Macro Outlook

The Baltic Region

The Baltic Outlook

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Abbreviations

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

Summary

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Although the final results for 2006 are not yet published, we can assert that the last year was very good for all three Baltic countries: Estonia and Latvia reached the highest economy growth rates in recent years (expectations of 11.2% and 11.5% respectively) and Lithuanian economy grew also strongly (7.4% according to preliminary data). The economic growth was based mostly on domestic demand: both private consumption and investments grew strongly. Although there were unfavourable developments in exports in the 2nd half of the year, which might continue this year, we can still consider exports developments as good. A significant shift has taken place in labour market and consumption – rapid growth in employment in already stretched labour market brought also rapid growth of wages. Higher incomes and good borrowing terms have encouraged families to increase their spending significantly. This has supported growth of domestic production and imports. The financial situation of enterprises has improved substantially and this has made possible to expand production. At the same time, the growing shortage of labour and increasing labour costs motivated to invest into modernisation of the production.

Successful economic year increased budget revenues and the situation turned out to be better than projected in budget plans in 2006. In Estonia the state budget was in surplus of 1.5% of GDP; the central government budget deficit was marginally below 1% of GDP in Latvia and in marginal surplus (0.02% of GDP) in Lithuania.

Strong economic growth has its negative outcomes also. First, increasing shortage of labour force and rising labour costs. Second, rapidly growing imports, which increase current account deficits. And third, high inflation, which is hard to curb.

We are of the opinion that the economic developments in all three countries will remain good in 2007-2008, though economic growth will slow because of above-mentioned problems (but also because of higher comparison base).

For all three countries the one most urgent question is how the economy adjusts with changing situation in economy, first of all growing labour costs. We expect positive developments, i.e. that economies will adjust with more expensive production, but we are not excluding the possibility of negative developments. Namely, companies may lose competitiveness because of higher production costs both in domestic and external foreign markets, which would bring even higher misbalances into economies. This in turn, would end with a wave of bankruptcies in the economy, rapid increase of unemployment and much slower economic growth.

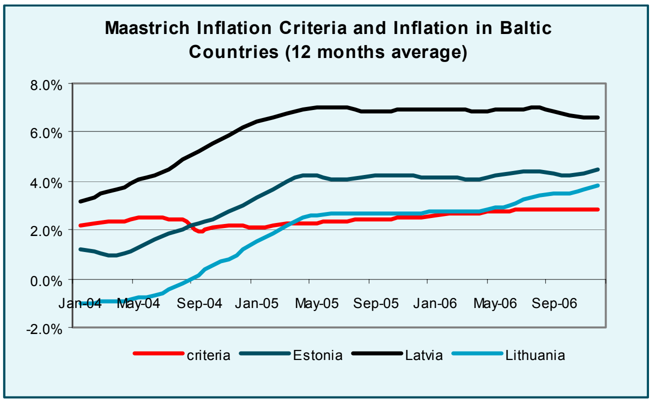
Current account deficits so far have been financed with foreign capital either in form of direct investments or with loans coming to economy mostly through (foreign owned) banks. The foreign capital is inspired with good business environment and good growth opportunities, which have been backed with strong results in the recent years. However, the inflow of foreign capital might be suddenly and significantly reduced, if misbalances in economy (e.g. in labour market or in current account) will grow dangerously high. Our forecast is, however, so far based on expectation that foreign capital will continue to flow into the Baltic economies, albeit with somewhat slower growth rates.

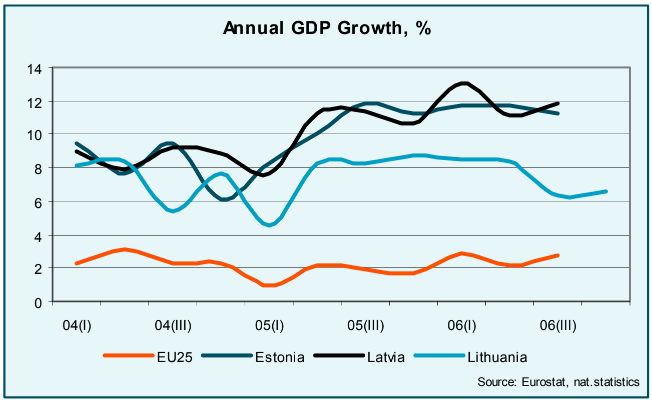
The high economic growth is inevitably accompanied with higher inflation, although in the Baltic countries several additional factors have also impact on prices. In all three countries some taxes on goods (e.g. VAT and excises on certain products) need to be increased for fulfilling promises given in the EU accession. Also some other taxes on goods and production are about to increase (e.g. tax on the use of natural resources in Estonia etc). The global price dynamics affects local prices more than in most of other EU countries, as, for example, fuels and food have much bigger share in consumer baskets in the Baltic countries. Also the rapidly increasing price of natural gas (imported from Russia) forces three countries to adjust production (e.g. in chemical industries) and increase other prices (first of all long-distance heating). It is hard to rein back price growth in sectors closed for competition, as price regulators have to accept the tariff increase related with increasing production costs (e.g. labour, fuels). The similar situation is in public sector services (e.g. health services).

Additionally to those administrative and external factors, in some cases shortage of goods has emerged (e.g. for certain building materials) and the competition situation in some areas (or regions) is poor. Arguably companies are using the wage growth as an argument for increasing selling prices, even if the actual price growth turns out to be higher than required by that factor. However, consumers have become also less concerned about price growth as incomes are growing rapidly and often accept such price increases (i.e. are not cutting spending on services or goods).

As result of those factors, we expect that in Estonia and Latvia consumer price growth in 2007 will remain approximately on the level of 2006 (i.e. 4.3-4.5% in Estonia, 6.2-6.6% in Latvia) and will increase in Lithuania to 4.5%. Inflation will remain the only factor why three countries cannot join the euro zone in coming years. We are of the opinion that the earliest possible date is 2010[1], but it requires minimal external impact (first of all oil prices at current or lower level) and smooth adjustment of economies with above-described problems in economy.

[1] For Latvia perhaps 2011-2012, given considerably higher inflation





	2002	2003	2004	2005	2006f	2007f	2008f
Economic growth, %							
Estonia	8.0	7.1	8.1	10.5	11.2	9.0	8.0
Latvia	6.5	7.2	8.5	10.2	11.5	9.0	7.5
Lithuania	6.9	10.3	7.3	7.6	7.4*	6.5	6.5
EU25	1.2	1.3	2.4	1.7	2.8	2.4	2.4
GDP, millions €							
Estonia	7,759	8,494	9,376	11,063	12,993	14,891	16,809
Latvia	9,911	9,978	11,157	12,837	15,759	18,603	21,099
Lithuania	15,018	16,452	18,126	20,621	23,620*	26,740	30,245
EU25	9,816,479	9,970,254	10,450,001	10,848,774	11,375,438	11,893,071	12,420,211
Harmonized consumer price growth, %							
Estonia	3.6	1.4	3.0	4.1	4.4*	4.3	3.9
Latvia	2.0	2.9	6.2	6.9	6.6*	6.1	5.0
Lithuania	0.3	-1.1	1.2	2.7	3.8*	4.5	4.5
EU25	2.1	1.9	2.1	2.2	2.1*	2.3	2.0
Consumer price growth, %							
Estonia	3.6	1.3	3.0	4.1	4.4*	4.4	4.0
Latvia	1.9	2.9	6.2	6.7	6.5*	6.3	5.2
Lithuania	0.3	-1.2	1.2	2.7	3.8*	4.5	4.5
Harmonized unemployment level, %							
Estonia	10.3	10.0	9.7	7.9	5.6*	4.0	3.8
Latvia	12.2	10.5	10.4	9.0	6.9*	5.5	5.3
Lithuania	13.5	12.4	11.4	8.3	5.9*	5.6	5.6
EU25	8.8	9.0	9.1	8.8	7.7*	7.6	7.3
Goods and services balance, % of GDP							
Estonia	-6.9	-7.3	-8.1	-6.2	-9.0	-9.0	-8.5
Latvia	-10.0	-12.7	-15.9	-15.3	-21.2	-23.5	-24.5
Lithuania	-5.5	-5.7	-7.0	-7.3	-10.4	-11.8	-12.3
Current and capital account balance, % of GDP							
Estonia	-9.5	-11.1	-11.7	-9.5	-9.0	-7.5	-6.8
Latvia	-6.4	-7.5	-11.8	-11.4	-18.5	-21.0	-22.5
Lithuania	-4.7	-6.4	-6.4	-5.9	-10.3	-11.4	-11.7
EU25**	0.4	0.2	0.3	-0.4	-0.5	-0.4	-0.4
General government balance (ESA95), % of GDP							
Estonia	0.4	2.0	2.3	2.3	2.0	1.5	1.5
Latvia	-2.3	-1.2	-0.9	0.1	-0.3*	-1.4	-1.0
Lithuania	-1.5	-1.3	-1.5	-0.5	-0.5	-0.5	-0.5
EU25	-2.3	-3.0	-2.7	-2.3	-2.0	-1.6	-1.4

Estonian, Latvian and Lithuanian forecast by HBM; EU25 forecast by EC
*actual results
**only current account

General Assumptions

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Global Economy

There have been few changes in expectations regarding global economic developments since November. Global economic growth is set to slow in 2007 as the US economy cools and this affects other economies.

Global economic growth projections, %

	2004	2005	2006f	2007f	2008f
USA	3.9	3.2	3.1	2.4	2.7
EU 25	2.4	1.7	2.8	2.4	2.4
Eurozone	2.0	1.4	2.6	2.1	2.2
Germany	1.2	0.9	2.5	1.2	2.0
Finland	3.5	2.9	4.9	3.0	2.6
Sweden	3.7	2.7	4.0	3.3	3.1
UK	3.3	1.9	2.7	2.6	2.4
Denmark	1.9	3.0	3.0	2.3	2.2
Russia	7.2	6.4	6.6	6.4	6.2

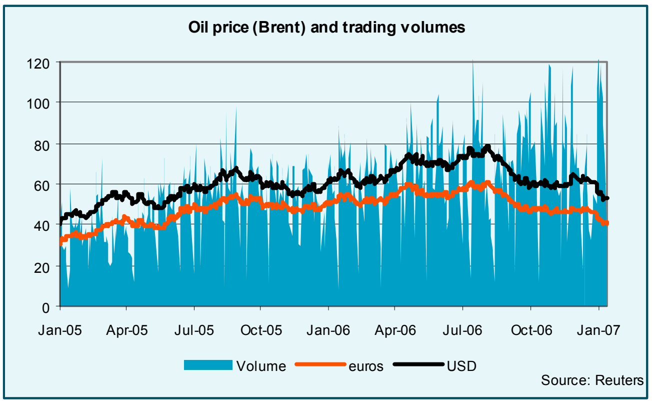
Source: consensus forecasts from various sources

- For US economic developments the soft-landing expectations prevail: although many economic indicators point to much gloomier developments, the others show a surprisingly strong stance (e.g. base inflation and employment are up). However, one still cannot exclude the possibility of a much faster deterioration of the situation, and risks related to budget and current account deficits. The direct impact of the US economy on the Baltic economies is minimal; however, the indirect impact might be quite significant. Still, as we expect a relatively modest impact of the US slowdown on European developments, we also forecast the indirect impact to be rather modest on the Baltic economies.

- The EU economy has showed stronger than expected developments in the 2nd half of 2006; in particular, the German economy has surprised analysts with stronger than expected developments. Hence opinions have emerged pointing to better than expected developments in 2007 with only modest negative impact from the US economy. The expectations are strengthening that the VAT increase in Germany might have only a short-term effect on consumption, as employment is growing bringing with it income and spending growth. Investments and construction have grown well, and sentiment indicators are pointing to a positive business cycle.

- For the Baltic countries the German, Swedish and Finnish economies are the most important in the EU and as the outlook for 2007-2008 for all these countries is positive, though weaker than for 2006, we expect only a modest negative impact from demand developments in those countries on the Baltic economies. More important is how the Baltic countries can keep their competitiveness in these markets (see below).

