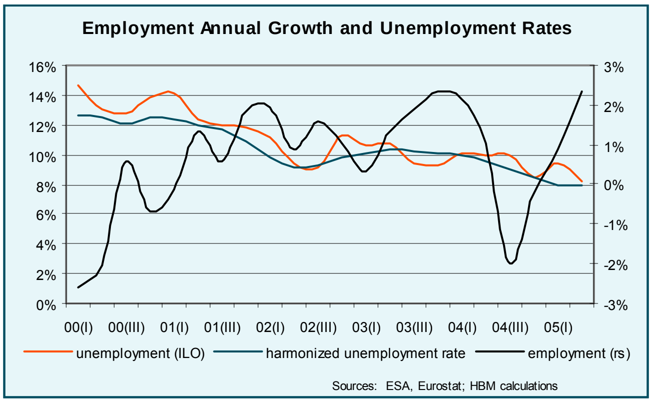
1. The competitiveness situation among the Baltic Sea ferry companies has been favourable to the Estonian Tallink company – bigger capacities have been better employed because of lower prices and hence the company has earned good profits. However, the income growth might slow in future as the number of passengers between Tallinn-Helsinki has grown significantly slower in the 3rd quarter already.
2. The impact of a new – Sillamäe – harbour (opened in October 2005) on exports and economic growth is difficult to predict. That port might take cargo flows from Tallinn Port but also might take them from Finnish and Russian ones (Kotka, Ust Luga). It will definitely help related businesses – railway cargo transport, and the storage business. In the long term, the connection with Russia by road transport (the passing capacity of Narva bridge) might become an obstacle for development. Our forecast is rather cautious now, but we also admit that the development of Sillamäe port is the reason for a potential forecast upgrade in future.

The exports of other services are more difficult to forecast as there are many types of services, often small in volume, and the factors influencing them are very different. But we are of the opinion that stronger than average growth (ca 12-15%) is easy to reach as the adoption period took more time for service companies than for manufacturing or retail. The results of the 2nd quarter already indicate strong advancement (particularly in construction, financial and business services).

Household Incomes and Consumption

Labour Market

Our fears about possible slower developments in the labour market were not realised – employment growth strengthened in the 2nd quarter and unemployment has fallen much faster than expected. We have revised our expectations and forecast to ca 2.5% increase in employment this year and more than 1% next year. Unemployment will fall to 7.6% this year and to 7% next year (harmonized figures). As wage growth strengthened well in the 2nd quarter, we forecast stronger growth for the full year 2005 (8.1% in real terms) and approximately the same growth in 2006.



Rapidly declining unemployment and increasing wage growth suggest that processes, which we expected to start to work in 2008, are already in place. If it is the case, there

[1] E.g. at the same time that a sharp increase of shopping tourist numbers occurred (after EU accession) Estonian households started to consume significantly more alcohol and tobacco – while usually the growth had been 3-4% in a year, now the growth rates jumped by over 20%. As the growth rates of shopping tourism decreased, so did the Estonian household alcohol and tobacco purchases. However, it is well known that alcohol and tobacco are the most attractive goods for shopping tourists from Finland and Sweden.

is a very good chance that the Estonian economy will, in a couple of years, find itself working with full employment (the natural unemployment level is, according to our estimates, ca 5-5.5%, which might decline ca by 1% if the labour market policy is successful) and that will mean that employees will have more bargaining power in wage disputes. If the economy is not flexible enough to adjust to those developments, then Estonian economic growth might drop to very low levels. But currently we are not forecasting such bad developments, as the Estonian economy has so far proved to be flexible enough.

But now and in the next years the following processes will take place in the Estonian labour market.

- Employment is growing because of the rapid growth of several service sectors (construction, retail, accommodation, catering, transport, business and personal services), which need more working hands for development and where an increase in productivity is more difficult to achieve than in producing sectors.

- The labour supply will remain stable in 2005-2006, but will start to decline afterwards, as the new generation entering the labour market will be smaller than that leaving (see our special theme).

- The number of non-active working age persons has started to decline as the number of those in early retirement is declining. The same is true of the number of students (there are less young people). The better chances of finding a job have started to bring to labour market those who were so far living on the expense of the social system – those taking care of the ill and disabled, or the partly disabled. It is possible that students are taking more part-time jobs. The increase in the amount of part-time employment might suggest such developments. We are of the opinion that these processes will deepen, as they will allow companies to solve the problem of the labour shortage.

- The labour outflow, which so far has been short-term and seasonal, will become more and more permanent. Still, we expect that the outflow of labour will not increase much in future, although the seasonality might strengthen. The inflow of labour from other EU countries will remain marginal, although it will increase from CIS countries despite strict limitations (particularly from Ukraine, but also from Russia). The latter will mostly be short-term, although with the option of becoming permanent.

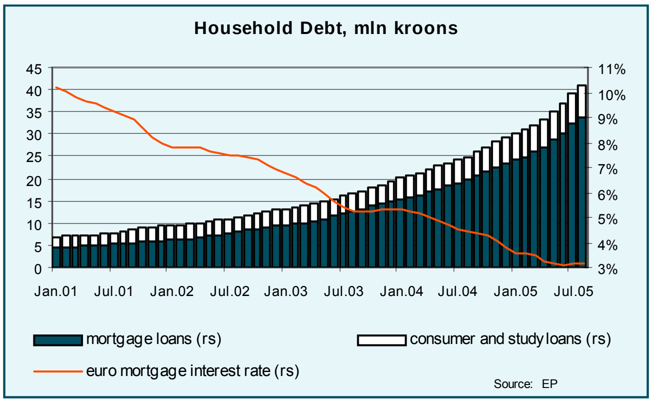
- The shortage of labour will strongly affect wages – we expect that in this year real wage growth will reach at least 7%, and next year a slowdown is not expected. Wage increases in the public sector are unavoidable because of earlier wage contracts (e.g. for medical personnel); we expect wages to grow for teachers, and also for those who are paid from the state budget (e.g. police workers). It is however important to keep in mind, that official wage figures for the last and next couple of years include the disclosure of hidden wages as the Tax Office has become more aggressive and effective in that respect.

- The diminishing labour supply and faster growth of wages is already now forcing companies to pay more attention to productivity growth. That means that production is shifting from labour intensive areas to capital-intensive areas. The situation in the labour market and its outlook suggest that structural changes in the economy will continue. More expensive labour means that labour-intensive and low-value-added production will shut down (e.g. textile industry). However, as at the same time more workers are demanded in service sectors, unemployment will not increase despite rather significant layoffs.

- Labour costs will increase slightly less than wage costs in the next year, as several government officials have expressed readiness to cut unemployment insurance rates. The tax cuts will not affect average gross wage growth, at least not in any meaningful way, as the demand and supply situation in the labour market is too tense.

Other Disposable Incomes, Savings and Loans

Household disposable incomes are growing faster than wages as income tax cuts mean higher growth in net wages compared to gross wages. The experience from the last years suggests that tax cuts do not affect wage growth. The higher employment, of course, also means bigger revenues. And the government will continue the rapid growth of pension payments (from April 2006 old-age pension will be over 3000 kroons) and the growing payments to families with children (birth support payment, maternity leave payment).



The growth of consumer loans has been strong in 2005, however their share (8.4%) in household debt is still low and surprisingly declining. Strong future prospects and belief in the stability of employment suggest that consumer loans will continue to grow rapidly. The fact that households have increased purchases of household durables (related to growing wealth and real estate purchases) also indicates strong growth in consumer loans in the future.

Real estate purchases might not decline in future as favourable future expectations are well matched by increasing requests on wealth. Estonians stand rather poorly in many living standard comparisons (e.g. square-meters per person, quality of living spaces), which means that there is lot of room for improvement. It is also important to keep in mind that Estonian residential spaces were mostly built in the 70-80ies (and badly built), which means that in the next decades they should be replaced with new ones. The Estonian real estate market is also influenced by the fact that it is an owners', not a rental, market, which means that the increase in potential owners (e.g. families, youth leaving home) will also increase demand for real estate ownership. Most of the real estate purchases are at least partly financed by loans and the share of bad loans in the commercial banks' loan portfolio is very low because borrowers are mostly owners and they do not want to loose their homes. The slow increase in interest rates will have no substantial effect on loan demand, as incomes are set to increase constantly by ca 7-8% in a year. Consequently mortgage loans will continue to grow rather rapidly in the next years.

The growing debt burden means higher debt servicing costs and is negatively affecting household financial freedom. The borrowing also has compulsory side-costs (e.g. insurance), which cut financial freedom more. Insurance payments are also growing because of the pension reform, and hence household savings are growing. Our analysis and household confidence indicators suggest that households have increased savings other than these above-mentioned already, and will continue to do so in future.

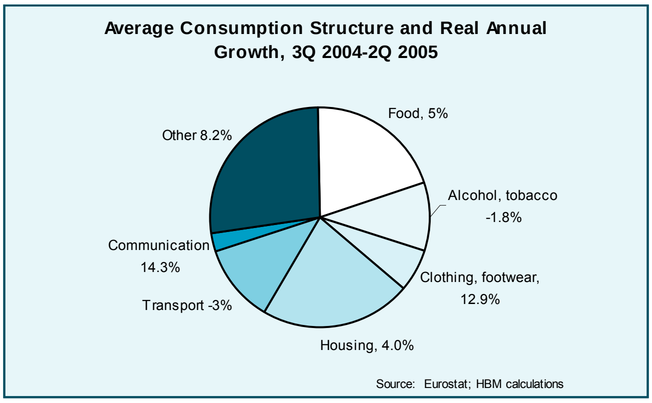
In conclusion, everything points to rapidly growing incomes but also to the even faster growth of savings. It is not surprising that in the 1st half of the year household consumption grew by 6.7%, while incomes were up more than 10%. We are of the opinion that a similar ratio between incomes and consumption will remain and if loan-servicing costs start to grow faster (e.g. because of rapid growth of interest rates and borrowing) this ratio might become even more unfavourable toward consumption.

Consumer Spending

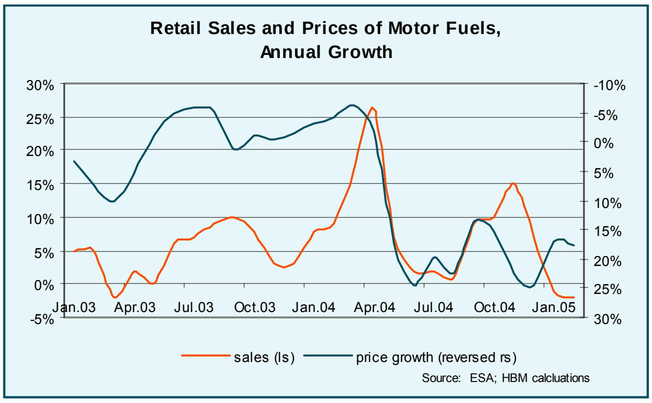
Household consumption will grow by 6.3-6.5% this year and by less than 6% next year due to the developments in savings and increasing obligatory payments. At the same time changes in consumption structure will continue as the wealth of households increases and price dynamics differ.

Rapid development of the residential real estate sector means bigger spending on furnishing, construction and consumer durables. The maintenance costs per square metre are declining as living conditions improve, but bigger living spaces mean bigger spending from the budget.

Household spending on wealth services and goods – leisure time, restaurants, personal services, travelling, and communication – are growing rather fast. The growing demand could push up prices of those goods and services, but as supply is also growing at least at the same pace as demand (sometimes faster), then the price growth in those areas has been rather modest and prices have even declined in some cases. As expected, the share of food in household consumption continues to decline.



Somewhat surprisingly we have seen growth in clothing and footwear purchases, and in their prices also. We are of the opinion that there are several reasons for this. It seems that a few European producers (or retailers) have divided the market and are rather effectively blocking the inflow of cheap but good quality products into the Estonian market (e.g. it is hard to find cheap Asian products in Estonia). Household incomes have grown so much that consumers want and can afford to buy higher quality products. Another factor might be the entry into the market of consumers who have just moved up from a very poor level of income (e.g. families with many children), whose income level only now allows them to buy something more that essential goods and services. Usually those people will at first start buying clothing and footwear as those items have smaller prices.



Unlike in Estonia's southern neighbours, spending on transport has been more or less stable, and until recently the contracting process dominated. There are several reasons for this. There were lot of purchases of cars before EU accession and consequently the number of new car purchases dropped after that. Only recently a slight recovery could be seen. Households also shifted toward buying used (and cheaper) cars after accession. Another factor is gasoline and diesel price – there exists a very straightforward connection between sharp price increases and fuel purchases. It is hard to expect that consumers will continue with the same amount of purchases when gasoline prices have increased more than third in 9 months. We are of the opinion that households are ready to increase spending on transport but definitely not much faster than their incomes.

Government Spending and Policy

The better than expected economic growth and economic situation allowed the Government to overcome the fiscal problems that were in sight in the 1st half of the year. We expect that the budget surplus will be ca 1% of GDP this year. It is more difficult to make projections about 2006 as elections and a supplementary budget for 2006 (or a change to the budget in the next 1-2 months) are coming. Both factors support bigger spending. There is also major uncertainty about the use of EU funds. But it seems that the Government's economic policy will remain modestly expansive (a budget with a small surplus), and due to intra-governmental problems spineless (e.g. regarding the fight with inflation, state supports).

We agree more-or-less with the Government projections on supplementary budget revenues (in 2005), although we are of a slightly different opinion regarding different taxes. The budget projection for 2006, however, clearly under-estimates tax revenues as it is made on old (and wrong) assumptions – the projected economic growth and inflation are well below those actually coming. So we can expect that the Government will at least in mid-2006 present a new supplementary budget, which of course will then cover the promises of the next elections. But there is also the possibility, and we would welcome it, that the changes will be made already before adoption of 2006's budget in December.

The Government's attitude toward taxation is somewhat mixed. While the income tax cut seems to be sure at least for 2006 and the Government will most likely not increase fuel excises, then the cut in unemployment insurance payments is still in the air. Last year it was not made, although trade unions, employers association and various ministries support it. The Riigikogu is now reading the law, which increases payments on the use of natural resources, which might increase the costs of certain enterprises. However the total effect of those increases on overall price levels should be rather modest (except in monopolistic areas), as due to tight competition companies have to pay more attention to efficiency. The possible effect on the electricity price (and hence on the overall economy) is unclear due to a lack of information.

The area where the Government is optimistic and we are highly sceptical is the use of EU funds: our previous expectations, which we thought to be pessimistic, turned out to be optimistic – the real use of the funds has been extremely poor. Approximately 56% of the funds for 2004-2006 are matched with approved projects, but only 13% have been distributed to completed projects. And it is already known that Estonia has to return and will never use some of the money because of poor cooperation and administration. Probably the number of approved projects and use of the funds will improve in 2006, but we are sceptical about this year. Depending on the timing of disbursements and approvals, the state budget might gain extra net income – the part of co-financing planned in the budget will be used only if a project gets approval. If more projects are approved, then more budget spending will occur and hence the budget surplus will be smaller. It is also possible that at the end of this year some of money transferred to Estonia at the year-end will be paid to projects only next year. This ups the budget surplus.

Available Foreign Aid Funds, mln euros

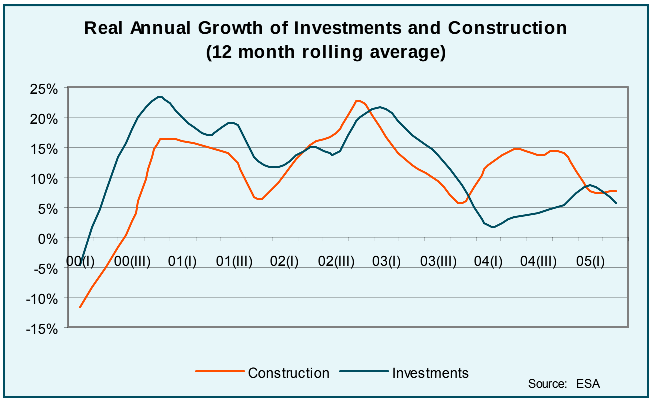
Fond	mln euros	of which covered with approved projects	payments made
ESF (Social Fund))	76.1	64.6%	2.4%
ERDF (Regional development)	211.3	49.4%	11.5%
FIFG (Fisheries)	12.5	48.3%	11.1%
Schengen	76.3	96.0%	3.6%
EAGGF (Agriculture)	56.8	59.1%	31.2%
EQUAL	4.1	88.3%	3.4%
Other funds	323.6	48.0%	15.5%
Total	**760.8**	**55.9%**	**12.9%**

Source:Estonian MoF

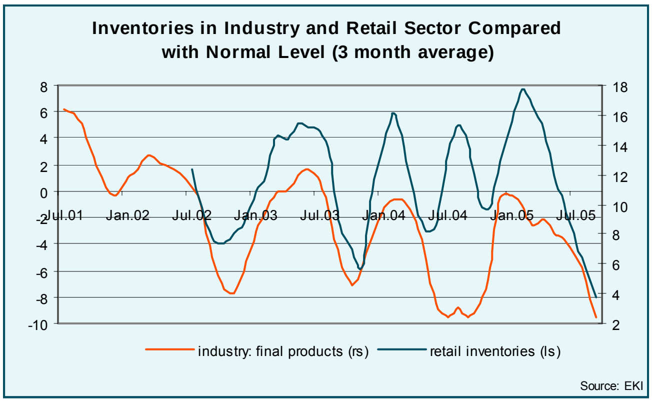
Good tax revenues are backing strong government spending however EU funds are used. As improvement is expected in the use of the funds, government spending should also grow. However, prices of government services are growing very rapidly (ca 7-8% in a year, for some services even faster) and we do not expect changes in that respect.

