The Baltic Outlook

Macro Outlook, The Baltic Region, May 2007

HANSABANK MARKETS

Touching down smoothly

Hansabank 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: Katrin Tahves

Summary

Strong growth in 2006

2006 was an exceptionally good year for all three Baltic countries: Estonia and Latvia showed remarkably strong growth rates (11.4% and 11.9%, respectively) and Lithuanian economic growth (7.5%) was also among the strongest in the EU. The growth was biased towards domestic consumption, particularly household spending and investments. Household spending got a boost from increasing employment and incomes, but also from the rapid growth of borrowing. Investments were triggered by growing and strong demand, but also by rising labour shortage and costs. Favourable monetary conditions (e.g. real interest rates negative or close to it), good financial position of companies, good budget revenues and inflow of EU funds were supporting factors for investment, but they also boosted consumption. Rapidly growing demand increased not only domestic consumption but also imports and this led to growing external imbalances.

Though this built up imbalances in the economies

Early this year we can point to several major imbalances, which were present in all three countries albeit to a different extent. Improvements have started to take place in the economies, but the 1st half of the year will be very similar to 2006.

First of all, increasing shortage of labour and rapidly growing wages (real wage growth 11-15.5% in 2006) are putting increasing pressure on the production costs and competitiveness of local producers, particularly on those working for export markets. Second, high and growing external imbalances (current and capital account deficits reached 12.3% of GDP in Estonia, 19.9% in Latvia, and 9.7% in Lithuania). Rapid price growth in all areas of the economy, particularly in the construction and real estate sectors, has resulted in accelerating inflation (CPI in March was 4.6% yoy in Lithuania, 5.7% in Estonia and 8.5% in Latvia), which is further delaying euro zone membership. The current situation of rapid domestic credit growth, fears of the bubble in the residential real estate sector and relatively undisturbed of all it governments, led to a first break out in February in Latvia, where imbalances were the biggest.

Turbulence in Latvian financial markets triggered action

While rumours about devaluation in the domestic market were effectively played down, the downgrade of the rating outlook from “stable” to “negative” by S&P had, however, a much harsher impact: the lats fell to its weakest edge and interest rates soared. The reaction of financial markets was over-exaggerated (helped by some biased comments), but the situation calmed down quite rapidly with the lats now trading below the central rate. However, this turbulence clearly awoke the government and central banks, as well as local banks and their foreign owners, and led to specific actions.

The situation was (and still is) most difficult in Latvia, where the current account deficit, inflation and wage growth are the biggest, credit growth stabilized only in the 4th quarter and exports straggled in 2006. The situation in Estonia has been slightly better – credit growth has already been slowing from mid 2006, the real estate market has clear signs of calming, and inflation, wage growth and current account deficit are smaller than in Latvia. Additionally, the government has run a stricter fiscal policy for years (budget surplus in 2006 3.8% of GDP). The situation in Lithuania was the least worrisome; however, there are signs that developments are heading in the same direction as those in Estonia and Latvia: wage growth acceleration, current account and inflation growth etc.

The authorities reaction was fast and appropriate

After harsh warnings the Latvian government came out with an anti-inflation plan, on which it had been working since late 2006, to tackle the issue of rapidly growing prices and strong domestic consumption. The Lithuanian government also made their action plan, albeit the situation in Lithuania is the least worrisome. However, due to the general elections and change of the government, nothing particular besides discussions happened in Estonia in March. Still, the new government has promised to keep the budget in surplus and handle the long-term problems of the economy (labour supply, education etc). However, a more detailed short-term action plan would be good for avoiding unnecessary nervousness in markets.

Despite speculations by some foreign observers that local currencies may fall, we are of the opinion that there is no reason to expect any change in local monetary systems, and especially devaluation of currencies. Devaluation would not solve any problems (e.g. the labour shortage) in the economies as the economies are very open but would create even more (e.g. causing even stronger labour outflow and extremely high inflation).

