The Baltic Outlook

Macro Outlook, The Baltic Region, July 2007

HANSABANK MARKETS

Some clouds, but weather still fine

Hansapank
Swedbank

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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

PPI - producer price index

REER - real effective exchange rate

Photo by: Kätlin Juurik

Summary

The Baltic countries have remained at the top of the list in the EU with their 1st quarter economic growth: albeit with lower rates Latvia (11.2% yoy) and Estonia (9.8%) still head the list, and Lithuania with a rather strong jump to 8.3% growth improved its position from the 6th to the 4th. But they also are positioned in the top 5 for annual inflation rates (Latvia with 8.9% being first, Estonia with 6% third and Lithuania with 5% fifth), and current and capital account deficits (Latvia with 23.7%, Estonia with 17.1% and Lithuania with 12.2% of GDP[1]).

These imbalances did not stay without attention – rating agency Standard & Poor's downgraded the sovereign risk outlooks from stable to negative and even cut the long term rating of Latvia to BBB+. Moody's and Fitch Ratings have taken the situation with a stronger stomach but we can expect that if the situation does not improve, they may follow the S&P path. The major concern for ratings agencies was and is definitely fiscal policy – all three governments have taken the economic situation with an easy heart, mostly being concerned about their political polls and elections. Still, the harsh warning at least forced them to assess risks with a more sober head. So far we cannot confirm that the governments have made serious conclusions as fiscal policies are seemingly inclining towards expansionary developments, although we see budget surpluses in 2007 in Estonia and Latvia and a small deficit in Lithuania. Only the Latvian government took a harsh warning of the financial turmoil in spring a bit more seriously by implementing the anti-inflation plan – some legislative changes have been made already and further activities are to be seen. We are of the opinion that more conservative spending policies would be very beneficial for all three countries for achieving a balanced and sustainable growth.

Despite those and many other similarities, we see the three countries standing in somewhat different positions on the curve of the economic cycle. While Estonia has clearly gone down to the slowdown path, Latvia is only making its first steps (but we expect to see the results more clearly in data published this autumn) and Lithuania is still moving up to the top. We are of the opinion that Estonia and Latvia will follow the soft landing scenario, and Lithuania has good chances to avoid the Estonian- and Latvian- type problems (e.g. overheating, huge imbalances) with an earlier correction in the economic structure than those other countries have witnessed. The major risks we see are government economic policies, while current global economic developments are favourable in general. Still, the slowdown of economic activity in the EU would hit the export demand, and a high oil price remains a constant threat.

We have made minor changes in our forecasts although we see possibilities for additional revisions in October as more data will become available, particularly regarding Estonia's and Latvia's economic developments. Household consumption forecasts may be upgraded as wage growth have been very strong in the tightening labour markets. While forecasts of Latvian and Lithuanian investment growth rates may be upgraded, Estonia may face downgrading. There is a strong pressure for increasing consumer price inflation forecasts, but we have not made it yet waiting for the actual developments. We have increased expectations regarding current and capital account deficits in response to the continuously strong household demand (which supports imports) and export troubles in Estonia and Lithuania (e.g. structural shifts push down growth; Russian trade problems).

Maris Lauri

1 Slovakia was 3rd with GDP growth of 9%; CPI in Hungary is 8.5% and 5.3% in Bulgaria (they are rated as 2nd and 4th respectively); the current and capital account deficit in Romania was 14.9% of GDP, 13.2% in Cyprus, and 24.5% in Bulgaria (this is 4Q06 figure, others are from 1Q07).

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %								
Estonia	8.0	7.1	8.1	10.5	11.4	8.6	6.9	6.8
Latvia	6.5	7.2	8.7	10.6	11.9	9.0	7.0	7.0
Lithuania	6.9	10.3	7.3	7.6	7.5	8.0	7.0	6.5
EU27	1.2	1.3	2.5	1.8	3.0	2.9	2.7	na
GDP, millions €								
Estonia	7,759	8,494	9,375	11,061	13,074	15,300	17,600	20,000
Latvia	9,911	9,978	11,176	13,012	16,180	19,753	22,848	26,109
Lithuania	15,018	16,452	18,126	20,621	23,746	27,441	31,183	34,870
EU27	9,893,047	10,053,820	10,546,701	10,980,760	11,557,853	12,172,536	12,756,829	na
Harmonized consumer price growth, %								
Estonia	3.6	1.4	3.0	4.1	4.4	5.0	5.0	4.0
Latvia	2.0	2.9	6.2	6.9	6.6	8.0	5.5	4.5
Lithuania	0.3	-1.1	1.2	2.7	3.8	4.5	4.5	3.3
EU27	2.1	2.3	2.3	2.3	2.3	2.2	2.1	na
Consumer price growth, %								
Estonia	3.6	1.3	3.0	4.1	4.4	5.1	5.2	4.4
Latvia	1.9	2.9	6.2	6.7	6.5	8.0	5.5	4.5
Lithuania	0.3	-1.2	1.2	2.7	3.8	4.5	4.5	3.3
Harmonized unemployment level, %								
Estonia	10.3	10.0	9.7	7.9	5.9	4.5	4.6	4.7
Latvia	12.2	10.5	10.4	9.0	6.9	5.5	5.2	5.0
Lithuania	13.5	12.4	11.4	8.3	5.6	5.0	4.9	4.8
EU27	8.8	9.0	9.0	8.7	7.9	7.2	6.7	na
Goods and services balance, % of GDP								
Estonia	-6.9	-7.3	-8.1	-6.2	-10.3	-11.5	-11.0	-10.0
Latvia	-10.0	-12.7	-15.8	-15.1	-21.0	-20.0	-16.5	-13.6
Lithuania	-5.5	-5.7	-7.0	-7.3	-10.3	-13.5	-13.2	-12.5
EU27	1.5	1.2	1.1	0.6	0.2	0.4	0.3	na
Current and capital account balance, % of GDP								
Estonia	-9.5	-11.1	-11.7	-9.5	-12.3	-12.5	-10.0	-9.0
Latvia	-6.4	-7.5	-11.8	-11.2	-19.9	-18.3	-15.2	-15.5
Lithuania	-4.7	-6.4	-6.4	-5.9	-9.7	-12.8	-12.2	-11.3
General government balance (ESA95), % of GDP								
Estonia	0.4	2.0	2.3	2.3	3.8	1.5	1.4	1.7
Latvia	-2.3	-1.6	-1.0	-0.2	0.4	0.5	1.5	1.5
Lithuania	-1.5	-1.3	-1.5	-0.5	-0.3	-0.5	-0.5	0.0
EU27	na	-3.1	-2.7	-2.4	-1.7	-1.2	-1.0	na

Estonian, Latvian and Lithuanian forecast by HBM; EU27 forecast by EC

General Assumptions

1. Global Economic Growth

Global growth consensus expectations have remained more or less same as in April-May 2007, although the range of the forecasts has narrowed. This indicates that nothing very important has happened in the global economy over the last couple of months which could significantly affect the Baltic economies.

This year global economic growth is expected to be smaller than in 2006, but despite that growth will remain strong. There are signs of weakness in the US economy, but in recent months risks related to real estate sector in autumn-winter have diminished. This is the reason why it is expected that the US economy will start to gather speed already in the end of 2007. Economic growth in the EU will also be somewhat smaller than in 2006, but it is expected to strengthen already in the end of next year. For the three Baltic countries strong economic development in Germany, Sweden and Finland is very important. Moreover, the good results published lately suggest that consensus forecast may grow for those countries. The new members of the EU – Bulgaria and Romania – are expected to show remarkable developments, not only because their economic position but also the inevitable strong and fast convergence process they face.

Global economic growth projections, %

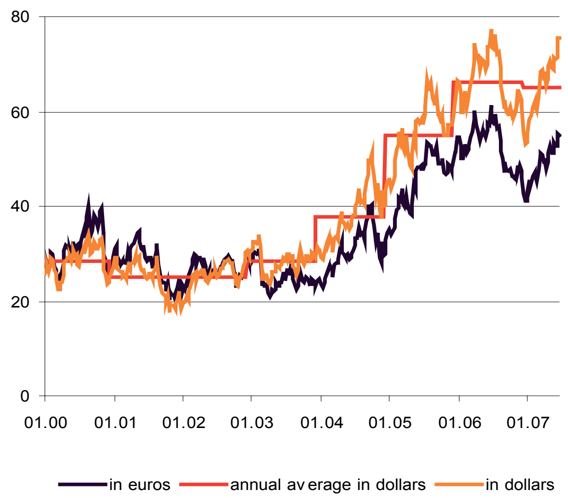
	2005	2006	2007f	2008f
USA	3.2	3.3	2.2	2.9
EU27	1.9	3.2	2.8	2.7
euro zone	1.4	2.6	2.7	2.3
Germany	0.9	2.7	2.1	2.1
Finland	2.9	5.5	3.2	2.9
Sweden	2.7	4.7	3.5	3.1
UK	1.9	2.7	2.8	2.4
Denmark	3.0	3.2	2.3	2.1
Russia	6.4	6.7	6.7	6.4

Economies of Asia but also in other developing regions are growing rapidly, albeit the expansion will be a bit less than in previous years (i.e. economic growth in China is expected to marginally slow from 11.1% in 2006 to 10% in 2008). Economic growth in Russia will remain rapid because of coming elections (Duma in December, president in March), as the government will boost spending to increase household incomes. However, this development has also a negative side: rapid growth of imports. This, together with the growing pressure of exports (there has been far too little investment in oil and gas production, export customs for timber etc), means that trade and budget surpluses will diminish.

2. Prices of Oil and Other Raw Materials

Oil prices have shown slight upward trend in recent months, which we do not expect to change in the (near) future, although strong short-term fluctuations are very likely (as happened in July[1]). Smaller economic growth should mean smaller demand and lower prices for oil, but many factors are working against this scenario. If the oil price falls because of weaker demand, then we could expect OPEC to cut production. However, the most important factor, which determines the oil price, is the geopolitical situation in Nigeria, Iraq, Iran and possible problems in other oil producing countries. As the increase of production capacity in non-OPEC countries has slowed, there is no relief to expect from those (e.g. Norway, Mexico, but also Russia). One also should not forget that global economic growth, although smaller than in 2006, is still strong. Hence, the demand for oil will remain strong, which consequently will lead to a relatively high and probably growing oil price. But as mentioned, the fluctuation band is wide and easily affected by various economic and political developments in producing countries.

Oil Price (Brent)



Source: Reuters; HBM calculations

1 Despite strong upsurge of oil price in the July (USD 78 per barrel; Brent price), markets still expect that oil price will fall in the 2nd half of the year, and that annual average price will be close to 2006's price (2007's average forecast is USD 64 with forecast range USD 55.5-70.5; 2008's average is USD 60.5 from the range of USD 50-75).

Expectations are the same for metals and agricultural products – weaker demand should bring lower prices, but as the global economic situation is strong, prices continue to grow. However, many analysts also point to several factors indicating that at least for some products, prices have reached their current high level (e.g. base metals). It is generally expected that differences inside groups of raw materials will increase, due to the actual price level, demand and other factors (incl. weather).

3. Interest Rates

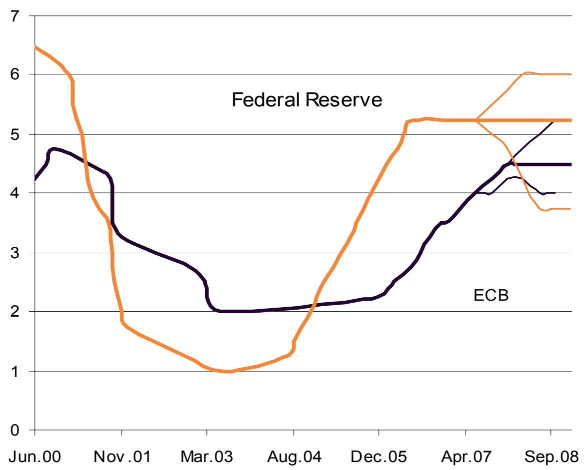
Different growth rates of inflation and base inflation, but also increasing shortage of capacities have put central banks into a difficult situation and make it hard to forecast interest rate movements. Slower economic growth and inflation should mean lower or stable interest rates, but the shortage of capacities, growth of money supply and increasing base inflation are supporting expectations which foresee higher interest rates.

Current (early July) market consensus expects that interest rates in the US will remain stable at 5.25% for the coming year and a half. Interest rates in the euro zone are expected to be increased by 25bp to 4.25% in August-September and once again in the 4th quarter, but after that they will remain flat. However, the expectations vary significantly: for the end of 2008 policy interest rates in the USA are expected to be between 3.75% and 6% and between 4% and 5.25% in the euro zone.

4. Foreign Exchange

Expectations regarding exchange rates vary, as do interest rate expectations. According to the market consensus the US dollar will, after current weakening, start to strengthen gradually. This expectation is based on the assumption that the US economy will start to improve by the end of 2007.

