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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2005 was a very good year for the economies of Estonia, Latvia and Lithuania. In particular Latvia reported very strong growth (ca 10.5% according to our estimates), but Estonia was not far behind (ca 9.5%). These figures are based on our revised estimates after very strong advancement in the 2nd and 3rd quarter. Developments in Lithuania were less surprising – preliminary figures show 7.2% growth vs. 6.8% forecast. Strong performance made us raise economic growth projections for 2006 also – we expect the Estonian economy to grow ca 8.4% and that of Latvia by 8% in 2006, while the Lithuanian forecast has remained the same 6.5%.

Strong growth in Estonia and Latvia was a result of strong advancement in both domestic and external demand. Merchandise exports growth rates were close to 30% in both countries, however that also meant bigger growth in imports, particularly services imports. Hence our expectations about the current and capital account deficit have weakened – for Estonia we expect ca 10.2% of GDP shortage, while for Latvia the respective figure is 10.3% of GDP (8.7% and 9.8% previously). Still, the improvement continues and we expect it to continue in 2006: 7.8% of GDP in Estonia and 8.8% of GDP in Latvia. Our expectations regarding Lithuania have remained the same and we expect deterioration to 8% for 2005 and 8.5% for 2006 (only current account).

Domestic demand, particularly household consumption, has been important for economic growth. Declining unemployment and fast-growing incomes have pushed up consumer confidence; low interest rates and good future prospects have encouraged households to take and banks to give loans, which in turn has given an additional push for many sectors from real estate services and to sellers of furniture and carpets. EU structural and cohesion funds are now fully working for local economies – the actual process of approval of projects has already triggered additional investments in the economy, though actual monetary transfers to Baltic countries are relatively low. We expect that in 2006 the inflow of actual money will increase significantly and that will cement strong advancement in investment also in future.

The most problematic area for all three countries is price growth, which hinders plans to adopt the euro at the beginning of 2007 in Estonia and Lithuania and in 2008 in Latvia. Consumer price inflation is pushed up by external factors (mostly oil prices), domestic administrative price increases and rapidly growing demand – all these factors are present in all three countries, though their impact varies by country. Last year consumer price growth reached 4.1% in Estonia and we expect it to slow to 3.5% in 2006 and to 3.3% in 2007, which is clearly not enough to fulfil the Maastricht inflation criterion. Latvian price growth reached 6.7% in 2005 (HICP was 6.9%) and is expected to fall to 6% in 2006 and to 4% in 2007, which is also too much for euro approval. Lithuanian consumer price growth reached 2.7% growth in 2005, however it is on a clear upward trend and might reach 3% in 2006, which makes difficult, but not impossible to fulfil the Maastricht criterion.

Summary of Forecast				
	2004	**2005f**	**2006f**	**2007f**
Economic growth				
Estonia	7.8%	9.5%	8.4%	7.7%
Latvia	8.5%	10.5%	8.0%	7.5%
Lithuania	7.0%	7.3%	6.5%	6.5%
Inflation (SKP deflator)				
Estonia	3.1%	4.9%	4.2%	4.1%
Latvia	7.2%	8.3%	6.9%	na
Lithuania	3.3%	6.5%	7.5%	7.0%
Current account, % of GDP				
Estonia	-12.7%	-11.0%	-8.8%	-7.5%
Latvia	-12.9%	-11.6%	-11.3%	-12.0%
Lithuania	-7.8%	-8.0%	-8.2%	-8.6%

Hansabank Markets

General Assumptions

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The Global Economy

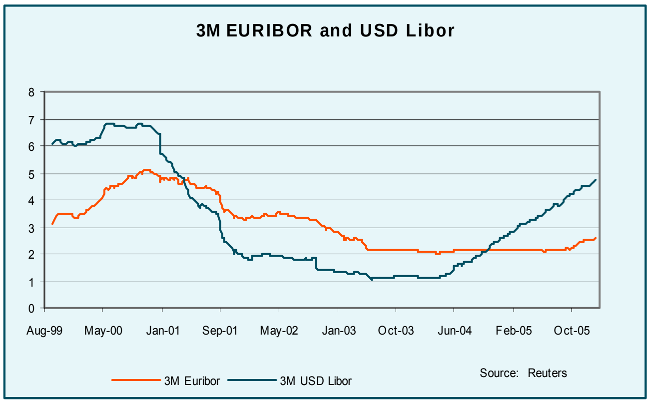
- Global growth expectations are strong, although the numerical forecasts are slightly smaller than for 2005. The reason for this is slightly smaller growth, (though stronger than the long-term average), expected in the USA. Additionally, some very fast growing economies (e.g. China) are expected to show slightly smaller growth rates. At the same time however, the economies of Japan and the euro zone (and the whole EU) are expected to show stronger growth rates. How these contradictory developments accord with each other, is not very clear at the moment, although most analysts believe that global economic growth in 2006-2007 will be somewhat smaller than in 2005.

Global forecasts

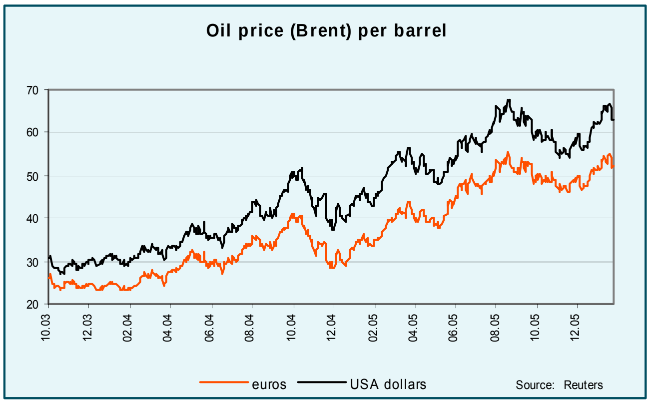
	GDP				CPI			
	2004	2005f	2006f	2007f	2004	2005f	2006f	2007f
USA	4.2	3.8	3.5	3.3	2.7	3.3	3.0	2.8
Japan	2.7	2.4	2.5	2.2	0.0	-0.3	0.3	0.8
Euro zone	1.8	1.4	2.1	1.8	2.1	2.2	2.1	2.0
Russia	7.4	7.1	6.5	6.0	10.8	12.4	11.0	10.0

- Economic growth in the euro zone is expected to strengthen slowly, as it is hoped that the recovery seen in Germany at the end of 2005 will continue and strengthen in 2006-2007. German impact on the EU economy is considerable – it is expected that the economies of neighbouring smaller countries will start to grow faster and those economies that have performed rather well so far, will increase their growth rates. However, growth in Europe will remain relatively modest in 2006-2007 as economic developments in France, and in particular Italy, are not good. The effect of these economies on Baltic countries is however rather modest as economic connections are not very strong. However, the strengthening of the German economy is very important to all three countries, as is the development of Nordic countries. The setback that occurred in Central Europe after EU accession is over for now and it is expected that growth in this region will accelerate. While this might mean stronger competition between new member states, it also provides additional opportunities for tighter cooperation.

- The strengthening of price growth is expected to bring some increase in interest rates in the USA, although the general opinion is that the phase of increasing interest rates is about to end soon. The situation is different in the euro zone, where the phase of increasing interest rates is only starting. At first it will be rather restrained – the economic situation in the euro zone is weak and at least for now, inflation has slowed a bit (albeit being higher than targeted). However should inflation look set to rise, the ECB will act immediately. There might be some discussions, if stronger inflation is caused by higher energy prices, but the cause will be not the reason for the ECB to call off the interest rate rise.



- The dollar/euro exchange rate in recent months has been dependent on the difference in interest rates. This means that if interest rate increases end in the USA, then the euro will start to strengthen as the likelihood of interest rate increase in the euro zone is bigger. The weakness of the USD is additionally supported by big current and fiscal deficits. While there is no change in interest rates in the USA and the euro zone, there will be no substantial change in exchange rate. But at the end of the 2006, the dollar might be significantly weaker than now.



- While there were expectations that the price of oil had stabilized, recent political events have increased oil prices more than expected. The security of energy supplies sprang rapidly into importance in early 2006 as the dispute between Gazprom and Ukraine interrupted gas supplies to Europe. The following processes and behaviour of Russian energy giant have done little to increase the confidence of European governments and consumers. Our forecast is based on the assumption that oil price will not fall in global markets and price fluctuations will be very wide.

Although we cannot say with certainty that there will be no new big price increases, we still are of the opinion that the probability is higher for stable prices or slowly growing prices. A rapid and permanent price increase would cause energy consumption to fall and that would diminish the income of oil producers. We also expect the prices of other energy products (primarily gas) to grow. We also see the likelihood that wealthy countries will increase their efforts to find solutions to high energy costs. First, dependence on one supplier (or a limited number of suppliers) will be diminished; and second, investments in alternative production (and related research) will grow.

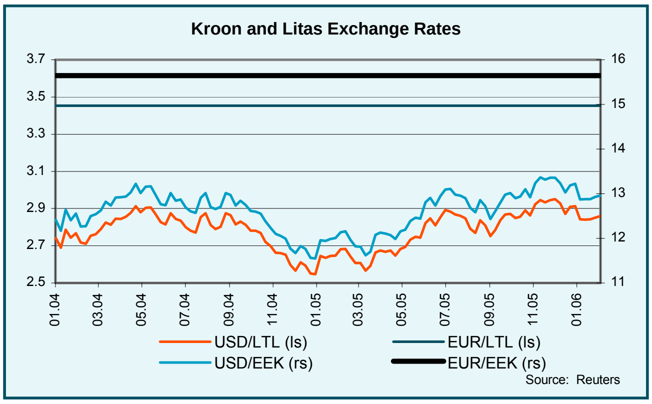
Domestic Processes

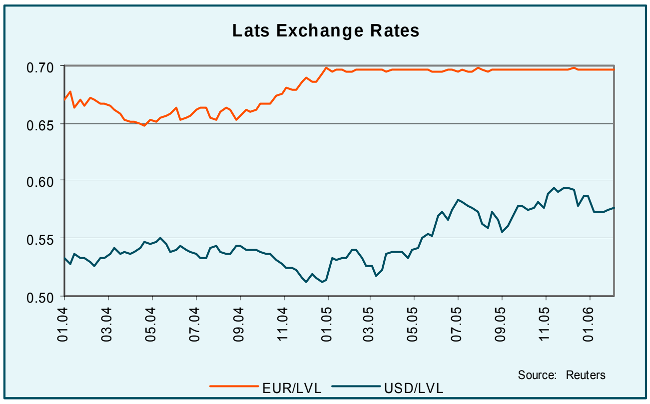
- The internal policy situation will remain unstable – there is clear antagonism behind the superficially stable situation, and this might cause rather serious setbacks. The Estonian presidential elections in 2006 will be a prelude to general elections in March 2007. A government crisis looks unlikely, though it cannot be excluded – tensions in the government are clearly growing. Latvia is preparing for general elections in October 2006 and we do not expect the current government to fall before then, though tensions between parties will definitely increase as the elections approach. We do not expect changes in Latvian economic policy after elections (the same applies to Estonia), as the new government will be a coalition government with many partners. However, slight differences might occur in economic policy depending on the actual structure of the governments. In Lithuania the situation will remain as it is – the current relatively intensive period of small scandals will continue until the local elections. However, this situation will not cause the government to fall, at least not in near future.

- The population of the three countries has gradually adapted to EU membership and the processes accompanying it. The current major issues in economic policy are as follows: the outflow of labour to other EU countries, the use of EU funds and the adoption of the euro.

- Low incomes and high unemployment are behind the outflow of labour from the Baltic countries. Lithuania and Latvia have been particularly strongly affected by population outflow; for Estonia it has been a smaller problem, and mostly seasonal (to Finland), although it is increasingly becoming a permanent characteristic. The strongest negative impact from the labour outflow will be felt in Lithuania, where the current demographical situation is worse than in Estonia and Latvia (see previous *Baltic Outlook*). It is possible that some of the people who left will return in future, however this process will be rather modest. The outflow could be reduced only with the availability of higher local wages and more opportunities of finding a good job.

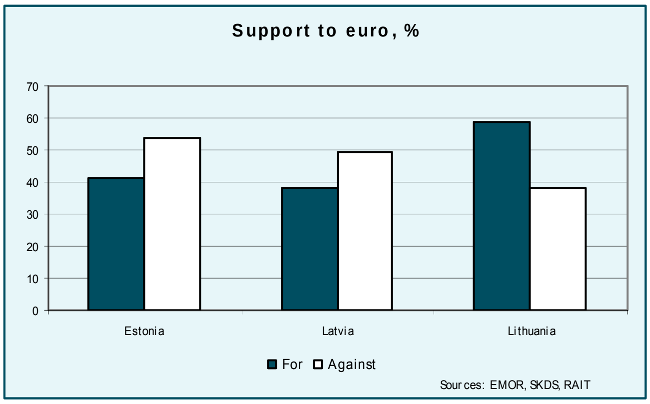
- The use of EU funds has been relatively modest so far. The cover of available funds with approved projects is good, but as money distribution takes place only after the project has ended, the monetary inflow into the Baltic countries has been relatively modest so far. However, we expect strong improvement this year. The processes affecting the next budgetary period (2007-13) have been very worrying for all three countries (as it has for other new member states). If the European Parliament, the European Commission and governments do not find the solution in the 1st half of 2006, the new member states might experience a rather serious setback in the future. The most problematic year would probably be 2008, as in 2007 distributions from 2004-2006 budgetary period will continue. The substance of the problem is in the preparation period, which will be prolonged if the possible monetary support for the EU budget is not known. That might slowdown investment and economic development in the new member states and worsen the already strained relations inside the EU. Our current forecast expects that EU financing will remain at least at current levels, though accession agreements promised a lot more money.