- The Russian economy has shown good developments in recent years, as revenues from oil and gas exports have through the budget flowed into consumers' pockets thus fuelling spending and construction in the private sector. As investments in the domestic production sector have been undersized, import growth rates have increased. At the same time export growth rates have started to diminish in the 2nd half of 2006 as oil prices have fallen. With the approaching general and presidential elections it is hard to expect changes in Russian economic policy, but rather bigger distributions from the budget to households. So we do not expect any improvement in the overall economic development, but a rapid deterioration is also unlikely as Russia has big reserves and the price of oil is unlikely to fall to threatening levels. Consequently, we can expect strong demand from Russia and that should help Baltic companies and economies.



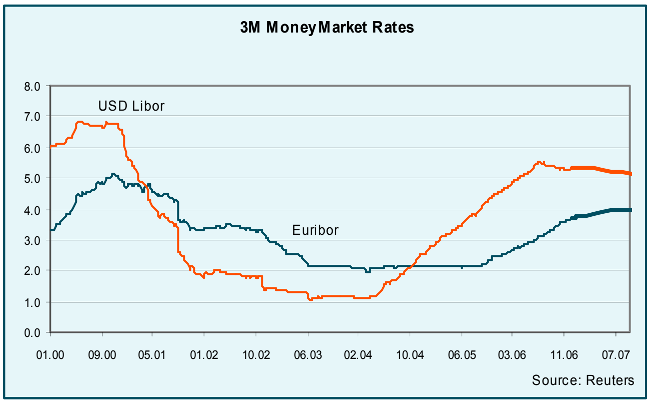
Source: Reuters

- Inflation pressures have recently receded as oil prices have fallen in response to the warm winter so far in the Northern Hemisphere and weaker than expected economic developments in the USA. However, few analysts have revised their forecast for inflation, as the fall in oil prices might be reversed. We are of the opinion that external inflation pressures will be modest in 2007, expecting lower prices for most if not all raw materials. However, better economic developments are about to bring higher prices for raw materials in 2008, although fuel prices will determine much of the actual development in consumer prices.

- Interest rate expectations for the two major global economic powers are different: it is expected that the Federal Reserve will start to cut interest rates, while the ECB is expected to increase rates. The exact timings have recently shifted further, particularly for Fed movement: but the consensus forecast still expects the

ECB to increase the refinancing rate from 3.5% to 3.75% in the 1st quarter and to 4% in the 4th quarter. The cut is expected in the 2nd quarter of 2008.

- The US dollar weakened rapidly at the end of 2006; however, it has now recovered a little as inflation developments suggest that the Fed will not start with interest rates cuts soon. As in last couple of years, the USD/EUR exchange rate is mostly determined by interest rates. With expected interest rate developments we could expect a weakening of the dollar during 2007; however, relatively high fluctuations are likely.



Baltic developments

- The election period continues with general elections in Estonia (on March 4th) and local elections in Lithuania (on Feb 25th). Thus we can expect no significant changes in economic policy or decisive decisions. The political stalemate is expected to last approximately a month after the elections. However, the possible general strike of medical workers in Estonia brought first-hand solutions, which might have troubled consequences (for the budget and health system). The short post-election period in Latvia has not yet brought expected fiscal tightening in terms of addressing imbalances in the real estate sector (e.g. reducing incentives for speculation).

- The economies of the three Baltic countries are becoming increasingly interdependent; consequently, favourable developments or probable troubles in one country will spill over quite rapidly into the others. This growing interdependence has a strong price and cost competition background helping to equalize the price levels in the three countries (and is also behind different inflation rates). At the same time the impact on labour markets is very limited because of very low movement of labour inside the Baltics and similar problems in the labour market. The process also includes the growing number of companies working in all three countries, and related to that M&A and FDI.

- The labour markets of the three countries are facing increasing problems: the shortage of labour (caused by labour outflow and demographics) is pushing up wages, which affects prices and competitiveness of companies. We do not expect any change in this respect in any of the countries and – although governments are beginning to acknowledge the problem, they still lack a reasonable and good solution for the problem.

- We see growing production costs (incl. because of wages) as being the big threat for the future developments of the three countries. Competitiveness is already falling compared with EU countries (we see falling exports growth rates as a proof of this); however, it might also start to fall in comparison with other countries (i.e. Russia). The loss of competition will be reflected not only in exports, but also in domestic markets, where imports will gain a stronger position (and with strong domestic demand they already have a good standing). If local companies (and governments) do not address increasing costs then the negative growth scenario with very modest (3-5%) growth rates will start to operate. The most important step is to increase productivity through the change of economic structure toward higher value-added production. However, strong domestic demand and the increasing shortage of goods and services are feeding the opinion of many entrepreneurs and governments that there is no need to pay attention to cost management.

Elections schedule	
Estonia	
Presidential	September 2011
General	March 2007
Local	October 2009
Latvia	
Presidential	March 2007
General	October 2010
Local	March 2009
Lithuania	
Presidential	June 2009
General	October 2008
Local	February 2007
European Parlament	2009

Estonia

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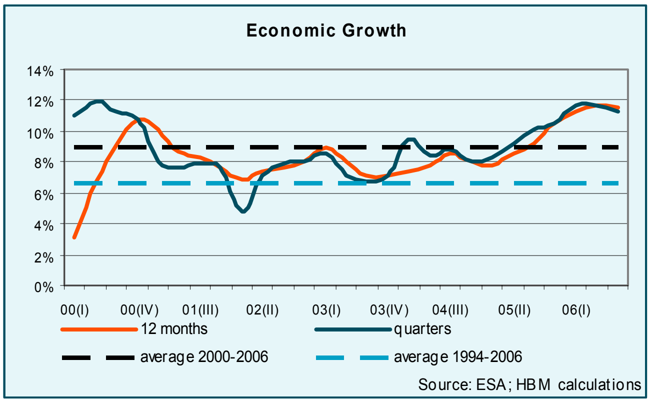
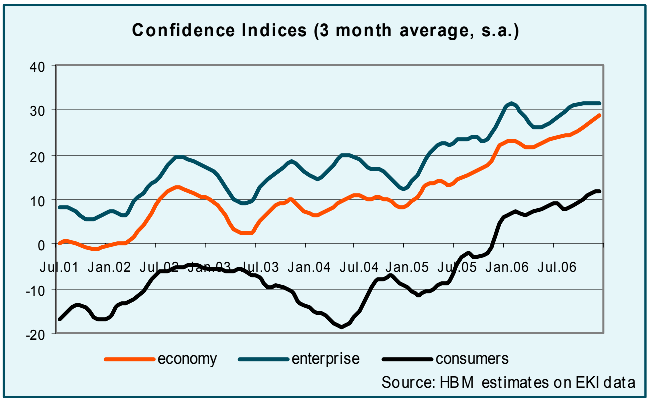
Recent Economic Developments

As we expected, economic growth slowed somewhat in the 2nd half of 2006: according to the preliminary figures from 11.7% in the 1st half (in both quarters) to 11.3% yoy in the 3rd quarter. Growth has slowed mostly because of exports (7% yoy), which suffered from a drop in production in the electronics industry and probably also from less active growth in transit. Domestic demand advanced by 16.1% as investments picked up by 20.6% yoy (excl. changes in inventories by 27.3%). Growing employment and wages were behind the 16.4% growth in consumer spending; but strong price growth cut the real spending of the government sector to 0.8% yoy.

We do not expect significant changes in the 4th quarter of the year – the growth rate of retail sales suggests that households continued to increase their spending and warm weather kept the construction sector activity high. The industrial production continued to grow, but was negatively affected by the energy sector (warm weather) and by some industries of the machine building. The activity in the real estate sector continues to decline, and that affects also prices in the sector. Rapidly growing wages and the shortage of labour has increased companies' intentions to raise selling prices. Yet this will affect the competitiveness of companies, and export companies are particularly open to the risk, though setbacks have been minor so far (see below). The slowdown in economic growth has paralleled falling growth rates of borrowing.

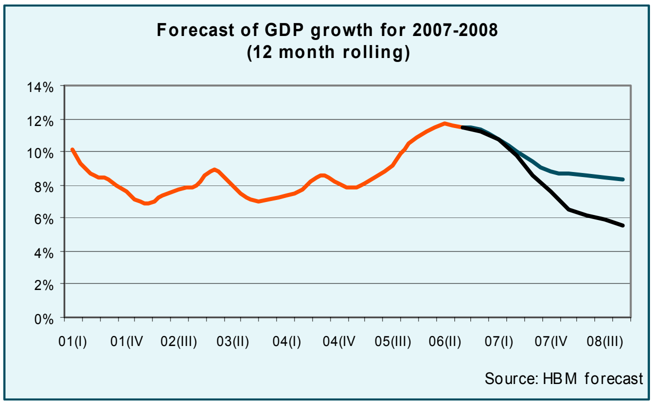




	2002	2003	2004	2005	2006f	2007f	2008f
Economic growth, %	8.0	7.1	8.1	10.5	11.2	9.0	8.0
GDP, mln EUR	7,759	8,494	9,376	11,063	12,993	14,891	16,809
GDP per capita, th kroons	89.2	98.0	108.6	128.5	151.6	174.0	197.0
euros	5,699	6,264	6,940	8,210	9,686	11,120	12,580
Growth of industrial production, %	8.3	11.1	10.5	9.1	7.5	7.8	7.5
Growth of GDP deflator, %	3.8	2.3	2.1	6.8	5.8	5.0	4.5
Growth of consumer prices, %	3.6	1.3	3.0	4.1	4.4*	4.4	4.0
Growth of harmonized consumer price index, %	3.6	1.4	3.0	4.1	4.4*	4.3	3.9
Growth of producer prices, %	0.4	0.2	2.9	2.1	4.5*	4.8	4.0
Harmonized unemployment rate, %	10.3	10.0	9.7	7.9	5.6*	4.0	3.8
Real growth of average monthly gross wage, %	7.7	8.0	5.2	6.1	10.3	11.5	10.5
Growth of exports of goods and services, %	-1.1	9.0	17.4	24.7	20.5	11.5	10.0
Growth of imports of goods and services, %	4.1	9.7	17.9	21.1	23.5	12.0	9.6
Balance of goods and services, % of GDP	-6.9	-7.3	-8.1	-6.2	-9.0	-9.0	-8.5
Balance of current and capital account, % of GDP	-9.5	-11.1	-11.7	-9.5	-9.0	-7.5	-6.8
Inflow of FDI, % of GDP	4.0	9.7	8.3	21.2	9.0	8.0	7.0
Foreign gross debt, % of GDP	57.9	66.0	78.3	86.0	92.0	95.0	97.0
General government budget position, % of GDP	0.4	2.0	2.3	2.3	2.0	1.5	1.5
General government debt, % fo GDP	5.6	5.7	5.2	4.5	3.2	1.5	1.7
* actual result							

Economic Forecast

We have made minor changes in our expectations regarding the 2006 outcome because of strong domestic demand and better than expected developments in Europe. We have also made some revisions in the outlook for 2007-2008. According to our base scenario economic growth in the 1st half of 2007 will remain strong, but it relies on the reserves accumulated in the economy in previous periods and often moves due to inertia. In the 2nd half of the year we expect the limiting factors to become more evident and in 2008 the slowdown will continue. Economic growth might fall slowly or rapidly depending on how economic agents act on these limits. We still have two major development scenarios – positive and negative, of which the positive one is closer to our base forecast. Which scenario comes into effect is largely dependent on how companies adjust the production conditions and what the changes in the government's economic policy are after the March elections.



External Demand

Although in the 3rd quarter of 2006 the foreign trade balance deteriorated significantly (according to the balance of payments), we expect an improvement in the 4th quarter. Our research shows that there were several factors behind weak export growth in the 3rd quarter, some of which in the 4th quarter already had retreated. The latest data on foreign trade and industrial export sales point to more stable developments, backing our optimistic expectations.

- Our analysis reveals that export growth slowed in the 3rd quarter mostly because of smaller exports of electronics to Finland, which is probably related to one company (Elcoteq). Such a fall in subcontracting exports also means a fall in related imports (i.e. electronic components from Finland, Sweden and Germany) and ends in a relatively minimal impact on trade balance and economic growth.