Soft landing is on the agenda for 2007-2009

Due to recent economic developments we have changed our forecast of economic developments in the three Baltic countries. For Estonia and Latvia we have two possible development scenarios – the soft- and hard-landing. We are of the opinion that the probability of the soft-landing is considerably higher (and hence this is our main scenario), but it requires a smooth adjustment process to take place in both of the economies.

Lithuania continues with balanced growth

The changes are minor for Lithuania. We expect slightly less unemployment (by 0.2%) and the expectations for economic growth are a bit higher for 2007 (7% instead of 6.5%) but the same for 2008 (6%).

Latvian inflation and current account forecasts revised

We have retained the earlier economic growth forecast (ca 9%) for Latvia for 2007 due to more rapid growth in the 1st half of the year than was expected before. In response to the anti-inflation plan, growth in 2008-09 is expected to be somewhat lower (ca 7%). Consumer price inflation expectations are increased to 8% this year (from previous 6.3%) and to 5.5% (from 5.2%) in 2008. We expect that the government steps and the more conservative lending policies of commercial banks will have a clear effect on domestic demand by the 2nd half of the year and bring down wage growth and imports. We also expect a positive impact on exports and thus a better outcome of the trade and services and the current account balances. We expect that the current and capital account deficit will fall almost twice for 2009 (to 11.6% of GDP).

Estonian soft-landing harsher than expected previously

Our new forecast for Estonia expects that the soft-landing of the economy will be a bit harsher than we expected in winter, because of stronger than expected results in the 4th quarter of 2006. Strong profits, which allowed wage increases and higher bonuses than expected, and the lengthy process of the government change after the general elections supported domestic demand and kept spending at high levels longer than we expected. We forecast the Estonian economy to grow ca 8.6% in 2007 (9% previously), but then the growth will slow reaching 6.6% in 2009, which will be the year of stabilisation and recovery of growth rates. Our expectations regarding inflation have grown (4.9% for this, 5.2% for next year) as the impact of expected administrative increases will be stronger than presumed previously. We are more pessimistic regarding wage growth – the labour market situation makes it hard to believe that wage growth will decline significantly in the next years. However, we are of the opinion that current imbalances between wage and productivity growth will diminish already this year and, hence, we expect quite good developments in foreign trade. We are more pessimistic regarding the fall of the current and capital account deficit due to slower than expected processing of EU funds.

Long-term strong developments will remain

We are of the opinion that overall economic developments in the three Baltic countries are strongly affected by the convergence process, i.e. as among the poorest in the EU, these three countries have and are forced to make a very rapid catch up process to keep economies properly functioning and not losing their population through emigration to richer EU countries. Unfortunately, such rapid growth very often brings imbalances, which should be handled quickly and in an appropriate way. It seems that the Latvian authorities were somewhat late to recognise the risk of unbalanced growth, but it seems that they have made a rapid correction after the first serious warning. The Lithuanian authorities got an early warning and will probably avoid the deviation from balanced developments.