Base Interest Rates of ECB and Federal Reserve, %



Source: Reuters

Interest and Exchange Rates

	10.07.07	3M	6M	9M	12M
Fed rate*	5.25%	5.25%	5.25%	5.25%	5.25%
USD (3M)**	5.37%	5.35%	5.35%	5.35%	5.35%
ECB*	4.00%	4.25%	4.50%	4.50%	4.50%
EUR (3M)**	4.20%	4.45%	4.50%	4.50%	4.50%
EUR/USD**	1.38	1.36	1.35	1.33	1.32
USD/JPY**	122.0	121.0	119.0	115.5	115.0

* according to market consensus

** according to market expectations (based on forward contracts)

5. Effects of Global Economic Developments on the Baltic Economies

The favourable global economic situation should be beneficial for Baltic enterprises creating opportunities to expand of export sales despite growing production costs. The fact that the outlook for Germany, Sweden and Finland is good is important for the Baltic countries, as this increases the probability of favourable developments. The rapid growth of emerging economies is also important, as it makes export expansion possible; taking into account that most of those countries have relatively high inflation rates, the competitiveness could be maintained for a longer period (real exchange rate of Baltic currencies towards those countries will not deteriorate).

The gradual and slow growth of oil prices has a modest impact on the local price level. However, sharp increase would trigger a significant rise of price levels, which could delay the euro adoption further. The prices of other raw materials also have a significant impact on local economies, this due to their great openness. Customs on Russian timber exports will affect all three countries, but also Finland and other EU members, which have to increase production prices or find ways to import raw materials form other sources (i.e. using local, but more expensive inputs). Generally, there is a clear push upwards, which definitely will be seen in construction but also consumer prices. We are of the opinion that Russia will not get additional investments into the domestic forestry sector due to increasing political risks. There is a small chance that Russia will drop those export tariffs after some time.

The faster than previously expected growth of euro interest rates will also bring local interest rates up faster than expected, but its effect will be quite modest. This interest rate increase should not affect the economy in a significant way, albeit it might have a certain calming effect on credit market.

Elections schedule

Estonia	
Presidential	September 2011
General	March 2012
Local	October 2009
Latvia	
Presidential	June 2011
General	October 2010
Local	July 2009
Lithuania	
Presidential	June 2009
General	October 2008
Local	2011
European Parlament	2009

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Estonia

1. Recent Economic Developments

Economic data published in recent months confirm our expectation that the Estonian economy is developing according to our soft landing scenario, which means that excessive economic growth slows down to optimal levels (ca 6-7%). The Estonian economy grew 9.8% in the 1st quarter, which is significantly less than at the end of 2006 (10.9%). Domestic demand growth slowed from 19.1% to 15.9% as investments growth slipped from 31.2% to 17.1% despite households increasing their spending even more than in 2006 (18.1%). The latter was caused by growing employment (1.9% yoy), but the biggest contributor was income growth (nominal wage payments were up 20%).

Stronger demand brought higher inflation: while in December the 12-month average CPI was 4.4%, then in March it reached 4.6% and in June 4.9%. Strong demand is behind a relatively high level of imports, and changes in exporting industries have substantially brought down foreign trade turnover figures. The current external deficit[1] was in the 1st quarter slightly better than we forecasted but worse than in 2006 (17.1% of GDP, a year before 13.4%), and FDI inflow was also surprisingly strong (15.5% of GDP; 17.1% in 2006).

Developments in the financial sector have been as expected: loan growth has gradually slowed, being now around 40% for loan stock, while interest rates have grown (an average kroon loan rate is ca 8%, household mortgage loan rate ca 5.3%), which means that real interest rates are now (after two years) again positive. The state budget revenues, particularly tax revenues, have been good. But spending has grown faster than usual and the budget surplus is slightly smaller than in previous years (0.9% of GDP in the 1st half of the year).

2. Economic Forecast

We have not made significant changes in our forecast compared with the end of April. We have made adjustments in labour market forecasts (also because of data changes) and foreign trade expectations; the latter has caused corrections in the external balance forecast. We are planning to make more significant changes in our forecast after the Statistical Office publishes new GDP time series in autumn.

We expect that economic developments will continue according to the soft landing scenario, which means that domestic demand growth rates will gradually diminish and external deficit will in the same way improve. It seems very unlikely that inflation will slow in next 9 months because of external and administrative factors. Major risk factors for this scenario are the same: contradictory budget policies and the rapid growth of domestic loans.

2.1. Economic Growth

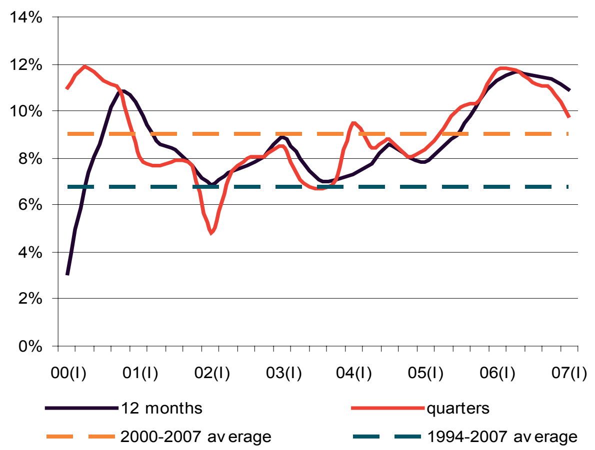
The slowdown of economic growth, which started in the 1st quarter, will continue during this and next year, and only favourable and successful structural

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	8.0	7.1	8.1	10.5	11.4	8.6	6.9	6.8
GDP, EURm	7,757	8,494	9,375	11,061	13,074	15,300	17,600	20,000
GDP per capita, th kroons	89.3	98.2	108.7	128.6	152.0	178.5	205.0	230.0
euros	5,709	6,275	6,950	8,218	9,717	11,400	13,150	15,000
Growth of industrial production, %	8.3	11.1	10.5	10.8	7.1	7.3	7.5	7.0
Growth of GDP deflator, %	3.8	2.3	2.1	6.8	6.1	7.7	7.7	6.8
Growth of consumer prices, %	3.6	1.3	3.0	4.1	4.4	5.1	5.2	4.4
Growth of harmonized consumer price index, %	3.6	1.4	3.0	4.1	4.4	5.0	5.0	4.0
Growth of producer prices, %	0.4	0.2	2.9	2.1	4.5	4.8	4.2	3.0
Harmonized unemployment rate, %	10.3	10.0	9.7	7.9	5.9	4.5	4.6	4.7
Real growth of average monthly gross wage, %	7.7	8.0	5.2	6.1	11.2	12.0	10.0	10.0
Growth of exports of goods and services, %	-1.1	9.0	17.8	24.5	18.0	6.5	7.5	8.0
Growth of imports of goods and services, %	4.1	10.4	17.6	20.9	22.9	9.5	7.5	7.8
Balance of goods and services, % of GDP	-6.9	-7.3	-8.1	-6.2	-10.3	-11.5	-11.0	-10.0
Balance of current and capital account, % of GDP	-9.5	-11.1	-11.7	-9.5	-12.3	-12.5	-10.0	-9.0
Inflow of FDI, % of GDP	4.0	9.7	8.9	20.2	9.7	8.7	7.3	6.5
Foreign gross debt, % of GDP	57.9	66.0	78.3	86.0	96.0	96.5	97.0	98.0
General government budget position, % of GDP	0.4	2.0	2.3	2.3	3.8	1.5	1.4	1.7
General government debt, % of GDP	5.6	5.7	5.2	4.4	4.1	2.5	2.2	2.4

1 i.e. the current and capital account deficit

shifts could grant the stabilisation of growth rates at the end of 2008 and higher growth rates in early 2009. Favourable economic developments in the rest of the EU could be one supportive factor for the early recovery of growth rates. Our current forecast, however, does not account for this. We expect the Estonian economy to grow 8.2-8.9% during this year and 6.5-7% during next year.

Economic growth



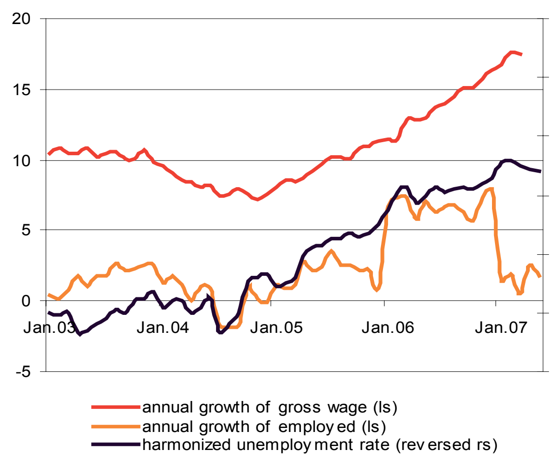
Source: ESA; HBM estimates

Several processes are showing that supply-side problems, which exist in the Estonian economy and are having a strong negative impact, may be resolved faster and in a more successful way than we previously expected.

2.1.1. Labour Supply and Labour-Related Issues

The shortage of labour has started to finally affect companies' personnel politics: the creation of new jobs has diminished and this has also affected employment growth. The seasonally adjusted unemployment rate and the number of unemployed have shown a tendency to increase[2] in recent months as the number of first-time jobseekers has increased. This is a reflection of the relatively numerous generation of the late 1980s[3] entering to the labour market. Despite lower job creation, the vacancy rate continues to grow, which suggests that the qualifications of new entrants are not satisfying employers.

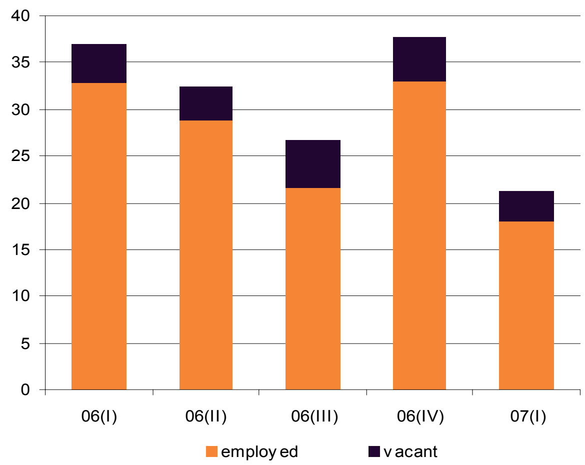
Labour Market



Sources: Eurostat, ESA; HBM calculations

Structural changes, which, in our opinion, have intensified, are behind the relocation of labour from low value-added production to higher value-added production. However, the process might not always be smooth as labour may need re-education and this requires time (1-2 quarters). If the training is made at the workplace, as is usual, then productivity falls at first and will start to grow only if re-trained people will start working.

Job creation (compared with year before data), th



Source: Eurostat; HBM calculations

The qualification mismatch is one of the major reasons why wage growth will remain very strong in the next years, even if employment growth slows and the unemployment rate stabilizes or grows. However, productivity and wage growth should correspond more to each other as production

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2 S.a. harmonized figures have been revised significantly as quarterly figures become available; April-May s.a. figures suggest increase in unemployment, however unadjusted figures, as well as official unemployment figures do not; hence we cannot be sure that unemployment grows; however there are clear signs of stabilisation now and possible pickup of unemployment in near future.

3 The process of regaining Estonian independence at the end of the 1980s and the beginning of the 1990s caused a sharp pickup of birth rates during 1986-89 (16.3 births per 1000 Estonians in 1989), and was fallowed by a sharp fall in birth rates during the 1990s (9.3 in 1998).

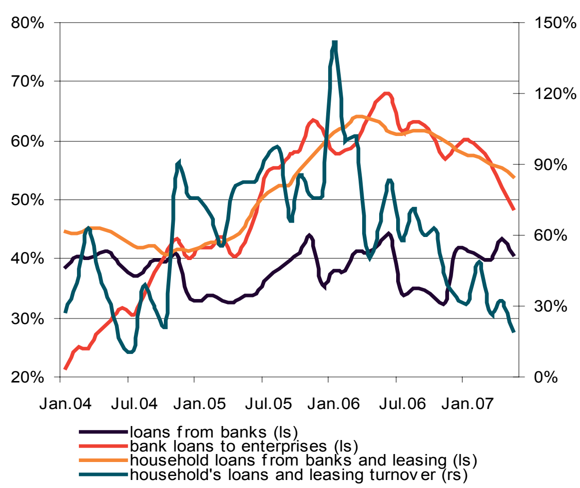
shifts toward producing higher value-added goods and services. This is confirmed by data from the 1st quarter when productivity growth (measured with real value-added per employed person) improved significantly (7.7% vs. 4.7% in 2006) and the difference between wage and productivity growth diminished[4]. Wage developments are also clearly lagging from employment developments[5], which means that wage growth might not slow significantly even in the 2nd quarter.