- The other factor that affected exports in the 3rd quarter, were administrative problems in Russian customs resulting in very long queues on the Russian border with Estonia and other countries. Hence export volumes fell (average export growth to Russia in 10 months of 2006 was 51.8%, but in September was only 30%). The situation improved in October, and exports immediately recovered (76.3%).

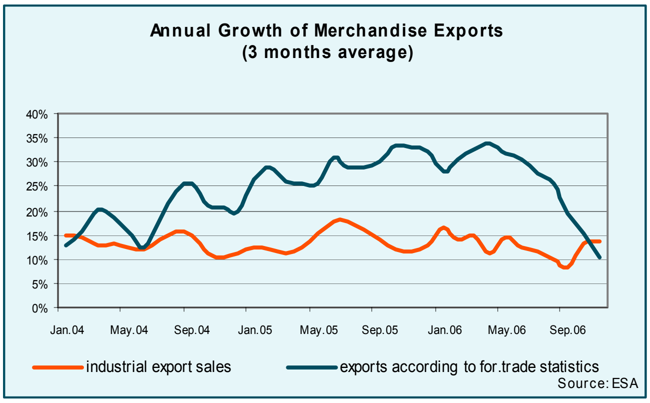
- If Finnish exports are excluded, Estonian producers have succeeded in increasing export growth rates to the EU. Growth in the 2nd quarter was approximately 5%[2], while in October it reached ca 15%. Even if the dynamic growth in exports to Latvia and Lithuania is excluded (growth increased from 23.8% yoy in May-June to 29.5% yoy in October), the growth in exports to the EU grew faster than in the 1st half of the year. So contrary to our expectations, Estonian companies succeeded in increasing their competitiveness in the 2nd half of 2006. However, the situation might be reversed easily in 2007-2008.

- Exports to areas outside the EU are growing extremely rapidly, though annual growth rates have receded from April's 140% to 88% in October. If there is no setback in those much riskier markets, then 2007 should be very good for export developments in those markets and 2008 might still bring good opportunities.

- The export of services grew more than expected in the 3rd quarter – mostly on account of the transport sector, where improvement took place in all sub-industries. As a result, we upgraded our expectations for the 4th quarter and 1st half of 2007. There were also negative developments (e.g. construction), but the cumulative effect of those was modest.

- The export sales of industry are still very strong (see chart), though a slight fall in growth rates is seen. Taking into account falling production growth rates, we also expect sales to expand more slowly in 2007.

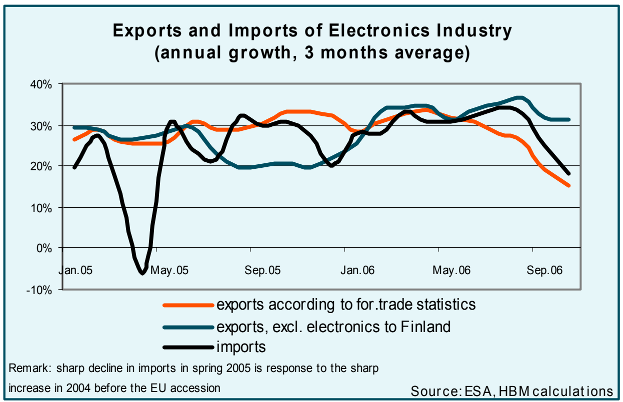
- Growing production costs and falling oil prices have resulted in an unfavourable development for the GDP real growth: export prices growing faster than import prices.



Although our expectations regarding exports are positive, we also see several risks, the most important of which is the dynamics of local production costs and companies' ability to adjust to it (i.e. how companies keep their competitiveness edge). We do not expect problems in the short-term; however, in the longer perspective existing reserves or comparative advantages (i.e. lower prices and quality levels in many industries) are about to become obsolete. The

[2] Growth rates of 3-month average exports

problem is that increasingly stronger wage demands are shortening the adjustment period in which companies can rely on these reserves. We are of the opinion that quite large adjustment problems will appear in the 2nd half of the year and in the case of the negative scenario might bring very serious problems in 2008.



Domestic Demand

We are of the opinion that in 2006-2007 and most likely also in 2008, domestic demand will grow faster than the overall economy: however, the difference between these growth rates will start to diminish in the 2nd half of 2007 in the case of the positive scenario. Our expectations are based on strong growth of incomes and investments.

Household Income and Spending

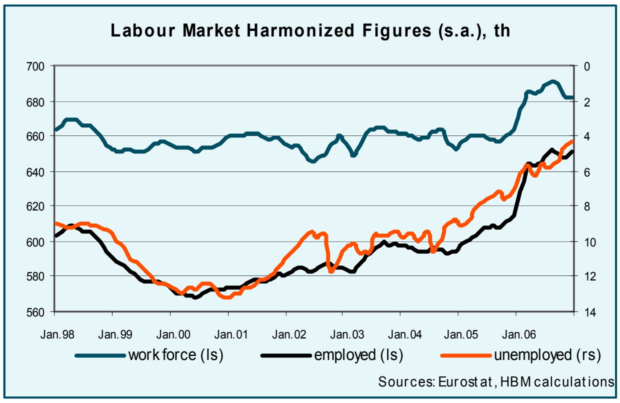
Incomes

The situation in the labour market is becoming tenser as the shortage of labour increases and wage growth remains very strong.

- Employment growth will fall from 6.6% in 2006 to a much more modest 3-4% as the free surplus of labour is declining rapidly[3]. Unemployment will also decline more slowly than in 2005-2006 when it fell from 7.9% to 5.6%, reaching ca 4% in 2007. The slowdown in 2008 and later will be even less pronounced.

- The increasing labour shortage will fuel wage growth (in Sep 2006 18.7% yoy, 10.4% in real terms). Taking into account the fact that unemployment fell very rapidly towards the end of 2006, increased wage demands (incl. warnings for strikes) and the strengthening of the employees' position in the labour market, we forecast wage growth remaining very strong in 2007-2008. At the beginning of this year we can also see significant bonuses for the previous, economically very successful year, regular wage increases, which will be probably stronger than usual, and growth of wages in the public sector.

- In Estonia several factors are affecting unemployment rates. First, the growing activity rate (i.e. non-activity declines[4]) decreases unemployment rates even if the number of unemployed remains flat (Estonia it falls). Second, the rapidly falling number of long-term unemployed and discouraged persons decreases the natural level of unemployment as it cuts structural unemployment. This development points to improved labour market services and the increasing flexibility of the labour market. However, it is also clear that unemployment cannot fall forever and we are of the opinion that this limit is approaching rapidly.



Household incomes are also growing because of state allowances – good budget revenues and continued election period has already brought an increase in several allowances. We expect this to continue after the elections: in particular pensions and allowances related to childcare are expected to grow.

Household Consumption and Savings

Strongly growing incomes are backing consumption growth, which makes the business situation good for those companies that target the domestic market (e.g. trade, services). We also expect rather strong imports because of that.

But there are also factors that will be obstacles to consumption growth.

- Household disposable incomes will grow more slowly than incomes in general as the **debt burden** has reached levels which set limits for spending. As most mortgages (ca 96,5%) are taken with floating interest rates, higher interest rates means bigger debt servicing costs. Interest rate increases have been relatively modest so far (and will remain so in the next 12 months) and no problems have emerged. Household debt is dominated by mortgages, but the rapid growth of consumer loans implies that obligations related to those loans might suddenly become very burdensome for some families despite rapidly growing incomes.

- Most families who have taken mortgages have to include into the budget much bigger **compulsory purchases** – loan repayments, life and non-life insurance, higher housing costs, together with furnishing and

[3] Our estimates suggest that, at best, in the next 2 years ca 50 th people might be additionally employed from Estonia. This figure includes ca 18-20 th currently unemployed, with the rest coming from currently non-active persons (retired, discouraged, or with partial working ability). This means 8% growth in employment in 2 years.

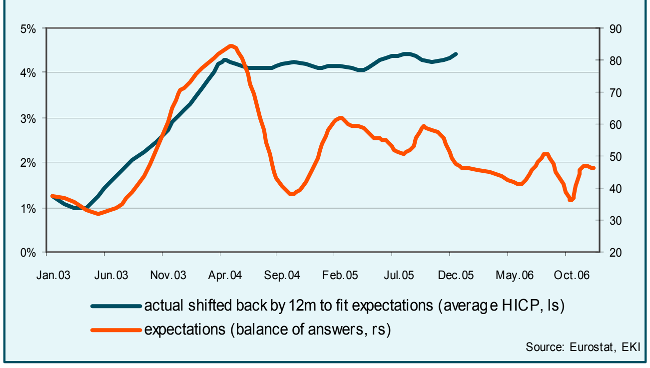
[4] We expect the non-activity to decrease further in 2007-2008.

gardening costs, safety services etc – which will cut purchases of other services and goods, though promote sales and price growth in those above-mentioned sectors.

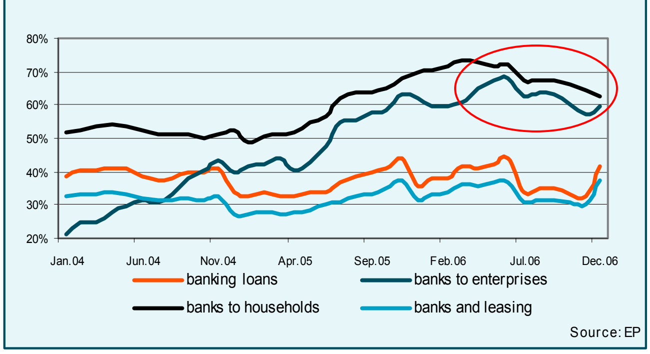
- The rapid rise in the **prices of** several **first need goods and services** sets limits to the growth of real spending in low-income families, which spend relatively little on those goods and services where prices are falling or growing modestly (e.g. gasoline for private cars, communication). Such price growth also affects households with mortgages, as several of those first need goods and services are also compulsory purchases of those families, and have grown in volume because of bigger houses/apartments (e.g. energy).

The growth of household consumption will be distributed more equally between various items in 2007 than in many previous years, but definitely less equally than in 2006. We still see good prospects for the sales of furnishing, wellbeing, leisure, entertainment and certain status and prestige goods and services, also the demand for quality is growing. We expect less dynamic developments in the food production for the domestic market, clothing and footwear (but some of them are status goods) and everyday services. Real spending has already fallen in real estate sales, but we see that the same sort of growth limit (very high prices) might also affect some other sectors (e.g. certain construction and repair services). One should not forget that despite growing incomes, household expectations regarding price growth are still quite modest.

Actual Consumer Price Growth and Expectations



Annual Growth of Loan Portfolio



Investments

The reasons behind our expectations of strong investment growth are repeatedly mentioned: favourable monetary conditions, EU funds, the strong financial position of enterprises, strong growth of demand and positive expectations of growth, capacity shortages, and more expensive and less accessible labour. We expect that investments in fixed assets will grow very strongly this year, as projects prepared for the EU financing in the previous budgetary period have to be finalised. Consequently, we expect that in the next 12-18 months up to EEK 6bn will enter the Estonian economy. Funds of the current budgetary period will start to flow into the economy only in 2008, and hence will not significantly affect investments in 2007-2008. It is highly probable that 2008 might be an interim year, in which EU funds will have rather modest impact on the economy.

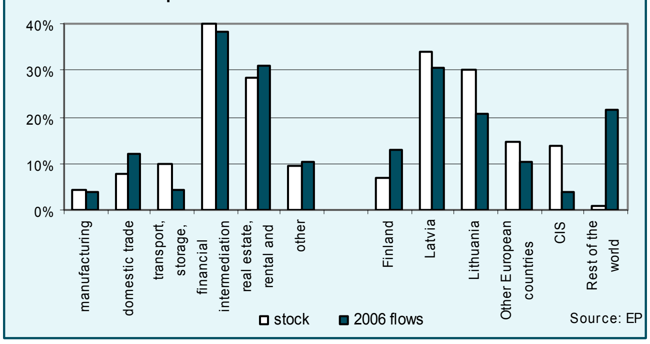
We expect the strongest growth to be in investments in businesses. Household investments in real estate are limited by very high real estate and construction prices, and by diminishing loan demand. Budgetary investments are also undermined by high price growth, and several projects will be not implemented (or will be postponed).