Investments

The share of investments in GDP will remain high but as investment growth in 2005 will be smaller than economic growth, its share will drop to ca 29%. Declining growth of inventories causes a slowdown in investment growth – capital investments in fixed assets will grow slightly faster than the economy (although quarterly fluctuations might be rather significant). We expect that investments in fixed assets will increase by more than 8% this year and ca 10% next year. However, inventories will increase slower than in previous years (ca 2.5-2.7% of GDP vs. 3.1% in 2004).



The slower growth of inventories is mostly the result of rationalisation of enterprises stocks: the correction in inventories, which increased before EU accession, and the more rational use of resources. In previous years there was a tendency for Estonian companies to have slightly higher inventories than they needed (probably due to overestimated growth projections), but now they have been cut to normal levels. Fast economic growth has even created a situation where in some cases inventories have fallen below normal. Started but unfinished buildings are also reported under inventories, and it might be that previously slowly developing or halted construction projects are now being finalised (i.e. decline of inventories and increase of fixed assets). Such developments cannot continue for long – we are of the opinion that most of the correction will take place this year, and in 2006 inventories will continue to grow at a normal pace.



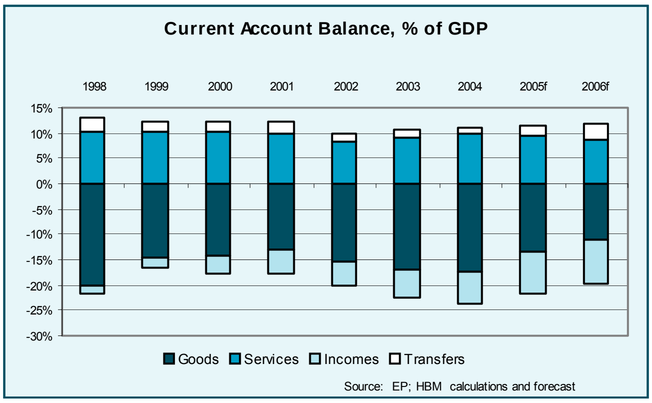
Our investment projection is based on following factors.

- Households will continue to invest in real estate – growth will be stronger in regions far away from Tallinn; however, the capital and its immediate surrounding will remain the biggest and most dominant market.
- Enterprises will invest in machinery and equipment and in increasing efficiency because of the tight labour market.
- Several big investments in infrastructure – e.g. the ports of Saaremaa and Sillamäe, the expansion of Tallinn Airport, road building, and also ship purchases by Tallink and possible plane purchases by Estonian Air.
- A more active period of completion of EU projects – investments in education, health and social care, environment protection, agriculture and fishery.
- Modest growth of service sector investments – most of all in retail spaces, but also in other service spaces and office buildings. A current slight oversupply (at least for some types of real estate) will mean that growth will be not fast, but modest growth in some regions and business areas is possible.

External Balance

Our expectations have not changed much for the current account deficit, although it is possible that the deficit will fall from its current level (slightly less than 9% of GDP) quite strongly. But our conservative prognosis is that the deficit will be ca 8% of GDP. The combined deficit of the current and capital accounts for this year will be 8.5-9% and up to 6% in the next year. Our forecast is based on the following assumptions.

- The trade and services deficit will fall due to the fast growth of exports and much more modest expansion of imports to 4-4.5% of GDP this year and 2.5-3% next year.
- Imports of services is a risk factor for that forecast, but we are of the opinion that the recent very sharp price growth of imported services will cut the competitiveness of imports and will support Estonian exports and domestic supply.
- We expect that rapidly growing merchandise import prices will stabilise this winter and hence prices will not add growth to imports.
- Domestic demand is mostly supporting domestic supply – services, construction and domestic goods – so the demand for imported goods should grow more slowly. As expected, domestic supply already surpassed import growth in the 2nd quarter.
- Our rather conservative expectations regarding EU fund usage will mean ca 1-1.5% of GDP in capital and current transfers; volumes should be bigger in next year.
- Estonian current transfers abroad have grown rapidly, but at the same time private transfers to Estonia have also grown reflecting higher employment abroad.
- The most difficult area to forecast is the income account but we still expect its deficit to increase, as there are no signs of declining profitability in Estonian companies. The takeover of some Estonian companies by foreign capital and the listing of new companies on the Tallinn Stock Exchange might mean bigger outflows. At the same time Estonian investments abroad have become more profitable, but their volume is too small to cover the outflow of incomes. Most of the earnings from FDI will remain in Estonia and the share of dividend payments will not increase substantially.
- The net interest payments will increase modestly as net debt will not increase this year in our opinion. Although workers' remittances are growing fast, their impact on the income account balance will remain small this year. But it will increase in the next years and we see this as one reason to expect a decline in the income account deficit.



The current account deficit will be financed by long-term capital flows in this and the next year. The inflow of FDI will be extremely high this year because of the takeover of

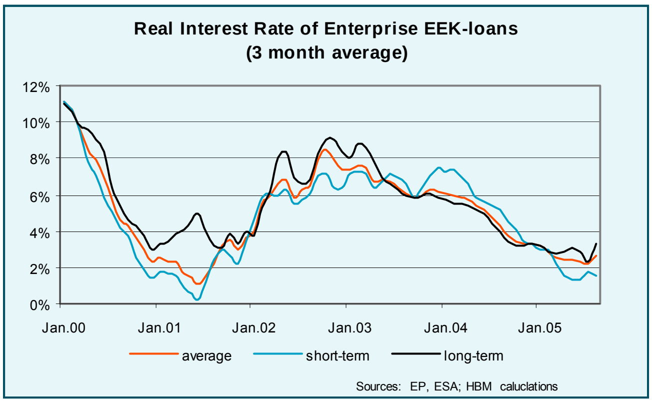
Hansabank. Thus there will be a decline next year. However we are estimating that FDI inflow (other than Hansabank) will be approximately the same as last year (ca 8% of GDP) and we expect it to be at the same level next year. However, as Estonian investments abroad are growing fast, we expect net FDI to decline.

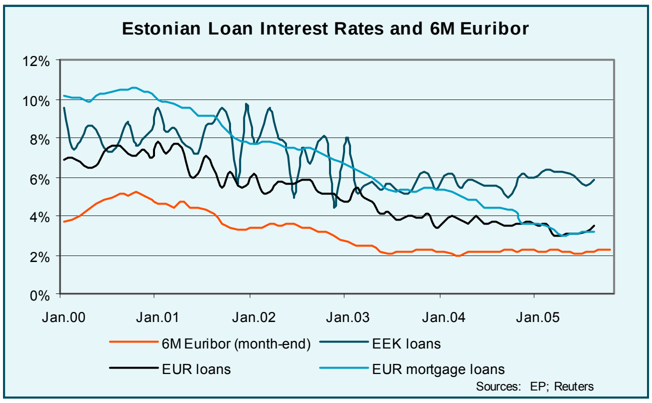
According to our estimates Estonian net foreign debt should not increase this year, definitely not by much, as foreign assets will compensate for growth of foreign liabilities. Foreign assets are growing because of the increasing investments by the Estonian financial system – the rapidly growing assets of pension funds will be invested abroad as demanded by law. Foreign assets will also increase because of the budget surplus – it should be placed in foreign assets by law. Foreign liabilities are growing because of the borrowing of the private sector. But foreign investors are also increasing deposits in Estonian banks.

Monetary Issues

Monetary Policy and Interest Rates

We do not expect changes in Estonian monetary policy until the accession to the euro zone. The official target date is still January the 1st, 2007; however, it is clear that Estonia will not fulfil the inflation criteria in its current definition (ca 2.7-2.8%). There is a chance that the decision-makers will accept Estonia as a new member. But currently the one-year delay looks more likely. We are of the opinion that the current definition of the inflation criteria lack credibility (see our special section). The delay should not affect Estonian credit ratings as the pickup of inflation is being caused by global oil prices. The lack of monetary measures (they do not exist in a currency board system) and the budgetary surplus should prove that the Estonian authorities are not supporting inflation and they have no other means to cut inflation.





Estonian interest rates are following those of the euro zone and hence they have remained low. As inflation has picked up, real interest rates have fallen. Real interest rates for corporate loans are positive (ca 2.4%, deflated with PPI), but household loans are bearing negative real interest rates (-1%). There has been a slight pickup in mortgage rates in recent months, which probably points to the poorer quality of the borrowers (the interest margin is higher), or (less likely) maybe to an increasing share of fixed interest rate loans.

Inflation

As expected, inflation in the 2nd quarter strengthened and this trend will continue in the 2nd half of the year. As a result, overall inflation in 2005 will be close to 5%, but we expect a slight slowdown in the next year. The major cause of increased price growth is the rapid growth of energy prices, which have had the strongest impact on consumer prices. There are also the effects of more expensive labour on prices (mostly services) and in recent months slight pressure from demand could be observed.

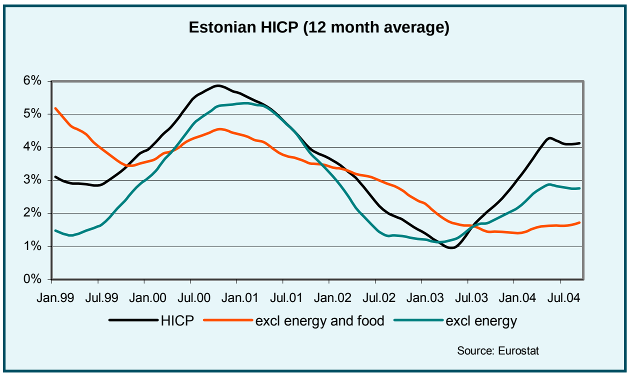
Increasing prices for energy causes approximately half of the consumer price growth – prices of transport (motor fuels, public transport) are up as is heating energy (all together ca 13.5% of consumer basket). The price growth is not limited to 2005 – next year there will be a rise in gas prices. The chances are very slim that energy prices will fall, although it might happen in the short-term (e.g. motor fuels, which take ca 6.5% of the basket). The indirect consequences are more difficult to estimate – on one hand they should be relatively modest because of the competition, on the other hand a sharp increase is a very good argument for the increase.

Wage growth has mostly affected construction prices as demand for construction and renovation works has grown faster than supply. There is tighter competition in other services, and hence the price growth has been less pronounced there; however, their share in the consumer basket is often very small (e.g. payable hospital services have became 11% more expensive, but their share in the basket is only 0.2%). But labour costs are about to affect inflation more – the wage contract for transport workers for 2006 foresees substantial increases in wages and that will affect public transport prices. Municipalities could compensate for that increase, at least partly, but bigger wages in one transport sub-branch will cause higher demands in others also.

Some of the price increase is being caused by food prices. As the remnants of the EU accession effect are mostly dominating we expect that by the middle of 2006 food price inflation will stabilise.

Base inflation, which excludes sensitive energy and food prices, has been rather stable, although it has slightly strengthened in recent months (12 month average in September 1.8%), being over the euro zone level (1.3%) in the last four months (in May both were 1.6%). The fact of the strengthening of base inflation might suggest stronger demand pressures in inflation, but it might also be a secondary effect of the energy price increase.

Our current forecast expects consumer prices to grow by more than 4% this year (4.1-4.2% depending on the actual development of the prices of motor fuels). As there will be a lot of price increases in the next year (long-distance heating, gas, transport) it is hard to believe that inflation will fall significantly – our forecast of 3.8-3.9% is based on the assumption that oil prices will not grow any more.



Latvia

Baltic Outlook 20.10.2005

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Recent Economic Developments

The 2nd quarter 2005 surprised us with unexpectedly high 11.6% GDP growth. All the largest sectors boosted output; reflecting favourable demand conditions both in internal and external markets. The extraordinary growth rate also could be attributed to specifics of the base period, as the 2nd quarter 2004 was characterized by significant accumulation of import. Inflation concerns did not diminish and inflation is still the highest in the EU. Although in mid 2005 the annual consumer price inflation was slowing down, the beginning of autumn came with a new inflation push.

The catching up process with EU is faster than had been thought. As convergence takes place, Latvia sees both extraordinary economic growth as well as a very strong price increases. On the one hand companies face substantial improvements in exports, on the other they run the risk of worker outflow. Although exports grew strongly, the external balance was under strong pressure from imports. Meanwhile the economic boom supported state finances and so far tax revenues have skyrocketed. The budget maintained a surplus throughout the period January-August.

Assumptions

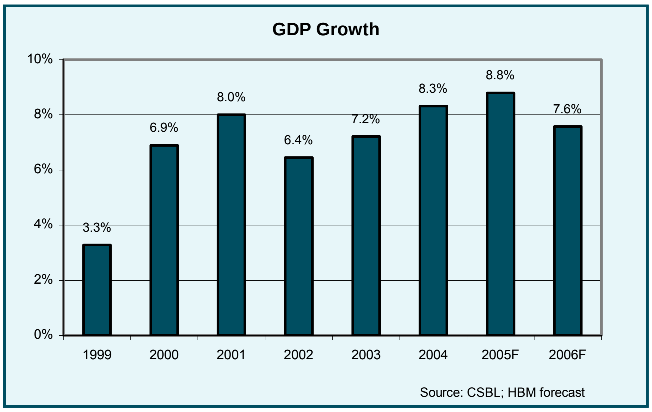
We have taken into consideration the following assumptions and factors specific to Latvia in our 2005-2006 forecast.

- The government will not bring into effect any anti-inflation actions that could considerably decrease economic activity.
- Despite mounting inflation, real income levels will continue to rise in the 1st half 2006, thus private consumption growth will remain strong.
- The labour shortage problems, although approaching will not yet be severe enough to substantially hinder the output growth in 2006; nevertheless, salaries will continue the steep upward trend.
- Banks will continue extensive lending campaigns and no cut-off in lending activity in 2006 is projected.
- Unless EU institutions soften the Maastricht criteria, the government sooner than later will have to declare the postponement of the euro adoption (target date so far 2008).
- Due to general elections in autumn 2006 the state spending will be loose; however, decisions with long lasting consequences will be mostly avoided.

	2003	2004	2005f	2006f
GDP, %	7.2%	8.3%	8.8%	7.6%
GDP, mln EUR	9,861	11,024	12,292	14,109
GDP per capita, EUR	4,200	4,800	5,358	6,180
Inflation (GDP deflator), %	3.6%	7.2%	8.3%	6.7%
CPI average, %	2.9%	6.2%	6.7%	5.4%
HICP average, %	2.9%	6.2%	na	na
PPI average, %	3.2%	8.6%	8.0%	7.0%
Unemployment level according to surveys	10.6%	10.4%	9.3%	9.1%
Average real wages, %	7.8%	2.4%	9.4%	9.0%
Industrial production, %	6.5%	6.0%	6.0%	6.9%
Manufacturing, %	8.0%	6.2%	6.1%	7.2%
Goods and services exports, %	14.3%	21.4%	27.6%	20.3%
Goods and services imports, %	19.5%	27.0%	24.0%	19.6%
Trade and services balance, % of GDP	-12.8%	-16.1%	-15.5%	-15.9%
Current account balance, % of GDP	-8.2%	-13.1%	-11.2%	-10.8%
Current account + cap.account, % of GDP	-7.5%	-12.0%	-9.8%	-8.2%
FDI net inflow, % of GDP	2.4%	4.4%	3.7%	3.0%
Total external obligations, % of GDP	80.0%	93.8%	97.0%	95.6%
Government fiscal balance, % of GDP	-1.6%	-1.1%	-1.5%	-1.5%
Government fiscal balance ESA 95, % of GDP	-1.2%	-1.0%	na	na
Central government debt, % of GDP	13.4%	13.3%	14.1%	16.8%
Central government debt,ESA95, % of GDP	14.6%	14.7%	na	na

Summary of the Forecast

We have revised our forecast in order to reflect the faster than expected convergence with the EU. Indicators of economic growth for 2005 and 2006 are increased as both internal and external demand has proved to be more persistent. Thus, in our new forecasts we see higher consumption (stronger revisions for 2006), higher imports and higher exports. Labour outflow is an increasing phenomenon with numerous consequences: we expect steeper rise in salaries and lower unemployment. Inflation is mounting and in 2006 price appreciation will continue with a noteworthy intensity. Although so far the budget has been in surplus, we observe strong spending incentives. The annual budget will sustain stable deficits, thus, contributing to rapid economic expansion. Currently the economy is on optimism trend, which at the moment is fuelling further growth.



Economic Growth

All indications show that Latvia is moving into the high-speed catch-up scenario. We have revised upwards both the 2005 and 2006 output forecasts. We expect 8.6-8.9% growth in 2005 and 7.5-7.6% growth in 2006. In contrast to our previous forecasts (6.8% in 2006), for the time being (forecasts period 2005-2006) we do not see a sizable slowdown in the growth rates. 2006 is most likely to continue Latvia's fast forward developments. However, the rapid developments bear risks of unbalanced growth, which could be felt later on.