- The adoption of the euro on the dates targeted by the governments (January 1st 2007 for Estonia and Lithuania, January 1st 2008 for Latvia) has become increasingly unlikely, especially in Estonia and Latvia. Inflation is to blame. It is very difficult to expect that Estonia and Latvia will be able to cut inflation fast enough, and there are clear upward pressures in

Lithuanian inflation that might be difficult to control. While energy prices were a very important factor affecting price growth in 2005, and they will also have a significant impact in 2006, for some time now demand has been coming ingloriously to the fore. There are also several administrative changes on the agenda which will result in higher inflation – e.g. public transport, 18% VAT on long-distance heating, and excise rates. Surprises might also come from gas prices, as Gazprom is clearly looking for opportunities to increase prices more than current contracts allow. The shortage of labour is pushing up the prices of some services and products, which will mean that those services and products will also become more expensive as productivity growth might not always follow wage growth. The popularity of the euro is falling constantly and, at least in Estonia, some parties (incl. those in the current government) are probably looking to use this popular opposition in their election campaign rhetoric.



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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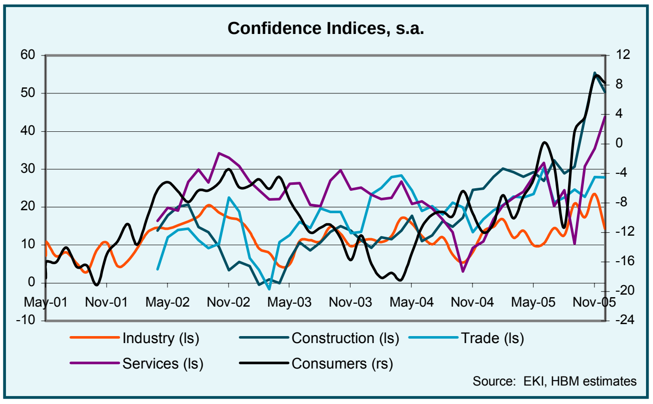
Recent Economic Developments

The Estonian economy showed remarkable growth rates in 2005 – in the 3rd quarter economic growth reached 10.6% p.a. and although final results are not published we expect that a strong 4th quarter will enable Estonia to achieve at least 9.3% growth. This figure, however, is rather conservative – the economy may well grow by close to 10%. Our strong growth expectations are based on strong developments in industry (production growth 9.7%, 11.3% in manufacturing), retail sales (14%, excl. vehicles related sales), foreign trade (ca 24% and 20% growth in exports and imports, respectively) and construction (8%). Strong expansion in the financial sector and very strong confidence in business and households point not only to the good situation of the economy in the past and present, but also suggest rapid development in the future. The slowdown of consumer price inflation was also a positive development, though it was not enough to secure euro adoption in January 2007.



Assumptions

Our updated forecast is based on following assumptions, which are specific to Estonia.

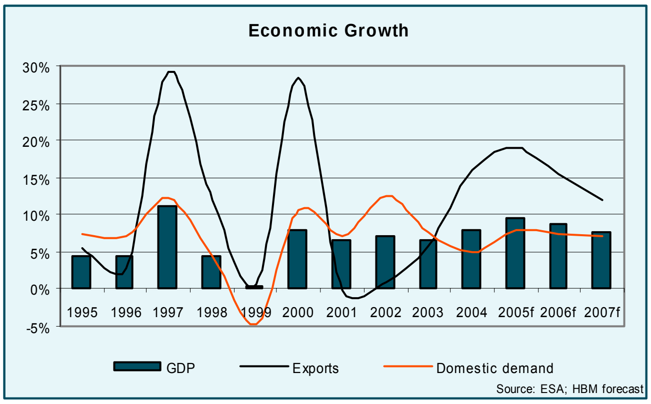
- The election period continues – presidential elections in Aug-Sept 2006 will be the prelude for general elections in March 2007. Tension inside the government will increase during the elections period, but we do not expect big changes in economic policy. Our forecast is based on the assumption that the economic policy of new government, which will be formed after March 2007, will not change significantly and possible changes will have not any strong effect in 2007.

- Our forecast is based on the assumption that Estonia will not adopt the euro in early 2007, as the fulfilment of Maastricht inflation criterion is very unlikely (see below and our *The Road to Euro* part). However, we do not expect any changes in the economy due to that fact. The developments, which might be different in the situation where Estonia has the euro in circulation, are mentioned in the text as alternatives.

- Our forecast is based on the assumption that there will be no delay in the EU budgetary process; that major regulations at EU level will remain the same (or they will not change the path of Estonian economic policy) and hence there will be no setbacks to the Estonian budget and investment activity. However, as the possible monetary transfers from the EU budget are currently unclear, we have decided to assume that the monetary flows will be slightly higher in the next few years (one can expect significantly bigger monetary allocations). In that sense our forecast might be conservative.

	2004	2005f	2006f	2007f
Economic growth	7.8%	9.5%	8.4%	7.7%
GDP, bln EUR	9043	10385	11725	13150
GDP per capita, EUR*	6693	7720	8700	9800
Industrial production	7.9%	9.7%	9.2%	8.5%
Inflation (GDP deflator)	3.1%	4.9%	4.2%	4.1%
Average growth of consumer prices	3.0%	4.1%	3.5%	3.3%
Average growth of HICP	3.0%	4.1%	3.1%	3.2%
Average growth of producer prices	2.9%	2.1%	2.0%	1.7%
Unemployment (ILO)	9.6%	8.0%	6.6%	5.7%
Harmonized unemployment	9.2%	7.4%	5.2%	4.5%
Average growth of monthly gross wage	4.5%	6.3%	6.1%	6.0%
Goods and services exports growth	17.2%	22.4%	17.0%	15.0%
Goods and services imports growth	16.9%	21.3%	14.0%	13.3%
Goods and services balance, % of GDP	-7.8%	-7.5%	-4.0%	-3.0%
Current account balance, % of GDP	-12.7%	-11.0%	-8.8%	-7.5%
Current and capital account, % of GDP	-11.9%	-10.2%	-7.8%	-6.5%
Inflow of FDI, % of GDP	9.3%	27.0%	9.0%	7.5%
Gross foreign obligations, % of GDP	82.7%	85.0%	86.0%	86.0%
General government budget, % of GDP	1.7%	0.9%	0.5%	0.2%
Government gross debt, % of GDP	5.1%	4.1%	2.8%	2.3%

**HBM estimates*



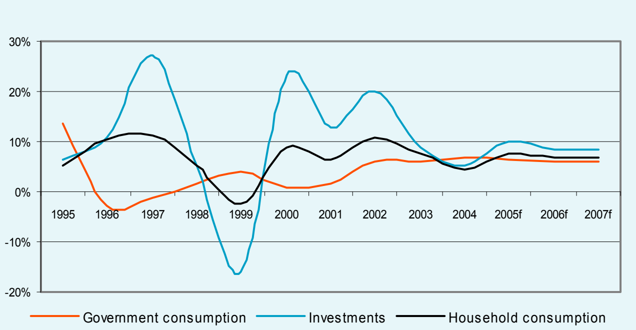
Summary of the Forecast

HBM has strongly upgraded the Estonian forecast for 2005 and 2006, as actual developments have been better than expected. We expect the Estonian economy to grow ca 9.5% in 2005 (9.3-9.7%) and ca 8.4% in 2006. We expect strong growth in exports, and in domestic demand where investment growth will reach 10% in 2005 and 8.5% in 2006 and household consumption will accelerate to 7.5% in 2005 and close to 7% in 2006 as unemployment is rapidly falling and caused wages to grow faster than assumed before.

Economic Growth

The Estonian economy grew by 9.3-9.7% in 2005 according to our estimates. We forecast that in 2006 economic growth will be 8-8.7% and in 2007 7.5-7.7%. Growth will remain broad-based, though real growth rates will slow both for domestic and external demand. The biggest contributor will be the same as in 2005 - household consumption. The contribution of net exports will be positive (i.e. net exports to GDP will decline) and domestic supply will grow faster than imports.

Domestic Demand, growth

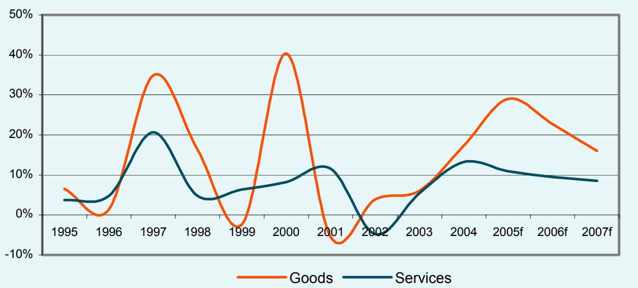


Source: ESA; HBM forecast

External Demand

Exports of goods have been surprisingly strong in 2005 – growth reached 30% and in some months exceeded 35% p.a. This activity growth is not only the result of increasing production of domestic producers, but also the result of growing trading flows in the Eastern Baltic region (see *Oct05 The Baltic Outlook*). We expect that these trading volumes will continue to increase as economic growth in the region remains strong and economic connections tighten.

Real Growth of Exports

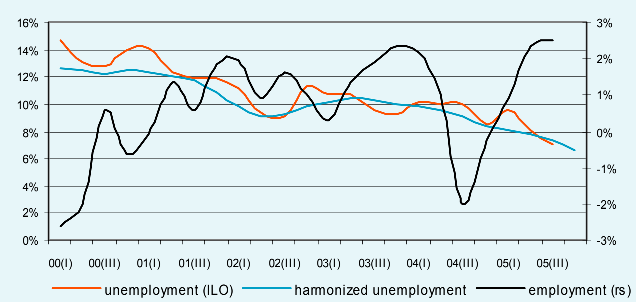


Source: ESA, HBM forecast

Domestic manufacturers are reporting a stronger outlook for exports in the next months, so we do not expect a decline in export sales in the 1st half of 2006. There are also good chances for growth as investments made in 2005 were mostly targeted at increasing production capacities. This and the fact that the economic situation in the biggest European countries (e.g. Germany) is improving and Estonia's trading partners (e.g. Latvia, Lithuania, Sweden, Finland, Russia) is good, gives us reason to believe that exports will continue to grow rapidly, though probably not as fast as in 2005.

One development that has disappointed us is the relatively weak exports of services especially taking into account the strong growth of services imports. Growth of services exports has been smaller than expected while imports of services have expanded faster. We are still of the opinion that part of tourist purchases (mostly alcohol and tobacco) is included in domestic household spending; however the main reason for such an unfortunate development lies elsewhere. Competition has not allowed domestic companies to raise prices while import prices have grown very fast; however the situation is about to change as the latest indicators show. Still, we are not very optimistic regarding services exports growth, particularly due to the very strong competition in the transit business where countries are sometimes giving preference to domestic companies. However, a gradual improvement in the services trade is expected.

Employment Growth and Unemployment Levels



Sources: ESA, Eurostat; HBM esimates

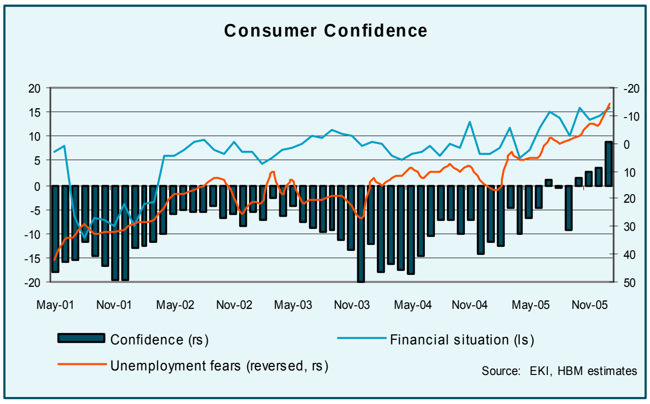
Household Incomes and Consumption

Employment and Unemployment

The major factor that influences Estonian economic environment and overall mood is consumer confidence and it continues to climb. Such strong confidence is most of all based on strong employment developments and related good incomes. Growing employment and declining unemployment in a situation where demand for labour is growing rapidly has forced companies to increase wages. As the economy continues to grow, demand for additional labour also grows. However, as Estonian unemployment is structural – having clear regional and professional patterns – it is rather difficult to find the necessary workers amongst the unemployed, especially those with high qualifications.

Although the labour market services provided by the state have improved a lot, companies still lack workers for some specific and rapidly growing areas. As a result we can say that the labour market has increasingly become an employees market – people are not afraid to lose their job as they know that it will be difficult to replace them or that they can find another job easily. Wage demands have also grown, though trade unions are still weak in Estonia, except some closed sectors (e.g. transport, health care etc).