External Balance

We have slightly revised our expectations regarding the external balance, though generally developments have been in accord with our forecast so far. We still expect that the deterioration of the 3rd quarter will have been reversed in the 4th quarter of 2006 and will continue to improve in 2007. But the question how production will adjust to fast growing costs will remain a key issue in the actual result.

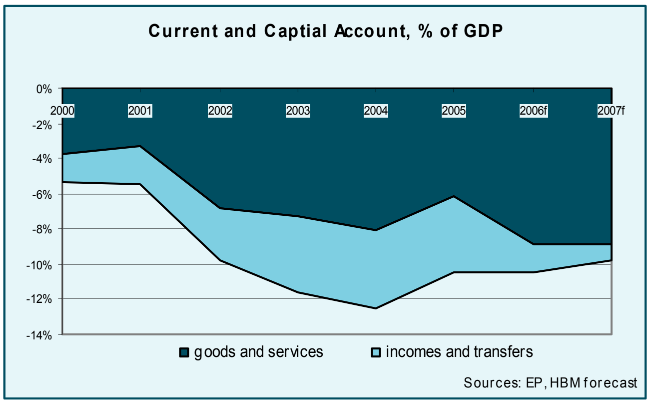
The departure of cheap subcontracting business is not affecting the foreign balance significantly, as it is mostly based on processing imported goods, i.e. together with exports, imports will fall. The value-added produced in cheap subcontracting businesses is small, hence the impact on the economic growth will be less than modest.

Estonian FDI Abroad: Structure of Stock at the End of Sept 2006 and Flows in 9 Months of 2006



We are surprised by the strong FDI inflow into the Estonian economy, but the same applies (and to a greater extent) to Estonian FDI abroad. Last year's figures were affected by the Tallink purchase of Silja Line (investment to Finland). Estonian entrepreneurs have also become more active in Latvia and Lithuania, where they see good growth opportunities from lower costs and income levels than in

Estonia. We do not expect such investments to decline in the near future; indeed we expect that they might grow rather strongly in Central and Eastern Europe.



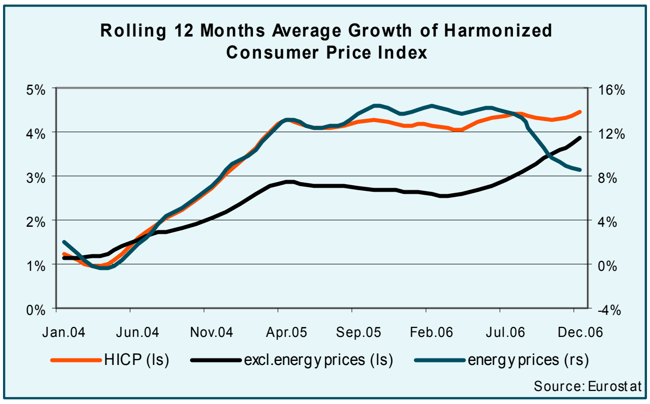
Economic Policy

A significant factor, which will determine economic developments in the 2nd half of 2007, and more strongly in 2008 and onwards, is the economic policy of the government. Our base scenario is based on the expectation that the current modestly expansive economic policy will remain in place. This means that strong tax revenues will be distributed to households via government sector wages, state allowances and high investments (in current prices[5]), but that the budgetary surplus will be over 1.5% of GDP.

However, we see a real danger that government policy might become more expansive. Firstly, stronger revenues than had initially been planned (and approved in budget plan) provide an opportunity to increase spending while keeping the budget in surplus. Secondly, wage demands in the public sector have strengthened significantly, and will most probably be met, as many employees of the public sector work in socially sensitive areas (e.g. health care and the police). The need to invest in the social sphere is enormous (e.g. health care, education, science etc), as is the need to invest in infrastructure (road network, environment); but the EU funds will grow significantly only in 2008 (2007 will be utilised for project development and planning). Finally, and perhaps the most important, the new government might have a totally different agenda and view about the position of the state in the economy. Bigger spending, however, requires bigger incomes, which means higher taxes and/or borrowing (i.e. budget deficit). Greater spending (and higher taxes) means that inflationary pressures will increase. It is worthwhile mentioning that there are some parties that see low taxes and budget surplus as an abnormality. But it is also important to mention that our negative scenario has not included any change in economic policy into it.

Inflation

Consumer price inflation in 2006 was as we expected – 4.4%, but the price dynamics at the end of the year clearly suggested that price growth in the beginning of 2007 would be stronger than previously expected despite the falling price of oil. The strong growth of wages and mounting wage demands are major factors behind that expectation, as they increase both demand and costs. Also, many companies have put price increases on their 3-4 month agenda.



It is expected that in July the VAT rate for long-distance heating will be increased from 5% to 18%: this will immediately affect the price index, but not other prices, which will feel the fall in demand only when heating bills are be sent out (in November). It is highly probable that in October prices of natural gas will be increased again (and this will be followed by related increases in heating costs etc), as the current agreement ends. The beginning of 2008 is the latest date for the introduction of the higher excise rates agreed in the EU accession treaty; however, these increases might not have a significant impact on the overall price level – everything depends how much of the excise increase producers will cover from their profits.

We expect that non-regulated price growth will remain strong mostly because of wages and will not imitate effect of regulated price increases (though food and fuel prices might act differently depending on global markets and external demand). The factors that might limit price growth are as follows:

1) prices of some goods and services are very high compared with overall price levels (e.g. construction and renovation prices and real estate);
2) external supply or imports;
3) the slowdown of the growth rate of disposable income;
4) growing prices of first-need goods will limit spending in low-income families, and in households with mortgages.

Taking into account the abovementioned factors, we expect that inflation in Estonia will remain at approximately the same level as in 2006 (i.e. ca 4.3-4.5%) provided government policy does not become more expansionary.

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[5] Taking into account strong price growth and the fact that state investments are strongly biased toward construction, we see a high probability that real growth of investments will be very modest.

Latvia

Baltic Outlook 26.01.2007

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Recent Economic Developments

The Latvian economy continues to grow swiftly. On the back of high overall optimism, in the 3rd quarter of 2006 GDP growth remained high at 11.8% yoy (12% in 9 months 2006). Growth was driven by an unprecedented rise in employment (up by 4.8% yoy in 9 months of 2006; 1.5% in 2005), whereas average labour productivity growth slowed (6.5% yoy in 9 months of 2006; 8.7% in 2005). Tighter labour market driven by emigration and rising domestic demand for labour (harmonised unemployment rate down to 6.2% in late 2006 from 7.7% in late 2005) has led to accelerating real wage growth (13.8% yoy in 9 months of 2006; 9.5% in 2005). In 2005 real wage growth was about 1 percentage point higher than average labour productivity growth whereas in 3Q 2006 it was already 10 percentage points above the productivity growth. This points to strengthening wage-price inflation pressures, rising risks of inflation and a reduction in Latvia's external competetiveness. Inflation has remained high (6.5% in 2006). The current account deficit reached a new record of 24.2% of GDP in 3Q (19.3% for 9 months of 2006), which currently is perhaps the key risk to the Latvian economy as it may potentially reduce foreign investment in Latvia, thus inducing a faster slowdown of growth. Unbalanced growth is another key issue for the Latvian economy – growth is very much generated via domestic demand (e.g. wholesale and retail trade up by 18.5% and 14.8% yoy in 9 months of 2006 whereas manufacturing increased by 6.8%). In the 3rd quarter, domestic demand growth accelerated to 19.7% yoy and imports to 24%, whereas export growth fell to 7.5%. The challenge is to navigate the economy while avoiding the risks of overheating – solving capacity shortage issues, avoiding a build up of irrational exuberance and ensuring a soft landing in achieving sustainable GDP growth rates of 7-8% p.a.

	2002	2003	2004	2005	2006f	2007f	2008f
Economic growth, %	6.5	7.2	8.5	10.2	11.5	9.0	7.5
GDP, mln euros	9,911	9,978	11,157	12,837	15,759	18,603	21,099
GDP per capita, euro	4,238	4,291	4,824	5,580	6,886	8,276	9,471
Growth of GDP deflator, %	3.6	3.6	6.9	9.2	10.1	8.3	5.5
Growth of consumer prices, %	1.9	2.9	6.2	6.7	6.5*	6.3	5.2
Growth of harmonized consumer price index, %	2.0	2.9	6.2	6.9	6.6*	6.1	5.0
Growth of producer prices, %	1.0	3.2	8.6	7.8	10.3*	8.8	7.5
Harmonised unemployment level, %	12.2	10.5	10.4	9.0	6.9*	5.5	5.3
Real growth of average net monthly wage, %	6.0	7.8	2.4	9.7	14.3	13.0	11.0
Growth of exports of goods and services, %	8.7	14.4	21.2	31.4	15.5	17.5	14.5
Growth of imports of goods and services, %	9.1	19.5	26.8	27.4	27.5	22.0	16.0
Balance of goods and services, % of GDP	-10.0	-12.7	-15.9	-15.3	-21.2	-23.5	-24.5
Current account balance, % of GDP	-6.6	-8.1	-12.9	-12.7	-20.0	-23.0	-23.0
Current and capital account balance, % of GDP	-6.4	-7.5	-11.8	-11.4	-18.5	-21.0	-22.5
Inflow of FDI, % of GDP	2.7	2.7	5.1	4.6	7.9	5.5	4.0
Foreign gross debt, % of GDP	72.7	79.6	93.2	100.7	115.5	122.0	129.0
General government budget, % of GDP	-2.3	-1.2	-0.9	0.1	-0.3*	-1.4	-1.0
General government debt, % of GDP	13.6	14.6	14.5	12.1	10.2	10.3	10.6

**actual result*

Summary of the Forecast

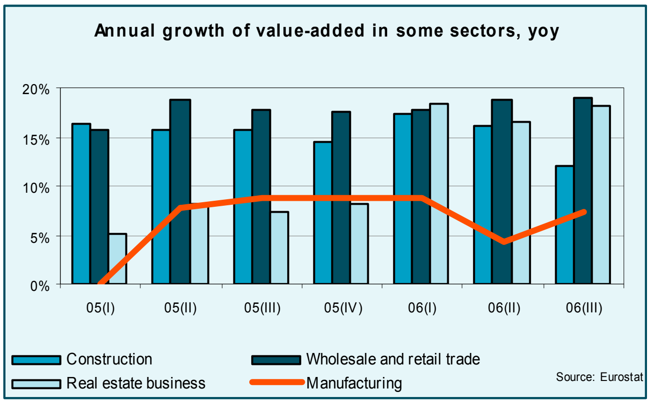
We expect that GDP will have grown by 11-12% in 2006. As the domestic labour supply is drying up, future growth predominately depends on productivity growth. We retain our earlier forecast of GDP growth slowing to 8.5-9.5% in 2007 and 7-8% in 2008. The slowing is expected to become visible in the 2nd half of 2007 through mounting capacity constraints (the growth momentum may extend somewhat further if labour immigration is eased, however this currently does not seem likely). Harmonised unemployment rate is expected to decrease to 5.2-5.8% in 2007 and 5-5.5% in 2008. The real net wage growth forecast is revised up to 14-14.5% in 2006 (previously 12-14%), to 12-14% in 2007 and 10-12% in 2008. Our CPI forecast has been increased to 6.2-6.6% in 2007 and 4.9-5.4% in 2008. Due to relatively poor export performance and very strong demand for imports, the current account deficit is likely to reach 19-21% of GDP in 2006 and perhaps 21-25% in 2007 and 2008 unless imports growth is substantially reduced (either by direct decrease in optimism or via foreign financing becoming more expensive). The FDI forecast is retained at 8–9% of GDP in 2006 and 4-6% in 2007 and 2008. The budget deficit is likely to remain at 1.4% of GDP in 2007 and 1% in 2008.