Real growth of value added

	2003	2004	2005f	2006f
Gross value added at basic prices	6.8%	8.4%	8.5-8.8%	7.4-7.7%
Agriculture, hunting and forestry	0.0%	4.2%	1.0%	5.0%
Fishing	-43.1%	8.1%	30.0%	4.0%
Mining and quarrying	28.0%	10.9%	20.0%	20.0%
Manufacturing	6.0%	7.9%	6-7%	7.5-8%
Electricity, gas and water supply	4.5%	4.8%	4-4.5%	5-5.5%
Construction	13.7%	13.0%	15-16%	13-14%
Services	7.3%	8.7%	9.5%	7.2%
Trade	10.0%	10.1%	15.5%	8.5%
Transport, storage and communication	8.9%	13.0%	10-11%	8-8.5%
Financial intermediation	3.3%	8.3%	8-8.5%	7-7.5%
Real estate, renting and business activities	6.7%	7.4%	8.0%	6-6.5%

Source: Eurostat, HBM forecasts

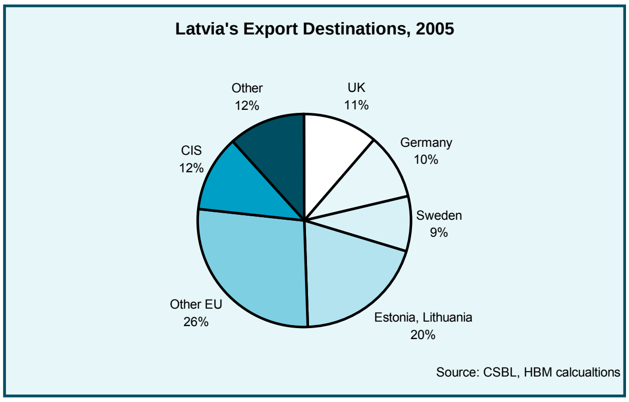
Growth in manufacturing sectors (in order of importance)

	2004	2005f	2006f
Manufacturing, total	6.2%	6.1%	7.2%
Wood, paper, furniture	-4.6%	11.3%	5.2%
Food production	6.5%	6.2%	6.5%
Metals and their products	-0.5%	6.0%	3.1%
Textiles, clothing	1.2%	3.7%	3.5%
Machines and electrical equipment	5.5%	-0.7%	3.9%
Minerals	12.4%	18.0%	15.0%
Chemicals	22.2%	14.0%	20.0%

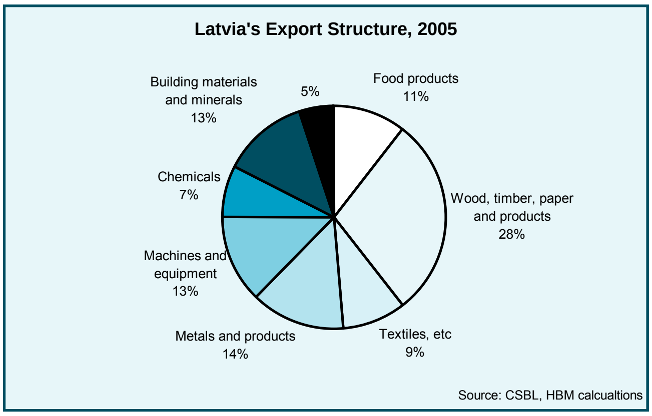
Source: CSBL, HBM forecasts

External Demand

Convergence is showing itself strongly in foreign trade. Exports have sustained above 30% growth rate both in the 1st quarter and the 2nd quarter. We are especially pleased by the May-August results that on average sustained 30% export growth. This rejects the fears that strong export growth since May 2004 is merely a methodological phenomenon (the underlying statistical methodology differed substantially for data before and after May 2004 making these periods non-comparable). We interpret these growth rates as a sign that Latvian producers have sufficient competitiveness in EU markets. No doubt the simplified access to an enlarged Union has considerably speeded up Latvia's producer penetration of foreign markets.

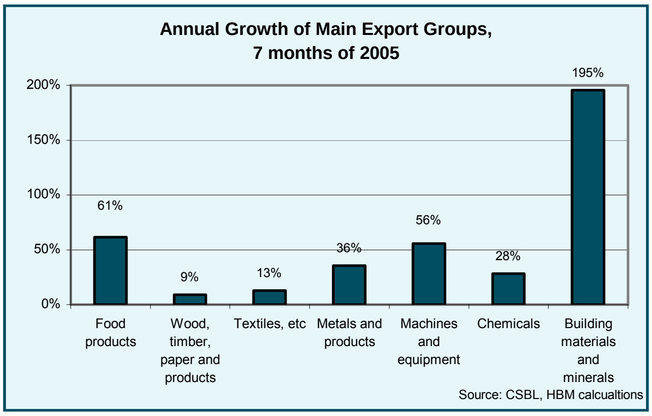


Nevertheless, the economic stagnation of EU15 is showing in export volumes. If export growth to EU10 is enhancing by 80-90% in yearly terms, the sales to EU15 grow by a moderate 10-15% (with exception of July 30%). Also exports to the CIS markets are growing explosively (7 months growth 60%). Currently both EU10 and CIS markets are ensuring the success of Latvia's exports. Taking into account that eventually the companies would face limits in their market penetration (as growth is based mostly on existing products), we expect a gradual easing of the export growth rates into these 'star markets'. Furthermore, assuming a pretty quick labour and energy cost convergence, Latvia is going to loose the cost competitiveness rather fast.

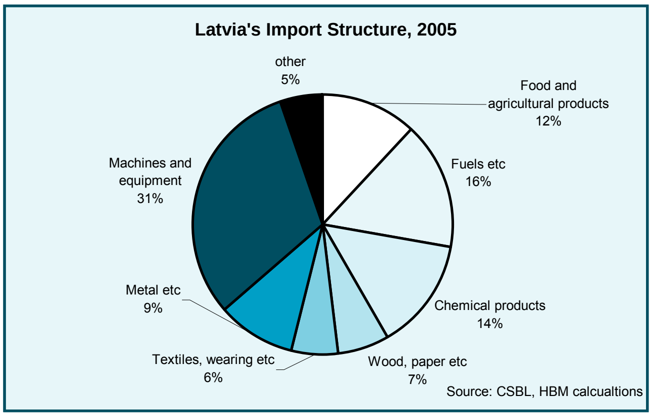


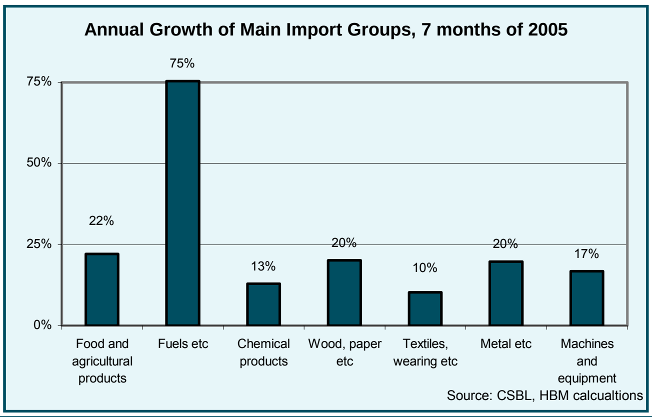
Most of the export sectors have been healthy. We are relieved that the consequences of January's storm on the timber industry were less harmful than had been feared. Timber exports stagnated only in the 1st quarter and in the 2nd quarter the growth rates recovered (7 months growth 9.2%). Food exporters have been exceptionally successful: in contrast to the expected 30-35% growth rates, the actual increase was in the range of 50-60%. Another booming sector is mineral product exports. The latter is most likely to double the volumes in 2005 and become one of the leading export groups. The traditional export segment - textiles is rapidly diminishing in importance, although growth (to our surprise) has been marginally positive. Chemical exports show growth below the 20% annual rate, and are slowly losing to those industries with exports growing above 50-60%. Exports of metal production have lately weakened and we expect a decline in growth in the 2nd half of the year.

Although goods imports growth rate in the 2nd quarter declined it was temporary (lower growth rate was due to extensive importing in the 2nd quarter 2004). In general import growth tails along export developments. The usual growth rates are in 20-30% range with occasional peaks to highest 30's. Similarly to exports the most development is in imports from the new EU members and CIS countries (7 months growth of 36% y-o-y and 45% y-o-y respectively). Definitely the largest growth is in mineral (fuel) imports as a reflection of both higher prices and increased demand (7 months imports up by 75% y-o-y). With the exception of textiles and clothing, which have grown moderately, most of the import groups have advanced by 15-25% compared to a year ago.



We have upgraded the forecasts for goods exports and imports in 2005 and 2006. The new forecast implies export growth of 30% (2005) and 20% (2006), and imports growth of 22% and 19%.

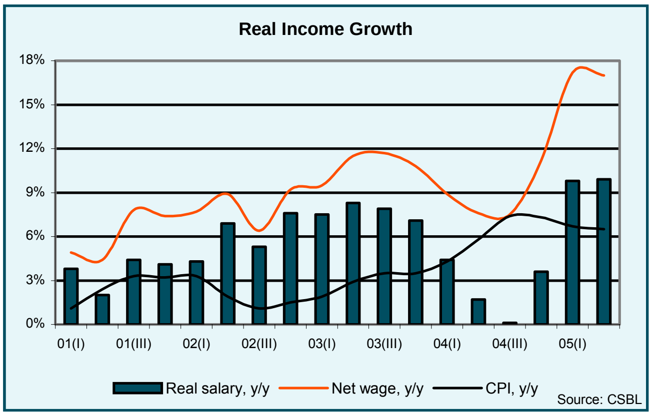




The services exports have performed better than expected. The core driver has been transport services, or more specifically the rising price level (cargoes). However, in the 2nd quarter cargoes exports did not sustain their growth rates while passenger transportation continued its rapid development (65% y-o-y growth). In the 1st half, the transportation and travel services ensured the total service export growth of 20-27% y-o-y. We expect the growth rate to remain in the lower twenties in the 2nd half and a bit below 20% in 2006. Meanwhile service imports continue to develop faster than exports (the 1st half growth rate 40-45% y-o-y). We expect a slight lowering in the growth rate; however, services imports in the coming years will still develop faster than exports.

Household Consumption

In the 2nd quarter household consumption grew by 9.3% y-o-y (8.6% in the 1st quarter) but government consumption continued with a moderate value enhancement of 2.4% (2.8%). There are several indications that private consumption is sustaining strong growth despite mounting inflation. The inflation is offset by the growth in disposable income.



Retail sales growth has been close to 20% (or even higher) throughout January – August period. The trade sector (in GDP) was one of the top performers in the 2nd quarter with 18.7% y-o-y real growth. Particularly strong growth is in non-food sales, especially in sales of non-durables. This trend is related to the growing wealth of households and the continuously boom in household borrowing. The two principal groups that reflect this are housing related goods and cars. Despite a strong base of 2004 (when cars were extensively purchased in advance of joining the EU), car sales this year have sustained tremendous growth.

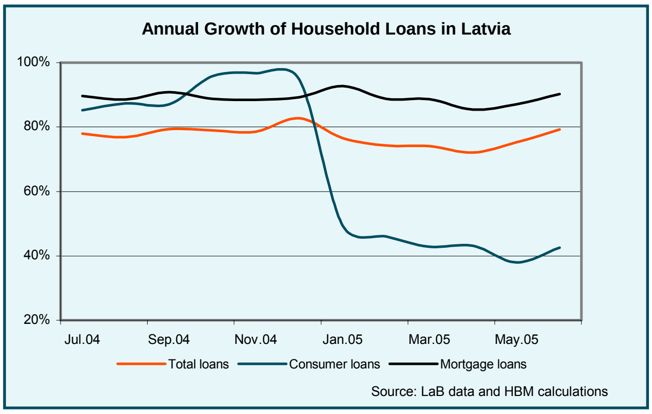
In the 1st quarter we saw inflation compensation to the workers. In the 2nd quarter the salaries continued to increase far in excess of price advances. Since incomes are compensated for past inflation, in the 1st half the real incomes have advanced:

- real salaries have increased by ~10% y-o-y,
- pensions have seen 7-8% inflation adjusted growth.

We expect the income (especially salary) adjustments to continue in the 2nd half 2005 and 2006. This brings with it the risk of additional inflation pressures as a vicious inflation-consumption circle is emerging. We attach a high probability to the scenario that real wage growth could start to exceed productivity (potentially dangerously much), as employers would be forced to react to the mounting labour shortage. The labour shortage is emerging both due to demographic and migration factors (see the special topic). Unless no additional labour supply is created (e.g. via labour importing) the balance of the negotiating powers would be clearly in favour of employees. The risks of excessive wage growth in relation to productivity growth lies in mounting labour costs which in turn could cause loss of competitiveness, exit from business and economic slowdown.

The labour shortage is an approaching phenomenon. Although the unemployment level is still at a high level (especially in some regions), the labour squeeze is imminent in these ratios too. In mid 2005 unemployment level declined: the official rate was down to 7.8% compared to 8.5% a year ago. No data exists on the number of workers actually moving from Latvia to other EU countries (e.g. Ireland), however indications are severe. The labour outflow is most likely to continue in 2006. Although we could expect falling unemployment rates, by itself it would not guarantee an increase in the number of employed. Nevertheless, the consequence of the labour outflow will be a rise in domestic salaries and increased earned money transfers from abroad. These would further facilitate the spending in Latvia.

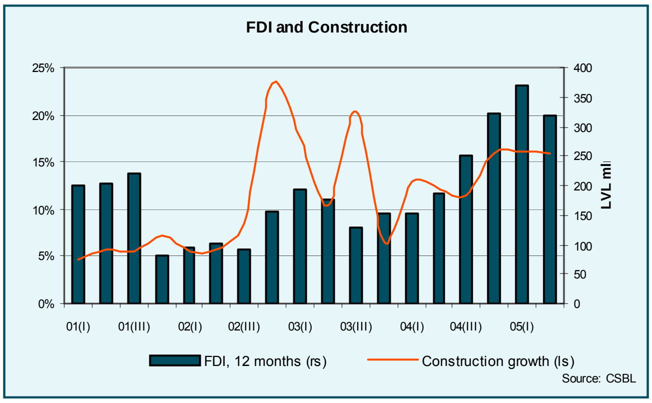
Another wealth facilitating factor is the inflow of EU funds. If the processing of EU structural and Cohesion funds is slow, other programs are implemented in a more timely fashion. For example, the direct payments to farmers have added to purchasing power in the rural regions, and consequently have facilitated consumption there.



Household leverage is growing and the new lending activity is beating all expectations and at the end of August the private person loan portfolio grew by 77% y-o-y. Since April, loan growth has been especially strong driven by banks' aggressive marketing campaigns. Most of the issued loans are mortgages and facilitate consumption indirectly. Loan margins have shrunk, and since most loans have euro interest rate benchmark, the real interest rates are negative. We estimate that lending activity will also grow in 2006, and most of the largest banks will strive to achieve higher market shares. Borrowed funds will continue to support consumption in 2006; nevertheless, the situation might reverse later, as households will start to feel the debt burden in their budgets.

Investments

For investments the 2nd quarter was weak from a statistical point of view – the volumes (as part of GDP) declined by 0.7% y-o-y (compared to 6.7% growth in the 1st quarter). However, the negative growth rate is mainly related to strong base effect, as the 2nd quarter of 2004 was a very investment intensive period (EU entry related projects were finalised) - as result the gross capital formation soared by 32% y-o-y. Maintaining such extensive investment activity is difficult, especially if no new strong investment drivers occur. Nevertheless, we could expect a new wave of company investments in the coming years driven by the shift from labour intensive to more capital-intensive production. The mounting labour shortages (discussed in more detail in one of the special topics) will force companies to think of new ways to enhance the value added, i.e. how to boost productivity by investing in technologies.



FDI inflow has been moderate in 2005. In January–August the net FDI inflow amounted to LVL 175 mln compared to LVL 197 mln a year ago. As noted in previous years, there is rather low green field capital and most of the FDI is related to existing companies (e.g. profit reinvestment). In 2005 there have been significant dividend payments (thus decreasing FDI). Although part of these dividends has been capitalized, we expect generally lower reinvestment activity. With every year the earnings outflow will be growing.

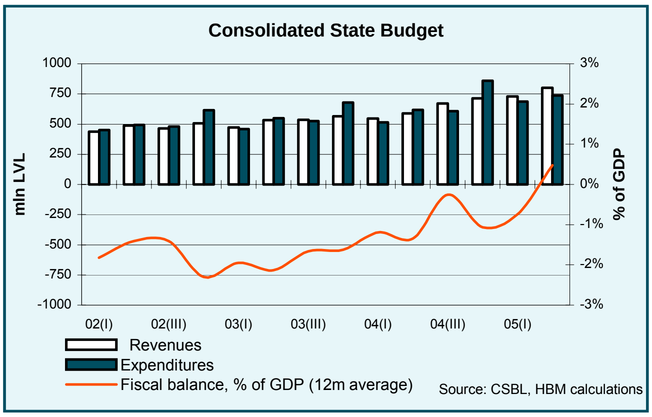
EU fund progress is slow and EU money inflows are modest. Reporting on the progress is fragmented and infrequent. The most successful areas are agriculture and business infrastructure (modernization), where the relative amount of approved projects is the highest. However, project implementation in these areas is time consuming, and only a fraction of approved projects will be realized in 2005. The rest of the investments will move to 2006. In our opinion the actual fund inflow in 2005 will be only half that projected by the government (reflected in the state budget for 2005). Our estimates are that via EU funds Latvia will attract LVL 200-250 mln in 2005 and LVL 300-350 mln in 2006. The next planning period (2007-2013) is uncertain, as EU members failed to agree on the budget. There is hope that sums will grow, but confidence on this could be gained only in 2006. Future funds will put more emphasis on production (building of competitive advantage) rather than social issues.

Cash flows between EU and Latvia, 2004- 2006			
mln EUR, 1999 prices			
	2004fact	2005plan	2006 plan
Pre-accesssion funds	103.9	85.9	52.3
Agriculture expenditure	32.8	116.0	155.7
Structural funds	64.2	151.3	188.6
Internal policies	37.1	45.2	50.9
Compensations	21.6	3.4	3.4
Total payments from EU	266.0	401.8	450.9
Payments to EU	-71.1	-107.3	-110.2
Net payments from EU	194.9	294.5	340.7

Source: European Comission, Finance Ministry

Government Spending and Fiscal Policy

Similarly to 2004, the consolidated state budget this year is performing well. The budget has run a constant surplus so far owing to the strong growth in revenues. The 8-month surplus was LVL 173 mln, 2.5 times the amount a year ago. Revenues rose by ~30% (corporate income tax and excise tax revenues were especially strong). The inflow of EU funds fell short the planned amount proving that the initial state projections have been too optimistic. 8 months foreign aid inflows were LVL 172 mln, just 35% of the annual budget; nevertheless, in comparison to 2004 this still is a 115% rise. Meanwhile budget expenditures rose by ~25%.