We do not expect changes to the current trends. Employment will continue to rise, though more slowly than in 2005 as companies have intensified investments to increase productivity and efficiency. Unemployment will continue to decline, though little slower than in 2005. As a more numerous generation will enter the labour market in the next 5 years, the pressures there will not increase very rapidly. This ease, however, will not last more than 5 years. We also expect that employment will continue to increase among those over 50 and over 60 (or among people eligible for a pension). The new trend, which currently is only at a very early stage, is part-time employment, and employment with flexible hours and place (at home) – these methods make it possible to hire older people, people with disabilities and those on maternity leave.



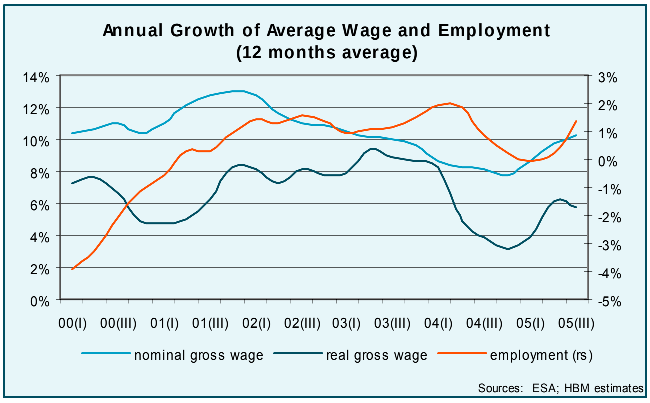
Labour Outflow and Inflow

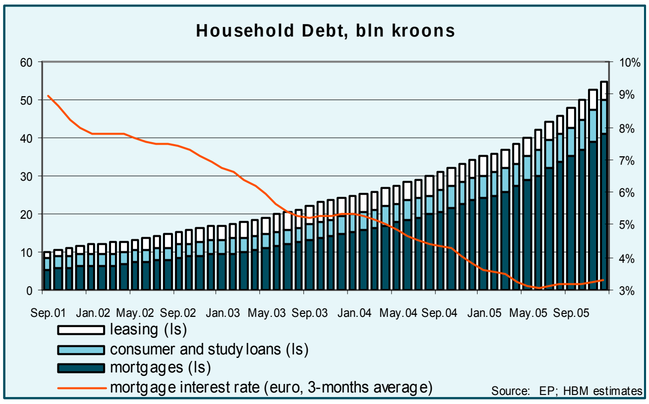
We do not expect the net labour outflow to increase; in fact if Bulgaria and Romania join the EU in 2007, the labour inflow might increase. If Finland opens its labour market from May 2006, then this will probably not change the number of those working there already much, but will mainly have an effect on employment contracts. At present people are working as employees of Estonian-based service companies, after May 2006 direct employment will become easier. However taxation issues might still make people prefer current arrangements, especially taking into account the less regulated labour market in Estonia and short-term (or contract-based) employment in Finland (up to 6 months). Still, the number of Estonians working in other EU countries (particularly in Finland) will grow in 2006-2007, but with diminishing growth rates as domestic wages are growing rapidly (and wages are the major reason why people are going to work abroad).

At the same time, the labour shortage has forced companies to look for workers in other countries – construction workers are already employed from Poland, and shipyards are employing workers from Ukraine and Russia, etc. So we expect that more foreign workers will start to work in Estonia, although at first mostly on a non-permanent basis.

Household Incomes

Household incomes have grown not only because of higher wages (we forecast ca 6-7% real wage growth in the next couple of years), but also because of bigger disbursements from the state budget. The old-age pension is about to exceed EEK 3000 in April 2006, and we are of the opinion that ca 10-15% growth is also expected in 2007 and beyond. The reasons are as follows: very low level compared to wages (35% of average wage in the 3rd quarter of 2005), strong incomes from social tax and approaching elections - retired people are a large and very active voter group. The maternity[1] payment period has been extended from 12 months to 15 months. There have been other, minor increases of various other social payments from 2006 and we expect that there will be additions in 2007 and onwards. The government is continuing its tax-cutting programme for personal income tax, increasing the non-taxable minimum and lowering the tax rate (23% in 2006, 22% in 2007).





Household Borrowing and Real Estate

Household have got additional financial freedom from borrowing – the total loan portfolio of households (incl. leasing) grew by 59.2% in 2005; however mortgage loans (74.8% of loans) grew significantly faster (74.5%) than consumer loans (64.3%). The latter started to expand faster only in the last months of the year (annual growth was 13.4% in June). The leasing portfolio of households is

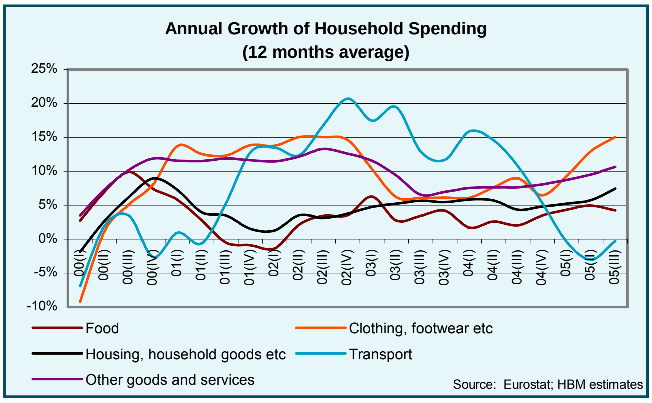
[1] We use term maternity payment here, though it operates also as paternity payment if the child has reached 6 month age

slowly declining. Low interest rates and growing incomes (and good prospects of this continuing) are the main reasons why households are taking loans and banks are ready to give loans. The high need to improve living conditions is also an important factor, which means that demand for mortgage loans will continue to grow. We expect that the household loan portfolio will continue to grow rapidly in the next few years (mostly mortgages). The peak in the growth of mortgage turnover might be already over (in July-August 2005), but turnover amount will soon exceed EEK 3 bln a month (probably in March).

Slowly growing interest rates have only a slight effect on loan demand; prices of real estate are a more important factor and prices of real estate (apartment selling prices) clearly heated up at the end of 2005 in Tallinn. So 2006 started on a much calmer note and we expect that for some months actual selling prices will be stable (a general fall is unlikely) and somewhere in the middle of 2006 or even in the 2nd half of the year they might start to increase again though probably at a slower rate than in 2005.

Household Spending and Saving

Strong income growth and increasing leverage is making it possible to increase household spending and savings. The average income level has reached a level that makes it possible to save. At this point many families are deciding to take mortgage as a way of saving, however this step also requires resulting saving-like spending (e.g. life and property insurance).



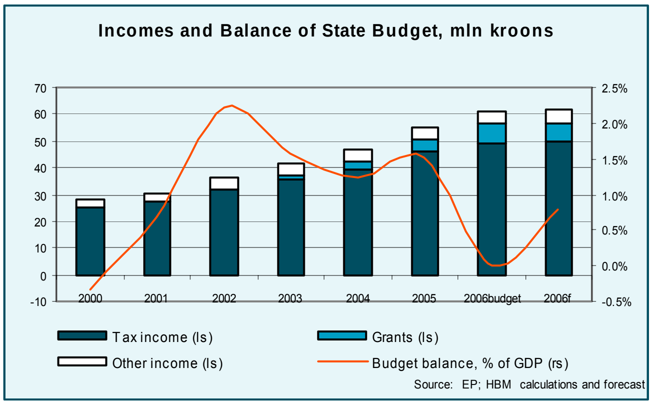
The 2nd pillar of the Estonian pension system has been successful – it has 483 th members (ca 60% of persons aged from 16 to pension age), which is close to the maximum taking into account the fact that it is voluntary for older age groups (those born before 1968 can no longer join the system). The possibility of saving and the above-mentioned need to save is good for household saving and the savings are growing quite rapidly (non-life insurance and life insurance gross premiums grew in 2005 by 14% and by 57%, respectively).

The common understanding about good saving is investment in real estate; however other ways of saving are also gathering support. We expect households to increase savings together with income growth; interest rate growth and the more stable economic environment together with more developed financial market in Estonia are also important. In that sense it is very important that domestic investment opportunities grow – the shortage of investment opportunities is probably one reason for the relatively low level of savings so far and one reason for the signs of overheating in the Tallinn real estate market.

Spending on goods and services is growing slower than incomes due to growing savings. The fastest growing areas of spending are various services (e.g. health, vocational services etc) and consumer durables – particularly those related to housing (furniture, electronics etc), and investment related goods and services (construction and repair works and materials). The growing sales of clothing and footwear could be explained by the wealth phenomena (like vocational services), but also by the fact that only recently has a relatively significant group reached income levels that make extra spending possible. Hence we expect that retail sales of those products will start to grow more slowly quite soon.

Government Spending and Economic Policy

The Government's policy will remain slightly expansive although the budget will be in surplus. Strong budget revenues and EU funds are making it possible to increase spending extensively in coming years.



Last year ended with a surplus of ca 1.5% of GDP in the state budget, however municipal budgets will probably create a deficit and hence the overall surplus will be ca 0.7-0.8% of GDP. The budgetary situation will not improve in 2006 or 2007 although the budget plan for 2006 is based on rather conservative expectations of economic growth and inflation.

The budget is planned to increase by 10.5% compared to 2005 actual results. This growth is smaller than the expected nominal growth in the economy (close to 15%), which is clearly too little taking account government assumption of the successful use of available EU funds during 2006 (ca EEK 7.2 bln of various grants). If the hardly predictable EU funds are excluded from the budget then according to our estimates the budget plan underestimates revenues by ca EEK 1.5-1.6 bln. For example, VAT revenues for 2006 are planned at only 2.5% bigger than the actual outcome in 2005. This EEK 1.5 bln gap is far too big to be explained by forecast errors – we are of the opinion that the government intentionally kept the revenue plan smaller than actual outcome will be so as to have extra funds to distribute through supplementary budget(s) in 2006. Such a step is explained by the approaching presidential and general elections. So we expect that in 2006 there will be one or two supplementary budgets (in spring-summer and/or in autumn), which will use those underestimated revenues for election-motivated spending (e.g. allowances to households, pension payments increases, investment in municipal schools etc).

We are also of the opinion that the current government is reluctant to change the pension index (currently a simple average of social tax income growth and price growth) as the current system creates rather big extra revenues for the Social Fund and makes it possible for the Government to make extra increases in retirement benefits and hence to benefit from that politically. Unfortunately no change is expected soon and we forecast additional to regular pension increase in 2007.

Probably the most problematic area is the financing of the health system. The Estonian health insurance system, which is basically a good system, has a contradiction between revenues and spending. While revenues depend on income level, which is low, expenditures are mostly open to external competition (pharmacy, equipment; partly labour as medical personnel are in great demand in other EU countries and there is no restriction for those professions in the labour market). The Ministry of Social Affairs is currently proposing to cut illness payments from the Health Insurance Fund and to shift payments to employers, who of course are strongly opposed to this. As Estonia does not have special insurance for working accidents and work-related illness, in some cases this approach is economically and socially acceptable. However, when the health insurance was created in the early 90ies – then it was planned that capital costs (construction and renovation of buildings) of the health system should be financed from the state budget and that was why the tax rate was set at 13% of the gross wage and not more. It was only in recent years that some (minor) capital costs were covered from the state budget. However the government is seemingly not interested in widening the spending made directly from budgetary sources.

The odd composition of the government (two parties from the left and one from right of the political spectrum) constantly affects the government's decisions on spending, taxation and regulation. The approaching elections have increased tensions in the government and the strengthening of the opposition in opinion polls has not made the situation easier. In this situation the government has to make some important decisions soon. One of the most intriguing is the purchase of privatised Eesti Raudtee (Estonian Railway) by the state. The privatisation of the company in the form it was done (not separating the everyday operation of the cargo flows and infrastructure) turned out to be unsuccessful, creating a lot of problems in the sector. As a result, the private company is ready to sell its part in the company, however the price issue now seems to be problematic. We do not expect that any party will be against the purchase, however the price (ca EEK 2.2-3 bln) will definitely have some kind of future political risk. Probably some kind of agreement will be found in the next couple of months and the company will be in the hands of state again. It is highly probable that afterwards the company will be split into two – one operating as infrastructure owner, the other as an ordinary railway operator. While the first will remain in the hands of state in future (as strategically important), the other's future has many possibilities (as a state company, part of the state company Tallinna Sadam (harbours), or privatisation). The purchase of the Eesti Raudtee will increase budget spending or will cut revenues (dividends) to the budget depending on legal form of the purchase.

The Government also needs to make decisions on road building and the permanent connection between the mainland and the island of Saaremaa. The government has so far supported the development of those bigger roads that have big international importance (Tallinn-Narva-St.Petersburg, Tallinn-Riga-Europe, lately also Narva-Tartu-Riga), while the most important domestic route between Tallinn-Tartu-Southeastern Estonia (and further to Russia) has received relatively small attention (and money). As dissatisfaction with this approach has grown very strongly - local governments see problems for future economic growth - the government probably will make some changes in financing of road building ahead of elections.

The Use of EU Funds

The monetary transfers from EU have been poor and although in the last two weeks of 2005 big transfers were made (according to state budget statistics), the overall outcome has been poor (actual spending was 57.2% of planned in the budget). However we expect improvement in 2006 as projects started in 2004 (and 2005) are about to be finalised in 2006 (and some in 2007), which means that monetary transfers from EU funds will start to increase significantly this year. In 2007 the outcome is dependent on the ongoing EU budgetary process discussions, however it will mostly affect the project and planning phase in that year while actual monetary flows are still mostly dependent on the current budgetary period. Still, if there is any delay in the EU budgetary process, investment activity might slow at the end of the year affecting mostly social and infrastructure investments. We remain more pessimistic than the government regarding the use of the funds – while the government expects that Estonia can use over 7 bln kroons in this year, we see that 6 bln would be a good result. The good thing is also that Estonia has one of the highest levels of approved projects among the new members of the EU (over 62% of possible allocations during 2004-2006).