Maris Lauri

	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	6.6
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	7.0	6.5	6.5
EU27	1.2	1.3	2.4	1.7	2.9	2.7	2.4	na
GDP, millions €								
Estonia	7,759	8,494	9,375	11,061	13,074	15,300	17,600	19,800
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	27,187	30,750	34,386
EU27	9,881,543	10,041,693	10,532,595	10,957,941	11,528,510	12,080,000	12,650,000	na
Harmonized consumer price growth, %								
Estonia	3.6	1.4	3.0	4.1	4.4	4.7	5.0	4.0
Latvia	2.0	2.9	6.2	6.9	6.9	8.0	5.5	4.5
Lithuania	0.3	-1.1	1.2	2.7	3.8	4.5	4.5	3.3
EU27	2.5	2.1	2.3	2.3	2.3	2.0	2.0	na
Consumer price growth, %								
Estonia	3.6	1.3	3.0	4.1	4.4	4.9	5.2	4.0
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	5.6	4.0	4.2	4.3
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	5.4	5.3	5.3
EU27	8.8	9.0	9.1	8.8	8.0	7.6	7.3	na
Goods and services balance, % of GDP								
Estonia	-6.9	-7.3	-8.1	-6.2	-10.3	-9.0	-9.0	-8.8
Latvia	-10.0	-12.7	-15.8	-15.1	-21.0	-17.6	-13.8	-10.5
Lithuania	-5.5	-5.7	-7.0	-7.3	-10.3	-11.7	-12.1	-11.7
Current and capital account balance, % of GDP								
Estonia	-9.5	-11.1	-11.7	-9.5	-12.3	-10.5	-9.5	-8.5
Latvia	-6.4	-7.5	-11.8	-11.2	-19.9	-15.4	-11.9	-11.6
Lithuania	-4.7	-6.4	-6.4	-5.9	-9.7	-11.3	-11.4	-10.8
EU25*	0.0	0.0	-0.1	-0.5	-0.5	-0.4	-0.4	na
General government balance (ESA95), % of GDP								
Estonia	0.4	2.0	2.3	2.3	3.8	2.2	1.5	1.5
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	-1.4	-1.1	na
Estonian, Latvian and Lithuanian forecast by HBM; EU27 forecast by EC or consensus forecast								

*only current account

General Assumptions

1. Global Economic Growth

Global economic growth will remain strong this year and the next, although growth rates are expected to diminish. Analysts' views differ significantly depending on their assesment of developments in the US economy, thus opinions also vary about exchange rate and interest rate developments beyond a 3-month perspective.

Global economic growth projections, %

	2005	2006	2007f	2008f
USA	3.2	3.3	2.3	2.8
EU 27	1.9	3.2	2.8	2.7
Eurozone	1.4	2.6	2.3	2.3
Germany	0.9	2.7	1.6	2.0
Finland	2.9	5.5	3.1	2.8
Sweden	2.7	4.7	3.5	3.1
UK	1.9	2.7	2.6	2.5
Denmark	3.0	3.2	2.4	2.2
Russia	6.4	6.7	6.3	6.0

Source: consensus forecasts from various sources

General outlook for global economy has improved slightly in recent months and most analysts have increased their expectations somewhat after strong 4Q results. Despite that, a slowdown of the global economic growth in 2007 is expected; however, in 2008 (many analysts expect that by the end of 2007) the growth will start to strengthen again. This slowdown, however, means that the growth will remain strong and there are no grounds to talk about crises or major troubles. Expectations vary due to differing estimates about the economic development of the US economy. Consensus forecast expects that the slowdown in the USA will not significantly affect most other economies as it will be short-term and affect only some overheated sectors (e.g. residential housing market). It is also indicated that growing economies in Asia (e.g. China) are about to show strong growth, albeit slightly less than they have so far. The economic developments in the EU will be rather good for 2007-2008, although growth rates will be lower than in 2006. The general conclusion is that the importance of the USA in the world economy has diminished. As always, our Baltic forecast is based on the assumption that the global economy will perform as consensus (or majority forecasts) expect, if we do not indicate differently.

1.1 USA

The US economic growth has stacked in the range of 2-2.5%, which is a welcome development as several imbalances in economy have started to diminish. Particularly, after several years, exports are contributing positively to growth and the current account deficit is diminishing. The mortgage market and residential construction sectors are slipping down. This will also affect consumption and overall growth is expected to stay below the long-term average for 2007, and recover close to the average in 2008. This development is accompanied by relatively low unemployment and relatively high inflation: unemployment is expected to grow slightly, while inflation may remain close to current levels (this applies particularly to core inflation). Disappointing developments in the US could be the major risk for global economic developments, but so far this is estimated just as a possible risk.