At the end of summer the regular budget law amendments were introduced. Based on healthy tax revenues and the surplus, the government increased expenditures for the 2nd half 2005. Unfortunately the deficit was not reduced, and the previous level is maintained - 1.7% of GDP. This reminds us of the budget amendments of 2004 when extra revenues were also directed to additional spending. However, in 2004 the actual budget deficit was smaller than planned (1% of GDP vs. budgeted 2%). The upcoming months of 2005 will definitely incur substantial deficits. We anticipate a 2005 annual budget deficit of 1-1.5% of GDP. The revenues (and expenditures) will fall short of the budgeted amount due to weaker than planned EU fund inflows (and consequent lower transfers to the private sector).

At the beginning of October 2005 the government approved the 2006 budget; however, it still has to be ratified by Parliament. The 2006 budget proposal is as ambitious as that of 2005. The most characteristic trait of the budget proposal is the approaching parliamentary elections in 2006. Both for revenue and expenditures the planned growth is strong (19.2% and 17.6% matched against 2005 budget law). Still the estimated budget deficit is similar to this year (LVL 140 mln or 1.5% of GDP). In our opinion this budget does not address the inflation problem (but inflation currently is seen as the main obstacle to timely euro adoption in Latvia). We also do not see any ambition to reduce inefficiency in the state sector.

The revenue growth is aggressive, especially in tax income: for example, corporate income tax revenue is to grow by 40%. The sums of foreign aid inflows (EU funds) are slightly lowered compared to the 2005 budget. We can only hope that the low capacity of processing EU funds in 2005 will be balanced by more active inflows next year. The positive side is that any delay with EU fund inflows is matched by lower expenditures, thus the net effect on fiscal balance is small.

Central government consolidated budget*					
	annual growth				mln LVL
	2003	2004	2005p	2006p	2006p increase
Revenues	**11.8%**	**19.5%**	**31.7%**	**19.2%**	**521**
Tax revenues*	10.8%	12.9%	19.2%	25.2%	496
Non-tax local revenues	8.7%	21.2%	9.3%	12.8%	35
Foreign aid	81.4%	203.3%	201.9%	-2.3%	-11
Expenditures	**11.1%**	**18.3%**	**32.0%**	**17.6%**	**503**
Current expenditures	10.7%	18.3%	27.3%	16.0%	408
Capital and investment exp.	15.5%	18.8%	95.1%	32.3%	94

p - budget law for 2005, proporal for 2006
** does not include municipal budgets*
Source: Finance Ministry , HBM calculations

2006 year's budget is socially oriented. In reaction to mounting social pressures (e.g. risks of labour outflow), the salaries for public sector employees will rise (e.g. education, health, courts and the police). Total expenditures might grow by LVL 500 mln: one fifth of it is attributable to 'maintenance' expenses (salaries etc.), another two fifth to a rise in subsidies and an additional one fifth to state investment and capital expenditures. The latter two areas are partly linked to EU funds, although many positions are intended with solely state funding.

The main changes in 2006 affecting the fiscal situation:

- Increase of minimal monthly wage (from 80 to 90 LVL) and non-taxable minimum;
- Increased salaries in education, internal security and other public sub-sectors;
- Overall private person income declaration from 2007 (with extensive preparations in 2006) aimed at fighting the envelope salaries and grey economy;
- Minimal alterations in indirect taxation (increase of beer and tobacco excise taxes, unchanged fuel excise taxes since exchange rate adjustments will most probably be postponed, possible application of VAT on heating from July 2006);

- Elimination of corporate income tax allowances to large investment projects (substituted by higher amortization rates);
- Increased defence spending to meet NATO criteria (2% of GDP);
- Larger spending on infrastructure (e.g. roads).

Possible future changes affecting fiscal situation:

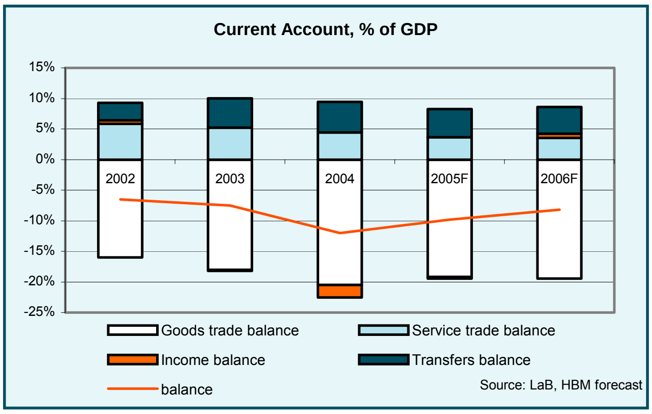
- Further increase of minimal wage and private income tax allowances;
- Further convergence with EU indirect taxation (pickup in fuel excise taxes in 2008, 2010 and 2013) and administrative requirements (fuel reserves to increase to 90 days eventually);
- Possible decrease of VAT on food from 18% to 5% - would support the poor, and temporarily diminish inflation (instrument usable for euro adoption);
- Aligning private and corporate income tax rates which currently are 25% and 15% respectively, i.e. possible decrease of private income tax (but not soon);
- Simplifying tax procedures for SME; currently individual entrepreneurs are taxed at 25%, possible substitution with a fixed sales tax (e.g. for size of annual turnover LVL 10-50 th);
- Discussions on capital income tax (currently highly uncertain).

In our opinion next year's budget is very aggressive in revenue forecasts and there is little chance of achieving a lower deficit than planned (1.5% of GDP). The government's medium term strategy indicates no political will to decrease the deficit and achieve a surplus. Taking into account the pre-election environment in 2006 we expect the deficit of the approved size (1.5% of GDP) in 2006. The state debt will continue to grow, however, its relative level will remain comparatively low (~15% of GDP).

External Balance

We forecast CAD at 11.2% of GDP in 2005 and 10.8% in 2006 (13.1% in 2004). But the forecast aggregate deficit indicator of the current account and the capital account is 9.8% and 8.2% for 2005 and 2006, respectively (12% in 2004).

The current account deficit (CAD) reached 10.7% of GDP in the 2nd quarter, while the combined indicator of current account plus capital account was -10% of GDP. We believe that the latter indicator is more informative as it accounts for the total EU fund inflows. Although the deficit was smaller than a year ago (19.1% and 18.4% of GDP for both ratios[2]), in fact there was no material improvement in fundamentals. Extensive importing related to EU entry artificially worsened the CAD in the 2nd quarter 2004 and other one-off items (e.g. large ship purchases by leading shipping company).



The goods trade deficit continued to widen with the only exception of the spring months. Generally export growth is matched by equally strong import growth. Due to internal demand, imports are most likely to keep growing with 20-30% annual rate for the rest of 2005 and 2006. Further progress with EU funded projects will facilitate the import of investment goods. As a result the goods trade deficit is going to increase at a faster pace in the 2nd half 2005 and 2006. Therefore we forecast minimal changes in the goods trade deficit relative to GDP: similar to 2004 the ratio will remain close to 20%.

The positive balance of the services trade shrank in the 1st half 2005 as the imports of services have been very strong (45% y-o-y growth). For the rest of the year we expect only a slight improvement: the services exports will sustain ~20% growth rate while services imports growth might decline from 40% to ~20%. Even with the assumed positive trend for the 2nd half, the service trade surplus in 2005 will be lower than in 2004, and relative to GDP there will be deterioration from 4.4% (2004) to 3.6% (2005). For 2006 we expect more balanced services export and import growth (20-23%, still with import dominance), and the ratio to GDP will stay stable (3.5%).

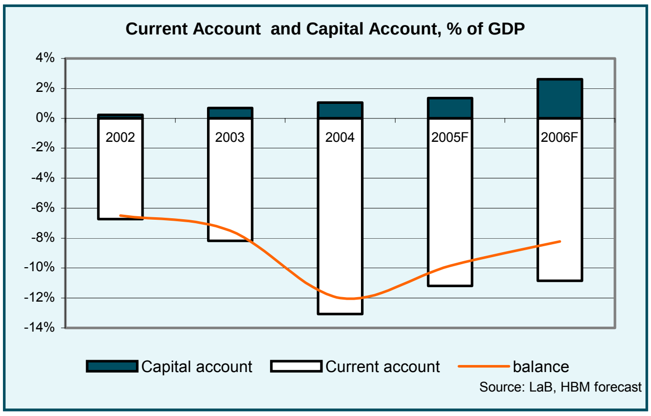
For the past two years the income account has been negative since non-resident incomes have increased, though part of these sums have been reinvested. Lately a new trend with a contrary effect is emerging: since the beginning of 2005 work compensation of residents abroad is increasingly growing as more people are leaving Latvia for a job in other EU countries (e.g. Ireland). This is offsetting the negative impact of FDI profit outflow. In coming years we expect a significant advance in work compensation (+80% annually). Meanwhile non-resident business earnings will also continue to grow. In 2005 the income account is most likely to remain in deficit, but next year it could become positive. We forecast the income account balance of –0.2% of GDP in 2005 and 0.7% in 2006 (-2% in 2004).

The transfer account growth is moderate but volatile. In the 1st quarter the transfer account got smaller because of large outflows, but in the 2nd quarter it increased as stronger inflows offset the rising outflows. Inflows of EU funds are not steady, and the division of the funds between transfers and capital account is non-persistent. For example, Latvia's

[2] In autumn 2005 the BoP statistics for 2000-2005 were revised

payments to the EU budget are accounted solely as a short term (i.e. under transfers). The classification of inflows depends on the type of the fund thorough, which the money is received. In the 1st quarter a relatively large fraction of EU monies went into the capital account (long term account), an additionally there were sizeable payments to the EU budget. In the 2nd quarter payments to the EU diminished and the transfers account improved accordingly.

We expect EU fund inflows in the 2nd half to be larger than in the 1st half; however, the increase will not be radical. Nonetheless, in 2006 the fund inflows could double if projects are successfully completed and the money transferred. Since we expect most of the funds to be recorded in capital account, the transfers' account will get only a marginal boost. However, since the exact classification of funds is uncertain, it is more appropriate to look at the aggregate measure, i.e. current account plus capital account.



Monetary Issues

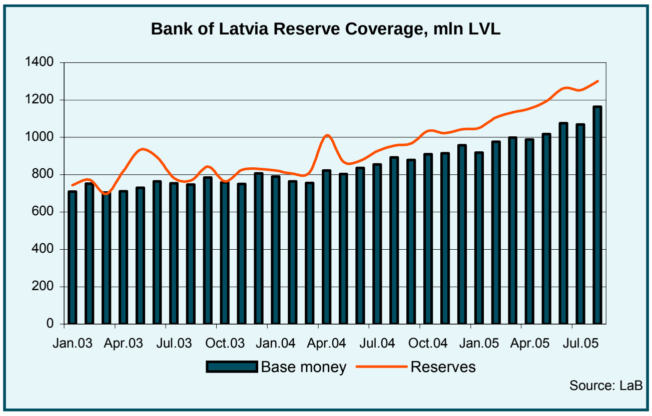
Inflation

Inflation turned out to be more persistent than expected. Although in the summer inflation eased, in September it advanced to 7.2%, the highest level in the EU. On the one hand the rise was partly caused by one-off factors (e.g. post Katrina storm fuel price peaks) that are to revert in the coming month. On the other hand, to our mind there are no fundamental changes that are in favour of sizable inflation decline.

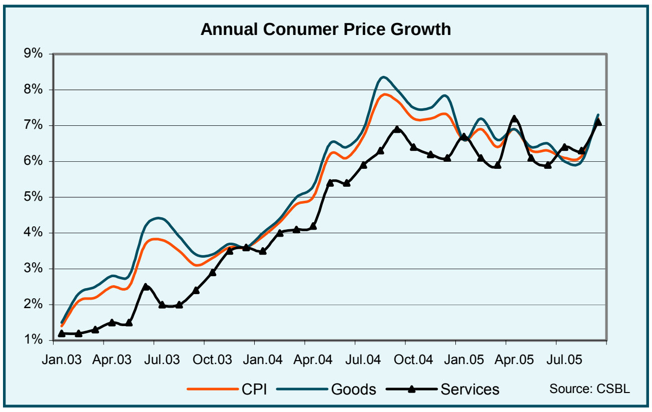
Several trends can be highlighted.

- Rising food prices give the largest impact on total price level. Food price inflation is stable at 10% and is unlikely to go up.
- Another strong inflation driver is fuel prices (annual rise of 25-35%). Besides the adjustments in excise tax in beginning of the year, fuel prices are driven by global processes. Although there is a heated debate on insufficient competition in the fuel wholesale and retail markets, we do not see any substantial improvement and consequently no price declines. The only chance of cheapening is if global oil prices decrease (we forecast only a minor price decline). In future additional administrative effects will shape domestic fuel prices:
    - o the excise tax should be recalculated according to updated EUR/LVL exchange rate, which could add further 1.5% to the price (most probably not brought into effect on 01.01.2006);
    - o the excise tax should be harmonized with EU minimal levels (expected rise in 2008, 2010 and 2013 with the aggregate effect of +10%).
- Although in the 1st half 2005 there were no substantial administrative price rises, now more important changes are about to occur, i.e. in mid 2005 gas tariffs started to increase. Gas tariffs will continue to rise both in 2006 and 2007, affecting heating (with a short lag) and eventually electricity tariffs. In 2006 gas costs will increase by 12-17%, and in 2007 by 6-22%. There is a potential for an even higher gas price rise in 2006 since Latvian Gas is facing steeper than expected supply price increases (estimated net effect additional ~15%). Heating costs are likely to rise by 10% a year. For example, Riga Heating has already obtained permission from the regulator for an 11% rise in November 2005. In mid 2006 VAT (18%) is to be applied to heating (effect ~3%). Electricity prices might be kept stable for this and next year, but eventually a rise is inevitable (reasons: more expensive gas and the closure of the Ignalina nuclear plant). Latvenergo, the electricity monopoly thinks that tariffs will rise by up to 10%.
- The level of regulated prices is well below EU levels, but most of the companies expect a quite rapid closure of this gap. This consensus opinion is leading to a pick up in other prices as enterprises try to price these changes in advance.
- Inflation expectations have become stronger recently. The demand driven inflation is at present stronger in Latvia than in other Baltic countries. This is fuelled by a vicious circle of inflation compensation in salaries and additional pressure on prices from increased purchasing power. The companies more frequently claim that the rise of salaries (besides the other factors such as high transport expenses, administrative prices) is grounds for increasing of their selling prices.

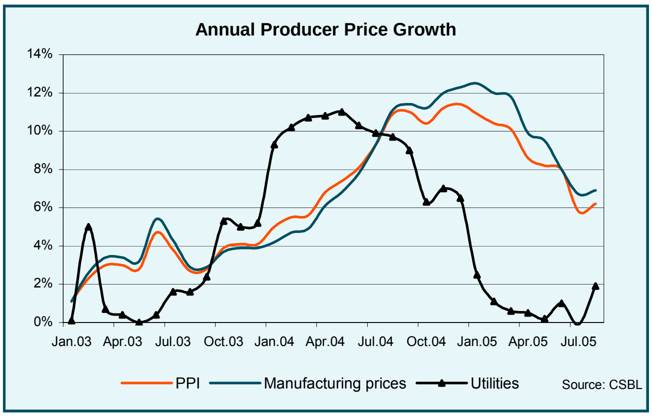
The recent developments show that convergence of the price level with the EU is very strong. Currently we see no forces that could substantially slow down the rise in salaries and consequently in prices. Furthermore, the administrative price increases planned for 2006 and 2007 will have an additional inflation effect (main changes in utilities). Although no official announcement has been issued, Latvia is slowly moving away from euro adoption in 2008. The fact that the government is not addressing the question of high inflation in their future policies is a clear indication of this. Most likely inflation will not be restricted in any substantial way and the fast catch-up scenario will be realized. This will leave euro introduction for later years.



We have increased our CPI forecast to 6.7% in 2005 and 5.4% in 2006 (previous 6.0% and 4.3%). Comparing both years we expect slightly slower inflation in food prices, health care, education and public catering, while public utilities will incur stronger tariff increases in coming years. While the transportation sector will depend on the global oil market, we hope for stability in prices. The competition effect would facilitate lower communication costs and to some extent lower inflation in clothing. Moreover, EUR/LVL exchange rate will not contribute to the inflation as it was in 2005.



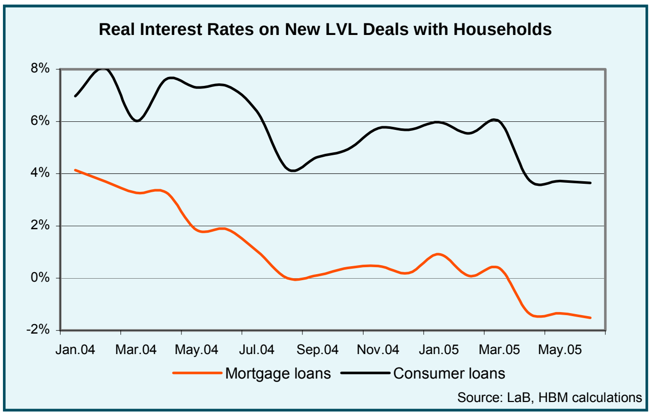
The other price indices will behave in a similar manner to CPI. Producer price index (PPI) inflation is revised to 8% in 2005 and 7% in 2006 (previously 9% and 8.6%). Within these the manufacturing price inflation will be 9% in 2005 and 6% in 2006. Some changes in the forecasts are due to the unforeseen sustainability of timber prices in 2005. The primary determinant of PPI is export price growth as well as the potential rise in labour costs. In 2006 the PPI will be pushed up significantly by rising utilities tariffs (~14%). One of the most problematic areas is the construction sector. Due to insufficient capacity price rises will remain at 10-15% p.a. Our forecast of GDP deflator has also increased: the revised projections are 8.1% for 2005 and 6.6% for 2006 (previous 5.8% and 4.8%).