This is our positive or soft landing scenario (see November 2006 issue of the *Baltic Outlook* for details). Although continued rapid growth and strengthening overheating risks have raised the risks of a faster slowdown (i.e., the negative scenario), our current analysis suggests that the soft landing scenario still has a considerably higher probability than the negative one. In order to ensure soft landing, joint efforts are necessary from all counterparts: the government (e.g. tighter fiscal policy), businesses (e.g. new technologies, raising productivity), and households (e.g. careful risk assessment when borrowing, increasing savings, investing in education and skills).

Domestic Demand

Private Consumption

Private consumption growth remained high in the 3rd quarter 2006 (i.e. only a marginal decrease to 16.8% yoy) driven by vigorous wage and credit growth, and upbeat consumer spirits. Current consumption is also fuelled by inflation expectations, which make expected real interest rates negative thus reducing incentives to save. We raise the forecast of private consumption to 16-17% for 2006, while retaining the forecast of 12-12.5% for 2007 and 9-9.5% for 2008. It is increasingly likely that it will be revised upwards, as the slowing in consumption growth is still very feeble (further wage growth is expected due to labour market tightening). In addition, strengthening competition through the entrance of such big players as *Danske Bank*, *GE Money* and *Societe Generale* will continue to boost consumption through credit growth, though not as much as in 2006. Unfortunately, it is not clear whether (and how) the government will try to restrict inflation, e.g. reducing demand by increasing property taxes and/or increasing incentives to save.



Investments

In the 3rd quarter 2006 gross capital formation grew by a record 36.7% yoy (5.1% in 2005). Such super growth is driven by shifts in inventories. Instead, the growth of gross fixed capital formation shows a continuation of larger than expected reduction in growth, i.e. to 10% yoy in the 3rd quarter (13.5% in 9 months 2006; 18.6% for 2005). Although this may be an early indication of a slowing of overall growth, investment data has often been substantially revised later thus precluding us from drawing any definite inferences here. Taking into account the latest available data, we decrease the growth rate of gross fixed capital formation to 12-12.5% (from 14-16%) in 2006, and retain the 10-13% growth forecast for 2007 and 2008.

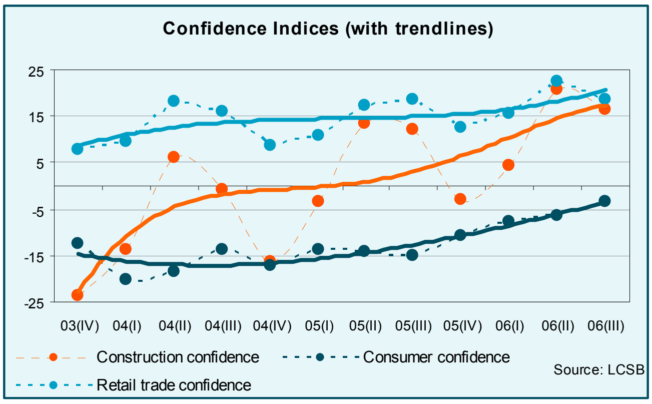
GDP annual growth rates, %

	1Q 05	2Q 05	3Q 05	4Q 05	1Q 06	2Q 06	3Q 06
GDP	7.6	11.2	11.4	10.6	13.1	11.1	11.8
Private consumption	7.9	9.7	13.1	14.3	17.3	17.0	16.8
Government consumption	2.5	-5.1	2.5	10.6	0.4	2.0	-2.3
Investments	8.4	1.5	3.7	7.1	15.1	9.7	36.7
Gross fixed capital formation	20.4	21.2	22.2	12.9	19.5	13.1	10.0
Exports	20.0	21.6	20.9	20.2	13.6	13.0	7.5
Imports	16.4	6.2	12.8	18.8	15.7	15.9	24.0

Source: Eurostat

The future investment developments are quite uncertain:

- The government mega-projects may play a crucial role – new buildings such as the National Library, Riga Concert hall, etc. The government will continue to finance construction of the South Bridge in Riga. These projects can increase labour market tensions by crowding other sectors out of the labour market if there is no sizeable immigration from Bulgaria and Romania or a radical change in immigration policy from third countries (which is very unlikely).
- EU funds will positively influence investments. The funds from the previous budgetary period (2004-2006) will continue to flow in in 2007 (and maybe even in 2008), while funds from the current period (2007-2013) will start to come at the earliest at the end of 2007.
- Capacity shortages and increasing labour costs might stimulate continued restructuring in manufacturing and investment in new, less labour intensive technologies.



Government Expenditure and Fiscal Policy

2006 was outstandingly good for the government budget. Strong economic growth was reflected in exceptional tax revenues even exceeding the plans of the revised budget made last October. Thus the central government finished 2006 with a budget deficit of 0.96% of GDP, which is smaller than assigned in the Budget Law 2006 (1.5% of GDP). The general government deficit is 0.29% of GDP due to local government budget's surplus. As we expected, the shortfall was due to the inability to spend the funding earmarked for capital and investment items assigned in the Budget Law amendments. However, current expenditures were spent as planned. Of course, a smaller budget deficit is good news, but it is regrettable that it is at the expense of development projects rather than current consumption. This 0.95% deficit also includes a rise of more than LVL 300m in expenditure above the initial plan, as the Budget Law was amended due to good revenues, i.e. the fiscal policy has in fact been more expansionary than it seems.

For 2007 and 2008 we retain the earlier forecast of 1.4% and 1%, respectively. This outcome is in line with the soft landing scenario with a gradual reduction in economic activity and lower tax revenues. The finance minister claims that 2010 is the most realistic time for a budget without a deficit and currently the budget deficit cannot be reduced further as it is needed to keep pre-election promises (e.g. to increase the salaries in the country). There is a slight hope that the next budget revisions will be mainly to cover the budgeted deficit.

General consolidated budget, annual growth, %

	2004	2005	2006	% of plan, 06
Revenues	19.7	27.1	25.7	98.4
Tax revenues	13.6	31.2	30.3	103.7
Personal income tax	18.6	16.9	29.1	101.4
Social tax	14.1	17.1	28.1	103.9
Corporate income tax	36.1	41.3	40.5	102.9
VAT	6.0	39.1	37.4	104.0
Excise tax	11.7	32.5	16.6	103.8
Custom tax	-8.7	12.2	7.6	107.4
Non-tax revenues	32.7	3.3	13.1	78.4
Foreign aid	208.4	65.5	6.8	70.8
Expenditures	17.5	27.7	24.4	95.3
Current expenditures	18.2	33.8	23.3	96.5
Capital expenditures	23.2	31.3	63.1	88.8
Investment expenditures	-0.9	100.8	19.2	86.7

Source: State Treasury, State Revenue Agency

Labour Markets

In the 3rd quarter of 2006 we saw a continuation of labour market tightening[6]. Employment during the 3rd quarter grew by unprecedented 6.9% yoy (4.8% yoy in 9 months 2006; 1.5% for 2005). The harmonised unemployment rate decreased to 6.2% of the economically active population in December 2006 from 7.7% in December 2005. The level of officially registered unemployed in December 2006 stood at 6.5% (7.4% a year ago). The officially registered vacancy rate by the end of the 3rd quarter climbed to 2.1% from 1.4% in late 2005. Fast employment growth has been reflected in 15.4% yoy real net wage growth in the 3rd quarter of 2006. Real wage growth accelerated throughout 2006, and exceeded average labour productivity growth rates by about 1 percentage point in 2005; by about 2 percentage points in the 1st quarter of 2006; 7 percentage points in the 2nd quarter; and 10 percentage points in the 3rd quarter. Although some of the wage growth does reflect legalisation, it is common knowledge that the growth is largely factual. As we have pointed out, such a trend enforces inflation risks and erodes Latvia's price competitiveness.

Very recent news implies that the government may consider an easing of the labour market via immigration from the countries outside the EU. To this end the Ministry of the Interior has drafted a proposal to reduce administrative barriers to immigration as well as to permit temporary and selective immigration in sectors facing the most severe labour shortages. This proposal has yet to be discussed by the Cabinet and if any suggestions are accepted, they will not come into effect earlier than late 2007. Hence, given the still strong demand for labour we see the tightening of the labour market continuing in 2007 unless there is a substantial labour inflow from the new member states of Bulgaria and Romania.

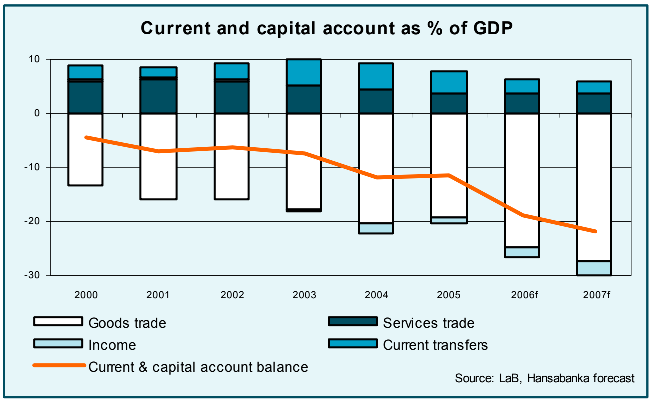
In view of the stronger than expected labour market tightening, we reduce our earlier forecast of average harmonised unemployment rate to 5.2-5.8% in 2007 and 5–5.5% in 2008. Real net wage growth is expected to have reached about 14-14.5% in 2006, which is at the top of our earlier

[6] For details of labour market tightening trends, see our *The Baltic Outlook November 2006* and Kazāks, M., Kūle, L. and Strašuna, L. [2006] "Does Latvia need labour force immigration?", Hansabanka Analytical Discussions.

forecast interval of 12-14%. In 2007 and 2008 we expect real net wages to grow by 12-14% and 10-12% respectively, and part of this will be due to income legalisation.

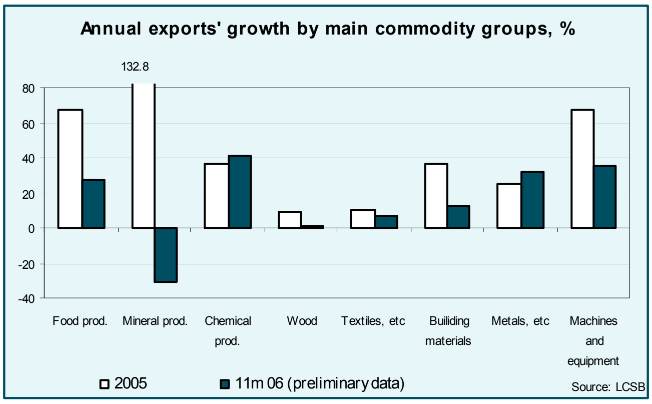
External Balances

In the 3rd quarter of 2006 Latvia's current account deficit worsened further to 24.2% of quarterly GDP, which is a new negative record of 19.3% in 9 months 2006 (12.7% in 2005). As before it is mostly driven by the deteriorating net trade in goods, where the deficit reached a record 26.5% of GDP in the 3rd quarter (19.2% in 2005). The services trade surplus in the 3rd quarter decreased to 2.9% (4.1% in 9 months 2006) from 3.9% of GDP in 2005. In the 3rd quarter 2006 FDI amounted to 4% of GDP (7% in 9 months 2006).



Current and capital account as % of GDP

Such figures would leave every economist worried about the sustainability of the economy. Rapid credit growth, expansionary fiscal policy, high consumer and businesses optimism does not promise any rapid improvement in CAD. Unfortunately, analysis of the current trends suggests a further worsening of CAD unless import growth slows down very sharply (e.g. if the current large CAD makes external financing for Latvia increasingly more expensive). We revise 2006 CAD forecast to 19-21% (from 16.5-17.5%) and to 21-25% for 2007 and 2008. Our FDI forecast is 7.9% for 2006 and 4-6% for 2007 and 2008, which is in line with our earlier forecast.