1.2 European Union

The stronger than expected growth in 4Q has been a reason for an upward revision of expectations for the euro zone. Some of the euro zone countries – particularly Germany – have performed much better than expected, but slowdown of economic growth is evident. Economies that are trading more intensively with non-EU countries, particularly with the USA, are expected to suffer from weaker external demand in the USA. However, export to other countries is expected to survive well until the slowdown of USA economic growth remains modest, as explained above. It is expected that the weaker demand in the US will be compensated by strong demand in emerging economies.

European growth is supported by exports and investments, and although thus far private consumption has not shown a significant positive impact, it should emerge soon as labour markets are tightening (unemployment was down to 7.4% in Feb). The impact of a VAT increase in Germany was less than expected; hence the negative effect on consumption will be less pronounced. Although economic growth rates in Finland and Sweden will fall in 2007, they will still be strong as the decline will be from exceptionally high levels.

In the euro zone inflation will remain slightly below 2% on expectation of stable oil prices. It is forecasted that the quite rapid fiscal tightening (the budget deficit falling from 2% in 2006 to 1.1% in 2008) will have a moderate negative effect on economic growth. The strong euro might be also a problem for some industries and economies, as might the higher interest rates.

1.3 Emerging Markets

Growth in emerging markets is expected to slow, however it will remain high. For example, in Asia it is expected to slip from 9% to 7.5-8% in 2007-8, and from 10.7% to 10-9% in China alone. The same applies to the countries of Latin America, while some of those countries are probably facing serious political risks (e.g. in Venezuela growth is expected to drop from 10.3% in 2006 to 4% in 2008).

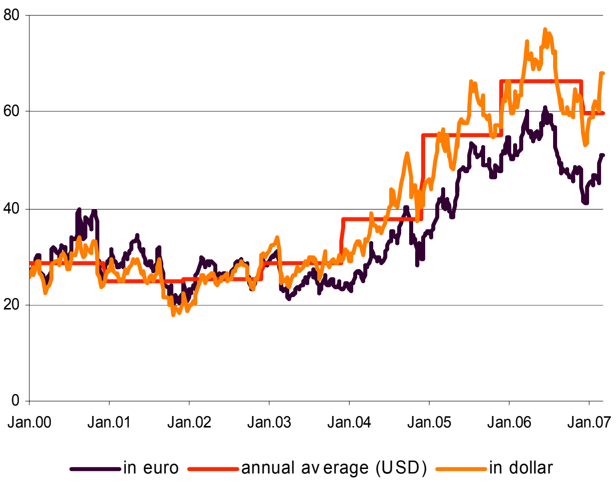
The approaching election period in Russia will boost government spending; hence economic growth is expected to increase in 2007. However, after that a weakening period might start, as reserves might be significantly less and oil/gas revenues are not increasing and will not increase as fast as imports. Still, 2007 will be definitely year of strong growth and if economic growth starts to slip, then this will happen gradually.

2. Resource Prices

Despite lower prices at the beginning of 2007, oil prices will probably not return to previous levels of 52-55 USD per barrel in 2007-2008. The economic slowdown should mean a lessening of demand and hence lower oil prices; however, there are several factors working against this. OPEC will probably act if the price of oil falls in response to weaker demand. But the most important factor is that of geopolitical problems, which include developments in Nigeria, Iraq and Iran, with difficulties likely in other producing countries. As non-OPEC countries are lagging in increasing production capacities, it is hard to expect a relief from those countries (e.g. Norway, Mexico, but also Russia); and the strong growth (albeit smaller than in 2006) of the global economy means that demand will remain robust. Hence, the overall outlook for the price of oil remains flat or slightly higher, with high fluctuations likely if the political situation becomes tense in producing countries.

Similar expectations prevail for metals and agricultural products – smaller growth should mean lower prices, but overall strong economic situation in the global economy actually favours price growth. However, several analysts point to factors which indicate that the high peak of several prices has been reached (e.g. for some base metals). Generally it is seen that differences inside different raw materials groups are growing, depending on price levels, demand and other factors.