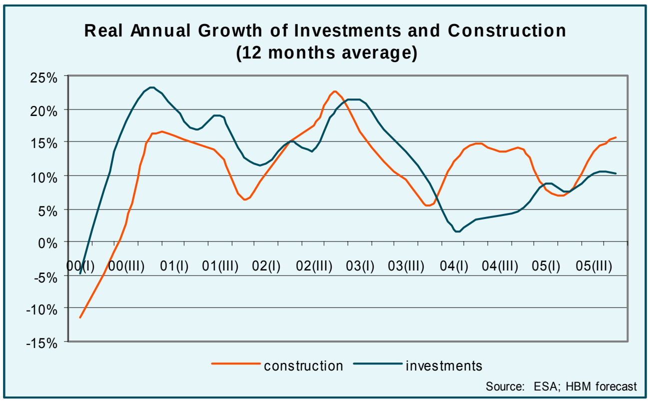
Available Foreign Aid Funds in 2004-2006, mln euros

		of which as of end-2005	
Fund	**mln euros**	**covered with approved projects**	**payments made**
ESF (Social Fund)	76.1	64.7%	9.5%
ERDF (Regional development)	211.3	61.7%	18.2%
FIFG (Fisheries)	12.5	63.3%	21.2%
Schengen	76.3	96.0%	12.0%
EAGGF (Agriculture)	56.8	64.9%	41.9%
EQUAL	4.1	88.3%	12.2%
Other funds	323.6	53.2%	23.6%
Total	**760.8**	**62.2%**	**20.8%**

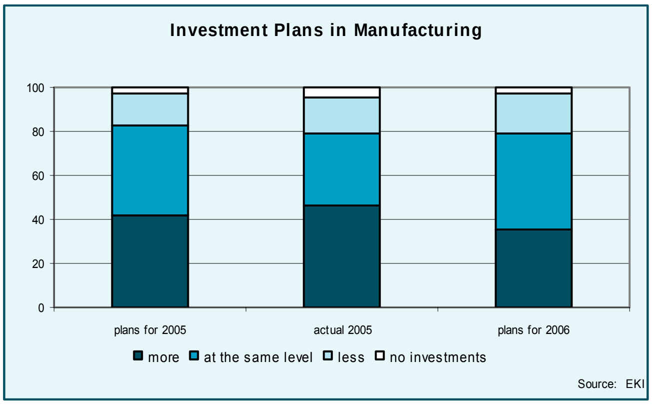
Source: Estonian MoF

Private Investment

We expect investments to grow ca 10% in 2005 and ca 8.5% in 2006 and 2007. The slowdown of the growth rate is related to smaller plans in manufacturing – there is a slight (only a slight) increase in the number of companies that are planning smaller investments this year than in 2005. Most of the companies are planning to invest for many reasons. Most companies (55.5%) are planning to increase production capacities (actually 54.8% did in 2005) and 70% of them are planning to increase their production mix at the same time. Investments to rationalise production processes are also very important – while in 2005 52% of companies made such investments, close to 55% are planning to do so this year. Investments for other reasons are also planned: environmental purposes (25%), labour safety (26%) and renovation of production capacities (34%). Investment activity is expected to fall or remain stable in the textile and clothing industry, the timber industry, and the rubber and plastic industry, however strong growth could be expected metalworking, the production of building materials, in the chemical industry and in the food industry. As production capacities are in almost full use in construction (95% in Oct 05), we also expect additional investments in the construction industry.



Growing domestic demand and wealth triggers investments in the retail trade, and various services sectors. We are of the opinion that after a somewhat poor situation in the hotel business, new bigger hotels will be constructed in 2006 and 2007. Estonian revenues from tourism have been very closely connected to available accommodation; hence the slowdown in the accommodation industry seen in 2005 will be reversed if new hotels are opened.

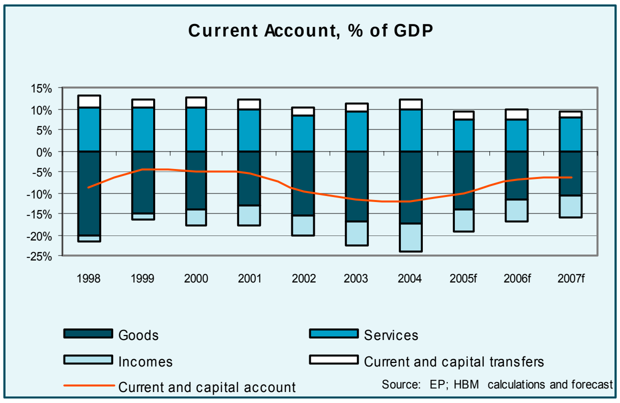


Households will continue to invest in real estate. As there are plenty of building permits issued but not yet realized into actual building and use, there is lot of room for growth in the future. The big problem, however, is the lack of labour. It seems that companies are favouring non-residential building (probably because of the bigger turnover), while residential building might be more costly (private houses). This capacity problem could trigger a price growth in construction, which might exceed 10% or even 15% (7.3% in 2005), however households are probably not ready to pay any price (see above *Household Borrowing and Real Estate*). Consequently we expect stable but relatively strong growth in residential building.

External Balance

We expect the Estonian current account deficit will fall to ca 11% of GDP in 2005 (12.7% in 2004), which is less than we expected previously. The biggest improvement takes place in the trade account, but improvement is also expected in the income account where the outflow has been smaller and inflow bigger than expected. The services account is the biggest disappointment (see above), but the transfers' account is also not very good. As a result, the overall improvement in 2005 was smaller than we expected.

Despite the weaker than expected outcome in 2005 we remain optimistic regarding 2006 and 2007. We expect the current account deficit to fall to 9% of GDP in 2006 and to 7.5% in 2007. Our expectations are mostly based on the improving trade balance, which might fall close to 10% in 2007/2008. We do not expect great improvement in the services account, however a slight improvement could be possible if there are no surprises. We also expect relatively strong improvement in the income account, where outflows will diminish slightly as profitability falls within the normal range, and inflows grow, as Latvian and Lithuanian investments start to generate more income for Estonian investors. We also expect growth in workers remittances. Our forecast expects improvement in the transfers and in the capital account, but that might not be very strong as outflows are also growing. Our forecast does not take into account the possible sugar fine or other non-regular big payments to the EU budget.



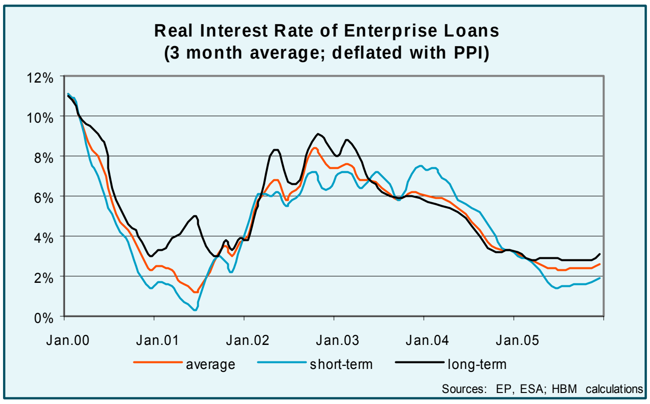
The current account deficit will be financed mostly by long-term capital. In 2005 FDI inflow was extraordinarily big as Hansabank went into hands of Swedbank and there were also other big sales of private companies (e.g. shares in Skype, Tallink). It is natural to expect that in 2006 and

2007 FDI inflows into Estonia will be smaller than in the previous year. But we expect them to be significantly bigger than in 2004. Net outflow of portfolio investments in 2005 was related to the abovementioned takeover. Portfolio investments outflow will remain rather big in coming years, as pension funds will invest mostly in foreign bonds and stocks. Bigger companies will continue to issue bonds, though there are signs that the Estonian government will not redeem its Eurobond in mid-2007.

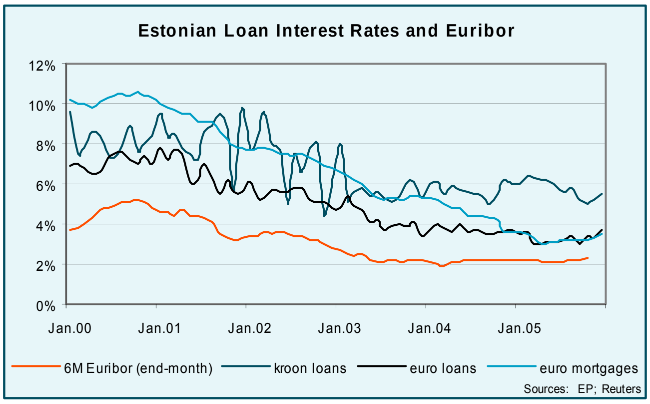
Monetary Issues

Monetary Policy and Interest Rates

The Estonian central bank will continue with preparations for euro adoption in 2006 but we are very sceptical about Estonia starting to use euro from the 1st of January 2007. We see a possible delay of between 2-3 months to 1 year, or even more if inflation is affected strongly by external factors or the competition situation in the domestic retail and services market deteriorates significantly.



We do not expect changes in Estonian monetary policy prior to euro zone membership and we are of the opinion that a delay in the accession will not cause any significant changes. If the delay is prolonged and the outlook for euro zone membership becomes gloomy (which we do not expect), some interest rate margins might grow. But we mostly see contrary effect – euro zone membership will increase Estonia's country ratings and cut interest rate differentials (if any).



Estonian interest rates will continue to follow those in the euro zone – a slight pick up at the end of 2005 will continue through 2006 and 2007, but as expected increases will be slow it will not affect Estonian monetary conditions seriously.

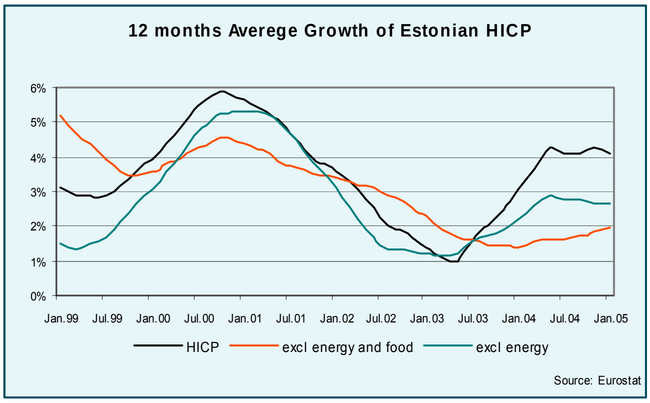
Inflation

Inflation is the major headache for those expecting the euro. Although consumer price inflation started to decline after rocketing oil prices in early September, the slowdown has been clearly slow and new threats have emerged.

The secondary effects of September's price rise have only now started to be reflected in the prices of heating; and now the gas price is posing a threat to many private consumers (mostly through long-distance heating). Although Estonia has a contract with Gazprom until 2008, the company is still pressing ahead with much faster price growth than agreed. Having the power of a monopoly (the Baltic countries have gas supply only from Russia) Russia has already limited supply during the recent cold period in January. Although Gazprom has a strong "argument" being the only supplier of gas, Estonia has the possibility to supply domestic oil shale oil. Still, the price differential is rather big as after deregulation of the price of oil shale oil, the price of domestic products grew ca 60% (being one reason for heating cost growth). Our forecast is based on the previous assumption – gas prices growing ca 10-15% every year for the next 3-5 years.

The growth in oil prices in January 2006 have also been encouraging for our inflation forecast, but so far we still expect that this is only part of a wide-range fluctuation and the price will fall afterwards. Still, transport costs are on the rise – not only because of oil and gasoline, but also because of growing labour costs.

Competition is a very important factor, which has so far kept inflation level relatively low compared to the economic growth (particularly if compare with Latvian situation). We expect it to stay approximately at the current level. While the German Lidl company's entry of Estonian retail market might increase competitiveness and limit price growth, the situation in services is different. With the shortage of labour, prices of various services might grow easily.



Our current forecast expects ca 3.5% consumer price increase in 2006 and only slightly less in 2007 (3.2-3.4%). There is a very-very slight probability that inflation will fall to 3% at the end of 2006 making possible to join the euro zone. It demands three factors working together at the same time: global oil prices falling to USD 50-55 per barrel level, competition remaining strong in the domestic market and no administrative price increases (incl. that of oil, long-distance and public transport). While the competition situation might not worsen, several price increases are already in the pipeline, not to mention the price of oil, which is hardly predictable.