2.1.2. Capital Supply

The shortage of capacities has diminished slightly in recent months, this applies particularly in construction where demand has slipped in some sub-categories (the average utilization rate has fallen from 91% in the 3rd quarter of 2006 to 89% in the 2nd quarter of 2007). In construction the shortage of capacities is mostly seen in engineering and non-residential construction, while no such problems exist in residential construction. The utilization rate has slightly fallen also in manufacturing, which probably reflects the structural shift (old capacities are under-utilized, while new ones are in shortage).

The inflow of foreign capital is still an important contributor for economic growth, and foreign-owned commercial banks are the main channel here. The interest of foreign financial enterprises with the Estonian market has clearly grown; there are several big international companies entering or have entered to the market; however they currently have only a marginal market share. But we can assume that the risk appetite of such investments is high (as the assets involved are small) and those companies will be probably more aggressive than the old market participants. So they may supply more aggressive marketing and more favourable terms for customers than the existing market offers.

Annual Growth Rates of Lending



Source: EP

Although the growth of loan portfolios continues to slow and the growth rate of loan turnover has slipped very strongly, we can see that households are increasingly using leasing (i.e. passenger cars) and probably (there is no statistics available) lending from non-financial enterprises has grown (e.g. SMS-loans).

2.1.3. Goods and Services

The slowdown of economic growth, as expected, has diminished the share of imports in total supply (see following chart), hence the continued weakening of demand in 2007-2008 should favour local producers even more. If look at the chart one can see that imports acquires the highest/lowest share in supply 1-2 quarters after the peak/low-point of economic growth. This means that the very high trade deficit in the 1st quarter was at least partly a lagging reflection of last year, and it should diminish in the 2nd and 3rd quarter. There are two major processes taking place in foreign trade now:

- Trade contracts for imports, which are agreed at the time when the situation is good and hence the outlook for the nearest future is overestimated – the more the economy depends on domestic demand, the stronger this lagging impact and losses for companies will be, if actual demand turns out to be weaker. We see that this factor has strengthened in recent years very significantly, as economic growth is increasingly dependent on domestic demand.

- Exports' high dependence on imports means that imports should take place before exports, but it also means that if there are troubles in exports, imports will also end immediately; the lagging effect could be 1-2 months. If the production of exports is based on contracts (e.g. subcontracting), then imports will slow before exports. These types of bounds are particularly strong if subcontracting dominates in the production. However one should make a clear distinction between trade flows and produced value-added. If subcontracting is based on low labour costs, then economic

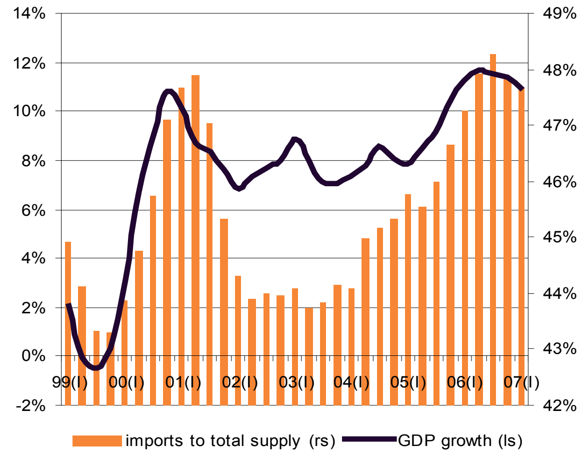
4 This applies to all major economic sectors, excluding real estate, rental and business services, where due to falling real estate sales and prices the generation of value-added slowed significantly

5 Bonuses are paid after the working period – so the 1st quarter wage growth also reflected the good economic results of 2006. Regular wage increases, especially in the public sector, very often take place at the beginning of the year, taking into account last year's incomes and profits.

growth is mostly affected indirectly through employment and employees' consumption, while the direct impact of such exports-imports might be very small[6].

Last year's Estonian imports were strongly affected by both factors, and due to strong domestic demand, this effect has deepened the related misbalances in the economy (the trade deficits in the 4th and the 1st quarter).

Economic Growth and Imports
(12 months rolling average)



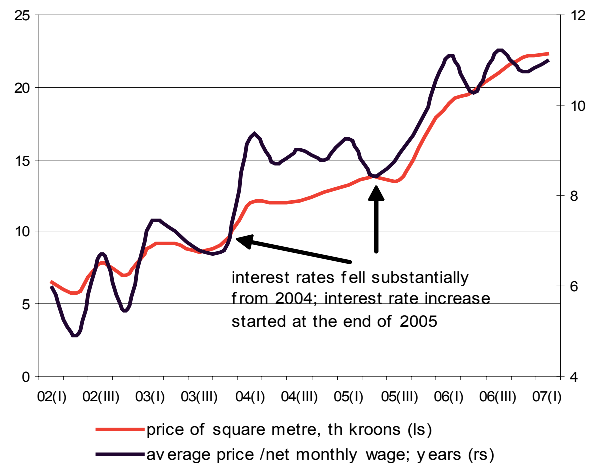
Source: ESA, HBM calculations

2.1.4. Household Demand – Incomes, Spending and Prices

Although we are not changing our economic forecast now, there are increasingly more signs that household spending may grow more than our spring forecast assumed (less than 12% growth in this and 10% in next year). Two major reasons are faster than expected income growth this year and more extensive income tax cuts for households[7] than we expected in the spring (affects incomes and spending in 2008).

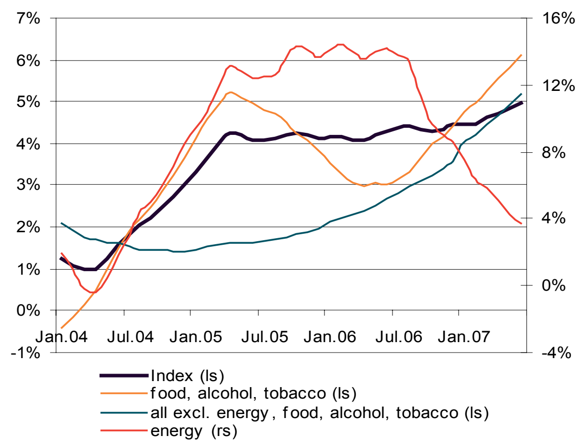
In the 2nd half of last year and in the beginning of this year worsened access to the real estate and mortgage loans, due to rapidly grown real estate prices, has become a new factor for supporting spending, and we expect it to remain in place this year and at least for 2008. Those families are now enjoying the financial freedom of increasing incomes – due to a relatively low wealth level (and an impossibility to improve it with a real estate (home) purchase) they prefer to spend their incomes, instead of saving. This is quite an important factor, albeit with difficult to estimate impact on consumption. Due to significantly worsened access to the real estate market we can assume that this type of spending will continue at least in the next two years.

Access to residential real estate: average price of 2-room appertement



Source: ESA; HBM calculations

Harmonized consumer price index
12 months average



Source: Eurostat

Household spending is highly dependent on price movements. Planned and expected administrative price increases in the 2nd half of this year and the 1st half of next year will be extensive and will have a

6 This was very clearly seen in recent Estonian economic history. The problem was exaggerated by transfer pricing. The remains of this process still exists in economy.

7 Additionally to the cut of the income tax rate (21% in 2008, 20% in 2009, 19% in 2010, 18% in 2011) and increase of non-taxable income (up to EEK 3,000 per month in 2011, EEK 250 every year) non-taxable income will be applied to all children (currently starting from the 2nd child); investment-related adjustments are not agreed yet (may be applied in 2009); changes in the corporate income tax are currently only in the proposal phase, but will most likely adopted by the Riigikogu (basically the current system will remain in place and changes will be only technical)

Major administrative and external factors for price growth in 2007-2008

Factor	Nature and scope
VAT on long-distance heating	from 5% to 18% from July 2007
Long-distance heating prices (heating energy)	mostly Oct 2007 - beginning 2008; depending on municipality 0-25% (more possible, but unlikely)
Natural gas price from Gazprom to Estonia	unknown, probably up to 50% in the begining of 2008
Natural gas price to consumers	unknown, probably 10-50% (Oct 2007 - Dec 2008)
Water, sewerage	depending on municipality: (0)5-15%; mostly Jan 2008
Garbage collection	depending on municipality up to 50%; 2007-2008 (once a year?)
Electricity, etc	5-20% in March 2008
Local (bus) transport	depending on municipality; price or subsidies growth; prices 15-30%; depends on wage demand, oil price; during 2007-2008
Global oil price	unknown, rapidly transfered to local prices
Alcohol excise rates	10% in Jan 2008, 20% in July 2008
Tobacco excise rates	in Jan and July 2008 up to EU minimum (ca 50%)
Excise rates on motor fuels	Jan 2008: ~25% for gasoline, ~29% diesel
Excise rates on heating fuels	Jan 2008: heating oil ~39%, will be implied to natural gas and electricity* (156 kr per th m^3 and 50 kr per MWh)
Different environmental taxes and duties	2008 and later; unknow; mostly indirect impact
* replaces CO_2 duty	

definite effect on consumption. This is even without taking into account weather factors[8], and so we expect that households will cut the sums they spend on other goods and services. This means that prices of these goods and services will be affected.

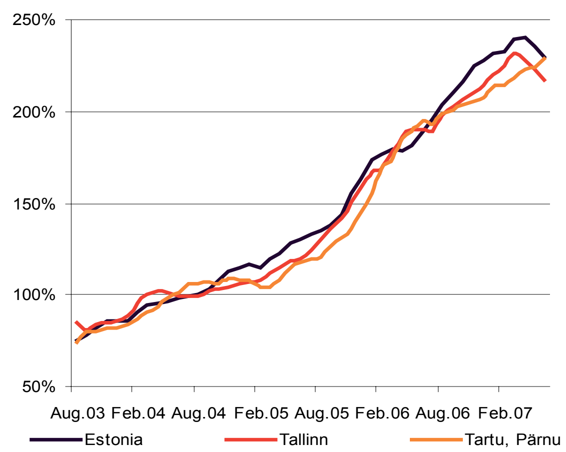
Our consumer price growth forecast has not changed: we expect consumer prices to grow approximately 5.2% this year and next year, but producer prices by 7.4% in 2007 (previously 4.8%). We are of the opinion that construction price inflation should already start to diminish this year, but consumer prices will see a significant slowdown only in 2009.

2.1.5. Investments

Investment activity slowed remarkably in the 1st quarter of 2007 after a strong 2006: investments were up by 17.1% yoy (incl. gross fixed capital formation 18.3%). Companies' investments into fixed assets (in current prices) grew by only 13.2% yoy. We forecasted the slowdown of investment activity, but these figures suggest that it has been more radical than we assumed. However, these figures will be most likely revised as more data will be available.

Companies have diminished investments into transport equipment, but also to machinery and equipment. However, the survey of the Estonian Market Research Institute suggests that investments in manufacturing are slightly stronger than in the past and that investment plans are also somewhat stronger. As expected, one could see a clear distinction between sub-industries: well-growing branches are increasing investments (e.g. food, chemical and metal industries) while contracting branches' investments are diminishing (e.g. textile and timber processing industries). That is what we expected – the development of low-value-added producing sectors is slowing and can even contract, while at the same time, higher value-added production is growing. The latter industries are also those facing a labour shortage.

Price Dynamics of Appartments (2004=100%)



Source: HBM constructed index covers the most active markets

As expected, the activity in the residential real estate market has clearly contracted – the number of contracts has diminished (e.g. in June there was 30% less house purchases than a year ago) and the price growth has also stopped. Depending on real

8 Production of heating energy in the last extraordinarily warm winter (Oct 2006 – March 2007), was 12.6% less than average production in 2000-2007, and 21.5% less than in the coldest winter (2002-2003) in recent years.

estate, some prices are falling quite rapidly while others slightly grow. The strongest setback has occurred for new developments in poor locations and lacking in infrastructure (roads, kindergartens, public transport, etc) in the Tallinn region.

2.1.6. Government Spending and Policy

The Estonian government economic policy choices have been contradictory in recent months. From one side one could see a significant tightening (increase of consumption taxes in 2008), but on the other side the government is planning to go ahead with even more extensive income tax cuts and an increase government spending so that the planned budget surplus would fall to 0.5% of GDP in next year (previously promising 1.5% of GDP).

According to the government, the tax increases and decreases should end with a negative impact on consumption, i.e. tax changes would tighten the fiscal policy in 2008. However, we are not so sure about that. Increasing consumption taxes (VAT, excise) will cut the spending of Estonian residents and tourists (first of all tobacco, alcohol, motor fuels). This would mean that budget revenues could be smaller than government expects. We also see that the Ministry of Finance has made quite an optimistic forecast for 2007-2008 (with economic growth rates 9.2% and 8.3%, respectively; we expect for 2008 only 6.6%). So they might overestimate the budget revenues for 2008.

We have not made changes in our economic forecast, expecting that the Ministry of Finance will correct their economic forecast in August-September and this will force the government to adjust its spending in 2008 to a more reasonable level. With current plans we see a high possibility that the government's fiscal policy will support household spending and cause higher misbalances in the economy (higher inflation, bigger imports).