Interest Rates

Lat interest rates in the interbank market have moved rather close to euro benchmarks. However, for this and next year some risk premium will be sustained. If the euro adoption is postponed from 2008 to later, the convergence of the lat and euro rates will be prolonged. We do not expect a widening of the lat - euro interest rate differential with the official announcement as this information is largely assimilated by the market already. Nevertheless, the market could become suspicious (i.e. financing costs increased) if no viable euro adoption till 2010-2011 is presented (long delays could be penalized).

Loan margins have experienced a great decline in 2005. The strong competition among banks will most likely result in a further drop in mortgage interest margins. However, the quality of loans will not necessarily become better as market saturation is approaching.



Hansabank Markets

Lithuania

Baltic Outlook 20.10.2005

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Latest Economic Developments

Lithuanian economic growth reached 6.4% for the first half of 2005, which all in all supports our full year forecast of 6.8%. The latest economic data indicates no significant deviations from previous forecasts, except that foreign trade data shows unexpectedly strong growth in exports and imports, partly boosted by growing commodity prices, and also the inflation level is bit below that expected. Consumer price inflation in the recent months was also slightly below expectations, although inflation intensified due to external factors in September to 2.6% (or 0.1% above), which casts doubt on Lithuania's ability to fulfill the Maastricht inflation criterion in mid-2006.

	2003	2004	2005f	2006f
Economic growth	9.7%	6.7%	6.8%	6.5%
GDP, mln EUR	16442	18084	20570	23600
GDP per capita, EUR	4760	5263	6020	6940
Industrial sales, annual growth	16.1%	12.4%	8.0%	7.0%
Inflation (GDP deflator)	-1.1%	2.8%	6.5%	7.5%
Consumer prices	-0.2%	1.2%	2.7%	2.8%
Producer prices	-0.5%	6.7%	15.0%	7.0%
Harmonized unemployment level	13.0%	11.4%	8.3%	7.5%
Average growth of real wage	5.1%	4.4%	7.0%	9.0%
Exports of goods and services	6.2%	12.0%	25.0%	15.0%
Imports of goods and services	6.9%	14.2%	21.0%	11.0%
Trade and services balance, % of GDP	-5.7%	-7.0%	-6.8%	-7.5%
Current account, % of GDP	-6.8%	-7.7%	-8.0%	-8.5%
FDI inflow, % of GDP	1.0%	3.4%	3.5%	4.0%
Gross debt, % of GDP	40.5%	42.2%	43.0%	44.0%
Budget balance, % of GDP	-1.9%	-2.5%	-2.3%	-1.7%
Government debt, % of GDP	21.4%	19.6%	19.0%	20.0%

Assumptions

In addition to the general assumptions, we took into account the following factors which could affect Lithuania's economic developments in 2005-2006.

- Currently the Lithuanian government is involved in negotiations with the Russian oil company Yukos regarding the sale of shares in the oil refinery Mazeikiu Nafta, the largest company in Lithuania and the Baltic States. Yukos will sell their shareholding (a 53.7% stake) while the government is considering the purchase and resale of the stake. Should the government borrow funds to buy the shares from Yukos in the end of 2005 and not sell the shares immediately, this would increase the country's statistical year-end debt by roughly 5% of GDP. However this action would not threaten the fulfillment of the Maastricht criteria and should have no significant effects in the macroeconomic sense. An additional consideration is to sell roughly half of the shares that are currently owned (40.7%). The funds received could be used to accelerate the scheme of property reinstatement (for deposits, land and real estate) and could potentially strengthen household consumption in 2006-2007. However at present we have not included this factor into the forecasts.

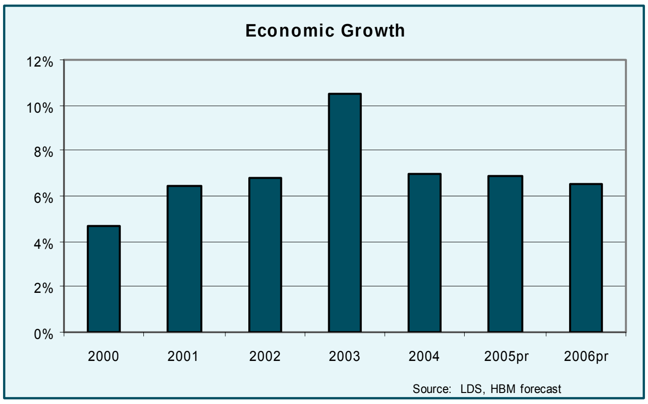
Highlights of the 2005-2006 Forecast

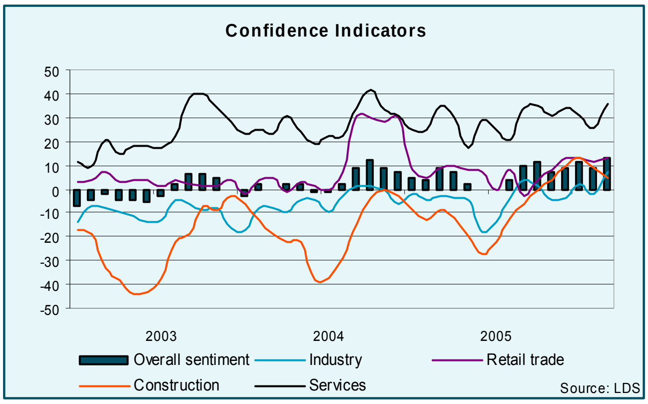
We maintain the GDP growth forecast of 6.8% for 2005 and the 6.5% projection for economic growth in 2006, largely counting on the sustained growth of domestic consumption and investments in the next few years. Household consumption is above the current income growth, although accelerated wage growth, tension in the labour market and tax reform will pour more money into consumers pockets in the near future. As the inflation level in the recent months has been somewhat lower than expected, we have decreased the CPI inflation forecasts for 2005 from 2.8% to 2.7% and for 2006 from 3.0% to 2.8%. Public finances are hard to predict, though a significant contraction of the fiscal deficit in the medium term is probably not intended or expected. Strong domestic demand and investments are expected to boost imports further, which in the medium term should result in wider trade and current account deficits (forecasts unchanged), covered by growing foreign borrowing mostly and FDI and money transfers.

Economic Growth

The latest economic sentiment indicators give a picture of overall positive developments in the economy, and especially strong improvements are seen in industry and construction, with growing present and future demand estimates. For the construction sector in particular the growth of supply is constrained by a lack of qualified labourers, therefore majority of companies also expect growing prices. The consumer confidence indicator has somewhat worsened lately, although it is harmed by weaker expectations for the country and fear of inflation rather than by a worsening personal situation. We would relate the present decline in consumer confidence to a mixture of factors: peaking fuel prices, intensified discussions about the euro adoption (esp. fear of inflation) and even the shareholder struggles regarding the oil refinery Mazeikiu

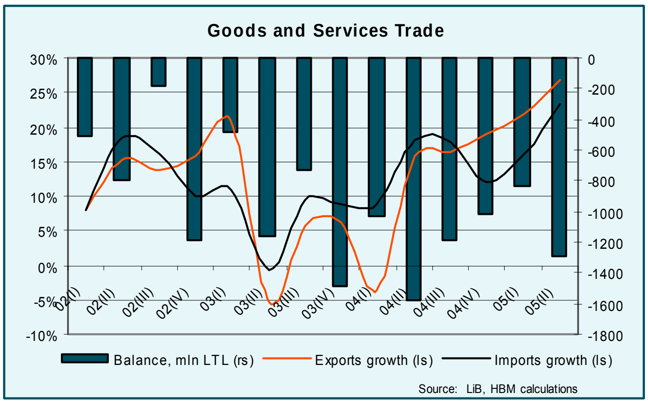
Nafta, the biggest local company. Poll results (RAIT) suggest that the number of people opposing the forthcoming adoption of the euro hit 38% in the end of September, the highest level ever observed, which we see as reflection of the fear of inflation. Nonetheless, consumer confidence seems not to have affected the actual consumption growth, which is booming.





External Demand

Lithuania's foreign trade turnovers are growing surprisingly well despite the sluggishness of the economies of many trading partners, particularly the EU countries. According to preliminary data the value of merchandised exports grew 24.2% in the first eight months of 2005 compared to the same period a year ago. The growth of imports was bit smaller 18.4%. Notably due to methodological changes in data collection in May 2004 the abovementioned numbers may not be entirely accurate, still the intensified trading activities should not go unnoticed.



Considering the fact that oil prices have been booming and that mineral products account for roughly one-fourth of Lithuania's foreign trade, it is no surprise to see the foreign trade numbers also booming. Even excluding mineral products, the growth in exports would still be outstanding, or some 20.1% (compared to imports growing 8.3%). Notably exports of chemical items are soaring 47.6% y-o-y on positive price developments for fertilizer producers, while exports of foodstuffs and beverages have expanded 36.9% (imports 17.1%). The producers of food items seem to be continuously trying to conquer the higher-priced CAP-governed EU market, and the sluggish consumption in the EU markets may even work in favour of Lithuanian producers as in such situations the demand is more price-cautious. The exports of base metals and their products are also soaring 30.6% on growing prices. Exports of other important items are growing more modestly – wood and its products 13.6%, furniture and various other items 13.2%.

However two important sectors may be mentioned as experiencing decreasing foreign demand and a consequent decline in export turnovers. The exports of textile items are slowly but consistently decreasing (-2.2%), as the growing labour costs and Asian competition reversed growth in the local industry which still accounts for 9.9% of the total exports. The other significant sector is producers of electric machinery and appliances (exports dropped 3.7%), while two large manufacturers of components (Ekranas and Vilniaus Vingis) for traditional cathode-ray tube TVs are even calculating losses.

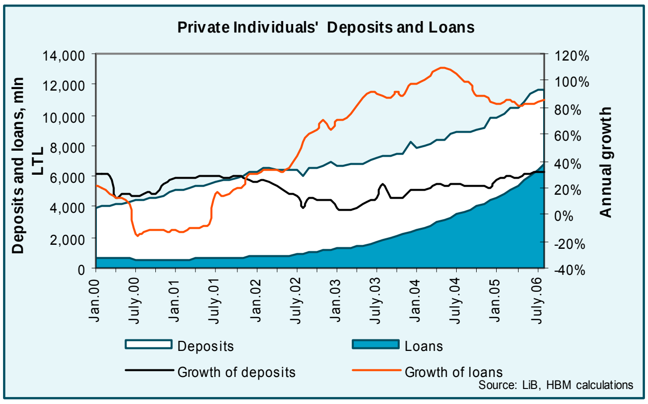
The developments in the prices of energy items increased Russia's significance among Lithuanian import partners to 28.4% of the total, while Russia is also in the top export destinations with 10.7% weight. The EU countries are the main trading partner and account for 66.9% of total exports and 58.3% of imports of Lithuania.

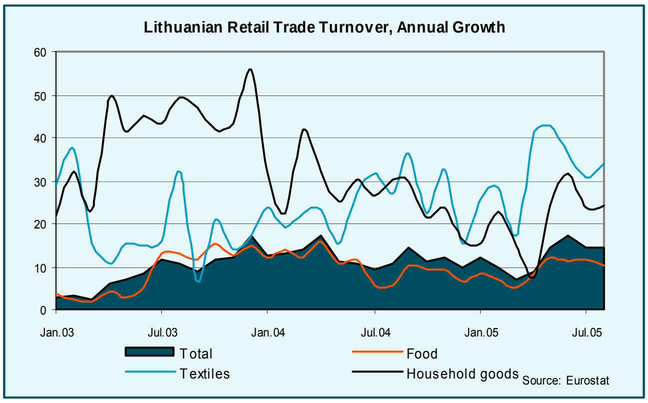
Household Incomes and Consumption

Disregarding the latest decline in consumer sentiment, households seem to be on a fast track towards higher income and spending. Wage growth started accelerating as early as the second half of 2004, while nominal wages grew 10.8% and 9.0% in the first and the second quarters of 2005, in year-on-year terms. The real wage growth rate (after-tax wage adjusted for CPI inflation) is still much lower, at 6.2% and 5.4%, which is below the consumption growth as seen by retail trade turnovers. The boom in crediting activities strengthens consumption, however the majority of borrowed funds go to the real estate market rather than direct consumption. It is highly likely that domestic demand is supported by family members working abroad, though there is no reliable data on this and the official registration of emigrants (e.g. 33ths in 2002-2004) is significantly smaller than the widely assumed 250-350ths people that have left Lithuania since 1990's (local population is 3,41mln).

The real wage growth should however intensify in the next couple of years due to evident tension in the labour market, while lately registered labour demand exceeds the supply by one-third. The estimated unemployment rate in

Lithuania in September (harmonized unemployment at 7.6%, seasonally adjusted) already stands below the average EU level, and unemployment is on a clear downward trend. Still we see a mere 1.5-2.5% potential for the decline in unemployment in the next couple of years, as more than a half of the presently unemployed are long-term unemployed with lack of any relevant skills, and therefore hiring people from such a pool becomes increasingly difficult. The income tax reform of 2006-2008 may partly eliminate the pressure on employers to increase wages, however it should not stop the growth.





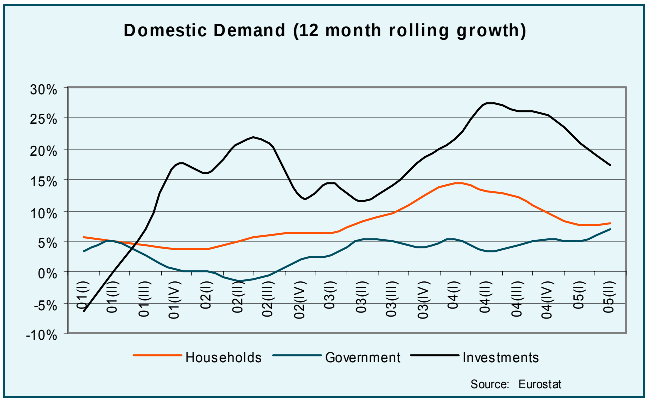
Government Spending and Policy

Although we mentioned the planned tax reform in the previous Baltic Outlooks, we will outline it once more as it can be considered a major economic reform of the next several years. Approved in July, the reform envisages the following changes:

- Personal income tax will be lowered from present 33% to 24% in two steps: from 33% to 27% starting July 2006, and from 27% to 24% starting January 2008
- Temporary "social" tax is introduced on corporate profit during 2006-2007, which is in essence a temporary increase of corporate profit tax by 4 percentage points for 2006 and by 3 percentage points for 2007. The effective rate of taxes on corporate profits will be 19% in 2006 and 18% in 2007, afterwards declining to the present level of 15%.
- Introduced tax on real estate owned by private persons but used for commercial purposes.

Since the corporate profit tax will be increased half a year earlier than the personal income tax is reduced, we expect it to create some additional surplus in 1H06, which is positive considering that the Lithuanian budget position will be monitored to fit the Maastricht criteria in mid-2006. The revenues of this tax (~LTL 400 mln in 2006) will be allocated to various social spheres, in this way proving the title “social”. The decrease in personal income tax is expected to stimulate economic growth through higher consumption and lowered wage-growth pressures. The temporary introduction of “social” tax (rather than balancing the budget through tighter spending) somewhat offsets the positive aspects of the reform and puts stress on the budget of 2008, the time when the tax is supposed to be eliminated.

The present collection of the state budget is excellent with preliminary revenues of the first nine months being 4.6% (LTL 399 mln) above the plan, which was largely weighted by record-high dividends (mostly unplanned) and income tax revenues received from the oil refinery Mazeikiu Nafta (total LTL 236 mln). Both income tax revenues and corporate profit tax revenues are significantly above the plan, and the collection of the budget can be considered successful in all major spheres.



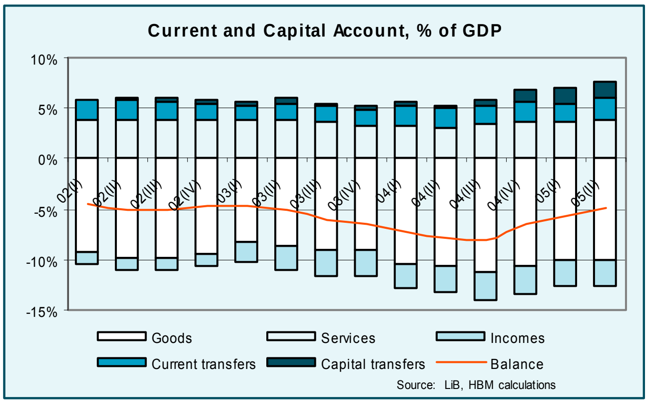
According to statistical data, the second quarter aggregate corporate profits of Lithuanian companies (EBT margin 6.4%) grew by an outstanding one-third compared to a year ago. Considering the situation we cannot exclude the possibility that the current growth in corporate profits is boosted by accelerated profit recognition, in order to report lower profits afterwards when the additional “social” tax is applied. If this is partly the case, then the growth of corporate pre-tax profits should significantly decline in the coming two years. Consequently the revenues from income tax should not grow as fast either.

The proposed national budged plan for 2006 marks a significant expansion in revenues (19.4% to LTL 18.7b) as well as expenses (+17.3% to LTL 20.4b), with particular focus on social spending. The net cash inflow from the EU is planned to reach LTL 2.5 bln., or some 3.4% of GDP. The planned budget deficit is 2.4% of GDP, and considering the approaching local elections we do not expect any tightening of the deficit, unless revenues turn out to be higher than planned. Lithuania's central government deficit of the first eight months of 2005 reached merely 0.5% of GDP on unexpected revenues, therefore the fiscal deficit for the full year may come out smaller than initially planned (2.95% of GDP) or lately expected (2.5%).

External Balance

The preliminary reports on the balance of payments indicate that the current account deficit (CAD) has declined compared to a year ago, the CAD in first half of 2005 accounting for mere 6.6% of GDP compared to 9.1% of GDP in 2004. The CAD has reportedly decreased 18.6% y-o-y to LTL 2.120 billion on the stable foreign trade deficit and lower income deficit, while the surpluses in services and current transfers have widened. The current transfers have significantly improved on account of EU funds received, as the net transfers to the general government in the first half of the year amounted to 1.1% of GDP, up from 0.4% of GDP a year ago. The preliminary CAD data however usually tends to be revised upwards with more precise estimates, while for the full year we maintain the CAD forecast at 8% of GDP, which is slightly higher than the 7.7% of GDP recorded throughout 2004.