Oil price (Brent)



Source: Reuters

3. Other Prices

3.1 Inflation

Slower growth should also mean lower inflation rates as the weaker demand should make it difficult to increase prices. However, as written above, inflation will fall relatively reluctantly in 2007-8, and this particularly applies to core/base inflation. The latter is expected to remain flat or fall only marginally, leaving central banks in a difficult situation. Overall, the fall in inflation rates is caused by the negative effect of oil prices (prices fell from Sep06).

Consumer prices, %

	2005	2006	2007f	2008f
USA	3.4	3.2	2.3	2.4
EU 27	2.3	2.3	2.2	2.2
Eurozone	2.2	2.2	2.0	2.0
Germany	1.9	1.8	2.0	1.5
Finland	0.8	1.3	1.4	1.5
Sweden	0.8	1.5	1.7	1.9
UK	2.0	2.3	2.2	2.0
Denmark	1.7	1.9	2.0	1.9
Russia	10.9	9.7	8.3	7.6

Source: consensus forecasts from various sources

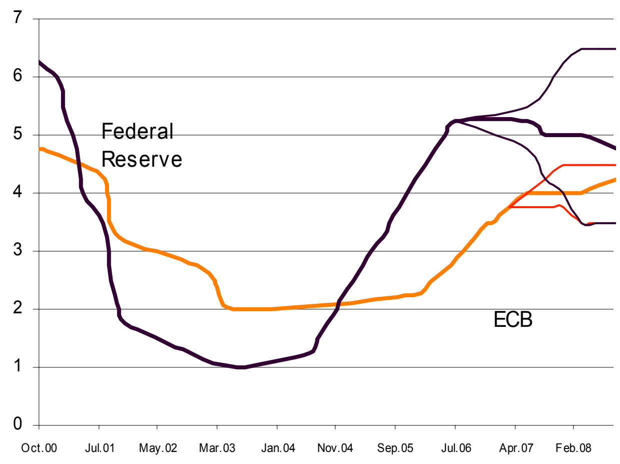
3.2 Interest Rates

The different tendencies of inflation and base inflation, and also growing capacity utilisation has increased the nervousness of central banks, and made it more difficult to produce forecasts. As a result, analysts' expectations are noticeably diverging; and they seem to have a good basis for their opinions. Slower economic growth and inflation should mean stable or falling interest rates, but high capacity utilisation, money growth and growing base inflation are inclining towards an increase in interest rates.

The market consensus is that the Federal Reserve will keep interest rates flat or will start easing, particularly if economic developments do not show improvement. However, optimists are betting on an interest rate increase at the end of 2008, while pessimists expect interest rates to fall substantially.

Low inflation has rapidly eroded expectations that the ECB will make two interest rate increases in the next 3-9 months (but such expectations are not completely abandoned). Opinions diverge significantly: many bet on stable interest rates (on current or increased level) however just as many are forecasting an interest rate cut in the future (but they disagree about when it will take place) and then there are also expectations which forecast an interest rate increase by 75bp by the end of 2007. The current consensus is that the ECB will increase rates in May-June by 25bp to 4% and this might be the last increase for the next 12 months. If the euro zone's economy performs well, then we could expect interest rates to increase in 2Q of 2008.

Policy Rates, %



Source: Reuters

3.3 Exchange Rates

Opinions regarding exchange rates are diverging as are expectations regarding interest rates. It is expected that the US dollar will continue to weaken slightly in the next 3-6 months (ca to 1.34 EUR/USD). For a longer period expectations are either for strengthening (up to 1.25) or for weakening (up to 1.4) depending what stance the analyst has taken regarding interest rate developments and the global economy (particularly how the US and EU economies will perform). We are of the opinion that a gradual weakening is currently more likely – due mostly to different interest rates, however the overall economic development (i.e. stronger euro zone and weaker US) might also influence the rate. However, together with economic improvement, it is expected that the dollar will start to strengthen gradually. This forecast is based on the expectation that the Asian currencies (particularly Chinese renminbi) will remain undervalued.