2.1.7. External Demand and Balance

The Estonian foreign trade turnover started to slow in last autumn, and in this Feb-April have shown very modest growth rates: both exports and imports almost stagnated in February, although recovered slightly in April. We have made changes in our expectations regarding foreign trade, as most of the expected processes have been significantly faster and stronger than we assumed in spring.

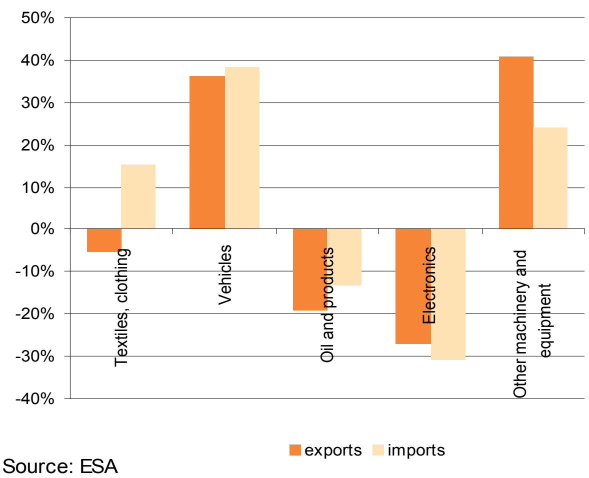
1. We see that trade with goods passing through Estonia (transit) has stabilised or even fallen in certain situations – this process has been significantly stronger than we expected. Mineral products (i.e. oil products) should be mentioned at first –imports have fallen by 13.4% and exports by 19% in Jan-Apr 2007. We will not expect a recovery of those flows in the near future, especially taking into account Russia's economic and foreign policy.

2. We are of the opinion that the growth rates may also fall for other transit goods (e.g. passenger cars through Estonia to Latvian and Russian markets). Again the process is stronger than expected in spring.

3. Structural changes in the Estonian economy are diminishing share of cheap production in exports. This means changes in the trade with clothing, textiles and cheap electronics. The process of restructuring in the textile and clothing industry has continued for many years, and is expected to last at least 2-3 more. In the electronics industry the setback was rather sharp (exports dropped from July 2006). If the changes in the industry are successful, we can expect positive exports growth rates already by the 2nd half of this year.

4. Structural changes are also influencing the exports of timber (and related) industries, where the price growth of imported timber (because of higher exports customs in Russia) forces many companies to give up production plans based on cheap production, and to close or make significant changes in production. New business plans should be based on more expensive raw materials and labour (Estonia's own timber resources are not used mostly because of unfavourable selling prices vs high costs). We are of the opinion that the correction in this sector might still be quite a lengthy

Annual Growth of Foreign Trade in Some Product Groups (4 months)



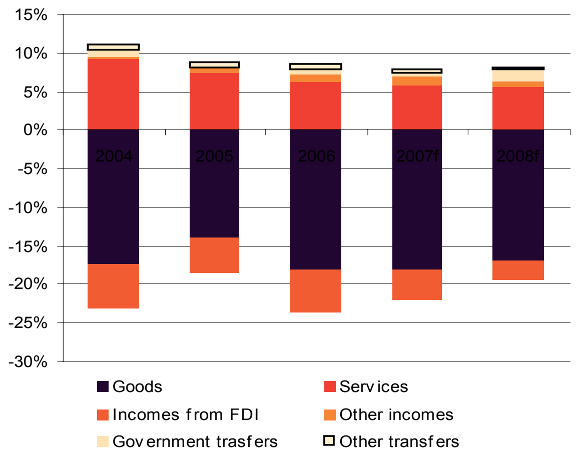
Source: ESA

process (industrial production in the sector grew very slowly in 2006, in this year it has fallen).

The stagnation of foreign trade turnover has appeared because several significant processes for exports are taking place at the same time. We are expecting exports growth rates to recover slowly; a more significant recovery could be expected only in autumn.

Russia has posed unofficial sanctions for Estonian companies in May. Estonian companies were affected rather modestly (some food processing companies), as after the 1998 crises, Estonian companies have been very careful with building up tight and extensive economic connections with Russia[9]. The more significant impact could be seen in cargo flows, where Russian railway authorities have allowed the use of limited capacity, only by Russian companies. This type of fall in cargo flows (ca 20-30%) will cut the revenues of state owned Estonian Railway and Tallinn Port; falls with the same amplitude have happened in past (e.g. in Tallinn Port liquid cargo fell 38% yoy in Feb 2006, close to 10% in Jan 2007 and 7.5% in April 2007). So we could expect some negative impact on the revenues from transport services, which however, as we talked about in the previous issue of the Baltic Outlook, are hardly possible to forecast, hence we have been quite conservative in making forecast and kept low growth outlook.

Current and capital account, % of GDP



Source: EP; HBM calculations and forecast

The outflow of incomes in the 1st quarter was slightly bigger than expected as reinvested earnings were stronger than we forecasted. This means that despite growing costs, foreign companies have managed to keep their profitability high. But we are still of the opinion that profitability will fall this year, and consequently the outflow of incomes will diminish. The negative outcome came also from small transfers from EU funds in the 1st quarter (and the 2nd quarter seems to repeat the same), which has significantly changed our expectations. Still, we cannot exclude the possibility that the transferred sums will strongly increase by the end of the year.

As a result, we have changed our expectations regarding foreign trade, and current account towards a more negative outcome in 2007: when in spring we expected the current and capital account deficit being 10.5% of GDP (9-12%), then now we see the probable range as 12-14%.

Maris Lauri

9 Transit goods are dominating the Estonian-Russian trade (Russian raw materials, particularly oil, to western countries, and food, consumer and investment goods from there to Russia)

Latvia

1. Recent Economic Developments

Data for the recent months confirm that domestic demand pressures have abated and preconditions for a soft landing (i.e. return to sustainable economic growth of 6-8% pa) have set in. In the 1st quarter of 2007, however, growth still replicated that of 2006 – GDP grew by a hasty 11.2% yoy, and imbalances widened. Domestic demand sectors grew faster than external demand sectors, e.g. wholesale and retail trade by 15.3% yoy whereas manufacturing by a mere 2.4%. Current account deficit expanded to 25.7% of GDP. The labour market tightened further and nominal net wage growth topped at 33.4% yoy supported by public sector salary reform.

A turnaround came in the 2nd quarter as the government started to implement its anti-inflation plan aimed at curbing domestic demand growth. Namely, albeit due to economic inertia and expectations of credit tightening[1] growth is still rapid and unbalanced and core inflation is rising, retail trade growth rates have shrunk below those in the 1st quarter, residential real estate price growth stalled in May followed by a 3.6% mom drop in June (cumulative growth at 8% in the 1st half of the year), consumer and business confidence levels have moderated, credit growth has slowed, and the government has accumulated a solid budget surplus[2]. We expect a slowdown to become increasingly evident in the 2nd half of the year.

Following volatility outburst in February 2007, the forex market has stabilized, though at a cost of largely closing down the interbank forward market (i.e. the Bank of Latvia does not act as counterparty in forward deals at reasonable maturities and thus the market hibernates). The lats' interest rates have come down and the central bank has more than recouped its reserves that were sold in February-April 2007.

2. Economic Forecast

2.1. Assumptions and Summary of the Forecast

Our forecast is based on the following assumptions:

- the external environment remains quite favourable (see General Assumptions);
- the anti-inflation plan is implemented in a swift and comprehensive manner (including at least balanced budget in 2007 and at least 1.5% surplus in 2008-2009); economic policy is promptly tightened if the slowing is insufficient.

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.5	7.2	8.7	10.6	11.9	9.0	7.0	7.0
GDP, mln euros	9,911	9,978	11,176	13,012	16,180	19,753	22,848	26,109
GDP per capita, euro	4,238	4,291	4,832	5,655	7,072	8,719	10,128	11,635
Growth of GDP deflator, %	3.6	3.6	7.0	10.0	11.1	12.0	8.1	6.8
Growth of consumer prices, %	1.9	2.9	6.2	6.7	6.5	8.0	5.5	4.5
Growth of harmonized consumer price index, %	2.0	2.9	6.2	6.9	6.6	8.0	5.5	4.5
Growth of producer prices, %	1.0	3.2	8.6	7.8	10.3	18.0	na	na
Harmonised unemployment level, %	12.2	10.5	10.4	9.0	6.9	5.5	5.2	5.0
Real growth of average net monthly wage, %	6.0	7.8	2.4	9.5	15.5	13.0	8.0	7.5
Growth of exports of goods and services, %	8.7	14.4	21.2	31.4	14.5	21.8	17.6	16.4
Growth of imports of goods and services, %	9.1	19.5	26.8	27.4	28.6	19.8	10.9	10.3
Balance of goods and services, % of GDP	-10.0	-12.7	-15.8	-15.1	-21.0	-20.0	-16.5	-13.6
Current account balance, % of GDP	-6.6	-8.1	-12.9	-12.6	-21.1	-21.6	-18.2	-15.5
Current and capital account balance, % of GDP	-6.4	-7.5	-11.8	-11.2	-19.9	-18.3	-15.2	-15.5
Net FDI, % of GDP	2.7	2.4	4.3	3.7	7.4	5.5	4.0	3.5
Foreign gross debt, % of GDP	72.7	79.6	93.2	100.7	112.8	120.0	120.0	120.0
General government budget, % of GDP (ESA)	-2.3	-1.6	-1.0	-0.2	0.4	0.5	1.5	1.5
General government debt, % of GDP	13.5	14.4	14.5	12.0	10.0	10.2	10.5	9.4

1 Certain anti-inflation plan measures make future spending more expensive which affects current spending. For instance, higher tax on car purchases boosted demand for cars before June 1st when the tax came into effect.

2 In January-June it reached 1.9% of expected annual GDP. In contrast to 2006, the surplus is deposited at the Bank of Latvia (previously at commercial banks) and thus in effect cuts market credit potential by the respective amount.

Implementation of the anti-inflation plan

Measure	Planned activity	Planned to come/came into force
Fiscal policy and budget	No extra spending in 2007, balanced budget 2008, surplus in 2009-10	2007
	3 year medium term budget planning; basic budget expenditures cut by 1-3%	2008
	Stop employment and slow wage growth in public sector	2007
Taxes & duties	Tax on capital gains from RE* sales being a part of equity (>50%) for businesses	Jun 12th 2007
	Differentiated higher fees for RE and collateral registration in Land Register	Apr 16th 2007
	Additional tax on car purchases	Jun 12th 2007
Credit expansion	State Revenue Service confirmed income to receive a bank loan	Jul 10th 2007
	Confirmed income for certain purchases above 100 min wages	Jul 10th 2007
	10-15% down payment for a loan	Jul 10th 2007
	Common credit register	Jan/2008
Labour market	Increase labour mobility and economic activity in regions	
	Adequate immigration policy	
	Improving productivity	
Energy prices	Raising energy efficiency	
	Public Utilities Commission takes over regional regulators	
Competition	Enhancing competition (esp. in construction and retail/ wholesale trade sectors)	

For details see Appendix in May Baltic Outlook, * RE - real estate

In the early 2007 economic growth and inertia has been stronger than anticipated, and some of macro imbalances will widen somewhat further before a trend improvement, which is expected to clearly set in later in the year. Driven by a slowdown in domestic demand growth, the GDP growth forecast is retained at 8–9.5% in 2007. We expect a moderate decrease in residential real estate prices in the 2nd half of 2007 to perhaps the level of late 2006, i.e. cancelling the gain of early 2007. The CPI inflation forecast is still at 7.5–8.5%. The unemployment rate is expected to reach 5.2–5.8%. Real net wage growth has been revised to 12-14% in 2007 (8-10% before) on the account of faster than expected 1st quarter wage growth, largely driven by public sector salary reform. Though we retain the earlier forecast of 9-11% private consumption and 6.5-8.5% gross fixed capital investment growth, it is increasingly likely for these forecasts to be revised upwards in October. Nominal exports and imports growth for 2007 has been raised to respectively 19-23% and 16-20% (17-20% and 13-15% before) on account of still favourable terms of trade[3] and strong consumption and investment inertia. Accordingly, CAD forecast for 2007 has been increased to 20-22% (18-20% before).

This is our base or soft landing scenario. The success of soft landing depends upon businesses' ability to improve their productivity by reducing their labour dependency and moving up the value added chain. The hard landing scenario assumes a more abrupt decrease in economic activity with positive but very low growth rates and a sizeable real estate crash. We see two possibilities for the negative scenario to ensue:

1. implementation of the anti-inflation plan is too soft and macro imbalances strengthen considerably as reduction in domestic demand growth is not sufficient;
2. implementation of the anti-inflation plan turns out to contract domestic demand abruptly and induce a self-generated recession.

We do not see a significant possibility of a currency crisis as financial markets are thin and sealed off by LaB. Our analysis suggests that the soft landing scenario has a considerably higher probability than the negative one.