In the near term, the current account deficit will mostly by financed by loans (through the banking sector) and EU capital transfers rather than FDI. The FDI in Lithuania in the first half of 2005 dropped almost 56% compared to a year ago and combined mere 1.9% of GDP; however this figure is understated by significant negative reinvestments in the second quarter of the year, a result of several large companies paying out hefty dividends, which should not happen in the next two quarters. Nonetheless the FDI in equity capital (1.8% of GDP) was also bit weaker than a year ago (-9.2%), which indicates that FDI activities remain at modest levels despite Lithuania entering the EU. Possibly the current financing opportunities provided by the banks prevent local businessmen from selling shares to attract additional capital, while foreign green-field activities still are rather infrequent examples. However, the interest expressed by various EU companies in relocating manufacturing facilities to Lithuania is generally growing.

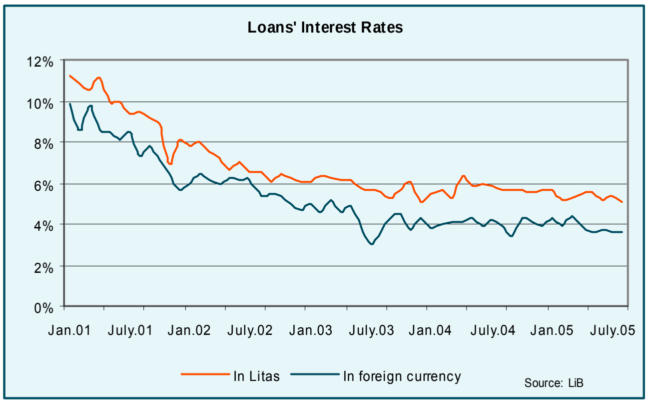


Monetary Issues

Monetary Policy and Interest Rates

As of lately the main focus of the Bank of Lithuania is to prepare for joining the EMU and adopting the euro on 1st of January, 2007. Final amendments to the laws of Lithuania will be voted on only after an official invitation to join the euro-zone is made, however technical preparations are running at full-speed. We observe all interested parties (esp. banks, retailers) preparing detailed action plans for the currency changeover, even if the fulfillment of the Maastricht criteria in mid-2006 and the resulting introduction of the euro cannot yet be taken for granted (see chapter on inflation and the special theme "The Road to the Adoption of the Euro").

The Bank of Lithuania operates under currency board regime with the litas fixed to the euro at the rate of 3.4528 litas per 1 euro (without fluctuations allowed), and the same rate is expected to be irrevocably fixed upon joining the euro-zone. Lithuania has no tools to control the interest rate environment; rather the local interest rates are "imported" from the euro zone. The differences in the average interest rates on loans in euros and in litas (see graph) appear due to the different nature of the loan portfolios rather than the currency risk, as e.g. mortgage loans are usually taken in euros, while higher risk consumer credits are often taken in litas.



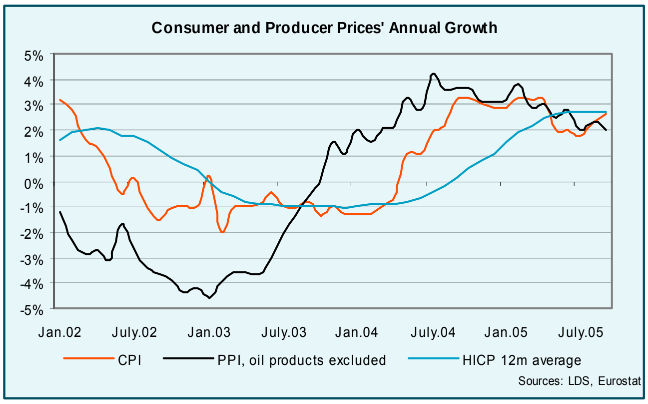
The present interest rates of the euro-zone have expansionary effects on Lithuania's economy (by fueling investments and consumption), and the growth in money supply has intensified in the latest quarters. Setting the required reserve rate for the commercial banks is one of the very few tools the Bank of Lithuania can employ to influence lending activity. The present required reserve rate at 6% is higher than the 2% used in the euro-zone, therefore Lithuania will have to reduce it to 2% before entering the EMU. Although a partial cut was considered in 2005, such action would allow the commercial banks to give out more loans and in turn it could accelerate inflation, which is not desired. In the meantime the Bank of Lithuania is seen to postpone any cut of the reserve requirement. Nonetheless in September the Bank started paying interest rates on the required reserve accounts (effectively only 1/3 of the ECB's rate), while previously no interest was paid on the required reserves at all, putting local commercial banks into a worse competitive position than the banks of the euro-zone.

In the coming quarters the local interest rates could be influenced by external factors only – whether it be the change in ECB's base rate (unlikely to happen until first half of 2006) or the announced verdict regarding Lithuania's readiness to adopt the euro (due in mid-2006). In case of approval of the euro-adoption in Lithuania, the presently tiny liquidity and currency risk premium on bonds in litas (10-15 basis points) may diminish further, while in case of negative decision the interest rate volatility and spreads could marginally increase, at least temporarily. However in any case the interest rates on loans and deposits will be affected very slightly. The currency board regime fully guarantees the exchange rate stability of the litas (currency is backed by 100% of foreign reserves), therefore the interest rates should remain very close to the rates of the euro zone.

Inflation

Despite strong growth in wages and domestic consumption, the inflation level in Lithuania remains at relatively modest levels and is predominantly driven by external factors. September brought an increase of annual CPI inflation to 2.6% on another hike in fuel and transport prices, while in the course of one year the main price drivers are transport prices, food prices and utilities. The changed terms of trade upon entering the EU in May 2004 have still some momentum effect on inflation, mostly upward pressure on food prices and downward pressure on various tradable goods due to lower import-related costs, although this entrance-effect is fading. The fact that the prices of 1/3 of the items in the consumer price index are falling despite the sharp growth in transportation and energy prices gives a hint that 1) the competition forces are strong in most of the production and service sectors, and that 2) domestic demand still exercises very low pressure on price growth (except on price of land and read estate – which are booming, but are not included in CPI).

The Lithuanian trailing 12-month average HICP index currently stands at 2.7% and may be expected to remain at this level until the end of this year. This index is supposed to be monitored to qualify for euro-adoption at a certain month (as yet unannounced) between May and September 2006, and the benchmark index is forecast to be at 2.5-2.7%. We consider that the Lithuanian 12-month average HICP index may decrease to 2.4-2.6% in the first half of 2006 on lessening price growth of foodstuffs and utilities, provided no additional external price pressures appear (like another boom in oil prices) and provided administrated prices are kept low. The annual inflation rates in the months May to August 2005, the first months that may count in the evaluation criteria, show inflation levels being only marginally below (and August was 0.1% above) the potentially relevant rates of the EU countries. In the meantime it is hardly possible to guarantee whether Lithuania will fulfill the formal inflation criteria, as both possibilitiesexist.



The official forecasts (by the Ministry of Finance, on September 29th) predict a slowdown in inflation in the near term, resulting in average annual CPI inflation at a mere 2.1% in 2006 which would secure adoption of the euro, however we are not as optimistic regarding a general slowdown in inflation. Indeed the annual inflation rates should decline in the first months of 2006 as the effect of increased electricity prices on consumers in January 2005 by ~9% will no more affect the index, while other administratively regulated prices seem to be being kept under strict control. The growth of prices of foodstuffs should also decelerate due to high comparable basis effect. However we see an accumulation of rather strong inflationary pressures and expect somewhat faster price growth in the second half of 2006 and in the next several years. First, the soaring prices of fuel have not yet fully hit consumers, as highly competing transportation companies have often absorbed the losses themselves. However if municipality-owned public transportation companies lobby for higher subsidies rather than an increase prices, then private companies cannot last long if they are merely breaking-even. Secondly, the administratively regulated prices have remained low in the last several years on political rather than economic grounds, initially due to the election period and lately in order not to harm euro-adoption plans. We have seen growing lobbying to increase the regulated prices lately (esp. for gas, electricity and even long-distance passenger transportation) and such requests may be taken into account after the euro adoption issue becomes clear. Thirdly, the current growth rate of wages can be expected to accelerate price growth in most service sectors.

However, as recent months showed strong consumer price resistance to domestic demand and growing prices of energy items, we have reduced the average inflation forecasts from 2.8% to 2.7% in 2005 and from 3.0% to 2.8% in 2006.

Other officially calculated price indices show no significant changes in the trends of the economy. With a significant oil industry the Lithuanian producer price index in September is soaring 15.5% on year-on-year basis, however, excluding the oil industry, producer price inflation is much more modest (2.0%) and has even been decreasing lately.

Construction prices are rising due to excessive demand in the sector, which has triggered faster growth of wages as well as wider profit margins. The construction price index in August was growing at a rate of 6.6% per annum.

The Road to the Adoption of the Euro

Baltic Outlook 18.10.2005

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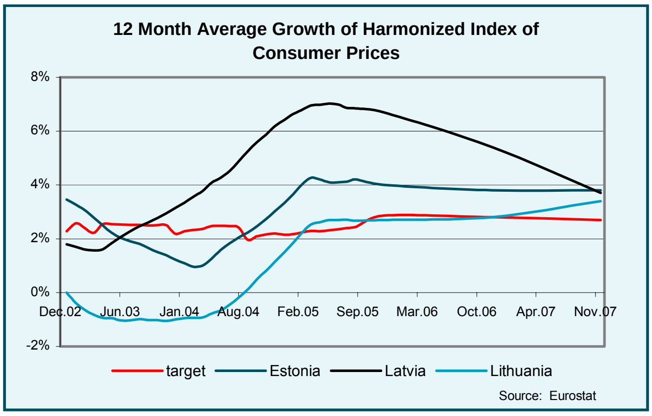
In this permanent part of our Outlook we give short overview of the road to the euro-zone of the three Baltic countries. The Maastricht criteria and other aspects important for euro adoption are discussed briefly. Although the legal framework is important for euro area accession, we are not looking deeply at the issue. Currently all countries have their own independent monetary policy and as the euro area accession is at least two years away, it is hard to expect that legislation is in line with that needed as member of the EMU (especially in the areas of policymaking and relations with the ECB). We expect that legislative convergence will largely take place a year before possible membership (i.e. in 2006-2007) and that many regulations will be executed at the time of each country's accession to the EMU.

The most important economic criteria under observation (the Maastricht criteria) are inflation, long-term interest rates, the exchange rate, budget balance and public debt. Current account and the labour market have also been studied, however they have no clear values needed and are not included in the official list. Our analysis shows the current (October 2004) situation of the three countries and gives forecasts for the next few years. Estonia and Lithuania are officially targeting 2007 and Latvia 2008 for the adoption of euro.



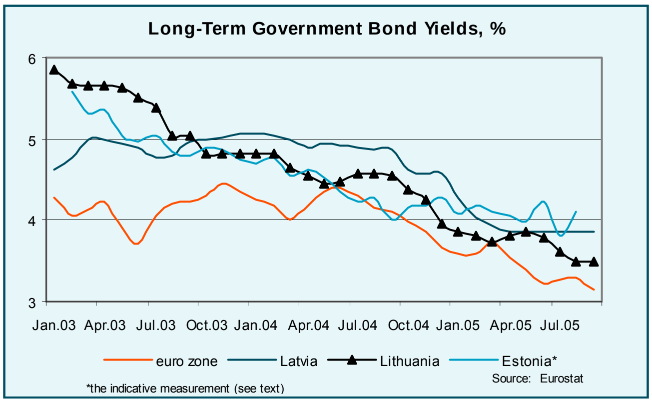
Inflation

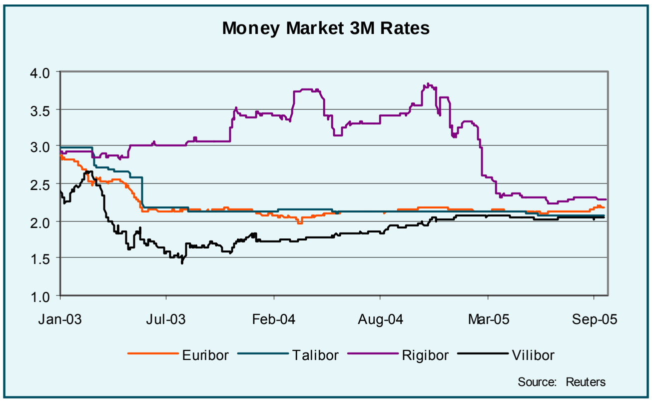
Inflation (measured with 12-months average HICP) should "not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability"[3]. Negative figures are excluded as not reflecting good economic performance. In September the criterion was calculated from the figures of Finland (12-months average 0.6%), Sweden (0.8%) and the Netherlands (1.4%), which have extraordinarily low inflation (one and by no means the smallest impact being the influence of new member-states, e.g. Finland lowered excise rates to face competition from Estonian prices). The resulting low target (2.4%) is fulfilled only by 12 of the 24[4] countries of EU (incl. 5 non-euro-zone countries). All three Baltic countries are exceeding the limit: Lithuania has 2.7% inflation, Estonia 4.2% inflation and Latvia 6.8% inflation.

Our forecast suggests that all three have trouble in fulfilling the criteria in next year and half. Estonia and Lithuania should fulfil the criteria in April-May 2006. Our estimates suggest that Estonian inflation at that could be 3.8-4.1% and Lithuanian inflation 2.5-2.7% at best but the value of the criteria will be ca 2.5-2.6%. Consequently the fulfilment of the inflation criteria is impossible for Estonia and rather problematic for Lithuania. Latvian inflation in spring 2007 should be ca 4%, which will also be above the value of the criteria (2.4-2.5%).

Long-term Interest Rates

The applicant country should have "over a period of one year … an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability." Interest rates of long-term government bonds or comparable securities are under observation. Latvia (3.9%) and Lithuania (3.5%) are fulfilling the criteria (5%).





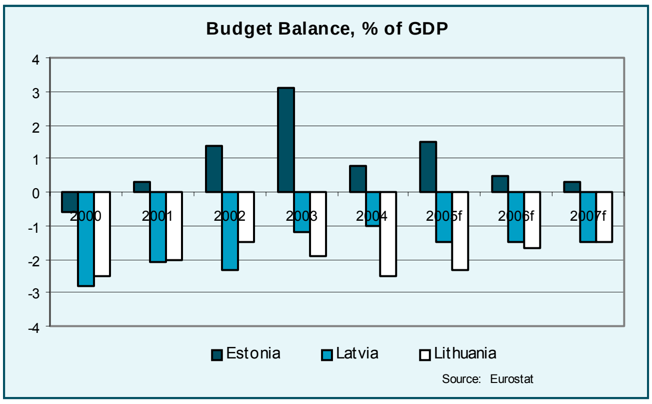
[3] This and following quotes are from the Treaty establishing the European Community taken from Convergence Report (Oct 2004), www.ecb.int

[4] The data on UK are not published yet (Oct.,18)

As Estonia has no similar financial instruments, an indicative measurement is used (new kroon-denominated loans to non-financial corporations and households over 5 years), though this is not comparable with other countries' rates. As the reason for the non-existence of the right interest rate is very low government debt, and not economic reasons, the EC has given a positive assessment on developments in the financial markets.

Fiscal Developments

There are two numerical criteria for estimating fiscal stance – the budget deficit should not exceed 3% of GDP and the ratio of government debt to GDP should be less than 60%. Both criteria are evaluated taking account long-term processes and hence the deficit might slightly exceed 3% in exceptional circumstances, and debt level should be falling towards the criteria. However, one should also remember that the long-term target of fiscal policy is to have a budget in surplus or close to balance, in other words a cyclically balanced budget.



Currently, all three countries are fulfilling those criteria, and in particular the debt levels are very low (at the end of 2004 5.5% for Estonia, 14.7% for Latvia and 19.6% for Lithuania) and unlikely to reach 60% even in long-term period. Estonia has achieved a budget surplus for several years and our projections are for slight budget deficit in the future while EC projects slight surplus or balanced budget. The situation with Latvia and Lithuania is somewhat different, though we are sure that the 3% limit will be not exceeded. However, it is likely that the budget situation in 2005 will worsen and in 2006 no significant improvement will take place.

Exchange Rate

A country seeking to adopt the euro should keep its currency fluctuating in "the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State." The provision states the need to be at least two years in ERM2, so as yet no country has fulfilled this criterion. Estonia and Lithuania have been members of ERM2 since June 28th 2004 and Latvia since May 2nd 2005.. As a consequence, the earliest dates to fulfil the criteria are July 2006 for Estonia and Lithuania, and May 2007 for Latvia.

The other aspect of the criteria is to keep the currency within the band of ±15% from central parity rates set when country joins the ERM2 mechanism. The parity rate for the Estonian kroon is 15.6466 and for the Lithuanian litas 3.4528. With ±15% fluctuation intervention levels are 17.9936 and 13.2996 for Estonia, and 3.97072 and 2.93488 for Lithuania. As both countries have currency board systems with fixed rates toward euro, they have promised to keep that rate while in ERM2. We are of the opinion that both countries will not change their stance and that the kroon and litas will remain within above-mentioned fixed rates.

Latvia pegged its currency to euro from the 1st of January 2005 with the central rate of 0.702804. The Latvian Bank intends to keep the previous ±1% fluctuation band before and after joining the ERM2 mechanism. We have no reason to expect that this stance could change.

Concerning Some Aspects of the Maastricht Inflation Criteria

Baltic Outlook 20.10.2005

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The theme of inflation has come into focus in all three Baltic countries, as the fulfilment of the Maastricht inflation criteria has become increasingly problematic. Questions about the definition and reasonability of the criteria and about inflation patterns and possible political action to limit price growth have emerged. Some explanations and a small analysis of these issues are provided in the following text.