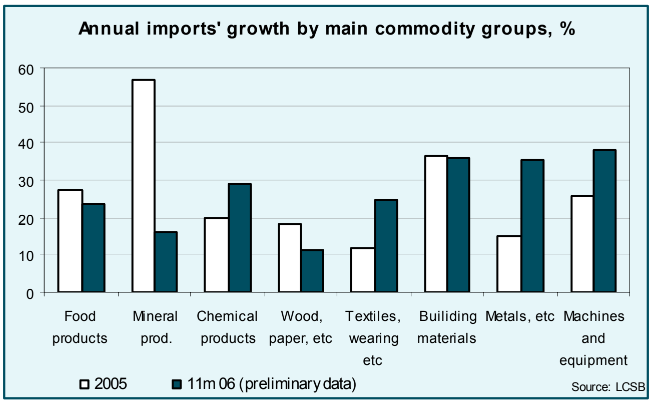


Annual exports' growth by main commodity groups, %

Trade in Goods

In 11 months of 2006, goods export growth has decreased to 13.7% yoy (34.7% in 2005) reflecting slower growth in manufacturing. The fastest growing export items remain chemical production (41.2% yoy), plastics (33.6% yoy), and base metals (31.3% yoy) while exports of mineral products (-30.9% yoy) and paper and pulp production (-13.2% yoy) had the largest lowering effect. Since September we have also seen a decrease in exports of optical instruments (7.4% yoy); however this is mainly due to its high base last year. Overall, export prices grew more slowly than producer prices for exported production (10.9% yoy vs. 12.4% yoy in the 3rd quarter), which could be one of the reasons for the export slowdown.

In addition, exports to Russia increased much more slowly in the 2nd half of the year, though staying at 25-35% yoy (one of the reasons could be long queues at the Russian border, as could some scandals about the quality of exported goods, e.g. fish production). Although exports to Lithuania maintained last year growth rates (over 50% yoy), exports to Estonia increased much more slowly than last year (ca 33% yoy vs. 71% yoy).



Annual imports' growth by main commodity groups, %

Goods imports growth somewhat slowed late in the year (29.3% yoy in 11 months 2006); however, it exceeded that of the corresponding period of 2005 (27.3% yoy). Imports of pure consumption goods continued to escalate most rapidly – transport vehicles soared by 62.9% yoy, while furniture slowed a little to 48.4% yoy. Construction sector developments (though a bit slower growth in the 3rd quarter) caused imports of building materials to maintain similar growth rates (35.7% yoy). In addition, import prices increased less than those of exports (8.9% yoy) thus bringing positive terms of trade and stimulating consumption even more.

Taking into account the above-mentioned factors, we do not expect any substantial improvement in export growth rates; it is more likely to remain at current levels. Thus we retain our earlier forecasts for exports of 13-15% in 2006 and 14-17% in 2007 (on the bottom side, however) supposing that mineral products export volumes will stay at the same level in coming years. We expect exports to maintain similar growth rates in 2008. Goods import growth may reach 29% in 2006 (which is at the top of our previous forecast). However, we think that internal demand will become somewhat weaker towards the end of 2007 and thus import growth will begin to decelerate (to 21-23% in 2007 and further to 15-18% in 2008). However, import growth may fall even faster if high CAD makes external financing for Latvia increasingly more expensive.

Trade in Services

The balance of the services' trade has somewhat worsened (2.9% of GDP in the 3rd quarter vs. 4% in the 3rd quarter 2005). Growth of transportation services' exports slowed to 19.2% yoy for 9 months 2006 (mainly due to freight transportation, especially by sea). Although imports grew faster than in 2005 (both transportation and travel), in 9 months 2006 its growth was still slower than that of exports (23.7% yoy vs. 25.2% yoy). The services' trade (especially imports) was also influenced by continuously decreasing volumes of freight by railway and this trend also continued in the 4th quarter. There are several reasons behind this: partial loss of freight from Belarus, shorter transportation routes through Latvia (to Riga only, Ventspils route is longer), and the warm winter (as northern and Latvian ports have not frozen, there is no incentive to transport by Latvian railway). Long queues of trailers at the Russian border have also had an effect on trade. On the other hand, travel services continued to develop successfully and this trend is expected to continue (the Ice Hockey Championship and NATO summit stimulated foreign interest in Latvia).

Due to the slower than expected growth of services' exports, we decrease its forecast to 21-22% (27-29% before) for 2006. There are no signs that services' exports performance might improve in 2007, thus we expect it to grow by 20-23% (23-26% before). We increase our imports of services forecast, expecting them to grow by 24-25% in 2006 (18-20% before) and 20-22% in 2007.

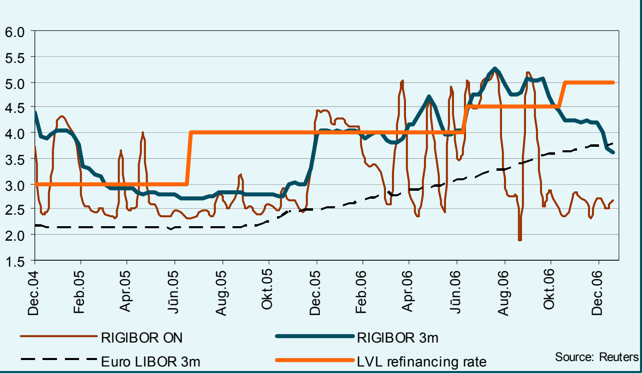
Monetary Issues

Monetary Policy, Credit Growth and Interest Rates

The end of 2006 can be characterized by a high inflow of liquidity into the banking system. Over the year the Treasury had accumulated more than LVL 300m of the budget surplus, which was rapidly run down late in the year causing a jump in liquidity and drop in Rigibor rates.

The LaB has continued its restrictive monetary policy and raised the refinancing rate of the lats to 5% in November. The move, however, did not affect the interbank interest rates, as excessive liquidity and low yield of time deposits facility in the LaB weighed heavily on overnight and short-term Rigibor rates. The 3-month Rigibor rate even fell below the 3-month euro LIBOR rate in January 2007, while overnight rates have fluctuated close to 2.5% since late October 2006 (See the chart).

Interbank borrowing rates of LVL and EUR, %



Source: Reuters

The proportion of euro denominated residents' loans was still at 70% in the 3rd quarter 2006. Tightening monetary conditions became more obvious to the general public after the ECB hiked the euro refinancing rate to 3.25% in October and 3.5% in December. Continuous increases in the euro interest rates drove a slightly higher demand for fixed rate mortgages during the 2nd half of 2006 as the increase in fixed rates lagged behind floating rates. Meanwhile, residents have gradually increased the holdings of deposits denominated in the euros to 31% of the total resident deposits.

As Latvian banks continued to borrow money from abroad, monetary aggregates continued to expand rapidly. Annual growth of M3 accelerated to 40.4% yoy in November (37.8% yoy in Nov 2005). The increase was driven mostly by the expansion of overnight deposits by 48.7% yoy, while the currency in circulation grew by just 23.6%. Commercial banks also had to increase the mandatory reserves in LaB thus accelerating the growth of the monetary base to 52.4% yoy in Nov 2006 (40.41% yoy in Nov 2005).

Mortgage lending was still the main driving force behind credit growth in Latvia. The growth of mortgage lending remained high at 90.7% yoy in the 3rd quarter 2006, slightly moderating from 94.6% yoy in the 2nd quarter. Industrial and commercial lending continued to slow to 16.2% and 27.7% yoy in the 3rd quarter, respectively.

Inflation

Annual average consumer price inflation in 2006 was 6.5%, which is in line with our forecast. This is only 0.2 percentage points less than in 2005. Although growth in food prices somewhat decreased to 8.2% in 2006, it was still the largest contributor to inflation (2.2 percentage points). In turn, housing related prices increased more rapidly (average of 13.8%) due to rising gas, electricity, heating, and water tariffs. Hotels and public catering prices also contributed markedly to CPI (12.1% average growth). Oil prices grew more slowly and thus the effect of transport on CPI was smaller (average growth of 5.4%). Communication services became cheaper through increased competition (7%).

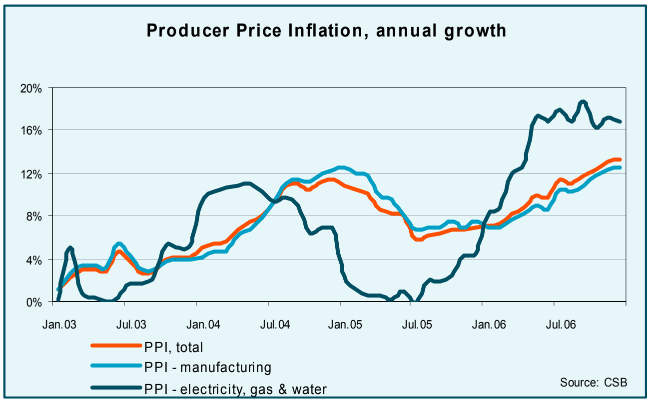
Main sources of inflation

	Weight, %	Average CPI, %		
	2006	2005	2006	2007f
Food products	25.6	9.2	8.2	6-7.5
Housing	13.2	5.8	13.8	13-15
Transport	11.6	13.9	5.4	3-7
Clothing and footwear	7.2	-0.1	0.0	0.5-2
Alcohol and tobacco	6.2	4.2	8.5	7.5-8.5
Communications	5.4	-3.7	-7.0	-4.5..-3
Health care	4.3	11.1	6.6	3.5-5
Hotels and restaurants	5.5	10.7	12.1	7.5-9

Producer price inflation hit recorded records reaching 13.2% yoy in December 2006 (10.3% average in 2006).

Taking into account the expected strong wage growth and rising utilities tariffs, PPI is also expected to rise rapidly in 2007. Thus we have raised the average producer price inflation forecast to 8-9.5% in 2007 (previously 7.7%). We expect about 7-8% producer price growth in 2008.

Such a rapid growth of producer prices will, of course, influence consumer prices. It seems that businesses are exploiting every opportunity to raise prices (in some cases more than it is justified). This, together with rising administratively regulated prices (natural gas, electricity, heating tariffs, public transport, etc.) and larger than expected tax hikes (e.g. tobacco), fuels inflation expectations, which are already high. Although the Ministry of Finance has created yet another work group to discuss the possibilities of reducing inflation, the government does not seem to be too anxious about current price developments and the priority is still rapid economic growth. Even if the plan is implemented, it is unlikely to yield its first results before 2008. Consequently, we raise our average CPI forecast to 6.2-6.6% in 2007 (5-5.6% before) and 4.9-5.4% in 2008 (previously 4.2%).



Lithuania

Baltic Outlook 30.01.2007

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Latest Economic Developments

According to preliminary data the GDP growth in 2006 reached 7.4% (6.6% in the 4th quarter 2006) and was in line with our expectations. Last year the most vigorous growth of value-added was observed in manufacturing, construction, transport, real estate and financial intermediation (ca 11%). Those sectors made up about 50% of a gross value-added.

In 9 months of 2006 the average gross monthly salary in the economy (excluding sole proprietorships) rose by 15.8% yoy. The fastest growth rate was recorded in the 3rd quarter (19.9% yoy), which is a surprising result considering the reduction in the personal income tax rate (from 33% to 27%) which came into effect from 1st of July and which could have had a stabilizing effect on wages in the 3rd quarter. The average gross monthly salary reached 1,654 litas (EUR 479) in the 3rd quarter.

Consumer price inflation accelerated to 4.5% yoy in December with rather worrying developments in the prices of foodstuffs (8.1% yoy), while the increased prices for utilities (housing, water, electricity, and etc. 10.3% yoy) were recently offset by the global decrease in the prices of car fuel. The average CPI inflation in 2006 reached 3.8% justifying the European Commission's warning that the low inflation level is not sustainable (compared to 2.7% in 2005), on which ground Lithuania's application to enter the euro zone was refused in spring 2006.

Strong domestic demand stimulates imports and consequently the current account deficit is widening induced by higher foreign trade deficit. According to preliminary data in 11 months of 2006 Lithuania's current account deficit exceeded 11.5% of GDP, compared to deficit of mere 7.2% in 2005.