Latvia

Baltic Outlook 06.02.2006

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Recent Economic Developments

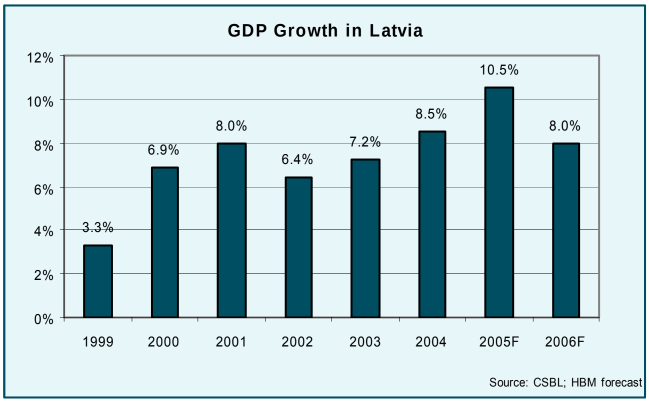
GDP growth in the 3rd quarter exceeded our expectations, indicating that optimism among companies and consumers is not disappearing. Output grew by 11.4% in the 3rd quarter, and by 10.1% in 9 months of 2005. Virtually every sector is experiencing growth. The strong demand is characteristic both to internal and external markets.

Consumer price inflation in 2005 reached 6.7% as pricing pressures did not decrease over the year. Price increases were also a by-product of strong growth in the production and construction sectors. In these circumstances the state budget revenue collection exceeded the plan and until autumn we saw a healthy budget surplus. However, the unpleasant pattern of previous years was repeated: heavy spending in the 4th quarter was responsible for the year's total state budget deficit (-1% in 2005).

	2004	2005f	2006f	2007f
Economic growth	8.5%	10.5%	8.0%	7.5%
GDP, mln EUR	11,167	13,362	15,426	17,250
GDP per capita, EUR	4,800	5,809	6,744	7,580
Industrial production	6.0%	6.0%	6.2%	na
Manufacturing	6.2%	6.9%	6.5%	na
Inflation (GDP deflator)	7.2%	8.3%	6.9%	na
Consumer prices	6.2%	6.7%	6.1%	4.0%
Harmonised consumer prices	6.2%	6.9%	6.0%	4.1%
Producer prices	8.6%	7.8%	7.0%	na
Unemployment (national definition)	10.4%	9.1%	8.5%	7.5%
Average monthly real wage	2.4%	9.7%	9.0%	8.0%
Goods and services exports	21.4%	30.0%	20.3%	15.0%
Goods and services imports	27.0%	25.8%	19.6%	14.0%
Trade and services balance, % of GDP	-15.8%	-15.1%	-15.4%	-15.0%
Current account balance, % of GDP	-12.9%	-11.6%	-11.3%	-12.0%
Current and capital account balance, % of GDP	-11.8%	-10.3%	-8.8%	-9.2%
FDI net inflow, % of GDP	4.3%	3.1%	3.9%	4.0%
Total external obligations, % of GDP	92.6%	97.5%	100.1%	103.0%
Government fiscal balance, % of GDP	-1.1%	-1.0%	-1.5%	-1.0%
as in ESA 95	-1.0%	na	na	na
Central government debt, % of GDP	13.1%	10.7%	11.6%	12.5%
as in ESA 95	14.7%	na	na	na

Summary of the Forecast

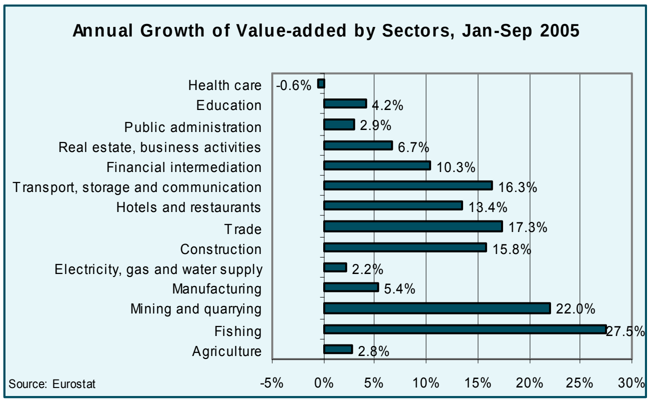
We have revised our forecasts in several disciplines. There is neither a radical change in the forecasts, nor a reversal in the trends. The alterations are more a question of degree. Many tendencies proved to be more persistent than had been expected in the middle of the year. For example, we have increased the output growth numbers, as sentiment is very optimistic. Meanwhile we have increased inflation forecasts, since inflation expectations are dangerously mounting both among consumers and businesses.



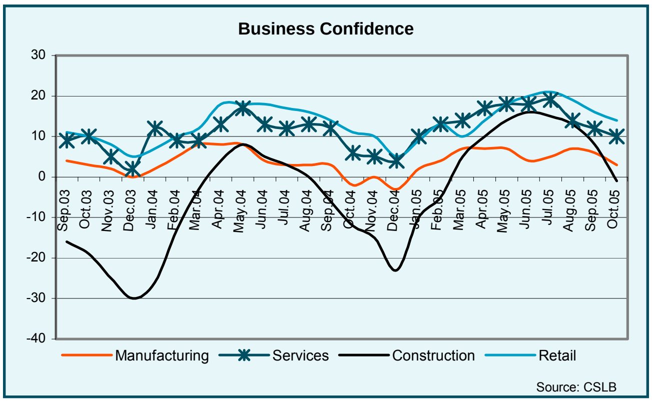
Economic Growth

After surprisingly strong growth in both the 2nd and the 3rd quarter we have altered the 2005 GDP forecast to 10.5% (previously 8.8%). The leading sectors are trade, transport, storage and communications, and construction. Apparently the growth of this group is linked to strong internal demand. Several smaller sectors also show growth ambitions (e.g. hotels and restaurants). Manufacturing is exhibiting improvement and the weakness of the beginning of 2005 has gone. Manufacturers are comfortable with the steep export growth.

For 2006 we expect growth drivers to be similar to those of 2005. We expect the list of the leading sectors to change little and aggregate output growth to be ~8%. Business and consumer sentiment indicators (the 3rd quarter) reveal optimism that could also be sustained in 2006. Manufacturers and construction companies point to favourable demand conditions; however, the greatest risk area for them is potential labour problems (shortage and/ or high cost level).

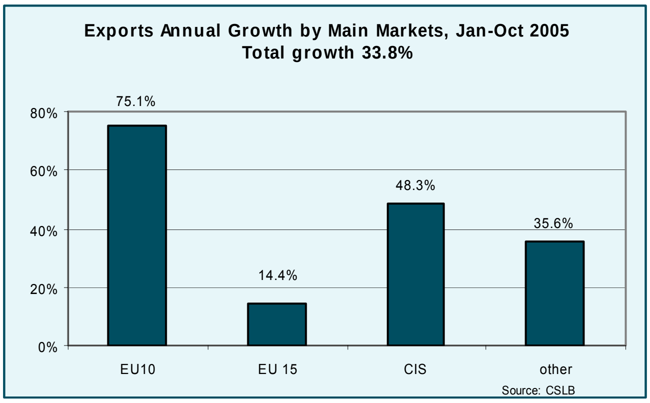


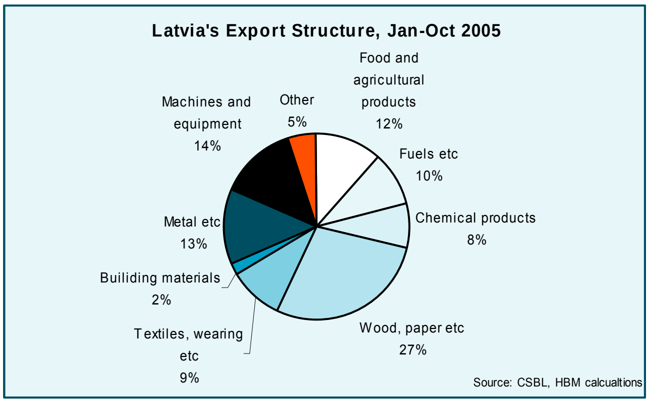
Official GDP numbers for 2004 and 2005 were revised to account for financial intermediation services indirectly measured (FISIM), a methodological alteration uniformly required by Eurostat. The historic numbers will be revised shortly, but for the time-being pre-2004 and post-2004 output figures are not directly comparable.



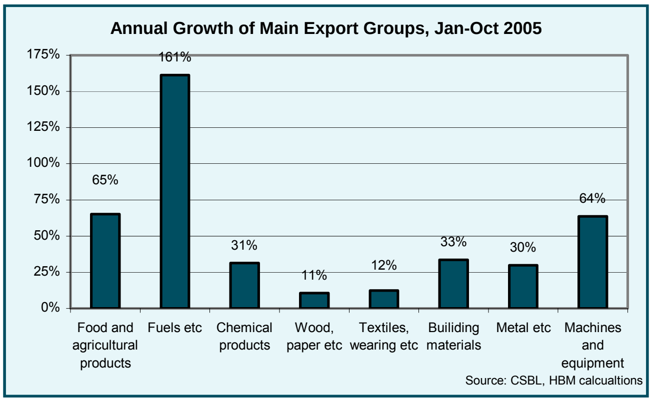
External Demand

Merchandize exports sustained a growth rate of about 30% in 2005. We have slightly altered our export growth projections for 2005 (32%) but retain our opinion about growth in 2006 (20%). Lower growth rate in 2006 is related to higher base and gradual saturation of the foreign markets.

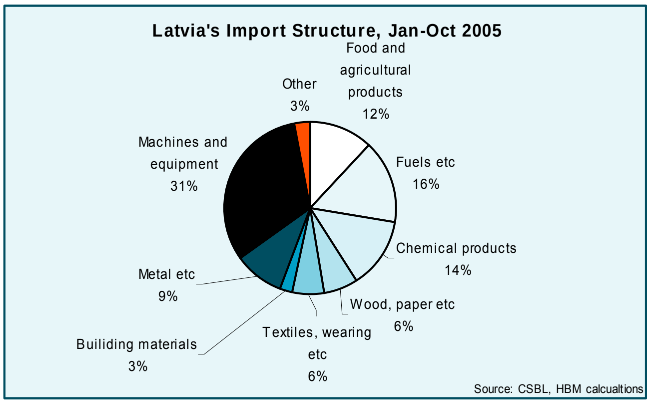


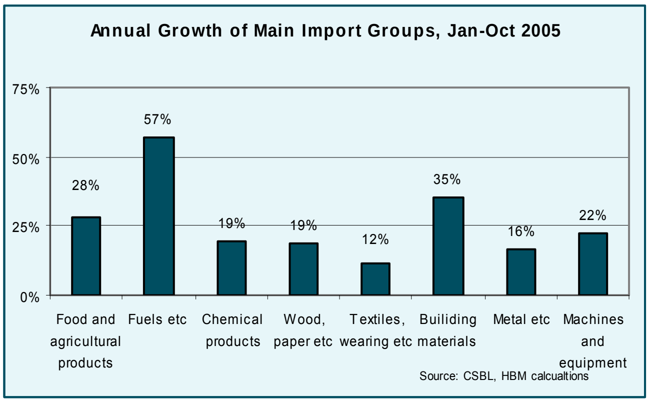


Geographically, export growth is the strongest in the new EU member states (Estonia, Lithuania, Poland) and the CIS markets. The EU15 market is growing more slowly due to economic stagnation; however, the UK and Germany are still the top export partners for Latvia. Export growth is dependent not only on the economic well being of the foreign markets, but also on network development and improved access to the markets. In this context, future export growth will be determined by improvements in selling skills and the offer of higher value products.



The most rapid growth has been in food exports (+60% estimate for 2005). It is positive that food product exports both to Eastern and Western markets are growing. Metal and metal products, chemicals, building materials industries experienced 20-30% growth rates. The traditional export sectors - wood and textiles – have grown comparatively slower (10-12%); however, the achieved growth rates here are higher than expected.

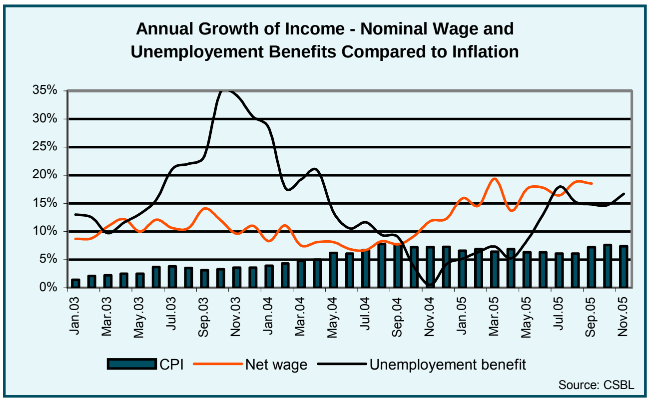




Services exports continue to sustain 20-30% annual growth pace. The dominant export group is transport services (~60% of export income). The remaining export income is split between various other services (~25%) and travel services (~15%). Currently, air transport is outperforming sea transport in terms of growth (especially in passenger transportation). The services imports are also growing strongly (growth rates are higher than for exports); thus, the services trade balance is shrinking.

Household Incomes and Consumption

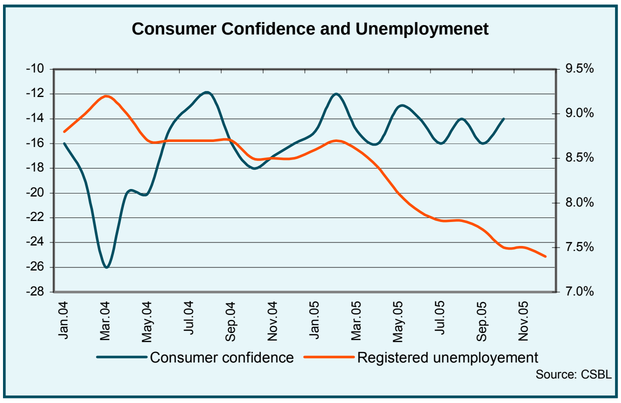
The present economic boom is possible because of confident consumers. Internal demand is driving growth in most of the leading sectors in Latvia. Consumer spending has not slowed yet – quite the opposite: in the 3rd quarter real growth in household consumption reached 10.3% y-o-y.