Definition of the Inflation Criteria

According to the **Maastricht Treaty** countries looking for euro zone membership should "acquire a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability."[5] In practice, the inflation rate must not exceed by more than 1,5% that of the three best-performing Member States in terms of price stability during the year preceding the examination of the situation in that Member State. The 12-month average inflation is observed and the best-performing countries are those with the lowest positive inflation. The criterion is based on calculations of all Member States of the EU, as all counties are expected to join the euro zone.

At the time the definition was formed there were no members in the euro zone, hence all member states were considered. However now when the EMU has already been operational for almost 6 years, one could argue that only euro zone members should be taken into account when estimating reference values of the Maastricht criteria (inflation, interest rates). There are two arguments against this approach. First, it would be very difficult to change the Treaty and its definition of inflation, as there would probably be many countries that would like to change the budget deficit criteria. Second, one could argue that all countries should be treated equally and the criteria should be the same for all countries.

The reason why the inflation criterion is defined as it is probably lies in the situation of the EU economies in 90's. The average inflation in 1991-98 was rather high – 3% (ranging from 1.3-5.3%). There were only five countries that had inflation below 2% (Ireland, France, Denmark, Belgium and Germany, ranging between 1.1-1.9%). Only Finland has had a short period of deflation – from August to December 1995. So the high inflation environment might have had effect on the decisions – it was probably hard to imagine long-term very low inflation or deflation.

The European Central Bank (ECB) has stated that its primary objective is to maintain price stability and that under price stability "inflation rates of below, but close to, 2% over medium term" are to be achieved. More exactly the annual growth of harmonized consumer price index is followed.

So we can conclude that the Maastricht criterion of price stability (inflation) and the ECB's approach to price stability are different:

- the Maastricht criterion is based on 12-month average figures, while ECB follows annual growth rates;
- according to the Maastricht criteria price stability is achieved with maximum low inflation, while ECB approach points to 1.7-1.9% inflation.

It seems that the Maastricht criteria has several weaknesses in economist point of view as even 0.1% growth is considered as price stability, however hardly any analyst or economist would say that this level represents favourable developments in the economy. It might also happen that euro zone applicants should show less inflation than that of the euro zone itself, as the value of the criteria might be only 1.6%.

It is possible that the value of the criteria depends solely on the inflation in countries outside the euro zone, moreover, from inflation in countries that have even not applied for euro zone membership (e.g. the UK, Hungary, Denmark). Now, when euro zone has existed for many years that approach seems to be, at least partly, on shaky ground.

The ECB's approach in following annual growth rates allows operative decision making on issues of monetary policy. However, the Maastricht criteria 12-month average approach allows one-off events effecting price level to be excluded and is in relation to medium-term price stability more sensible.

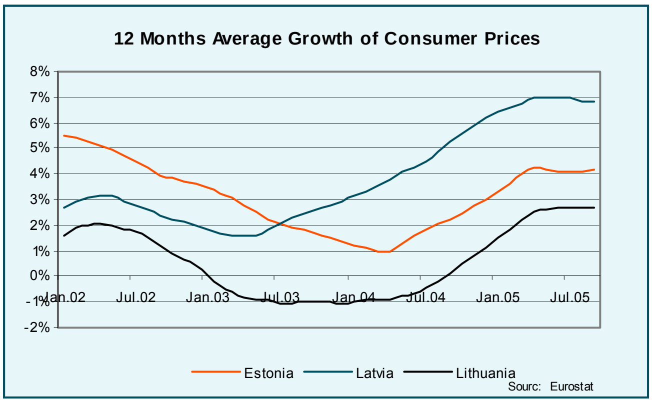
Inflation Expectations

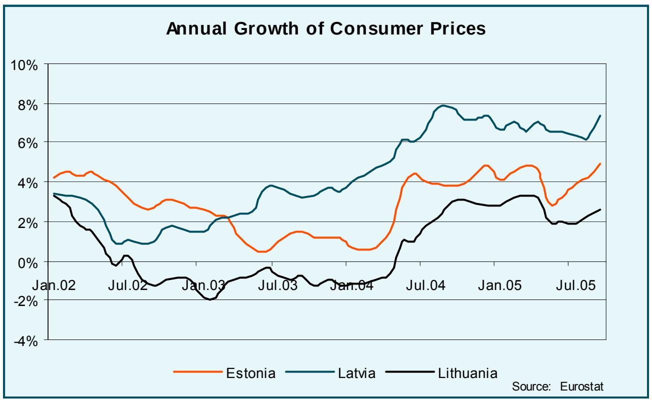
Inflation has strengthened in all three Baltic countries throughout the last year and half, though short-term drops have occurred. The forecasts suggest that Estonia will see only a minor slowdown in inflation, if any; Latvian inflation might drop slightly and although Lithuanian inflation has been relatively low, a very strong upward pressure exists.

The pickup in inflation is caused mostly by external factors, **oil prices** being the single most prominent factor. The growth in oil prices in global markets has had the strongest effect on Estonian prices, while Latvia and Lithuania have survived with smaller increases. For example, the price of the most popular car fuel 95E has grown by close to 35% in Tallinn (the top level was 45% higher than in early January), 34% in Vilnius (38.5%) and "only" 30.4% in Riga (39%). Energy prices in consumer basket have grown by 17.2% compared to December 2004 in Estonia, 13.1% in Latvia and 11.5% in Lithuania. The price levels of the EU8

[5] http://europa.eu.int/scadplus/leg/en/lvb/l25014.htm: the Treaty establishing the European Community.

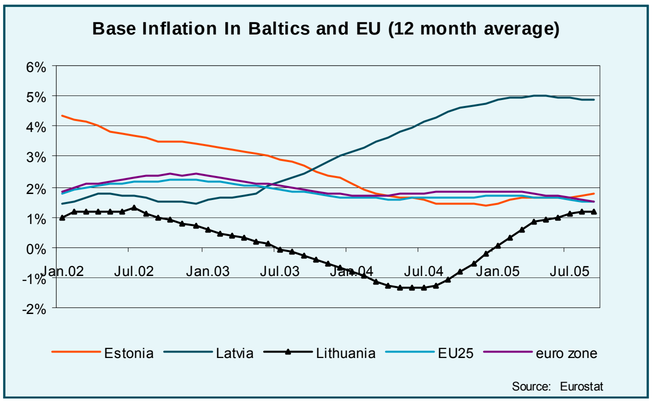
are more dependent on global oil prices than those of the EU15 as the share of energy (and transport prices) is higher here than in "old" member states (13.9% vs 8.7%[6]). This means that 1-dollar increase affects general price levels in new member states more than in old ones.





The second and very important factor, which caused prices to grow very rapidly in the Baltic countries, was the EU accession, or more exactly **the consequences of the accession**. It includes the effects of administrative changes e.g. increased excise and VAT rates, higher custom tariffs (prior accession Estonia did not have custom tariffs), which pushed up the prices of imported goods, and the introduction of the Common Agricultural Policy, which keeps the EU prices much higher than global ones, pushed food prices in Baltic countries also strongly up. The increased external demand had another upward effect on prices and food prices were most affected (the EU's food market was closed prior to the accession for Baltic food). As result prices rocketed in May and June. Estonian annual inflation jumped from 1.5% to 3.7% (or +2.2%), Latvian inflation from 5% to 6.1% (+1.1%) and Lithuanian inflation from –0.7% to 1% (+1.7%). The Baltic countries were the most affected by the accession (besides Cyprus, where prices increased from 0.1% to 1.2%). While June brought a correction in most new member states, Estonia, Cyprus and Poland experienced additional increases. Consequently the accession effects in price inflation will remain present until May (Latvia, Lithuania) or June 2006 (Estonia).

The **strong economic growth** also generates faster inflation; consequently Baltic countries should have one of the fastest growing inflation levels in the EU. And so it was – in September Latvia and Estonia (together with Luxembourg) held the top positions in annual price growth rates. In 12-month average comparison Latvia was followed by Estonia and Hungary. Strong inflation at a time of fast economic development should reflect the strength of the demand or more exactly the fact that growth in demand exceeds growth in supply. So if the effects of oil prices and the accession effects are excluded, we should see the effect of economic developments in inflation. It is simple to do as base inflation[7] index exists.



It is clearly seen from the graph that **base inflation** is quite stable in Estonia, though in recent months there has been a slight upward trend. But even now, it remains close to the level that the ECB defines as price stability. Consequently we can say that demand driven inflation is rather weak in Estonia. Lithuanian base inflation has grown rather straightforwardly in the last year – overcoming the deflation period is definitely a positive thing and for the economy it is also good to have higher than 1% inflation (1.2% in September). However, if this current upward trend continues, then Lithuania may in 1-2 years face the unwelcome pressure of demand on price levels. Latvian base inflation is high – 4.9% - however, it has declined slowly recently. This high inflation points to risks in the economy, particularly to lack of balance between domestic demand and supply. If the slowdown continues at the same pace, then Latvia will see more sustainable inflation levels only after two years.

What Is To Be Done About Inflation?

The Maastricht criterion is defined as it is and in that respect it would be interesting to know what measures are available to authorities to slow inflation down. First of all, it is important to mention that, as the previous overview of inflation triggers indicated, the majority of inflation is triggered by external factors (particularly in Estonia).

Authorities could use both monetary and fiscal policy measures. However **monetary policy** measures are scarce in Baltic countries. The Estonian and Lithuanian monetary systems are based on currency boards, which means that there is no means to fight inflation (e.g. using interest

[6] Simple average

[7] The exclusion of energy prices should eliminate the effects of oil price growth; the exclusion of food prices the effects of the accession, as food prices were the most affected.

rates). Latvia is running a tight peg to the euro and hence the possibilities of monetary interference are slim.

Central banks could use banking regulation to influence money supply and through that inflation, but it is mostly a theoretical possibility. The Estonian compulsory reserve requirement is already high and a further increase could make competition in the local financial sector even more unequal (foreign financial institutions are already bearing smaller costs because of the differences in reserve requirement). Latvia and Lithuania have cut reserve requirements in recent years to meet the euro zone level (2%). The Latvian central bank has increased the requirement to fight inflation (in autumn 2004 from 2% to 4% and in August 2005 to 6%), however it does not seem to have enough power to limit demand driven price increases. The reason is that domestic money supply is not the cause of inflation: banks can easily raise money from abroad. The central banks aggressiveness could also give the wrong signal about the overall economic situation in Baltic countries.

There are more options for **fiscal policy**, though the possible measures are also highly controversial. We can look to short-term measures, which should work fast, e.g. to cut inflation for April-May 2006, and long-term measures, the effects of which would probably emerge after 1-2 years. Short-term measures follow.

1. Cutting VAT tax rates (as excises are at the lowest levels, it is impossible to lower them). Only a significant cut could have an effect, and from that the possibility of cutting VAT on food emerges (from 18% to 5%). Such a cut could be big enough to cause a decline in food prices (probably not in the same amount however).

   But this cut should be done fast (for Estonia during November), which is legally very challenging, if not impossible. The cut would create free money for households, which probably would start to look for other goods and services. This in turn would cause stronger price growth for those goods and services. As a total – the effect of the VAT cut could have no impact on inflation. However it definitely undermines budget revenues.

   If governments now decide to increase the VAT to its previous level, a big shopping boom could follow, with it's the consequent negative effects on imports, and the retail sector, not to mention additional price increase. Moreover, this cut-increase approach looks rather bizarre.

2. The other option is provide compensation for price increases from state and local budgets. Long-distance heating, gas and public transport could be the targeted areas. The compensation should be made in such a way that would affect selling prices of companies, as increased subsidies for households will mean price growth. This approach demands budgetary resources, and as budgets are in good shape, it would not be difficult. However, the full organisation of the compensation has several short-backs. First, it needs time for budget changes. Second, most of the increases have already occurred, which means that the authorities are already late. And third, this action will affect only part of the energy prices, and hence the possible positive impact on prices could be too little.

Most of the measures that have long-term effect are politically unacceptable and hence difficult to put in place[8].

1. The simplest suggestion and the easiest to implement is to follow strict fiscal policy i.e. the government budget should be in surplus, the bigger the better. The Estonian budget is already in surplus (in 9 months ca 3.1% of GDP), and although expenditures are expected to increase in the 4th quarter, the budget will still end with a surplus of more than 1%. The Latvian and Lithuanian budgets will have small deficits this year, so they have some room for spending cuts.
2. Governments might give up income tax cuts, but politically this could be difficult.
3. Governments might increase VAT to diminish demand – the initial rapid increase in price levels would be followed by smaller consumption growth for the next years. This could affect all economic growth. However, as wages are growing rapidly, households might survive such a VAT increase with short-term consumption shock and continue spending at the same pace. One could expect that wage demands would increase even more. The result – inflation remains strong, and imbalances in the economy will grow.
4. Cutting or freezing wages (in the public sector) is more like science fiction than a realistic option and the same is true of pensions and other state allowances. One is a political and social issue, the other economic. Probably a lot of workers would leave the public sector, and the best ones, so the administrative capacity, which is not very good even now, could fall. One should also look into long-term wage agreements (e.g. in Estonia for medical personnel). The overall outcome can be stated simply – a strong slowdown in economic growth.

So we can conclude that authorities lack good options to fight inflation. Most of the possible measures could end in having no clear effect on inflation, but clear negative effects on economic growth and stability. So the three governments have a clear choice – the euro or an economic slowdown.

Conclusion

In the sense of price stability Estonia and Lithuania are now well comparable with the euro zone countries. However the definition of the Maastricht inflation criterion makes it difficult to fulfil it. Inflation in the Baltic countries is mostly triggered by external factors (especially in Estonia, less so in Latvia), hence options for economic policy to slow it down are few.

[8] One cannot forget about the coming elections in Estonia and Latvia – it is hard to expect that any politician would be ready to commit political suicide.

Long Term Outlook on Labour Supply in the Baltics

Baltic Outlook 20.10.2005

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The current state and the future state of the Baltic labour force have been very actively discussed recently. An increasing number of employers are complaining about labour deficit and considering labour import, while the low fertility and relatively high mortality rates along with increasing emigration levels indicate that these problems may only worsen in the future.

This research provides a brief insight into the current demographic situation in the Baltic States and sheds some light on the possible future developments of the Baltic labour force.

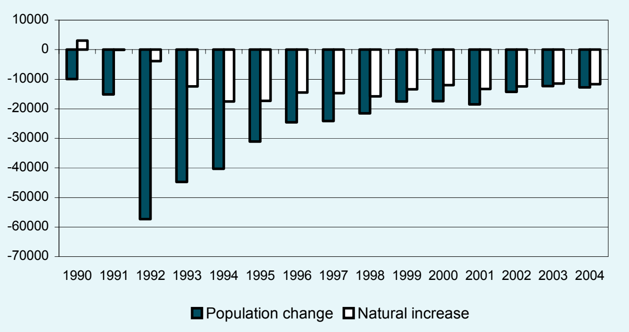
Demographic Trends in the Baltic Countries

After experiencing record high fertility rates[9] in the 1980s, since 1990 the population in the Baltic States has been decreasing. This trend was caused by both a large outflow of people, especially, in the first half of the 1990s (related to the fall of the Soviet Union), as well as a negative natural increase in the population. These negative demographic trends, which leave a long-term impact on the population structure, have continued for the last 15 years. The following sections take a look at the extent of these developments in each of the countries.

Latvia

Since the 1990s Latvia's population has been decreasing at an average rate of 1% per year. In 2004 there were only 2.3 million people in Latvia, which is 14% less than in 1990. The most pronounced population fall was in the first half of the 1990s, which was mainly caused by a large outflow of people – mostly Russian nationals after the fall of the Soviet Union.

Population Change in Latvia (1990-2004)

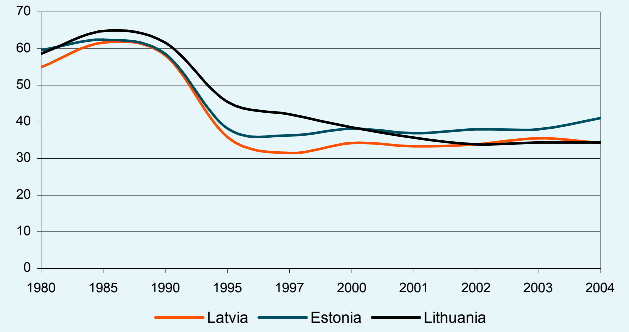


Source: Eurostat, HBM calculations

Also, in the 1990s, fertility rates decreased substantially. In the middle of the 1980s there were ~61.6 births per 1000 women (in reproductive age), in 2004 this ratio had decreased to 34.2. The number of births reached its peak in 1987 when there were 47 thousand births. After ten years it reached a record low of 19 thousand (21 thsd. in 2004).

The low birth rates have affected the population structure of the country. The proportion of people aged below 15 has decreased from 21% in 1990 to 15% in 2004 (from 571.8 thsd. to 356.5 thsd.), and this decrease should be even more easily perceived in the following years. For instance, from 2015-2025 there will be twice as few high school and university graduates than today. Some improvements have been observed this year, as the number of births has increased (in 8 months of 2005 +620 births y/y). Even though the mortality rates[10] have shown a tendency to decrease, they are still well above the birth rates; moreover, these are higher than mortality rates in developed countries (especially, for males in the early life stages).

Number of Births per 1000 Women in Reproductive Age



Source: Eurostat, HBM calculations

The second problem that has arisen in recent years is the increasing number of people who emigrate from Latvia. There is no objective statistics on the exact number of people who have left the country, and the official statistics largely underestimates the true number of emigrants (people do not register their purpose and expected duration of stay when crossing the border). The official statistics suggest that the population decrease in Latvia is mainly caused by the negative natural increase, and that migration plays only a minor role (–1 thousand people in 2004). This indicates that the official statistics overestimates the true population, and the actual number of inhabitants in Latvia is lower.