At the end of 2006 Lithuania's government finalized the sale of 30% stake in Mazeikiu Nafta, the sole oil refinery and the biggest company in the Baltic States, to the Polish oil concern PKN Orlen. The government received almost USD 852m (LTL 2.2bn or 2.7% of 2006 GDP) for the shares, and a large part of the received funds was instantly allocated to finalize the compensation scheme for the lost rouble deposits (LTL 1.1bn). Citizens' deposits lost value after the collapse of the Soviet Union and compensation (totalling LTL 3.6bn) was decided in 1996; however, the process was suspended in 1999 due to economic difficulties following the Russian economic crisis of 1998, and was renewed in 2002 though not finalized until now. These transactions have no effect on the government's budget; however, the sale of shares to the Polish company will significantly improve the statistical estimates of foreign direct investments for 2006 and will establish Poland as Lithuania's top-investor.

	2002	2003	2004	2005	2006f	2007f	2008f
Economic growth, %	6.9	10.3	7.3	7.6	7.4*	6.5	6.5
GDP, mln euros	15,018	16,452	18,126	20,621	23,620*	26,740	30,243
GDP per capita, euros	4,329	4,763	5,276	6,040	6,959*	7,911	8,984
Growth of industrial sales, %	3.1	16.1	10.8	7.1	7.3*	7.1	7.0
Growth of GDP deflator, %	0.2	-1.1	2.8	5.9	6.6*	6.3	6.2
Growth of consumer prices, %	0.3	-1.2	1.2	2.7	3.8*	4.5	4.5
Growth of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8*	4.5	4.5
Growth of producer prices, %	-2.8	-0.5	6.0	11.5	7.4*	5.4	5.4
Harmonized unemployment level, %	13.5	12.4	11.4	8.3	5.9*	5.6	5.6
Growth of real net wage, %	3.8	9.3	4.9	6.8	15.2	14.0	10.5
Growth of exports of goods and services, %	13.4	6.2	12.0	27.0	19.0	17.5	15.0
Growth of imports of goods and services, %	13.1	6.9	14.2	26.1	23.8	17.7	15.3
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.4	-11.8	-12.3
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-11.4	-12.5	-12.8
FDI inflow, % of GDP	5.1	1.0	3.4	4.0	5.8	3.5	3.6
Foreign gross debt, % of GDP	39.5	40.5	42.4	51.3	57.6	62.7	64.4
General government budget position, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.5	-0.5	-0.5
General government debt, % of GDP	22.3	21.2	19.5	18.7	16.4	16.0	15.5

** actual result*

Assumptions and Delimitations

This and next year will be a politically active period – local elections on February 25th, 2007 will be the prelude for general elections in October 2008. Consequently, we do not expect significant changes in economic policy (especially "unpopular" decisions) to take place before the elections.

There are discussions about cutting the personal income tax rate from the current 27% to 24% starting from October 2007 instead of the planned cut starting in January 2008, and even to cut the rate to 20% from 2008; however, for economic forecasting we disregard such discussions as yet.

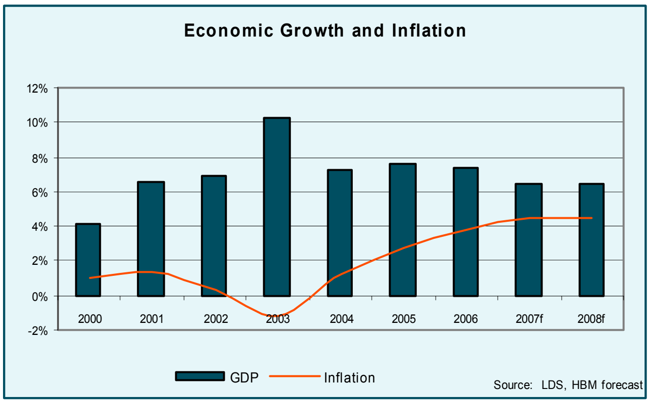
Highlights of the Forecast

This year the economy will grow rapidly though at a slower pace and inflation will be higher. Consumer prices are rapidly increasing supported by higher gas and electricity prices as well as higher excise duties for cigarettes from March. The towering salaries, increasing pensions, forthcoming elections and the possible cut in the personal income tax rate promised by the government all add up to a very favourable outlook for consumers, but might increase misbalances in the economy (i.e. higher domestic consumption, rapid inflation, imports growth vs. exports).

With the exception of those for wage growth, unemployment rate and current account deficit our forecast of main indicators remains unchanged. We retain 6.5% GDP growth forecast for 2007, counting not only on strong household consumption, but also on growing investments and government spending.

Observing recent developments in the labour market with strong growth of salaries and the lack of labour force, we upgraded the real net wage growth forecast to 14% for 2007. 19.1% growth of nominal net wage reaching LTL 1305 will be eroded by 4.5% inflation. The unemployment rate seems to have reached the kind of hypothetical bottom (5.7% in December) and will not decline this year as swiftly as it has in several previous years. We anticipate the unemployment rate being 5.6% in 2007.

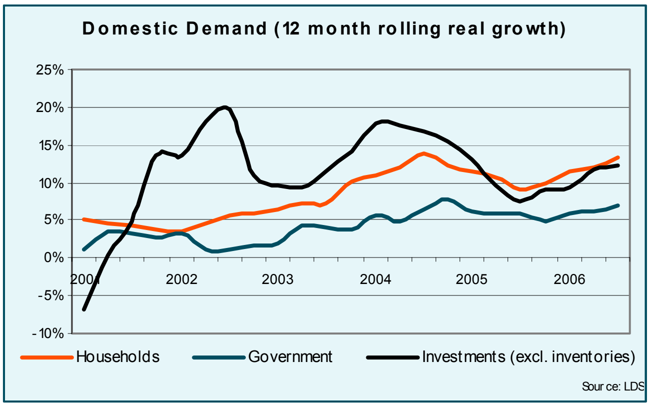
Looking ahead, we expect the current account deficit will increase to greater extent – we revised the forecast to 12.5% of GDP this year, as strong domestic demand is expected to boost imports further and the deficit of goods and services will rise to 11.8% of GDP.

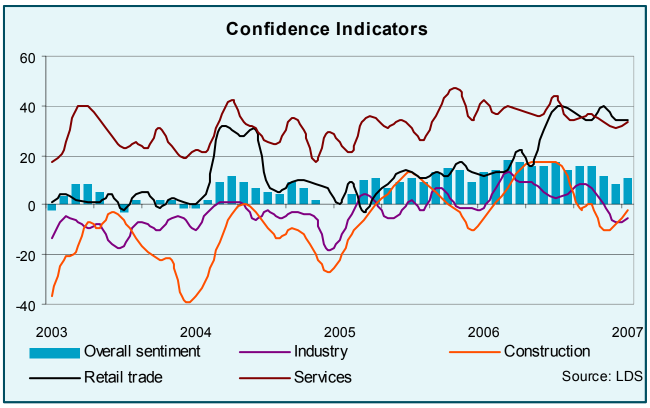


Economic Growth

The outlook for growth in 2007 remains favourable. GDP growth is projected to slow down gradually but remain robust at 6.5%. As previously, this year domestic demand will continue to be the growth engine of Lithuania's economy. Therefore, increasing household consumption, domestic investments and government consumption fuelled by traditional factors, such as growing borrowing (although at a slower pace), higher wages, transfers from emigrants and EU support, will drive the economy. At the same time the export-oriented industry will remain the sustainable base of economy development.

The economic sentiment indicators also give a picture of rather positive development in the economy, though the latest indicators have slightly weakened. The most significant slipping of confidence is observed in industry, where somewhat lower prospects for demand for production (particularly in machinery and equipment, and building materials sectors) were observed in recent months.

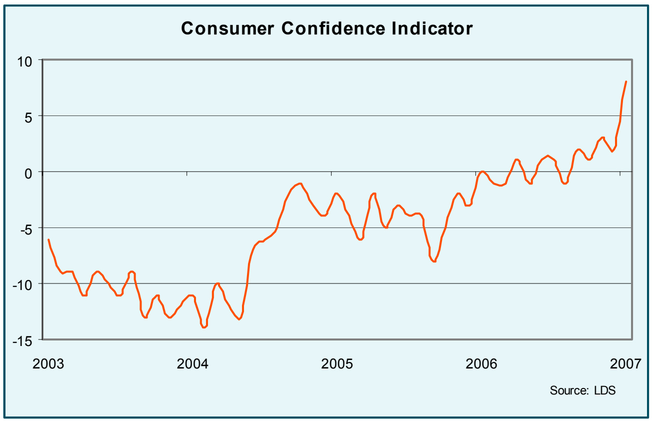


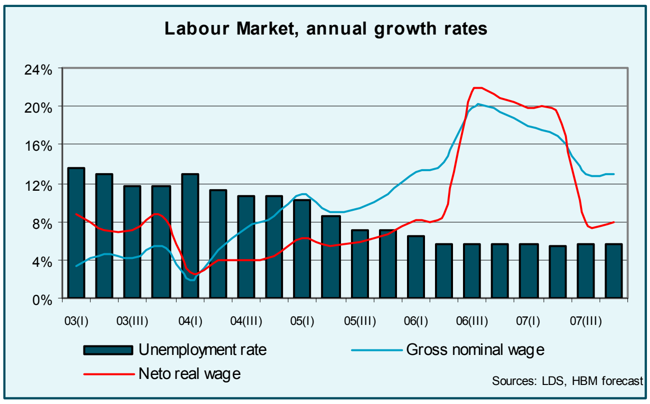


Domestic Demand

Household Consumption and Incomes

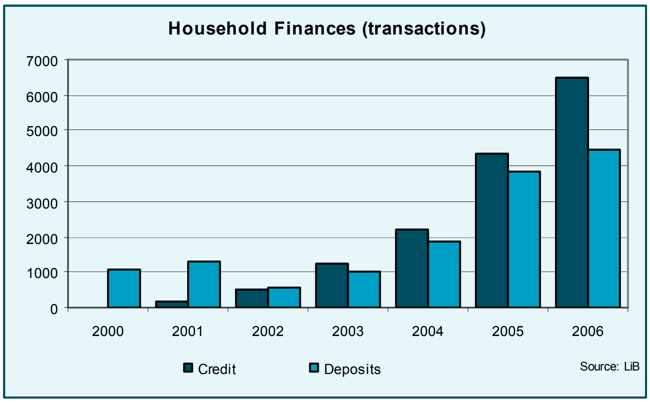
As mentioned above, household consumption will remain the main driver of economic growth. Household spending accelerated in the 2nd half of last year, being supported by the cut in the personal income tax rate, which was reduced from 33% to 27% from the 1st of July. Despite the tax rate cut, the growth of the average monthly gross salary (excluding sole proprietorships) was surprisingly vigorous (19.9%) in the 3rd quarter and the average nominal monthly wage reached LTL 1,654. The monthly net (after-tax) salary increased by 26.1%, though inflation has curtailed some of the purchasing power and therefore the growth of real wages in the 3rd quarter was 21.4%, being much higher than the general growth of the economy. According to preliminary data the average gross monthly earnings in Lithuania rose by 17.6% to LTL 1500 (EUR 435) last year and the average net monthly earnings were up 19.6% to LTL 1096. The real wage (adjusted for inflation) increased by 15.2%. Considering recent developments in the labour market we increased our forecast for wage growth. We expect the annual real salary growth in the whole economy to exceed GDP growth approximately twice and be 14% in 2007 reaching LTL 1963 gross salary in the end of period.

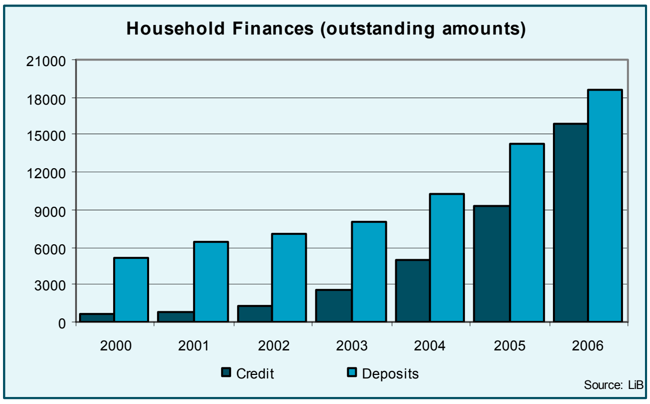




The unemployment rate over the last three quarters stabilised fluctuating between 5.6-6.1% and reaching an annual average rate of 5.9% in 2006. Looking forward, we expect the unemployment rate to reach 5.6% this year on average, although volatility should continue over different months. It seems that the lack of workforce is very strong, but the unemployment has reached some kind of bottleneck due to the lack of unemployed with suitable qualifications.