Retail sales sustained above 20% growth pace to the end of the year.

- Sales grow most strongly in the non-food segment.
- Buoyant spending on durables correlates with real estate boom.
- Consumers are not yet discouraged by high inflation and we suspect the opposite effect, i.e. fears of further price increases motivate quicker purchases, thus, further adding to inflation.

Part of retail growth is still attributable to shift from non-official to official trade. This tendency is supported by the ongoing process of sector concentration, i.e. old-type stores continue to lose market share to large chains, which follow more thorough accounting practices.

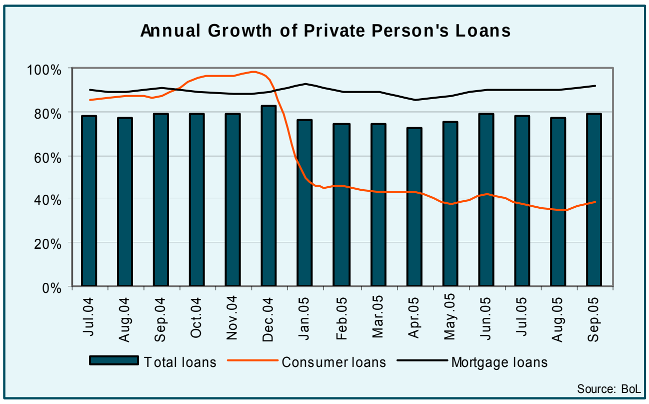


One of the principal components of consumer confidence is the encouraging dynamics of wages. In 2005 wage growth was close to 16-17%, which, after adjusting for inflation, gives 9-10% real growth of income. There is growing pressure to raise wages as the economy and labour demand are growing, while the labour supply is scarce. Other types of incomes have also been growing (e.g. pensions +14%). Furthermore, we estimate a large inflow of funds in rural areas, facilitating spending there. The incomes in rural areas have greatly benefited from EU direct payments and increasing monies received from relatives working abroad.

While demographic problems will become critical for the labour market in a couple of years, migration pressures affect labour supply now. The labour outflow intensified greatly in 2005, which is partly a consequence of the entry into the EU. Since 1 May 2004 only three countries of the EU15 have opened their labour markets (Ireland, the UK, Sweden), but this has generated considerable labour movement (mostly to the English speaking UK and Ireland). There is a lack of precise statistics, and guessing leads to a broad range for the number of workers abroad (40 - 100 th which corresponds to 5-10% of the total labour force). Most other EU states do not intend to open their labour markets soon. Nevertheless, we expect the labour outflow to wealthier EU countries to remain just as strong in coming years. The principal determinant for the labour outflow is income differences, and closing the income gap is a timely process. For 2006 we see roughly similar wage increases as in 2005.

The unemployment level continues to decline steadily. Officially registered unemployment was 7.4% in December 2005 (8.5% a year ago). We expect the unemployment rate (Eurostat methodology) to decline from 9.1% in 2005 to 8.5% in 2006. In our opinion regional differences will hold back steeper unemployment decline. Most hiring is concentrated in Riga, where the unemployment level is already rather low. In contrast, in high-unemployment regions (e.g. Latgale) long-term unemployment is dominant and that casts doubts on the existence of an easy and fast way of involving these people in the labour market.

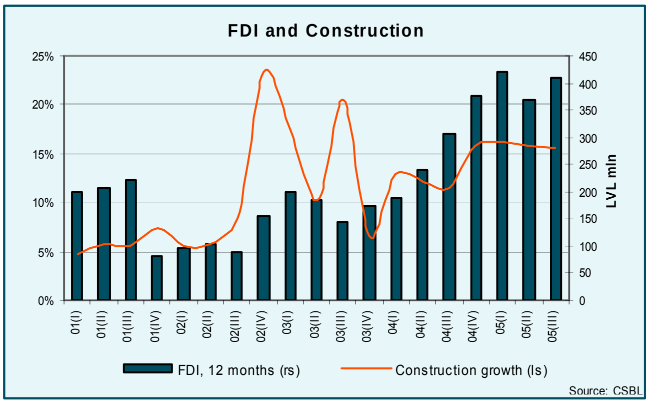
Loan market growth is ongoing and no signs of slowdown are detected. Consumers are expanding their leverage. Most banks are eager to continue active crediting in 2006; thus we expect that households will continue to enjoy higher purchasing power through borrowed funds. Only a gradual and marginal interest rate increase is expected and, thus, in 2006 households will still consider borrowing to be cheap.



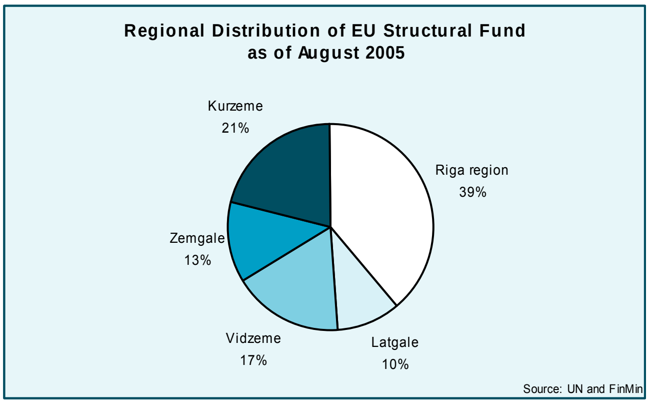
Investments

Gross capital formation grew slower than other GDP expenditure areas; however, in the 3rd quarter the growth rate improved (5.2% in the 3rd quarter vs. 0.5-1.1% preceding quarters). Investments in fixed capital increased (+20%) while inventory generation was slow. The latter is a consequence of the extensive inventory build-up in 2004.

In 11 months of 2005 total FDI inflow has been slightly lower than a year ago (-2.6%), nevertheless, the main sections – investments in equity and re-invested earnings kept growing (9% and 20%, respectively). There was a sharp drop in other capital investments (-68%), a position accounting for loans received from foreign parent companies. The sums invested by Latvia's residents abroad have increased strongly, though nominally these are still small amounts.



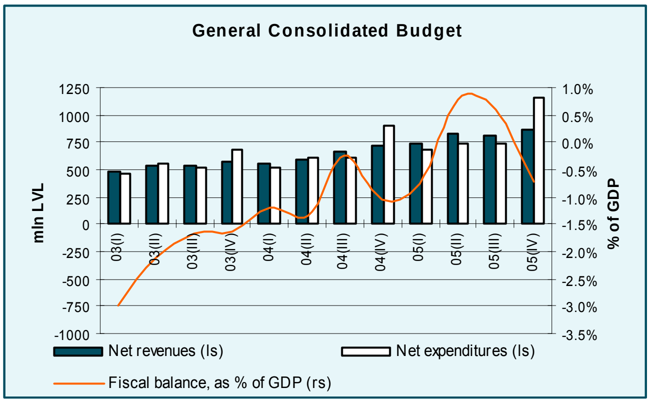
Although compared to its peers, Latvia is progressing well in processing EU structural funds, the number of completed projects is still low. Data for the end of the 4th quarter indicates that on average 68.6% of 2004-2006 period financing has been contracted, while completed (paid) projects constitute only 13.8%. The most successful is agriculture with 88.5% contracting and 48% payout rates (LVL 57 mln and LVL 31 mln respectively). Fisheries support programs are contracted rather weakly (57.7%), but also have one of the highest payout rates (33%). The largest funding is allocated to enterprise support programs (LVL 263 mln or 3/5 of total): the contracting rate there is good (69%), but the payout rate is one of the lowest (7.2%). The weakest activity so far is in the Social Fund (56% contracting rate, 5.4% pay-out rates), and re-balancing of funds to other activities might be considered. Meanwhile the Cohesion Fund is actively contracted at 92% (payout 16%, various problems have generated delays in project implementation).



The analysis conducted in autumn by the United Nations and the Ministry of Finance revealed that EU funds are mostly contracted in the developed regions. Although this nicely correlates with entrepreneur activity, the current spending pattern does not support the main aim – the reduction in regional disparities. The fund distribution principles for the next planning period (2007-2013) are currently under discussion; however, the main trends have already emerged: there will be more emphasis on regional development and a larger part of programs will be devoted to the development of human capital. At the end of January the Cabinet of Ministers approved the general approach: only 38% of financing will be targeted at infrastructure while the rest will be devoted to human capital, innovation and employment support. The preliminary agreement suggests that in 2007-2013 Latvia will be entitled to EUR 4 bln of EU money, which on an annual basis is more than currently.

Government Spending and Policy

Despite the fact that Latvia's general consolidated budget ran a surplus for the first ten months of 2005 (the cumulative surplus LVL 197.4 mln), the budget ended 2005 with a deficit of LVL 91.6 mln (estimated 1% of GDP). This was achieved by excessive spending and a slower rise in revenues at the end of the year. In December the budget had a record deficit of LVL 211.2 mln. These developments were in line with our expectations.



Over the year, the budget revenues showed a relatively good performance, supported by strong tax revenues. The consolidated general budget tax revenues rose by 26% y-o-y, of which the fastest growing were revenues from corporate income tax (+41% y-o-y), value added tax (+39%), and excise tax (+33%).

- The rise in corporate income tax revenues mainly reflects the strong performance of Latvian companies in 2004. In 2004 company turnover rose by 23.0%, while profits increased by 95.7%.
- The revenues from the VAT were affected by several factors: the growth in domestic demand, which fostered retail trade turnover and import growth, increase in consumer prices, and changes in the VAT calculation methodology after EU accession, which reduced the income from VAT in 2004, creating a smaller base effect.
- Regarding excise-tax goods, the strongest revenue growth was seen in revenues from oil products (+34% y-o-y), tobacco (+52%), and alcoholic beverages (+30%). The growth in tax revenues from oil products

was supported both by an increase in oil consumption and a rise in the excise tax rate (in effect from Jan 2005). The increase in tax revenues from tobacco was mainly determined by the increase in the excise tax rate, while the rise in tax income from alcoholic beverages was caused by higher sales of alcoholic beverages.

- The personal income tax (+17%) and social tax (+17%) revenue growth reflects the pick-up in gross wages and the number of employed in the economy. There are no strong indications that part of this growth can be attributed to income legalisation.

Foreign aid revenues reached only 54% of the budgeted amount, totalling LVL 252 mln. At the end of the 4th quarter about 68.6% of the EU structural fund financing was allocated to approved projects, whereas only ~14% of this was paid out to completed projects. Regarding the cohesion funds, in at the end of the 4th quarter about 92% (LVL 461 mln) of the available financing was allocated to approved projects *(for more detailed information see the section on Investments)*. A positive aspect of the slow processing of EU funds is lower government spending on co-financing, which accounts for ~30% of total financing; thus, lowering the budget deficit for the year. Higher EU project completion activity in coming years will definitely put more pressures on state finances, suggesting the possibility of larger budget deficits.

The largest disbursement activity of financing for EU projects was in the 4th quarter, when according to our estimates, about LVL 106 mln was paid out to completed projects. For the period 2006 – 2007,the Ministry of Finance plans to ensure that 100% of the EU financing is allocated to approved projects and 50% of the money is disbursed.

EU funds in 2004-2006 (end-2005 situation)			
Fund	mln lats	Contracting rate	Pay-out rate
Structural funds			
ERDF	263.6	69.0%	7.2%
ESF	93.3	55.9%	5.4%
EAGGF	64.6	88.5%	47.9%
FIFG	17.1	57.7%	32.9%
Total structural funds	**438.6**	**68.6%**	**13.8%**
Cohesion funds (total)	**499.5**	**92.3%**	**16.4%**

The budget expenditures have grown by 26% y-o-y, totalling LVL 3.32 bln. However, this is still slightly below the budgeted numbers, mainly due to slower than expected disbursement of EU financing. As mentioned, government spending substantially increased at the end of the year. In December alone, budget expenditures rose by LVL 160.1 mln (in 2004: +158.1 mln LVL). The largest part of this increase went on grants and subsidies, investment expenditures (related to financing of EU projects), and capital expenditures (such items as the acquisition of real estate, land, automotive vehicles, renovation expenditures, etc.). Such spending at the end of the year contributes to the increase in demand, thus adding to the already high level of inflation.

The budget law for 2006 is rather aggressive; however, we do not see it as ambitious as positioned by the government. Government projections are based on comparison with the 2005 budget law revisions of end of summer, while the actual numbers for 2005 differ – tax revenues were exceed, while expenditures fell below the plan. Therefore, to obtain deeper insights, we provide two growth rates – comparison to the 2005 mid year budget revisions (used by the government) and the actual results in 2005.