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9 General fertility rate - number of births per 1000 women in reproductive age (15-49) Hereinafter referred to as fertility rate.

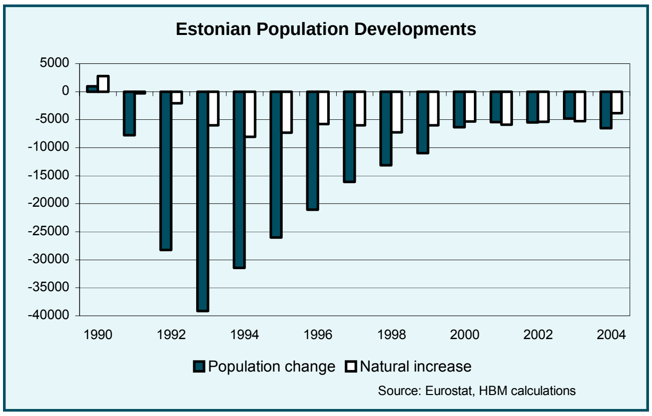
10 Mortality rates (death rates) – number of deaths per 1000 people

Currently, Latvia's labour force[11] is benefiting from the new entrants of the "baby-boom generation" (born in the 1980s). Therefore, we can expect a relatively stable/slightly increasing labour force in the next few years. However, when the new generation (born in the 1990s) starts to enter the labour market, the total labour force will experience a decline (more people leaving than entering the labour market). Additionally, the extent of net migration outflow will play a significant role - while the birth rates affect the labour force only after 15-20 years, emigration has an immediate effect, since the largest part of the migrating population are of working age.

Estonia

The trends in Estonia's population are very similar to those in Latvia. The population has also been decreasing since 1991 with an average annual growth rate of –1.0%. In 2004, the population was ~1.35 million, which is 14% less than in 1990.

The decrease in population has been caused both by negative natural increase in the population, as well as migration outflow. Compared to 1985 when the number of births per thousand women in reproductive age reached 62.4, in 1995 this rate had fallen to 38.2 (41 in 2004). The average number of births in the 1990s decreased more than twice (from about 25 to 12 thousand per year), and the number of births has not increased much since the end of the 1990s (14 thsd. births in 2004).



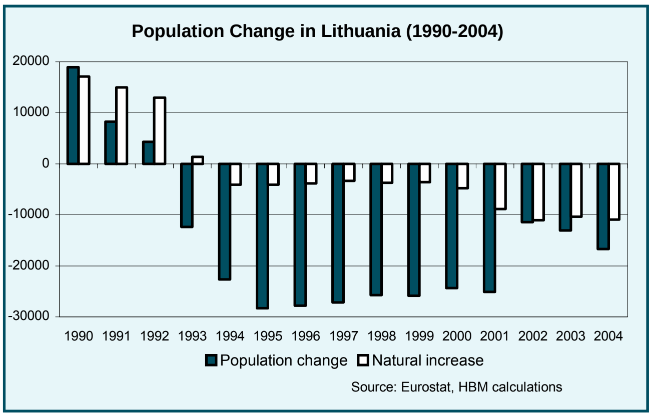
These trends have reduced the proportion of young people in Estonian society – in 2004 there were only 215.7 thousand people below 15 years old, constituting about 16% of the population (22% in 1990). The death rates have been decreasing over time, and they are slightly below the ones in Latvia; however, they still continue to exceed the birth rates, resulting in a negative natural increase of the population. As in Latvia, no data on the actual net outflow of people from the country is available.

Similarly to Latvia, while currently there is some addition to the labour force due to the high birth rates in the 1980s, even disregarding the effects of migration outflow, we can expect a decline in the labour force in the future due to the low fertility rates in the 1990s.

Lithuania

Compared to 1990, the population in Lithuania has decreased at an average rate of 0.4% per annum, reaching 3.4 mln in 2004 (a cumulative decrease of 7%). The migration outflow at the beginning of the 1990s have not been as large as from the other two countries and the demographic developments at the beginning of the 1990s were relatively more influenced by the natural increase of the population.

Still, in the 1990s the fertility rates in Lithuania also decreased, which resulted in a negative natural increase of the population (starting from 1994). If in 1985 there were 64.8 births per 1000 women aged 15-49, in 1995 this ratio stood at 45.5. Correspondingly, the number of births in 1990s was also lower than in the 1980s (e.g. 1985 vs. 1995: 58.8 and 41.2 thousand births, respectively), and this number has continued to decrease since then (in 2004 ~30.4 thsd.). The proportion of children and adolescents (below the age of 15) has been declining at a slightly lower pace than in Latvia and Estonia (in 2004 – 18% of the population).



The historic demographic developments seem to have been slightly more favourable for Lithuania. The relatively lower decrease in number of births during the 1990s should be reflected via lower decrease of the labour force. However, the current demographic trends are not promising. In 2004 the population in Lithuania decreased by 20 thousand people, of which about 10 thousand came from the negative natural increase of the population and the rest could be attributed to net migration outflows. Regarding the fact that the official statistics underestimates the net outflow of people, we can infer that the actual population decrease has been even larger. This indicates that the potential labour force in Lithuania will be relatively more affected by net migration trends than by the historic birth rates in the country.

Summary

The population in the Baltic States has been decreasing since 1990-1994 due to both negative natural increase as well as unfavourable migration developments. These tendencies influence the actual and potential labour force in the countries. While currently, there is a relatively large number of new entrants in the labour force due to the high birth rates in the 1980s when the generation from 1990s

[11] Economically active population or labour force – comprises employed and unemployed persons aged 15-74.

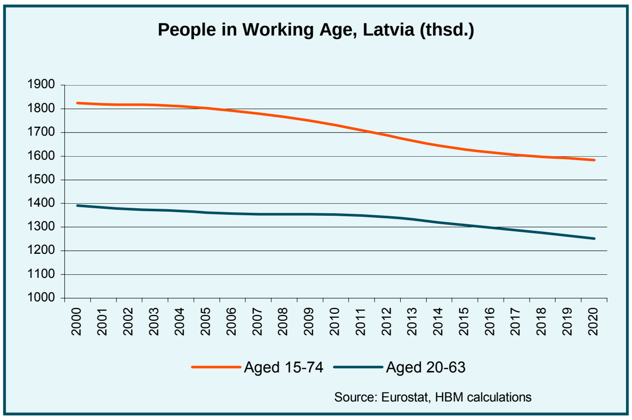
starts to enter the labour market, the number of potential workers will decrease (especially, in Latvia and Estonia).

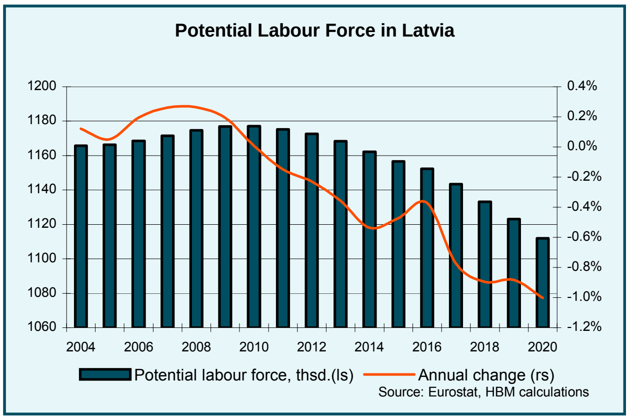
Potential Demographic Developments

The forecasts presented in the following sections assume that the demographic trends observed in recent years will also continue into the future. The forecasts are slightly positively oriented, as they assume gradually increasing birth rates and decreasing mortality rates. The migration forecasts are based on the assumption that the main triggering factor for labour outflow is unemployment. Thus, if there is high unemployment people will be more inclined to leave the country. Also, if economic growth is strong, there should be less labour outflow as people expect an improved economic situation in the country.

Estimates of Latvian Labour Force

When only taking into account the natural increase of the population, according to Hansabanka's estimates in 2020 Latvia's population will be 2.13 mln (-8% compared to 2004). The number of people of working age (15-74) will experience a cumulative decrease of ~10%, reaching 1637 thousand in 2020. The potential labour force will show some growth until 2013 (+0.5% per annum from 2004-2013) reaching 1220 thsd. people; however, in 2014 the effects of the low birth period will become visible in the labour market, and the labour force is expected to decrease (–1158 thsd. or -5%, 2020 vs. 2014).

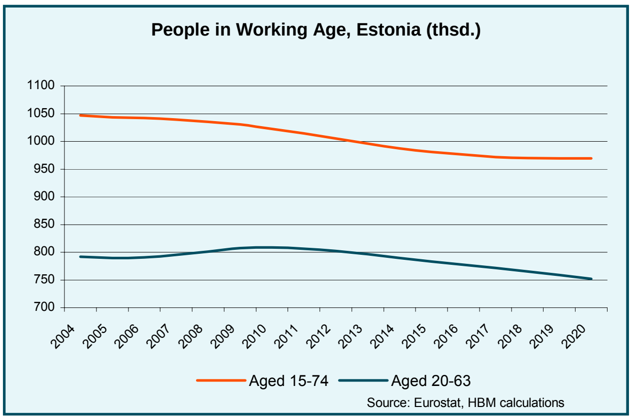




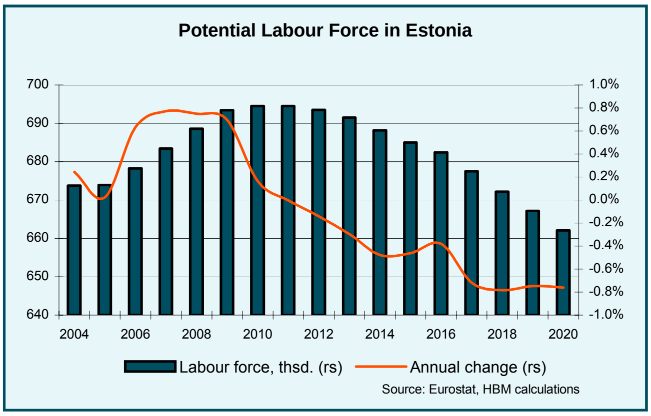
However, our estimates would be inaccurate, if we did not account for the net migration flows from the country. When including the migration estimates, for the year 2020 we come up with an estimated population of 2.06 mln (-11% compared to 2004). As expected, the number of people of working age will experience the largest decrease (-15%); thus, in 2020 there would be ~1.6 mln people in the age group 15-74 (1.8 mln in 2004). The labour force is expected to start to decrease in 2011 mainly due to lower numbers of people entering the labour market. In 2020 the labour force will reach 1111 thsd, which is 63.4 thousand or 5.4% less than in 2011.

Estimates of Estonian Labour Force

When only taking into account the natural increase of the population, the estimated population in 2020 amounts to 1.31 mln, which is 3% less than in 2004. The number of people of working age (15-74) is expected to decrease to 979 thousand (-7% compared to 2004). The potential labour force will grow until 2012, but in 2013 it is expected to start decreasing (cumulative change from 2013-2020 –4.6%).

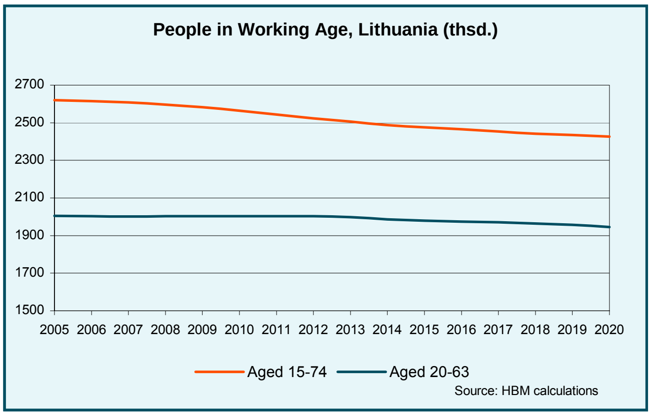


Looking at more precise estimates that include net migration projections, in 2020 the Estonian population is expected to reach 1.3 mln, which is 3.7% less than in 2004. As expected the number of people of working age will experience the largest decrease due to the low historic birth rates in the 1990s as well as the net outflow of people. Thus, in 2020 the number of people aged 15-74 will reach 969 thsd. (-7.4% compared to 2004). The potential labour force is expected to start to decrease in 2011, and during the period from 2011-2020 the aggregate decrease will be 4.7% (~32 thsd. people) to 662 thousand.



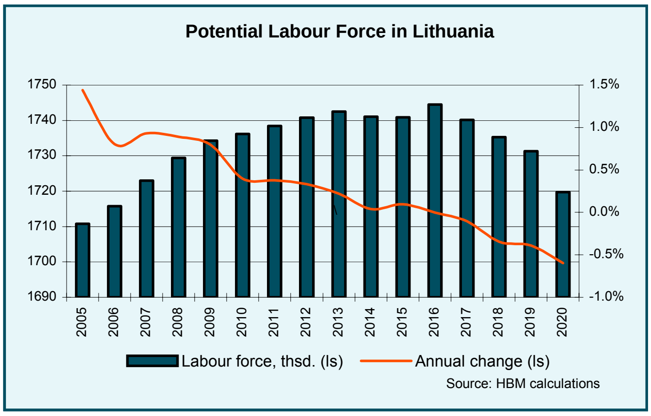
Estimates of Lithuanian Labour Force

From the current demographic trends, in 2020 the population will be 3.25 mln, which is 5.8% less than in 2004 (3.45 mln). The number of people aged 15-74 will start to decline in 2009, and the expected aggregate decrease from 2009-2020 will reach 5% to 2.51 mln people. The potential labour force will start to decline only in 2016 with an expected average annual decline of 0.5%.



People in Working Age, Lithuania (thsd.)

However, these numbers are overestimated, as they do not take into account the migration flows. Lithuania is experiencing a net migration outflow that will significantly reduce the potential labour force, especially in the next 'few' years. Unfortunately, no detailed projections on migration flows are available for Lithuania. Assuming similar migration trends to Latvia, the total population in Lithuania in 2020 would be ~3.15 mln (9% less than in 2020). The potential labour force will experience considerably lower growth rates, and the decrease will already have started in 2014, dropping to ~1.72 mln in 2020. While these are only rough estimates, they show that the positive historic demographic developments (before the 1990s) enable Lithuania to absorb the new shocks, such as migration outflow, slightly better than its neighbours. However, recent data suggests that the extent of migration is larger in Lithuania than in Latvia and Estonia; therefore, these estimates might also be positively biased.



Potential Labour Force in Lithuania

Implications

Over the next fifteen years, the population is expected to decrease in all three countries. We estimate that the labour force will start to decline in 2011 in Latvia and Estonia and in 2014 in Lithuania. However, even an interim annual growth in labour force of 0.2-0.4%[12] is unlikely to be able to fully support the rapid economic growth recently seen in the Baltics.

Some possible ways to treat the lack of labour are briefly discussed below; however, more in depth research on each of them is needed.

Population in the Baltic countries, mln

	2004	2010	2015	2020
Latvia	2,31	2,19	2,11	2,06
Estonia	1,35	1,32	1,30	1,30
Lithuania	3,45	3,30	3,20	3,15

Average annual change over the period, %

	1990-2004*	2005-2009	2010-2014	2015-2020
Population				
Latvia	-1,0%	-0,9%	-0,8%	-0,4%
Estonia	-1,0%	-0,3%	-0,3%	-0,1%
Lithuania	-0,4%	-0,7%	-0,7%	-0,3%
Labour force				
Latvia	-0,1%	0,2%	-0,3%	-0,7%
Estonia	0,2%	0,6%	-0,2%	-0,6%
Lithuania	0,7%	0,6%	0,1%	-0,2%

**With respect to labour force the period from 2001-2004 is taken*

- **Further increase in economic participation rate**. The current economic activity rate of the population is very similar to the average rate in the European Union (except for people aged 15-24). Therefore, a significant further increase in the economically active population based on an increase in the economic activity rate is rather unlikely, and the additions to the labour force would be marginal.

- **Increase in wages**. Increasing wages diminishes the incentives to migrate. Rising wages can already be observed now, especially, in particular economic sectors where the labour deficit is the largest. The wages are expected to continue increasing in the future until the wage differential (adjusted for productivity) between the Baltic countries and the EU average diminishes. However, wage growth is sustainable only as long as it is met by productivity growth.

- **Labour import**. Representatives of some industries are already discussing the option of labour import (mainly from Russia, Belarus, and the Ukraine - countries that have comparatively lower wage levels). However, currently, there are rather strict regulations regarding labour import from non-EU countries, and there are no signs that these regulations will be relaxed in the near future (no support both from local governments as well as at the EU level). Moreover, in the long run the economy has to be able to sustain itself; therefore, this could be considered at most a medium term solution.

- **Increase in productivity**. Theoretically, the labour deficit could be to some extent compensated by increased labour productivity, which in most of the

[12] Annual average growth rate expected for the period from 2005-2011 in Latvia and Estonia, respectively.

economic sectors in the Baltic countries is still below the average EU levels. However, looking at the sector composition of the economy, we see that the largest part of the value added comes from labour-intensive sectors (especially, low skilled labour) with limited possibilities for productivity increase. Therefore, a structural change – a shift from labour intensive to capital and skill intensive production should gradually take place in the economy.

- **Change in labour qualification**. The current discrepancies in the labour market – unemployment on one side and labour deficit in some industries (especially engineering) on the other, suggest that there are structural problems in the market. The existing labour supply does not meet the labour demand (mainly in terms of quality and corresponding education). Changes in the educational system such as incentives for young people to study engineering and improved quality of education along with more possibilities for qualification change, professional education at work, etc. could help to solve this problem.

Thus, the only long-term options for the countries to be able to cope with the decreasing labour force seems to be increased productivity and efficiency across economic sectors and a gradual restructuring towards more skill-intensive economies.

Number of economically active people, thsd.

	2004	2010	2015	2020
Latvia	1166	1177	1157	1112
Estonia	674	695	685	662
Lithuania	1686	1736	1741	1720

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