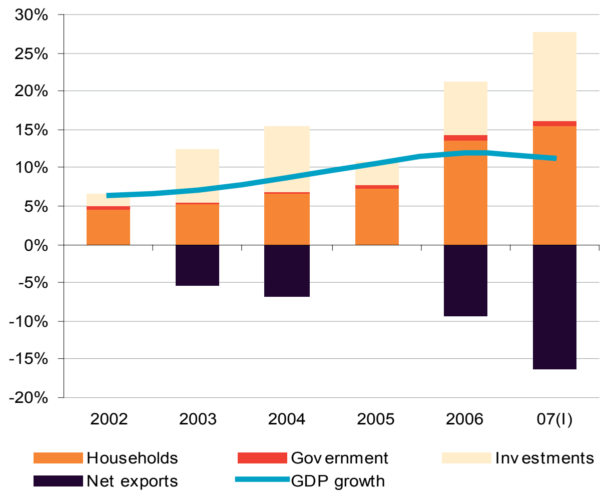
2.2. Domestic Demand

As in 2006, economic growth is still predominately domestic demand-driven. In the 1st quarter of

3 I.e., growth of export prices exceeds that of imports, which implies that in nominal terms exports volumes grow faster than that of imports even with identical real growth rates. Of course, rising exports prices may reduce the country's external competitiveness.

2007[4] the largest domestic sector, wholesale and retail trade, grew by 15.3% yoy (expanding to 22.1% of GDP). While the real estate, renting, and business activities sector slowed to 10.3% yoy from above 16% throughout 2006, construction growth sped up to 17.1% from 13.6% a quarter before. In contrast, the key exporting sector, manufacturing, grew by mere 2.4% (contracting to 10.9% of GDP) being the second weakest performance since the 1998 Russian crisis.

Contributions to the GDP Annual Growth



Source: Eurostat

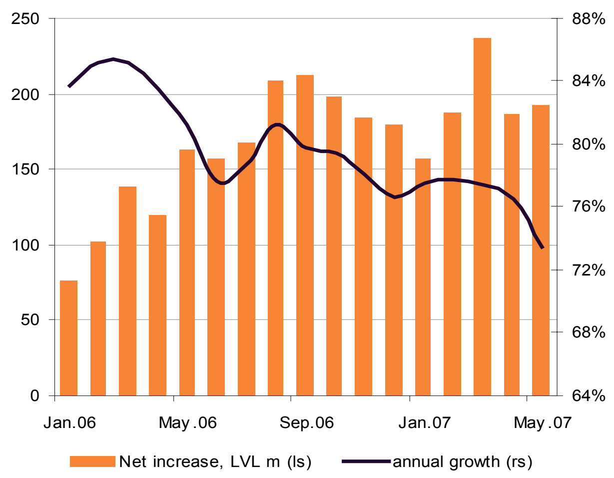
2.2.1. Private Consumption and Savings

In the 1st quarter of 2007 real private consumption grew by 20.5% yoy, which is a moderate slowdown compared to 23.8% in the quarter before and marginally above our forecast. Consumption was driven by strong wage, employment, and credit growth, as well as high overall optimism and rooting inflationary expectations. The slowing effect of the rising lats' interest rates was partly circumvented by borrowing in euros.

Optimism and negative real interest rates have been shifting incentives away from savings and towards consumption. Resident household deposits grew by 42% yoy in the 1st quarter (45% in 2006), which is far below the volumes of credit growth. Gross savings for the whole economy in the 1st quarter were at mere 10.3% of GDP (17% in 2006, 21.7% in 2005).

The 2nd quarter consumption data are not yet available but leading indicators suggest a continuation of slowing. Household credit cautiously slowed to 73.4% yoy in May from 77.4% in the 1st quarter. Retail trade turnover in April-May grew by still high 24% yoy, which is nevertheless below 28% in the 1st quarter.

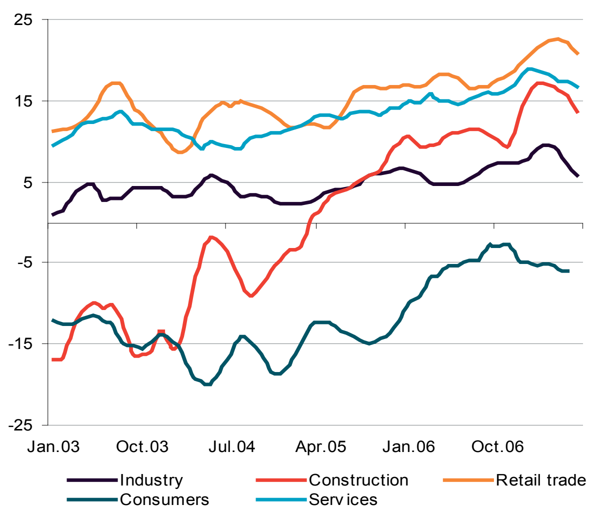
Loans to Households



Source: FCMC

More pronounced cooling of demand is anticipated later in the year. Wealth effects ebb as residential real estate prices shed 0.6% mom in May and extra 3.6% in June (a slight further correction is likely). As from July 10, borrowers must obtain the State Revenue Service notice on their taxable income if their loan exceeds 100 minimum wages (i.e. LVL 12,000). Thus, households with undeclared incomes will be increasingly credit constrained. Consumer confidence (12 month outlook) is retrenching, signalling that consumers are likely hold down consumption growth[5]. Also confidence in the retail trade, services, and construction (3 months outlook) has started to step down. Demand is expected to ease also as consumers had brought forward their expenditures before the anti-inflation plan implementation, i.e. knowing that certain goods/ services will become more expensive, they

Confidence Indices (3m average), s.a.



Source: Eurostat

4 2nd quarter GDP data will become available only in September.

5 Confidence sub-indices regarding planned major consumer purchases over 12 months are strongly diminishing.

have boosted their demand prior to the legislative changes coming into force, which must be followed by lower demand later on.

We cautiously retain our earlier forecast of private consumption growth at 9-11% in 2007; an upward revision is likely if a clear credit growth slowdown is not firmly established in the 3rd quarter.

2.2.2. Investments

In the 1st quarter of 2007 real gross fixed capital formation grew by 17.9% yoy, exceeding our forecast. Investments share in GDP in the 1st quarter rose to 30% of GDP up from 28% a year ago. Though rising to 2% of GDP (1.6% in 2006), the influence of EU structural funds on total investments is fairly limited.

Investment growth is expected to moderate. First, investment has expanded to perhaps unsustainable levels and its further growth at rates considerably above those of GDP is unlikely[6]. Second, owing to the anti-inflation plan, domestic demand sectors are expected to cool down – predominately wholesale and retail trade, construction and real estate activities (currently jointly accounting for about 30% of total non-financial investment). Investment activity in exporting sectors, such as manufacturing, is expected to increase, as they benefit from easier access to labour and financing resulting from slowing domestic demand. Yet, investments in exporting sectors would not fully compensate for the decrease in domestic demand sectors.

We retain our earlier forecast of gross fixed capital formation growth at 6.5–8.5% for 2007. Yet, given the exceptionally strong investment activity in the 1st quarter and strong inertia, we are very likely to revise the forecast upwards to about 11%.

2.2.3. Government Consumption

In the 1st quarter of 2007 real final consumption expenditures of the general government grew by 4.5% yoy (4% in 2006) reflecting growing current expenditures (particularly wages). Due to strong economic activity net revenues grew by 30.1% yoy in 6 months of 2007 (49.7% of the annual plan) while net expenditures were up by 31% yoy (42% of the plan). Current expenditures were almost as planned (45% of the plan), whereas capital expenditures remained low (24.4% of the plan). Hence, by the end of June the general government had accumulated a surplus of LVL 254m (1.9% of forecasted annual GDP).

On June 21 the State Treasury announced changes to its 2007 borrowing plans. By reason of rising lats' debt service costs (due to low liquidity and a high interest rate spread over the euro) the scheduled lats' debt issuance is replaced with euro debt until borrowing conditions improve. Consequently, EUR 500m bonds are to be issued in autumn 2007 while the 11-year lats' bonds issue planned for late June is cancelled.

General Budget, Annual Growth Rates %

	2005	2006	6m 07	2007*
Net revenues	26.7	25.7	30.1	23.2
Tax revenues	26.3	30.3	36.5	21.6
Personal income tax	16.9	29.1	36.7	16.0
Social tax	17.1	28.1	39.0	14.4
Corporate income tax	41.3	40.5	55.2	31.5
VAT	39.1	37.4	33.4	33.0
Excises	31.2	16.6	22.7	18.5
Customs	12.2	7.6	39.9	7.8
Non-tax revenues	19.3	13.1	10.7	9.4
Net expenditures	25.7	24.4	31.0	24.8
Current expenditures	33.8	23.3	31.8	23.6
Capital expenditures	31.3	63.1	46.7	21.5

Source: State Treasury, State Revenue Service

*budget plan

The Ministry of Finance claims to use borrowing only for debt rollover (EUR 200m in 2008) and refinancing, not current expenditures. In view of the government's repeated statement to ensure a balanced budget in 2007 (instead of the initially planned 1.4% deficit), we retain the forecast of government consumption growth at 2-3%; government debt will remain close to 10% of GDP – one of the lowest in EU. However, we do stress that the budget surplus already in 2007 is a more efficient choice to support a soft landing.

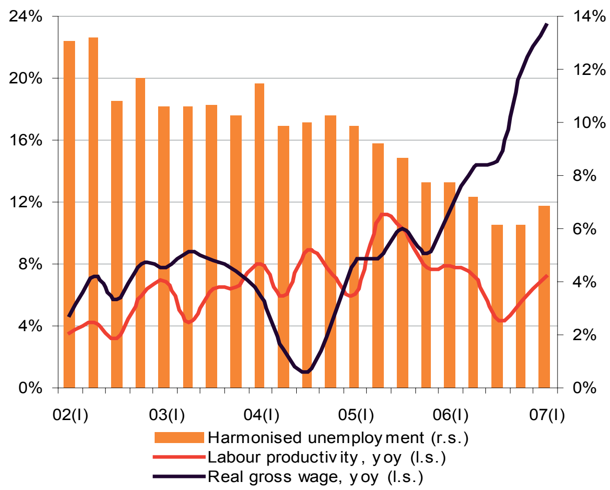
2.2.4. Labour Market

The labour market has tightened further. In the 1st quarter of 2007 nominal net wage growth accelerated to 33.4% yoy (real net wage up by 23.9%). Though healthy average labour productivity growth ensued, at 7.2%, the wage-productivity gap has widened further. Wages have risen rapidly in the public sector (by 35%) and especially so in state budget-funded institutions (36.7%). As private sector statistics are exaggerated by the legalisation of previously undeclared income, the divergence in the public/private sector might be even more pronounced. Therefore, the public sector has become a significant wage-growth driver. The public sector exerts pressure on the labour market also via high vacancy rates (e.g. 5.7% in public administration and defence, which is by far the highest among all sectors) – it would be fiscally responsible to address

6 Already for a few years the share of gross fixed capital formation has been above 35% of GDP. The average for EU25 in 2006 was at 21.7% whereas for EU8 at 31.1%.

staff shortages by improving productivity rather than simply driving up wages to fill in the vacancies. Given the unexpectedly strong wage growth early in the year, we raised the real net wage growth forecast for 2007 from 8-10% to 12–14%.

Labour Market Indicators



Source: LCSB, Eurostat

Labour productivity growth in key exports sectors was sluggish and considerably below wage growth, e.g. 6.9% yoy in manufacturing (major goods' exporter) and 2.4% in transport, storage, and communications (major services exporter). Excellent results were achieved by other exporters – financial intermediation (up by 21.4%) and hotels and restaurants (24.4%).

In the 1st quarter of 2007 employment reached 1,083.7 th, but the growth rate was down sharply to 2.6% yoy from the last year's overall rise of 4.9%. This is in line with our earlier 2.5% forecast for the whole of 2007. Employment shares shifted further in favour of mostly domestic demand sectors as real estate, renting and business activities increased their workforce by 35% yoy, construction by 26.7% yoy and financial intermediation by 17.6% yoy. The number of vacancies rose by 26.1% yoy to 21.6 th, almost 75% of them in Riga. Harmonised unemployment shrunk from 7% in January to 5.6% in June. As this is in line with our expectations, we maintain the unemployment forecast of 5.2–5.8% in 2007.

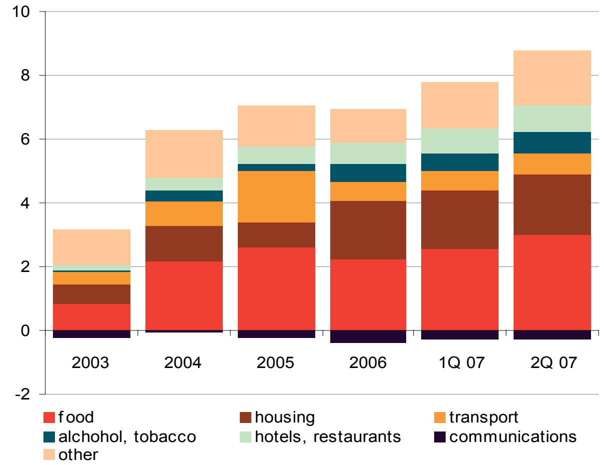
2.2.5. Inflation

In the 1st half of 2007 CPI inflation accelerated through vigorous domestic demand and a strengthening wage-price spiral. Following a fleeting slowdown in May (8.2% yoy), inflation picked up to 8.8% yoy in June. The core inflation contribution to CPI has grown to above 70%, indicating that inflation is primarily driven by demand, rather than by supply.