Due to growing incomes and continued borrowing we expect household consumption to increase more than 10% in real terms this year. Increasing nominal spending will also be related to higher central heating and electricity prices as well as more expensive services due to stronger demand and the considerably higher cost of hiring labour. Growing services prices also cause changes in the structure of household consumption: the share of consumption for services has a tendency to increase.





Traditionally, the pre-election period brings higher social benefits. Accordingly from the 1st of February the average old-age pension will be raised by 13.5% (LTL 70) to LTL 588 as the basic pension rate will be increased by 15.7% from LTL 230 to LTL 266 (EUR 77) and an individual's insured income[7] by 11.8% from LTL 1212 to LTL 1356 (EUR 393).

Lithuania's government has also decided this year to fully implement its scheme for the restitution of citizens' savings lost due to rouble depreciation. Accordingly, approximately 0.5 million Lithuanians will get access to LTL 1135bn (EUR 329m), worth 1.2% of our projected GDP in 2007. As the greater part of citizens who will get the receipts are the elderly, we expect that one-third of these funds may be saved, but some of the extra income will be eroded by the

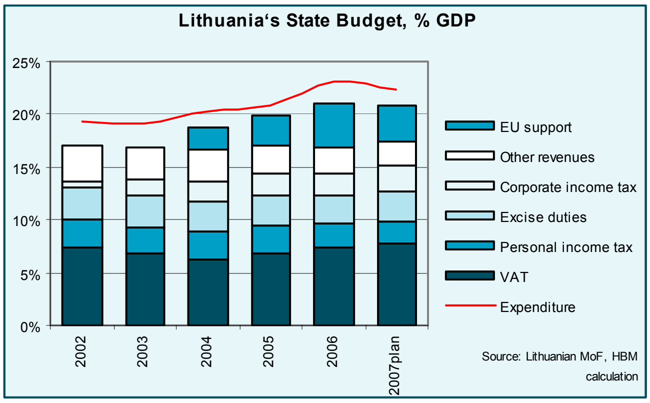
[7] **Insured income** means all the income of a person on which compulsory state social insurance contributions were paid or had to be paid as well as sickness and maternity (paternity) benefits, benefits for illness resulting from an occupational accident or occupational illness, and also unemployment social insurance benefits received.

growing prices for heating, electricity prices and will be spend on daily products. Moreover, the amount of funds received by a single person is limited to LTL 6000 (EUR 1737), which largely limits investments to spending on household appliances or home improvement.

Higher interest rates and stabilized real estate prices slightly slowed the booming growth of household mortgages. Meanwhile the consumer loans portfolio demonstrates increasingly strong growth. At the end of 2006 the annual growth rate of the banks' home-mortgage portfolio slowed to 63.1% from 86.5% the year before. In the meantime, as a result of other transactions, all loans to households increased by 69.4% and still strongly outpace the increase in deposits. Looking forward, we expect increasing borrowing, but at a slower pace.

Government Spending and Policy

Strong economic developments have been very beneficial to Lithuania's public finances. Lithuania's central government surplus in 2006 reached 0.02% of GDP due to exceptionally good revenue collection. The national budget revenues in 2006 grew by 17.5% compared to 2005, largely due to the significant and again surprising improvement in revenues from value added tax, which soared by 27.1% yoy. Both income tax revenues and corporate profit tax revenues in 2006 were significantly above that planned, helping to reduce the deficit.



As already mentioned the government of Lithuania received revenues of LTL 2.2bn with the finalization of the sale of shares in the oil refinery Mazeikiu Nafta. Nearly half of these funds or LTL 989m will be used to provide compensation for lost rouble deposits, some LTL 481m will be earmarked for various public investment schemes, while the remaining receipts should be assigned for investments (not yet exactly decided). The funds received for the shares of Mazeikiu Nafta are recorded in assets and will not influence the indicators of the general government budget position and/or debt. Considering the EC recommendation the compensation for lost deposit will be shown as financial transactions not as expenditure in the statistics.

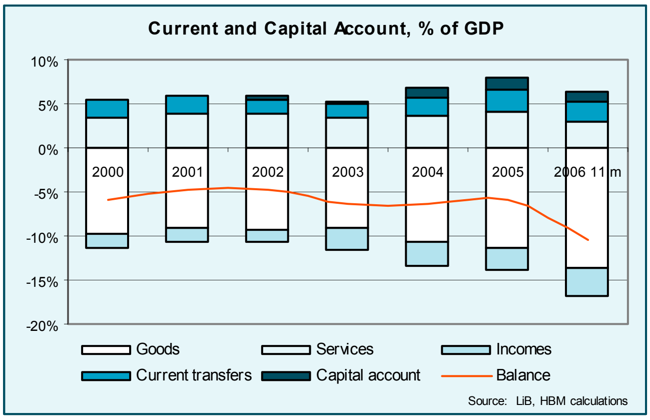
The government was set to further reduce the personal income tax in 2007 and the exact size of the tax cut should be decided around the middle of the year. This will be determined by the budget performance. The current plan is to reduce the rate to 24% from the start of 2008, but the government might consider cutting it earlier than planned.

One of the important factors for economic growth is the absorption of EU structural funds and other financial assistance. It seems that the distribution of the European Union structural funds for 2004-2006 was successfully completed and the doubts over failure to distribute EU support in due time have been dispelled. The direct effect of the absorption of EU funds comes at the time the supported investments are made; however, in 2007 and 2008 the resulting improvements to economic infrastructure and higher production capacities should fuel further growth of the economy.

Taking into consideration the political situation we do not expect a deliberate tightening of the budget this year; however, improvement in the deficit is possible if revenues turn out to be higher than planned and are not spent by a supplementary budget. Lithuanian general government debt, however, remains among the lowest in the EU and substantially lower than the reference value set in the Maastricht Treaty (60% GDP).

External Balance

We forecast the full-year current account deficit to be approximately 12.5% of GDP this year. Looking ahead, a big influence on higher CAD could be made by strong spending coupled with consumer's positive expectations regarding salary growth. Strong domestic demand has been the growth engine for imports lately and as a result, the deficit of goods and services strongly increased. According to preliminary data Lithuania's current account deficit in 11 months of 2006 increased in relative terms to 11.5% of GDP (from 7.2% in 2005), and a near-term decline of the deficit can hardly be expected.



Inflation

Inflation developments in recent months largely followed our expectations, generally pointing to accelerating pace of the growth of prices. The annual growth of CPI reached 4.5% in December, while due to a low start of the year the average annual inflation of 2006 was 3.8% (slightly above our latest forecast of 3.7%). The growing average annual inflation justified the European Commission's warning that the low inflation level (2.7% in 2005) was not sustainable, on which ground Lithuania's application to enter the Euro-zone was refused in spring 2006. In the meantime there remain more inflation-driving factors than inflation-stabilizers, while the latest worldwide decrease in prices of car fuel partly masks the accelerating growth of other prices.

- As expected, the increased tariffs in the utilities' sector in autumn brought a significant effect on CPI - some 1.2% of the 4.5% inflation in December can be directly attributed to 10.3% yoy higher prices of housing, water, electricity items (weight in CPI 12.1%). Due to the very warm start of the winter consumers have not yet felt the burden of higher prices of utilities on their budgets, which is expected to change. The higher prices of utilities will, however, have a lasting secondary effect on general price growth through higher costs of production. The producer price index excluding petroleum products in December was growing 4.3% yoy. Even with recent lower expectations for prices of oil we cannot expect lower utilities tariffs in the next year; furthermore, the prices of gas are set to increase following negotiations with Gazprom, the sole supplier of natural gas to Lithuania.

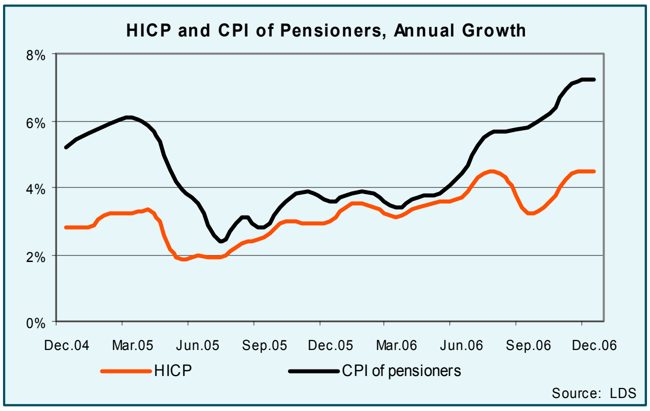
- The most important for consumers is the accelerated growth of the prices of foodstuffs and beverages, which in December were growing 8.1% compared to 4.4% yoy growth in January (average 6.1% throughout 2006). The accelerated growth in prices of foodstuffs has some objective justifications including poor harvest and soaring grain prices worldwide, though certainly it is difficult to separate the domestic supply/demand problems from the external factors. With free trade of goods all across the EU it would be reasonable to expect the prices of foodstuffs locally to follow the price developments in other neighbouring countries, also influenced by competition among retailers and other factors. Comparably the prices of foodstuffs and beverages in Latvia and Estonia are growing at similar paces, respectively at 9.7% and 6.5% yoy in December 2006.

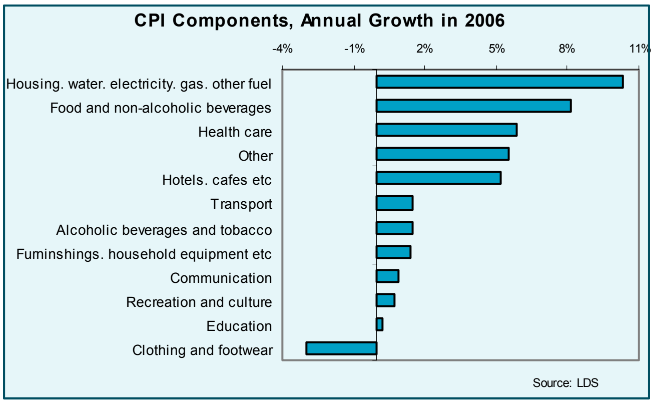
- The price of car fuels has declined in the last months of 2006 so that on average transport prices in December were growing mere 1.5% yoy, compared to the 10% growth rate a year ago. Further developments in the price of fuels are hard to predict, but with latest decrease in fuel prices the pressure to review prices of public transportation has also eased (also as many prices were reviewed in the 2nd half of 2006).

- Except for healthcare, most prices of other consumer products and services have not yet shown any significant acceleration, which hints that soaring domestic demand as well as production costs (incl. wages) are not yet spilling over into prices of goods and services directly. The effect of growing costs, however, cannot be ignored by producers indefinitely and should soon start to affect the prices of various other goods and services more significantly.

Notably the distribution of the price growth drivers with first-necessity items taking the lead in growth has a significant effect on consumers, especially low-income consumers (for whom first-necessity items form a larger part of their budget). The Lithuanian Department of Statistics calculates the little-known Pensioners' CPI index (see graph), which is weighted according to the spending of average low-pension receivers. The Pensioners' CPI index increased 7.2% in December 2006 compared to December 2005, while the average inflation of the Pensioners' CPI basket in 2006 was 5% instead of 3.8% as measured by regular CPI or HICP. Consequently the soaring social spending discussed in other parts of this Outlook is, to some extent, essential in order to maintain the living standards (offset inflation) of people receiving social support.

Considering the latest developments we maintain the inflation forecasts published in November's edition of the *The Baltic Outlook*, expecting average CPI inflation of 4.5% in 2007 and the same level in 2008, with the potential to review forecasts for the upside rather than downside.





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