The projected general consolidated budget revenues are LVL 3.24 bln (+18% compared to 2005 plan; +19% y-o-y compared to 2005), whereas budgeted expenditures are LVL 3.36 bln (+16%; +20%). The budget revenues should be mainly supported by the strong performance of tax revenues (+23%; +11%), in particular, value-added tax (+35%; +23%), corporate income tax (+40%; +33%), and excise tax (+28%; +18%). Moreover, a strong increase is expected in non-tax revenues (+21%; +22%). This is partly related to the planned sale of the state-owned shares in the Latvian transit company "Ventspils Nafta" (expected revenue ~LVL 70-80 mln). The deal is to be executed this spring. Foreign aid revenues are expected to reach LVL 466.4 mln (+0%; +82%).

The budget expenditures are socially oriented with main priorities in social security, health care, education, integration in the EU and NATO, as well as effective and full-scale utilisation of EU funding. Of the budget expenditures, current expenditures take up 89%, of which 68% are directed to grants and subsidies and 30% to maintenance expenditures (44% of these salaries). Investment expenditures, which are linked to EU funds, are expected to increase by 41% (to LVL 247 mln), and an increase is also expected in capital expenditures (+68% to LVL 138.4 mln).

Taking into account the rather aggressive projections for revenue and expenditure, as well as the general elections this October (bringing along large government spending incentives), we do not expect the budget deficit for this year to be below the government projection of 1.5% of GDP.

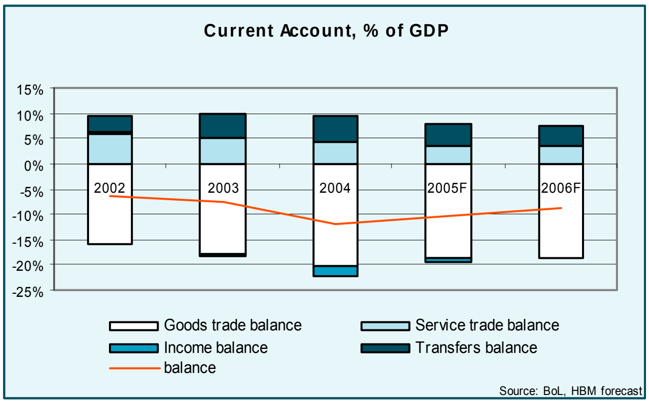
The state debt in 2005 was lower than expected. At the end of the year it decreased to LVL 955.1 mln (-19.9 mln y-o-y). According to our estimates, in 2005 the State debt will stand at ~10.7% of GDP, while in 2006 it will increase to ~11.6% of GDP.

State Consolidated Budget, annual growth	2003	2004	2005	2006p
Total revenues	**12%**	**19%**	**28%**	**23%**
Tax revenues	11%	13%	28%	17%
Personal income tax	14%	19%	11%	0%
Corporate income tax	-14%	36%	41%	32%
VAT	20%	6%	39%	23%
Excise	20%	12%	33%	18%
Custom	24%	-9%	12%	-1%
Social tax	6%	14%	17%	12%
Non-tax revenues	2%	28%	8%	22%
Foreign aid	82%	201%	64%	82%
Total expenditures	**8%**	**18%**	**27%**	**23%**
Current expenditures	11%	18%	23%	20%
Capital expenditures	62%	8%	28%	68%
Investment expenditures	-7%	27%	106%	41%

Source: State Treasury

External Balance

We have made only slight alterations in our balance of payments forecasts. Both in merchandize and services exports the results have been somewhat stronger than expected. However, import growth has also been higher, and, therefore, we have left our forecast for trade balance virtually unchanged. Similarly the inflow of current transfers has followed our expectations.



The only current account position where we cut our expectations is the income account. Income inflow has followed our expectation, while income expenditures has been stronger than expected. More specifically, the profits on non-resident investments intensified reflecting the general financial strength of companies in Latvia.

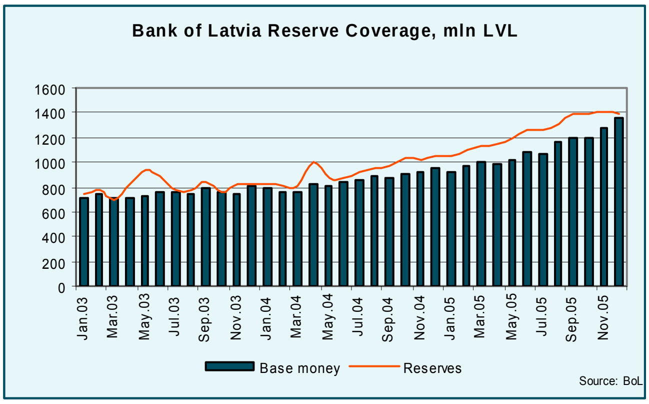
Thus, we have revised our current account deficit projection to 11.6% in 2005 and 11.3% in 2006 (previously 11.2% and 10.8% respectively). Taking into account the EU fund inflows, which are often recorded under capital account, we give an aggregate projection of current and capital account balances: in 2005 we expect a deficit of 10.3% but in 2006 - 8.8% of GDP (previous forecasts 9.8% and 8.2%, respectively).

There are little changes in respect to the financing of the current account deficit. As discussed in the Investments section, FDI net inflow has been more moderate in 2005 compared to 2004 (we estimate 3.1% of GDP compared to 4.3% in 2004). Portfolio capital inflows have been volatile and on net negative in 2005 (a slight surplus in 2004). Unchangeably the key source of capital is other investments, which on average have doubled compared to a year ago. The dominant role in attracting other investments is played by commercial banks: in 11 months of 2005 the net capital inflow via banks amounted to LVL 1.39 bln, which is +170% y-o-y growth. The latter is a result of active domestic lending, which is financed through borrowing from foreign parent banks.

Monetary Issues

Interest Rates

The liquidity situation remains ample and borrowing activity is still high. During 2005 lat interest rates experienced significant convergence with euro interest rates, although a gap of ~0.5 percentage points remained. The rate convergence is driven by the lat's peg to the euro (01.01.2005.) - only a small fluctuation band is allowed (+/- 1% around official 0.7028 EUR/LVL exchange rate).



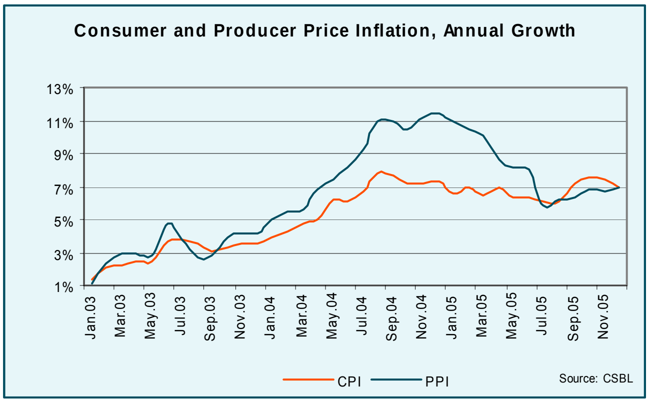
Seeing the unwelcome development of inflation, the Bank of Latvia has attempted to limit domestic demand growth several times. In the summer and at the end of 2005, the Bank of Latvia tried to limit lending activity by increasing the commercial bank reserve requirements. The rise in August had an insignificant effect on lat interest rates, while in December (when reserve norm was lifted from 6% to 8%) lat interest rates increased for a longer time period. We expect a gradual correction of the lat interest rates downwards as banks receive additional lat resources via the central bank intervention in the foreign exchange market. Nonetheless, we cannot rule out another attempt by Bank of Latvia to raise the reserve requirement during 2006; thus, higher lat interest rate volatility is possible.

By the end of 2006 we expect the lat and euro interest differential to return to stable levels (~0.5 percentage points). The expected gradual increase in euro rates this year will bring lat money market rates to 3.5-3.6%. The loan interest rates will follow the development in the interbank markets, and we do not expect any significant reduction in the loan interest rate margins (i.e. the fixed part of the rate above the floating base rate).

Inflation

Inflation expectations remained high throughout 2005, and unfortunately they are not diminishing this year. Average consumer price inflation in 2005 hit 6.7% (6.2% in 2004) while producer price inflation amounted to 7.8% (8.6%).

In 2005 consumers saw price rises in almost every sector with the only exceptions of clothing and footwear and communications. The highest average inflation was in transportation (13.9%) and health care (11.2%). Nonetheless, increases in food prices (9.2%) and housing costs (5.8%) had a large impact. The final inflation figure was the result of a number of inflation driving factors - high global oil prices, the rise in administrative prices (increasing towards the end of the year when they were growing faster than average CPI), convergence with the EU (e.g. effect on food prices), as well as buoyant consumption.

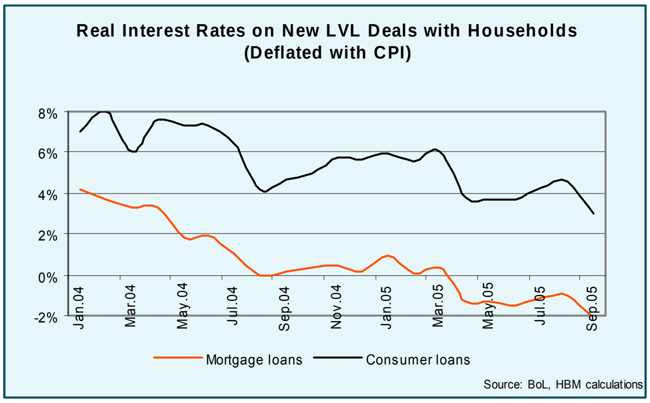


Consumer and Producer Price Inflation, Annual Growth

We have increased our CPI forecast for 2006 to 6.1% (previous 5.4%). The revision is based on several factors:

- Administratively regulated price rises will be more pronounced than had been thought despite the fact that 2006 is an election year (e.g. rise in electricity, gas, and heating tariffs).
- Inflation expectations have mounted; consumers and businesses see on-going indications of price pressures (rise in administrative prices, and severe rise in wages).
- Oil prices are not expected to fall and at best will remain at end-2005 levels.

We are of the opinion that the current path of inflation gives little hope of meeting the Maastricht inflation criterion in mid 2007, and thus there is a serious constraint on euro adoption in 2008. Our projections are that by mid 2007 the 12 months average HICP inflation in Latvia will be ~4.5% while the Maastricht criterion will most likely be below 3%. The government has not yet abandoned the initial plan of euro adoption in 2008, however, lately we have seen the first warnings in official opinions.



Real Interest Rates on New LVL Deals with Households (Deflated with CPI)

Lithuania

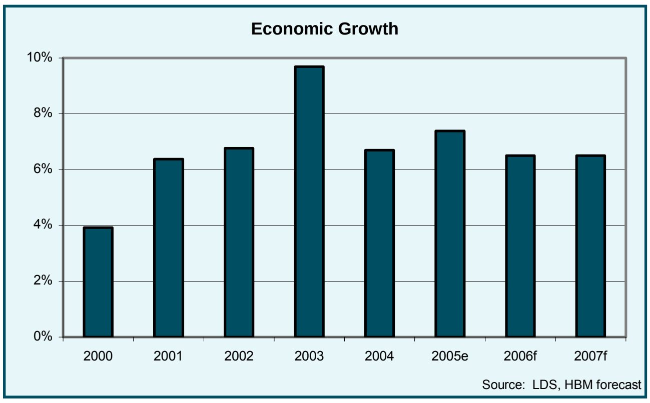
Baltic Outlook 06.02.2006

Maris Lauri +372 6 131 202 maris.lauri@hansa.ee

The official preliminary estimate sets Lithuanian economic growth in 2005 at 7.3%, which is more than we expected (6.8%). As general tendencies in the economy have been according to our estimates, we have made only slight adjustments in our expectations and hence the current cover of the Lithuanian macro economy is rather short. The end-April's *Outlook* will provide more comprehensive cover.

	2004	2005e	2006f	2007f
Economic growth	7.0%	7.3%	6.5%	6.5%
GDP, mln EUR	18084	20494	23450	26700
GDP per capita, EUR	5264	5983	6910	7940
Industrial sales, annual growth	10.8%	7.3%	6.8%	7.0%
Inflation (GDP deflator)	3.3%	6.5%	7.5%	7.0%
Consumer prices	1.2%	2.7%	3.0%	3.3%
Producer prices	6.7%	11.5%	6.5%	4.5%
Harmonized unemployment level	11.4%	8.2%	7.4%	6.7%
Average growth of real wage	4.4%	6.0%	7.0%	8.0%
Exports of goods and services	12.0%	26.0%	20.0%	15.0%
Imports of goods and services	14.2%	23.0%	22.0%	16.0%
Trade and services balance, % of GDP	-7.1%	-7.2%	-8.5%	-9.0%
Current account, % of GDP	-7.8%	-8.0%	-8.2%	-8.6%
FDI inflow, % of GDP	3.5%	2.3%	3.5%	4.0%
Gross debt, % of GDP	42.2%	44.0%	46.0%	48.0%
Budget balance, % of GDP	-2.5%	-2.0%	-1.7%	-1.5%
Government debt, % of GDP	19.6%	18.0%	17.0%	16.0%

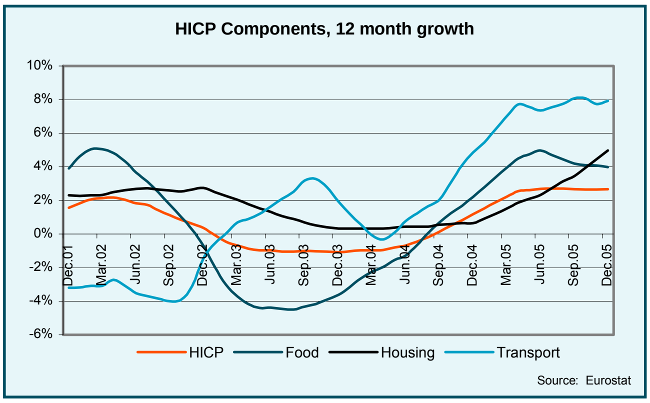
After a very weak start, growth in the Lithuanian economy strengthened at the end of the year. Household consumption was a major driver of the economy from the 2nd quarter of 2005 (12% annual growth in the 3rd quarter), while government consumption started to expand faster only in 3rd quarter (7.4%). At the same time gross investment activity slowed very strongly (1.8% growth in the 3rd quarter) – although fixed investments expanded strongly (14.1% vs. 6.3% expansion in the 1st half), correction in inventories was very strong.