Producer price inflation soared to 17.9% yoy in May 2007 (10% a year ago), which to large extent reflects a tighter labour market. It will put additional pressure on CPI inflation, as businesses pass their rising costs onto consumers. However, they will have fewer opportunities to do so as domestic demand growth is expected to slow later in the year.

The forecast of 2007 CPI inflation of 7.5-8.5% is currently retained (it heavily relies, however, on seasonal food price deflation in summer).

Contributions to CPI Annual Growth, pp



Source: LCSB

2.3. External Balances

The current account deficit widened to 25.7% of GDP in the 1st quarter (14.6% a year ago but less than 26.3% in 4Q 2006), which is somewhat larger than expected. While traditionally the largest part of CAD was due to the goods' trade deficit (26.7% of GDP vs. 22.5% in 1Q 2006), the current rise in CAD was largely contributed by a diminished surplus of current transfers (0.4% of GDP vs. 5.4% in 1Q 2006). This was due to growing transfers' outflow (42.2% yoy) and decreasing transfers' inflow (17.7%). The income account deficit was 2.8% of GDP (2.3% a year ago). This was mainly on account of larger dividend and interest rate payments, which caused income outflow to grow by 43% yoy to 8.7% of GDP. In turn, the compensation of residents employed abroad increased by 12.8% (staying at 2.4% of GDP).

The capital account surplus widened to 2% of GDP as EU disbursements (structural funds especially) grew by 48%. The combined current and capital account deficit was at 23.7% of GDP (12.9% a year ago). The deficit was financed by FDI (39.2%

of CAD) and bank loans. Net FDI reached 8.5% of GDP in the 1st quarter of 2007 (9.5% a year ago). The share of FDI flows to financial and real estate sectors shrunk to 33.8% and 12.6%, respectively (37.6% and 16.6% in 1Q 2006). In turn, 26.3% went to trade (8.5% a year ago) while mere 5.9% were invested in manufacturing (9.3% a year ago).

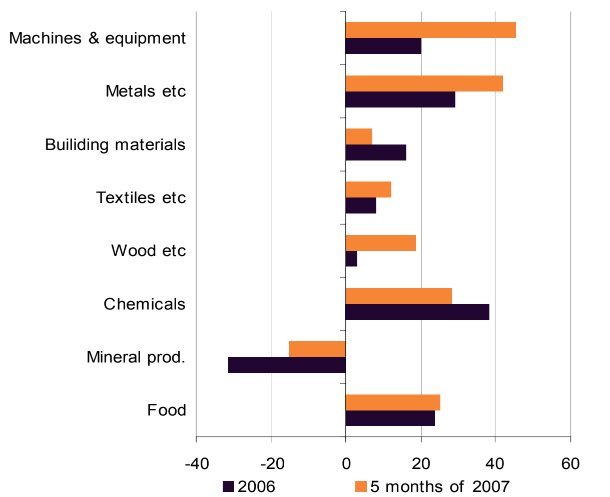
Before improving later in the year (expectations supported by e.g. diminishing optimism, slowing credit expansion) CAD may marginally widen further, driven by stronger than expected economic growth in early 2007 and stronger than expected economic inertia (due to earlier made orders etc.). On the account of this CAD forecast is revised to 20-22% of GDP for 2007 (18-20% before).

2.3.1. Foreign Trade

With export prices growing fast (record 15.9% yoy in 1Q 2007), exports of goods and services rose by 8.4% yoy in real terms; however, it is an encouraging pick up after a 3% yoy decrease in the previous quarter. With only a 6% yoy rise in import prices (the lowest increase over 3 years), imports of goods and services shot up by 29.5% in real terms. Thus, while competitiveness is eroded by widening productivity-wage gap, its impact is alleviated by favourable terms of trade. The fact that Latvian export prices have grown without a large negative impact on export volumes (real growth strengthens) shows that Latvian producers have been vigorous to maintain competitiveness even although costs grow rapidly (including wages). However, there is a need to move into higher value-added products as low production costs are not the factor to rely on in order to achieve sustainable economic growth.

Goods exports grew by 23.6% yoy in 5 months of 2007 (in May by 27.2% yoy) despite poor industry

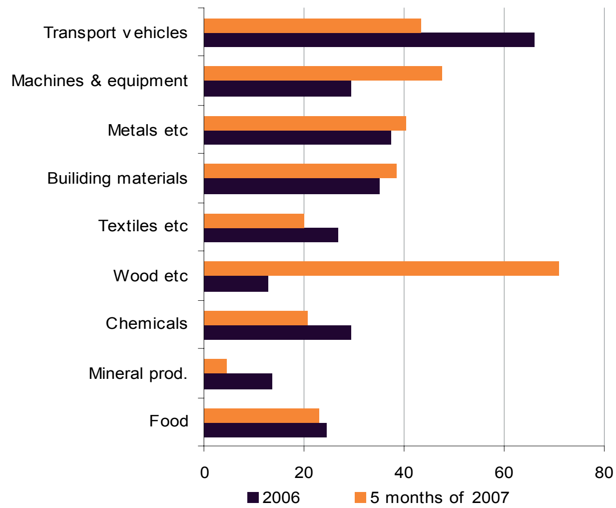
Annual Growth of Exports, %



Source: LCSB

developments. This is partly owing to favourable exports price developments. Metals and machinery and equipment showed particularly outstanding results (41.8% and 45.5% yoy, respectively) increasing their share in total exports to 26.6%. These are encouraging developments as the exports structure becomes more diversified. Other positive trends are in the wood industry (exports up by 18.7% yoy). In turn, exports of mineral products are still experiencing a decline (15.1% yoy). In view of persistently better than anticipated exports performance (further supported by exports sectors becoming more attractive as domestic demand cools off), previously cautious nominal goods and services exports growth forecast for 2007 is revised from 17-20% to 19-23%.

Annual Growth of Imports, %



Source: LCSB

Goods imports grew by 30.4% yoy in the first five months of 2007 driven by stronger than anticipated consumption and investment. Imports of wood products accelerated to 71.1% yoy mainly due to a shortage of local timber supply, as a consequence of unfavourable weather conditions. Growth was rapid for machinery and equipment (47.6%), metals (40.5%), and building materials (38.4%). While still growing fast, transport vehicle imports slowed to 43.4% yoy. There were positive developments in May, when transport vehicle imports[7] grew by only 8.7% yoy – while largely due to high base, we expect this trend to continue as legislative changes come into force from June and July[8]. We see imports growth to ease substantially in the 2nd half of 2007 resulting from implementation of the anti-inflation plan. The adjustment, however, is likely to be slower

7 A large share of this has been passenger cars that are predominantly used for consumption.

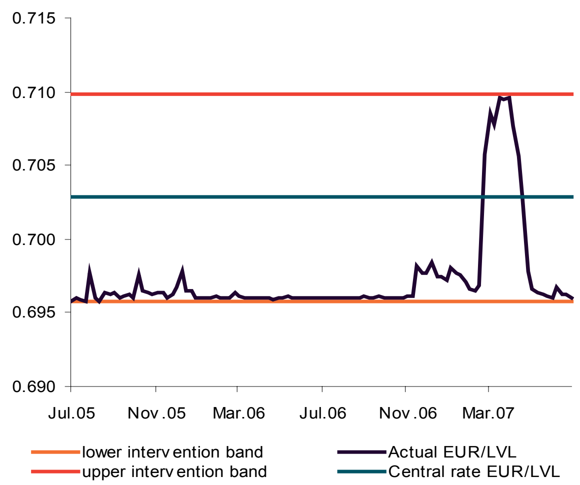
8 Additional tax on cars depending on engine size; requirement to submit a notice from the State Revenue Service about the declared taxable wage if the size of the loan exceeds 100 minimal wages (LVL 12 th)

than anticipated[9]. Besides, as exports' growth has exceeded forecasts, this also means larger imports[10]. Consequently, the nominal goods and services imports growth forecast is revised to 16–20% in 2007 (13–15% before).

3. Monetary Policy and Interest Rates

After the 1st quarter turmoil triggered by devaluation rumours, EUR/LVL rate remained above the peg rate of 0.7028 for two months (but always within the official +/-1% fluctuation band around the peg) before returning to the band's strong territory. Since late April the lats rate has been in the vicinity of the band's strong edge, and the Bank of Latvia has so far more than recovered the forex reserves it sold in February-April (i.e. EUR 482.6m vs. EUR 332.1m).

EUR/LVL Spot Rate

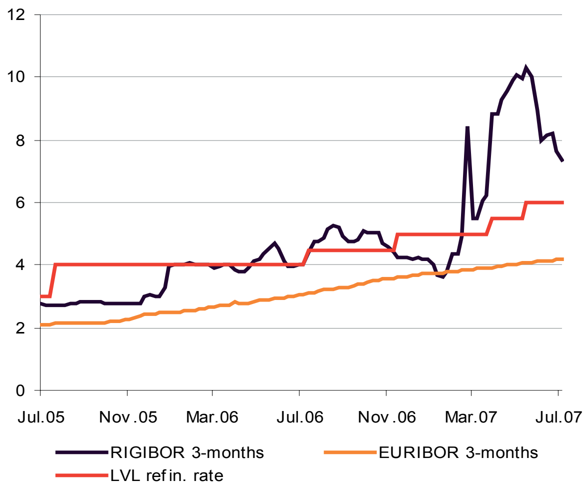


Source: LaB, Reuters

To slow credit growth and follow the euro base rate dynamics, over the course of the 2nd quarter LaB raised the lats' refinancing rate twice each time, by 50bp. The first increase to 5.5% became effective on March 24, the second increase to 6% on May 18. During its May meeting LaB also raised its overnight credit facility by 1 pp to 7.5% thus increasing the cost of fulfilling the 8% mandatory reserve requirement in case of the lats shortages. In its June and July meetings no further tightening was done.

In April-May the interbank interest rate structure was rather flat, with rates of all maturities around 10%, mainly driven by tight liquidity conditions, hedging, and some speculative activities. With LaB retaining only 1 week forex swaps and exiting from longer instruments, forward market activity soon subsided. LaB interventions by recovering its forex reserves gradually filled in the lats' liquidity shortage and by June the overnight rate had fallen below the refinancing rate. As liquidity expectations stabilised, longer rates have gradually decreased as well.

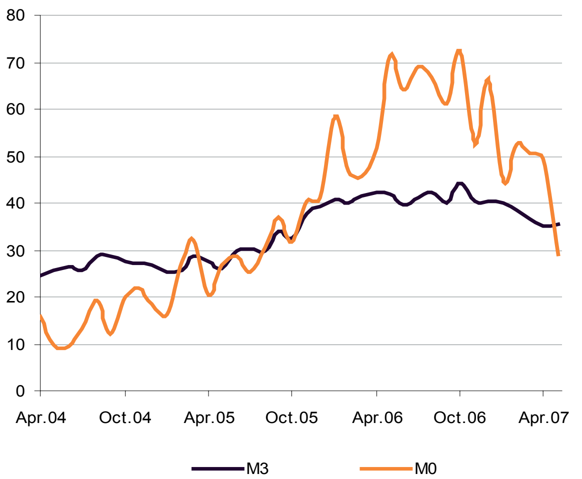
Interbank Interest Rates



Source: LaB, Reuters

By the end of June LVL 185.9m of budget funds were deposited at LaB due to high central government budget surplus, i.e. effectively withdrawn from the money supply, thus holding up interest rates and limiting credit growth. Growth of M0 (monetary base) has slowed to 28.9% yoy in May (66.5% in late 2006). M3 growth has gradually retreated to 35.4% yoy in May from 40.3% in late 2006. Slowdown in money supply growth is expected to assist in curbing inflation by holding up interest rates and decreasing optimism.

Annual Growth of Money Supply, %



Source: LaB

9 The lag between the order/contract (put when confidence was high) and actual imports is substantial, thus strengthening inertia.

10 Our estimates show that imports' share in exports could be up to 20% (imported intermediate goods used for exports afterwards).

The average weighted lats' deposit rate increased to 6.95% in May (4.2% in late 2006) owing to rising money market rates while euro deposits had the average weighted yield rate of 3.9% (3.5% in late 2006). In view of higher inflation, real interest rates of the lats and the euro (due to the exchange rate being fixed) remained negative; the savings stimulus of higher nominal deposit rates on slowing consumption has so far been modest. Consumption growth was largely affected by higher credit interest rates[11], which in May reached 12.7% for the lats and 6.1% for the euro (9.3% and 5.7% in late 2006, respectively). The spread between the average weighted lats' credit and deposit rates grew to 5.7% in May (5.1% in late 2006 and 4% in late 2005). The interest rate spread between euro deposits and borrowing was at 2.2% in May 2007 (2.2% in late 2006 and 4.5% in late 2005). This has stimulated a shift in borrowing away from the lats and towards the euro.