The major factor supporting household consumption is growing **employment** and declining **unemployment.** Employment has grown ca 2.5% in 2005 and unemployment slipped from 11.4% in 2004 to 8.2% in 2005 (only 7.2% in December 2005). Growing domestic and external employment causes the fall in unemployment. **Wage growth** is strong – in 9 months of 2005 9.7% in nominal terms and 6% in real terms (in 2004 5.7% and 4.4%, respectively). Rapidly growing leverage has also helped households to increase spending.

Exports growth has been strong - 25.2% in 11 months of 2005. However, imports have not grown much less – 24%. The trade and services deficit has grown in nominal terms ca 15%, but our estimates for the full year suggest that in relative terms it has remained approximately at 2004's level (7.1% of GDP). However, we see that the fast growth of export prices (especially compared to import prices) might be a risk for the economy. The Lithuanian **current account deficit** was also approximately at 2004's level in 2005 (ca 7.8% of GDP), although improvement took place in current transfers inflow as private inflows are growing rather rapidly.

Consumer price **inflation** remained relatively modest in 2005 – prices grew approximately 2.7% on average, however there is clear upward pressure in Lithuania. Producer prices went up by 11.5% in 2005, however if the manufacture of refined petroleum products is excluded, then the growth was much more modest – 2.6%. However, construction prices are pressing upwards – in January-November period they increased by 7.5% (6.1% in full 2004) – as are export and import prices; the latter started to grow faster at the end of the year. It is only a matter of time, before external pressures express themselves in domestic prices.



Current consumer price inflation exceeds the **Maastricht** inflation **criteria**, however if Lithuania manages to keep price growth at current levels, then there is a possibility that Lithuania will get approval for euro zone membership. Still, this might not happen, as price pressures are very strong – besides domestic demand and external factors, several administrative price increases are expected. We are of the opinion, that if Lithuania is able to join the euro zone, those delayed increases will push prices up very quickly; also if Lithuania does not fulfil the criterion, then it cannot avoid those price increases forever. We also see that the labour shortage resulting from strong economic growth and labour outflow will soon start to push up labour costs even more than now. This might trigger another price increase factor, which will be very difficult to handle.

Still, we remain quite optimistic regarding Lithuania's **economic outlook** expecting an average 6.5-7% growth in coming years as domestic demand is growing and exports continue to grow. Household consumption will continue to benefit from growing employment and incomes, and will get additional financial freedom via loans. Government spending will grow in hand with growing incomes and good tax revenues, while investments will get rather important support from monetary disbursements from various EU structural and cohesion funds.

The Road to the Adoption of the Euro

Baltic Outlook 06.02.2005

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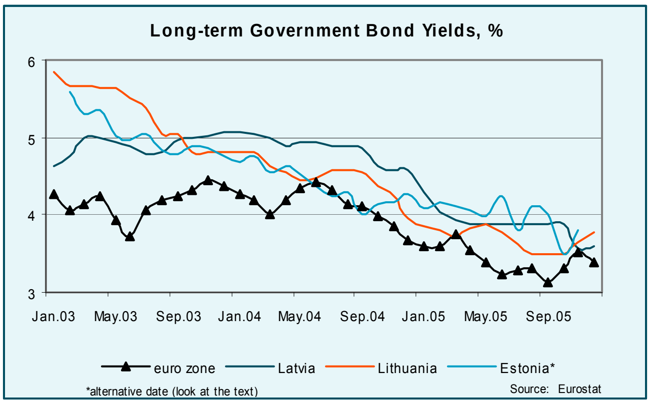
In this permanent part of our Outlook we give short overview of the road to the euro-zone of the three Baltic countries. The Maastricht criteria and other aspects important for euro adoption are discussed briefly. Although the legal framework for accession to euro area is important, we do not look deeply at the issue. Currently all countries have their own independent monetary policy and as the euro area accession is far 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.

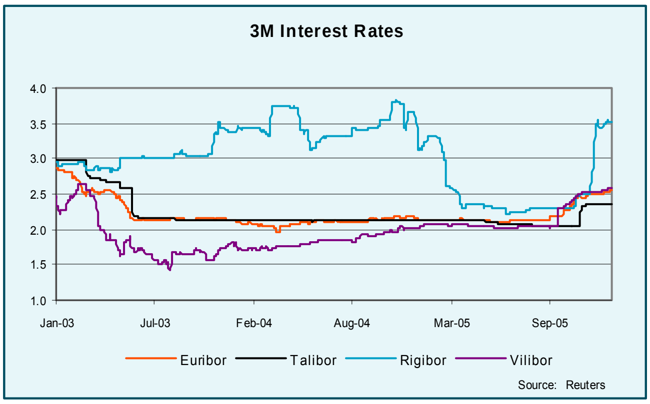
The most important economic criteria under observation (the Maastricht criteria) are inflation, long-term interest rates, the exchange rate, budget balance and public debt. The current account and labour market have also been studied, however they have no clear values needed and are not included in the official list. Our analysis shows the current situation (January 2006) 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 the euro. As the official target dates are looking more and more unreachable, we will also discuss the likelihood of fulfilling the inflation criteria and the consequences of the possible delay.

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 (3.6%) and Lithuania (3.8%) are fulfilling the criteria (5.33%).

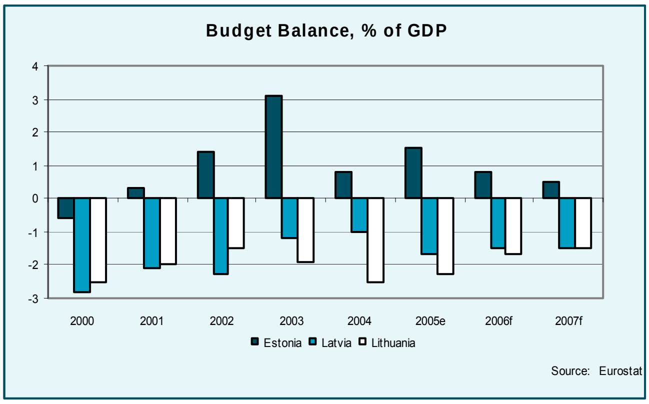


As Estonia has no similar financial instruments, an indicative measurement is used (new kroon-denominated loans to non-financial corporations and households over 5 years), though this is not comparable with other countries' rates. As the reason for the non-existence of the right interest rate is very 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 2005 according to preliminary figures 4.1% for Estonia, 12.1% for Latvia and 19% for Lithuania) and are unlikely to reach 60% even in the long-term. Estonia has achieved a budget surplus for several years and our projections are for a slight budget surplus in the future while EC projects a slight surplus or balanced budget. The situation regarding

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 2006 will not improve significantly.

Exchange Rate

A country seeking to adopt the euro should keep its currency fluctuating within “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 28^{th} 2004 and Latvia since May 2^{nd} 2005. As a consequence, the earliest dates to fulfil the criteria are July 2006 for Estonia and Lithuania, and May 2007 for Latvia.

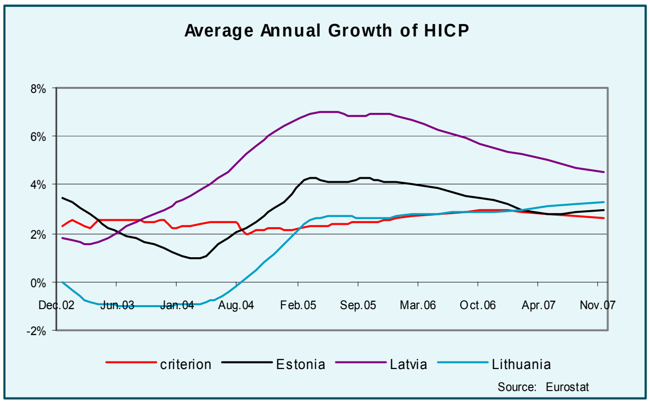
The other aspect of the criterion is to keep the currency within the band of ±15% from central parity rates set when the country joins the ERM2 mechanism. The parity rate for the Estonian kroon is 15.6466 and for the Lithuanian litas 3.4528. With ±15% fluctuation, intervention levels are 17.9936 and 13.2996 for Estonia, and 3.97072 and 2.93488 for Lithuania. As both countries have currency board systems with fixed rates to the 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 1^{st} of January 2005 with the central rate of 0.702804. The Latvian Bank intends to keep the previous ±1% fluctuation band after joining the ERM2 mechanism in 2^{nd} of May 2005. We have no reason to expect that this stance will change.

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”[1]. Negative figures are excluded as not reflecting good economic performance. In December the criterion was calculated from the figures of Finland (12-months average 0.8%), Sweden (0.8%) and the Netherlands (1.5%), 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 meet competition from Estonian prices). The resulting target (2.5%) is fulfilled by 15 of the 25 countries of the EU (incl. 5 non-euro-zone countries). All three Baltic countries are exceeding the limit: Lithuania has 2.7% inflation, Estonia 4.1% inflation and Latvia 6.9% inflation.

Our forecast suggests that all three will have trouble fulfilling the criteria in next year and half. Estonia and Lithuania should fulfil the criteria in autumn 2006 at the latest to take euro into circulation from the beginning of 2007. The same fate might await Latvia in autumn 2007.



- The value of Maastricht inflation criterion might increase in the near future, as extraordinarily low inflation times are about to end. According to the autumn forecast of the European Commission the value of the criterion might be as high as 3% at the end of 2006 (2.5% in 2005) and then in 2007 it might fall slightly (to 2.9%).

- Our forecast indicates that Estonia might reach this 3% criterion at the end of 2006, however it requires several things to happen or, more exactly, not to happen. First, it means that demand pressures should be extremely weak (and competition strong). However, if one looks at current price developments in Estonia, one can see that demand is gradually pushing prices up, although so far its impact has been relatively small. Second, the effect of already planned price increases in the public sector, long-distance heating and several public services should be small and cause a decline in other prices, which is, however, very unlikely. Third, external factors like oil and gas prices should stay at least at current levels, or decline. If one looks at the price tags at the end of January, this does not seem to be happening. So we conclude that Estonian consumer price inflation in 2006 will be ca 3.5%. There will be an increase of VAT rate from 5% to 18% on long-distance heating in 2007 (probably from June), which means that while at the beginning of 2007 inflation might fall below Maastricht criterion in Estonia, in the 2^{nd} half of the year it will again jump to over 3%.

- Lithuania might also fulfil the Maastricht criteria at the end of 2006 if its inflation remains at the current level. The same factors as in Estonia are playing here. We already see that upward pressures are mounting and demand growth is the major factor for price growth. There are also a number of regulated prices that are expected to increase after several years (e.g. local public transport, gas). Due to the very rapid outflow of labour Lithuania might face a rather early setback in domestic labour market – wages might increase so rapidly that companies will be not able to absorb this cost growth and will increase the prices of their products and services. As at the same time wages will grow rapidly and the general income level is low

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

(which means consumption is preferred vs. savings), the demand pressure on prices might turn out to be extremely strong. With poor competition in some sectors prices might jump a lot.

- Latvia is in an even more problematic situation as inflation in the rest of the EU might start to slow in 2007 and hence the value of the criterion might fall to 2.8-2.9%. Our forecast, however, indicates that Latvia might reach only 4.5%, maximum 4% inflation at that time. So the gap is even bigger than for Estonia and Lithuania, which in the best-case scenario might just meet the criteria in time. The factors are basically the same in Latvia, however demand factors already dominate very heavily now. There are also signs of a vicious circle of wage-price growth, which makes it very hard to bring inflation figures down.

In conclusion, there is a slight possibility for Estonia and Lithuania to fulfil the Maastricht inflation criterion at the end of 2006 or early 2007 (for Estonia); for Latvia the situation looks rather difficult unless serious measures are taken to increase competition (which could limit demand pressures on price levels) and to break the vicious circle of wage-price growth. This conclusion points to other conclusions:

- The governments of Estonia and Lithuania will probably look very closely at inflation developments and will ask for monitoring in addition to the regular monitoring[2] if only the inflation criterion is met.

- The adoption of the euro might happen not at the beginning of the 2007 if the approval is given too late (e.g. November-December). The adoption of the euro might be delayed especially in the case of fulfilling the criteria in the beginning of 2007. The delay might be 3-6 months (or more), which is a relatively short period of time. As all preparations are made with 1st of January being the target, then every short delay in approval will also mean a short delay in adoption. The longer the approval delays, the longer it will be until the actual adoption.

[2] It has usually been made in August-September, however there are signs that the EC is interested in shifting it to spring

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