Mārtiņš Kazāks
Lija Strašuna
Dainis Stikuts
Ilze Ramza
Pēteris Strautiņš

11 These are average weighted interest rates.

Lithuania

1. Recent Economic Developments

Lithuania's economy started the year with fairly impressive results. Lithuanian revised GDP growth statistics points to 8.3% annual growth achieved in the 1Q 2007, which is 1.2pp higher than the first estimate. In 1Q 2007 the most vigorous growth rates were observed in construction value added (26.2%). It has most rapidly augmented for already sixth quarter in turn. Stipulated by very rapid developments in construction, the real growth of investments was robust (excl. inventories – 32.3%). Household spending also increased vigorously by 12.4% in real terms, being driven by rising incomes (compensation to employees went up by 21.4% in nominal terms), employment, and borrowing.

As a result of strong consumption, retail sales soared (21.1% yoy). The industrial sales' growth (only 0.3% yoy) was impeded by lower production of refined petroleum products, relating to weaker operations of the Mazeikiu Nafta oil refinery. Excluding petroleum products, industrial sales attained a healthy growth of 14.7% yoy over the first five months of the year.

Strong domestic demand stimulates imports, and as a sequence the current account deficit widened induced by higher foreign trade deficit. According to preliminary data, during five months of this year Lithuania's current account deficit reached 14.1% of our projected five months' GDP.

Consumer price inflation accelerated to 4.8% yoy in June with rapid growth in the prices of foodstuffs (9.1% yoy) and utilities (housing, water, and electricity etc. 11.4% yoy). The average annual inflation for the last 12-month period was 4.3%.

The international rating agency Standard & Poor's has revised Lithuania's ratings outlook to negative, from stable. The revision was based on a pick up in domestic demand in the first part of 2007, which is increasing the likelihood of overheating the country's economy. According to the agency, fiscal policy was and currently is the main macroeconomic instrument in demand management. If the government fails to tighten its fiscal stance and implement additional measures to tame domestic demand, the external imbalances would build up further and the ratings for Lithuania could be lowered. Conversely, the government could tighten its fiscal stance in the short term to restrain domestic demand and to reduce inflationary pressures; thereby the outlook could be revised back to stable.

2. Highlights of the Forecast

Due to stronger than expected economic growth in the 1st quarter of the year and continuously strong household consumption, we upgraded our forecast for investments and government spending in GDP growth from 7% to 8% in 2007 and from 6.5% to 7% in 2008. We do not rule out a possibility of an

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.9	10.3	7.3	7.6	7.5	8.0	7.0	6.5
GDP, mln euros	15,018	16,452	18,126	20,621	23,746	27,441	31,183	34,870
GDP per capita, euros	4 329	4 763	5 276	6 040	6 996	8,122	9,266	10,398
Growth of industrial sales, %	3.1	16.1	10.8	7.1	7.3	7.1	7.0	6.5
Growth of GDP deflator, %	0.1	-0.9	2.7	5.7	7.1	7.0	6.2	5.0
Growth of consumer prices, %	0.3	-1.2	1.2	2.7	3.8	4.5	4.5	3.3
Growth of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8	4.5	4.5	3.3
Growth of producer prices, %	-2.8	-0.5	6.0	11.5	7.4	5.4	5.4	4.0
Harmonized unemployment level, %	13.5	12.4	11.4	8.3	5.6	5.0	4.9	4.8
Growth of real net wage, %	3.8	9.3	4.9	7.8	15.2	15.0	10.5	5.5
Growth of exports of goods and services, %	13.4	6.2	12.0	27.0	17.7	13.3	16.0	13.0
Growth of imports of goods and services, %	13.1	6.9	14.2	26.1	22.6	19.0	15.1	11.7
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.3	-13.5	-13.2	-12.5
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-14.0	-13.5	-12.5
Current and capital account, % of GDP	-4.7	-6.4	-6.4	-5.9	-9.7	-12.8	-12.2	-11.3
FDI inflow, % of GDP	5.1	1.0	3.4	4.0	6.0	3.5	3.6	3.7
Foreign gross debt, % of GDP	39.2	40.1	41.8	51.3	60.7	66.0	67.6	68.7
General government budget position, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.3	-0.5	-0.5	0.0
General government debt, % of GDP	22.2	21.2	19.4	18.7	18.2	18.0	17.7	17.3

even higher cyclical increase of growth rates in the nearest 1-3 years, considering the currently good business and consumers' sentiment, and the lack of policies aimed to limit the risks of overheating.

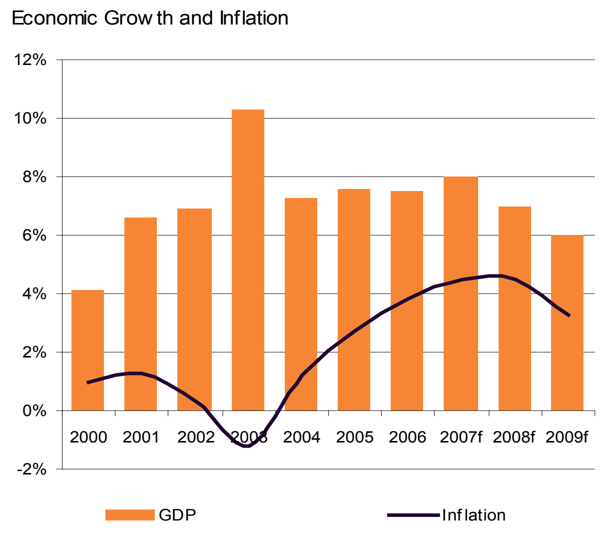
Observed recent developments in the labour market with strong salaries growth and continuously growing demand for employees supported our expectations on strong wage growth. However the Lithuanian government's decision to raise the minimum salary from LTL 600 to LTL 700 (EUR 203) from the 1st of July – three months earlier than originally planned – inclined our real wage forecast upgrade from 14% to 15% for this year. For the next year we will sustain a 10.5% real wage growth forecast. This year we also forecast a lower than previously anticipated unemployment rate (5% instead 5.4%), which may remain almost unchanged (4.9%) in 2008 due to a structural mismatch of labour demand and supply. Although the constructions and service sectors generate an increasingly strong demand for employees, some sub-sectors of manufacturing can be expected to reduce employment in such a way that it increases (at least temporary) the pool of unemployed.

In response of stronger than previously forecasted consumption, which is expected to boost imports further, we anticipate the current account deficit will increase to a bigger extent – we revised the forecast to 14% of GDP this year. We did not change average annual inflation forecasts (4.5% in both 2007 and 2008) however we are considering an upgrade (by 0.2-0.5 pp.) in the end of the year due to higher price pressures related to booming consumption. Other forecasts are largely retained from the previous issue (May) of the Baltic Outlook, while in the following sections we will discuss the latest changes in forecasts in more details.

3. Economic Growth

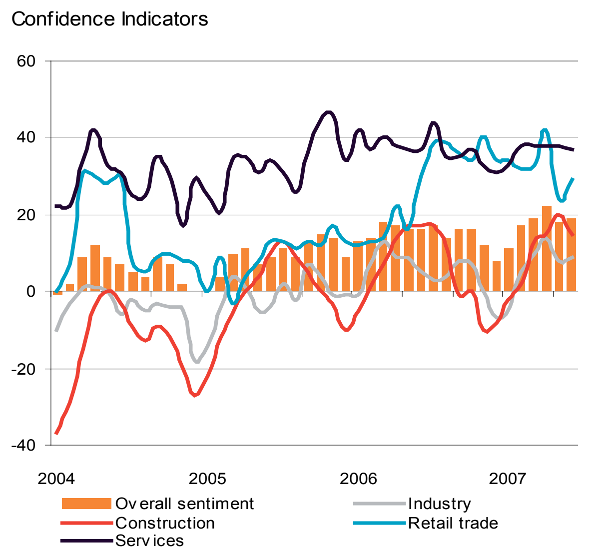
Boosting household consumption is still the main force driving the Lithuanian economy. Economic growth is projected to remain at the same level for several consecutive years. We forecast a robust GDP rise of 8% this year and only a slight slowdown to 7% next year. As it was in recent years the domestic demand will continue to be the growth engine of Lithuania's economy. Therefore, increasing household and government consumption as well as domestic investments fuelled by traditional factors – growing borrowing (although at slower pace), higher wages, transfers from emigrants and EU support – will drive the economy.

In the second half of this year recovered exports data should also add more impulses to the economy's



Source: LDS, HBM forecast

growth. The biggest exporter, the Mazeikiu Nafta oil refinery should show better results due to lower comparable base starting the second half of last year. In July 2006, the company reduced production due to the crude oil supply suspension from Russia as a result of the Druzhba pipeline damage. Further output decline followed in October after a fire in the refinery. The company is expected to return to its pre-fire refining capacity by the end of this year.



Source: LDS

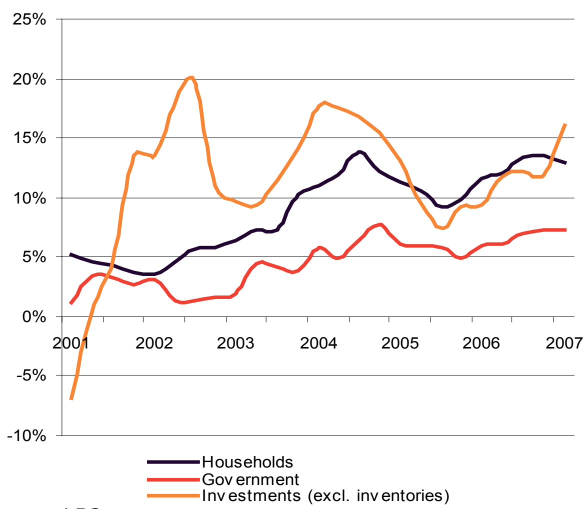
Moreover, economic participants do not lack optimism. Economic sentiment indicators show a positive outlook regarding favourable development in the economy. Compared to a year ago all indices improved or remain unchanged, only the construction confidence index worsened due to a shortage of workers.

3.1. Domestic Demand

3.1.1. Household Consumption and Income

As it was mentioned above, household consumption will remain the main driver for economic growth. The labour market is continuously tightening – wages grow vigorously and the unemployment rate is still decreasing. A lack of workers is becoming a serious problem for many companies. For instance, we observe worsening expectations on growth of the number of employees in the construction sector, because few employers retain hopes for finding additional specialists to recruit. In other companies, headhunting is becoming more and more popular as employers can not easily find workers in the market. With the intention of keeping existing employees, employers are constrained to increase salaries. The first quarter surprised us with extra-fast growth of gross wages, although one should keep in mind that the statistics may exceed the actual developments due to ongoing income legalization (businesses stop "saving" on taxes and start reporting the full salary paid to employees).

Domestic Demand (12 month rolling real growth)



Source: LDS

Considering recent developments in the labour market we increased our forecast for wage growth and decreased the unemployment rate. We presume the annual real salary growth to exceed GDP growth twice reaching ~15% this year and remain at 10.5% in 2008 as previously forecasted. The reasons underlying our forecast of wage growth are as follows:

- In the 1Q 2007 the **gross wages growth hit the highest level** in the last decade – salaries in the economy (excluding sole proprietorships) rose by 20.9% yoy reaching LTL 1,738 (EUR 503). The average net salaries in the entire economy soared by 28.2% yoy to LTL 1,307 litas in 1Q 2007, and real average wages rose by 22.9%. It was only partly stipulated by the cut of personal income taxes from 33% to 27% and the increase of minimum monthly wages to LTL 600 since the 1st of July last year, and the raise of the general non-taxed minimum from LTL 290 to 320 starting this year.

- The **tightening situation in the labour market**. According to Eurostat, Lithuania's unemployment contracted to 4.7% in June (seasonally adjusted), compared to an average of 5.6% in 2006 (8.3% in 2005). We anticipate the unemployment rate to remain at current ~5% levels this and next year as there is a lack of unemployed with suitable qualifications. Some reasons are as follows:

  - With the economy in the country growing and emigration continuing, **job vacancies** are on the rise. Increasing job vacancies also illustrate difficulties to find suitable employees swiftly. In 1Q 2007 there were 24.7th job vacancies in Lithuania, i.e. 13.8% more than in 4Q 2006 and 1.6 times more than in the 1Q 2006. And the most job vacancies (25.9% of total) were observed in industrial companies.

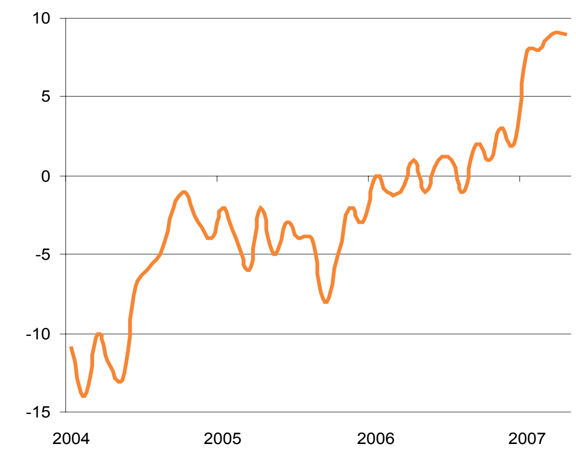
  - The employers are not in a hurry to employ **foreign workers** as there are still a lot of bureaucracy obstacles in Lithuania to do that, especially regarding immigrants from non- EU countries. That will take much time and also not all sectors can employ foreigners because of language barriers.

  - Most **pensioners**, who are willing to work, already are employed. For instance, in the first quarter of this year the number of working pensioners increased by 12%. We do not see big reserve remained to increase the number further.

- The Lithuanian government raised the **minimum monthly salary** by 100 litas to 700 litas (EUR 203) from the 1st of July 2007. Therefore the growth of wages in the second half of the year will be slightly higher than we expected before. In addition the government's 2006-2008 program calls for increasing the minimum salary to 800 litas by 2008.

- **Optimism.** Consumer confidence index hit the highest level in five years, due to a higher consumers' expectation of their financial standing in their households, economic development, and a decline in the number of jobless. Consumers are also waiting for the next year's increase in net salaries, according to the personal income tax rate cut from 27% to 24%, expected since 2008. This will add about 3.3% on average to the net wages.

Consumer Confidence Indicator



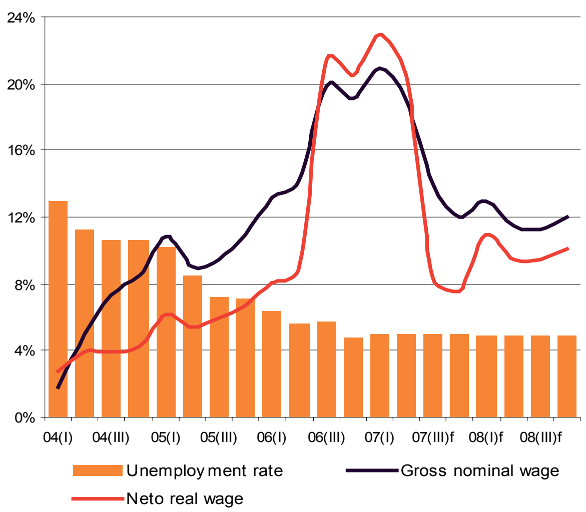
Source: LDS

- **Profits** of Lithuania's companies continue to grow and allow companies to increase wages further. In 1Q the aggregate pre-tax earnings were 44.6% higher than a year before. In this period revenues rose by 20.6% and the average profitability, measured as a ratio of pretax profits to revenues, increased to 6.7% from 5.6% in the 1Q 2006 (the average in 2006 – 6.2%).

- The growth of **borrowing** slowed down, but figures are still impressive despite increasing interest rates. In the end of May the annual growth rate of lending for house purchase slowed down to 64.3% from the 82.2% at the same time the year before. Meanwhile, all loans to households increased by 65.5% and still strongly outpace the increase in deposits.

Due to growing income, the low unemployment rate, and continuous borrowing, we expect household consumption to increase no less than 11-12% in real terms this year.

Labour Market, annual grow th rates

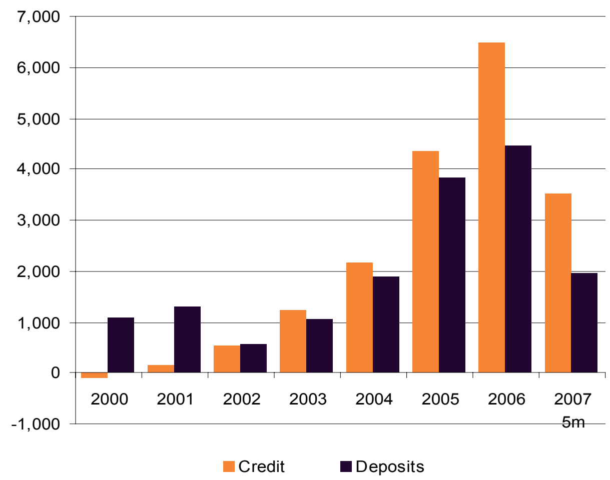


Sources: LDS. HBM forecast

3.1.2. Government Spending and Policy

Lithuania's government continues its expansive fiscal policy: government spending increased by

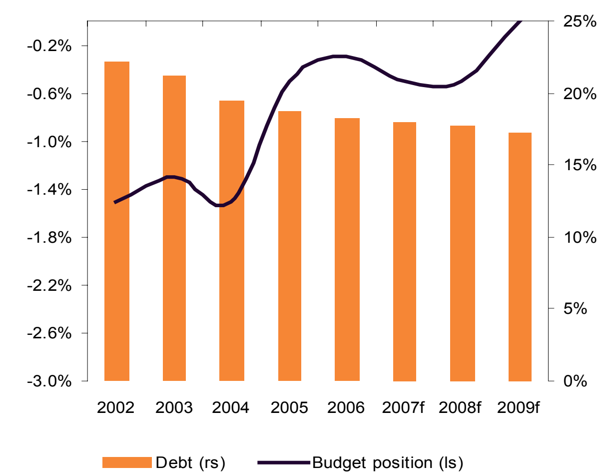
Household Finances (transactions), LTL m



Source: LiB

6.2% in real terms in the first quarter of this year. In this period Lithuania's general government fiscal deficit accounted only for 0.02% of this year's our projected GDP. However the central government sector ended May with a much higher deficit. A deficit was recorded of LTL 360m (EUR 104m) for the first five months of this year, which accounted for 0.4% of this year's our projected GDP. In May alone, it showed a deficit of LTL 428.1m. For the first five months revenues of the central government increased by 17.8%, meanwhile expenditures expanded by 21.8%. But assuming that the budget revenues collection will be good, we forecast that the general government deficit will remain rather stable in 2007 and 2008 (0.5% of GDP) on the back of strong revenue growth and improved tax collection.

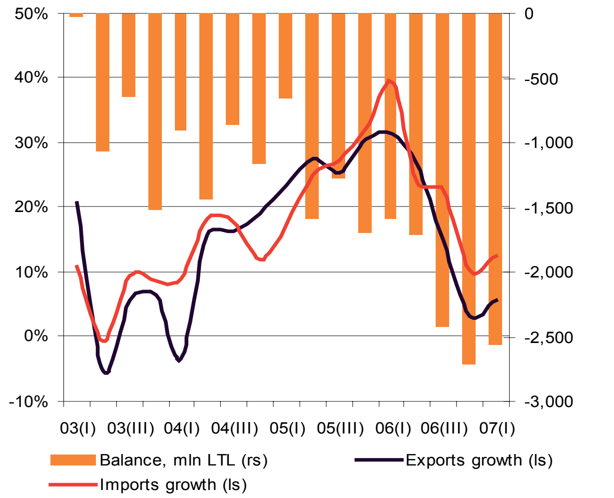
General Government Finances, % of GDP



Source: Lithuanian MoF, HBM calculation

The new nuclear power plant (NPP) construction already has been approved by Parliament and the President. It will replace the Ignalina NPP in Lithuania, which was built in the Soviet era, and according to its obligations to the European Union, must de fully decommissioned at the end of 2009. The nuclear power plant law provides that a national investor enterprise will be set up to implement the power plant construction project, to be joined by strategic partners Latvia, Estonia and Poland. The national investor will be comprised of state-owned companies Lietuvos Energija and Rytu Skirstomieji Tinklai and the private company VST, exchanging the shares of the latter for a maximum of 49 percent of the shares in the new structure. The national investor will hold title to at least 34% of the shares in the company, tasked with implementing the power plant project, and will have the same amount of votes at the shareholders' meeting. The remaining shares will be held by Latvia, Estonia and Poland in equal parts. The first reactor of the new power plant is scheduled to be completed around 2015. The power plant will require around a EUR 2.4-4bn investment and will need other resources, such as materials, equipment, services of qualified specialists etc.

Goods and Services Trade

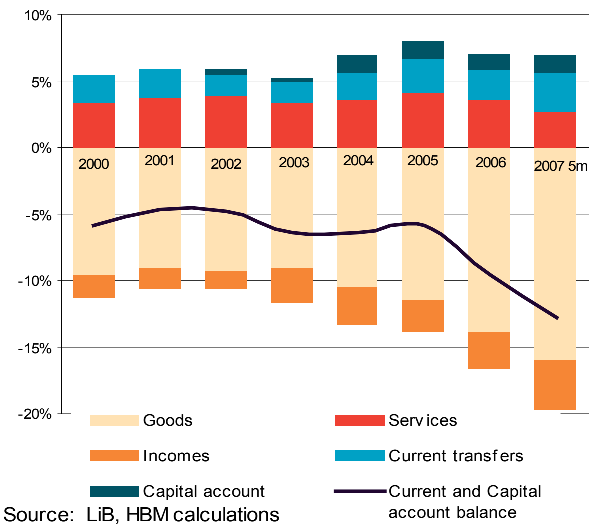


Source: LiB, HBM calculations

3.2. External Balance

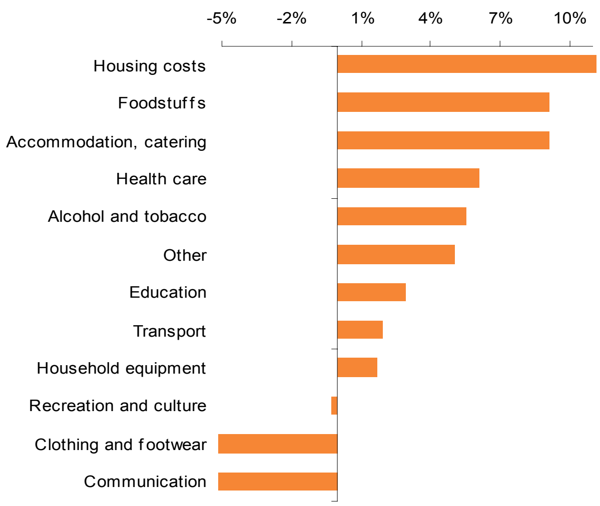
We revised the full-year current account deficit forecast from 12.5% to approximately 14% of GDP this year. The deteriorating balance of goods and services was the main factor of the widening current account deficit, as strong domestic demand supported by household spending stimulated the imports. In the first five months, goods imports increased by 14.6%, while exports expanded only by 5.9%. The main reason for the exports slowdown was the ~50% yoy decrease in exports of mineral oil products. However it is expected to recover in the second half of the year through the reviving of the biggest exporter, Mazeikiu Nafta, and the lower comparable last year's basis. According to preliminary data, Lithuania's current account deficit in the first five months of 2007 increased in relative terms (to 14.1% of GDP, from the 10.8% in average in 2006), and the further decline of the deficit is hardly to be expected.

Current and Capital Account, % of GDP



Source: LiB, HBM calculations

CPI Components, Annual Growth in June, 2007

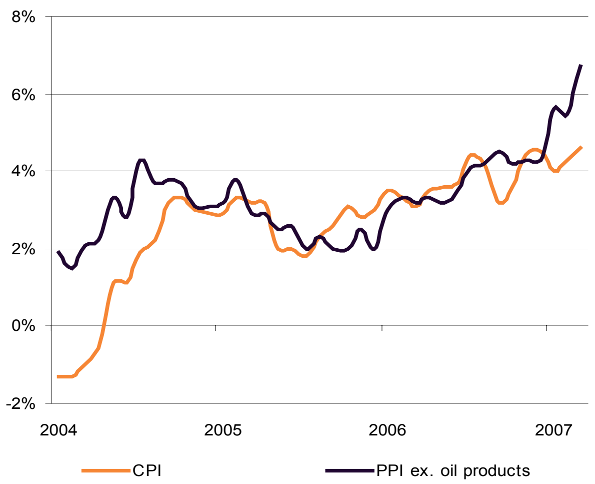


Source: LDS

4. Inflation

The higher costs (firstly wages) are already transferred to the final prices in some cases. The annual growth of the Lithuanian consumer price index (CPI) increased to 4.8% in June, mostly reflecting rising prices in food (by 9.1% yoy) and utilities (11.4% yoy). The annual average inflation stands at 4.3%. The prices of services growth still outpaces the growth of goods' prices. So far the latest trends in the price indexes confirm our average annual 4.5% inflation forecast for this year with the potential to review upwards. This year prices will be supported by higher gas and electricity prices, as well as higher excise duties for cigarettes. Considering the external as well as domestic factors like changes in the labour market, it is hard to expect inflation to decrease in the short-term.

CPI and PPI ex. oil products, Annual Growth



Source: LDS

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