Interest and Exchange Rates

	10.Apr.07	3M	6M	9M	12M
Fed rate*	5.25%	5.25%	5.00%	5.00%	5.00%
USD (3M)**	5.35%	5.32%	5.22%	5.04%	4.87%
ECB*	3.75%	3.75%	4.00%	4.00%	4.00%
EUR (3M)**	3.95%	4.15%	4.25%	4.28%	4.25%
EUR/USD**	1.34	1.34	1.34	1.32	1.30
USD/JPY	119.1	117.0	115.0	113.0	112.0

* USA Fed and ECB refi rate according to market consensus

** USD and EUR exchange rates and money market rates according to market expectations (based on forward contracts)

4. Global Effects on Baltic Economies

Due to the openness of their economies, the Baltic countries are generally open for global economic developments. However, the impact of different processes varies. For example, the direct impact of US economic slowdown is very small as the US is not among major export destinations. However, the indirect impact via exporting EU countries might be more significant, particularly if the growth in the US falls significantly and has a strong negative effect on its trade partners. As the consensus forecast is generally optimistic towards US economic developments, we assume that there will be no negative effect on Baltic countries.

Baltic economies are very open to economic developments in the EU, particularly to the processes in Sweden, Germany and Finland, but also those in the UK. The three countries are also strongly interdependent. As the outlook for the EU is positive, we can also predict a positive impact on developments in the Baltic economies. The fall of growth rates in Sweden and Finland does not mean that those economies will be in trouble, it is simply that the growth in the last couple of years has been exceptionally good. High employment rates, growing investments and the beginning of a growth in spending mean that there will be an increase in demand and higher export potential for the Baltic economies. Another question relates to the ways in which this potential will be exploited.

Strong economic developments in Russia (and other CIS countries) mean increasing opportunities for the

Baltic economies. This is particularly true due to very favourable exchange rate developments (currencies are appreciating against the euro, while depreciating or stable against the rouble). The same opportunities exist for companies which export to other emerging markets (e.g. in Asia or Europe). The Baltic countries are also about to benefit from growing transit flows from and to Russia (the latter direction is probably even the most promising).

The openness of the economy means that global prices are directly affecting domestic price levels – this applies particularly to oil (but also other energy) prices, but also metals, agricultural and timber products etc. Our forecast is based on relatively stable oil prices, but growing timber prices (due to an increase of export tariffs in Russia).

Exchange rates have only a modest impact on economic developments in the Baltic countries, as most of the trade is conducted in euros. However, as several products are globally traded in dollars, there is a direct effect also coming from dollar movements. There are two types of indirect impact: through major European exporters to the US if the euro strengthens significantly, and through real exchange rate in emerging markets (particularly in Russia).

Local interest rates – both lending and deposit rates - have been strongly correlated to euro rates, which is natural when we take into account the monetary systems these countries have and their membership of ERM2. However, interest rates are about to diverge slightly due to higher risks in the Baltic economies. If the Baltic economies follow the most likely soft landing scenarios, then the difference is expected to diminish in 2008 onwards, but the hard landing scenario would bring significantly higher rates in the Baltic countries.

In conclusion, we are of the opinion that the global economic situation offers a lot of opportunities for the Baltic economies, through strong demand (particularly in the EU and Russia) and the relatively stable prices of raw materials, interest and exchange rates. The question is, however: How successful will local companies be in handling these challenges if production costs are growing rapidly?

Elections schedule

Estonia	
Presidential	September 2011
General	March 2012
Local	October 2009
Latvia	
Presidential	July 2007
General	October 2010
Local	July 2009
Lithuania	
Presidential	June 2009
General	October 2008
Local	2011
European Parlament	2009

Maris Lauri

Estonia

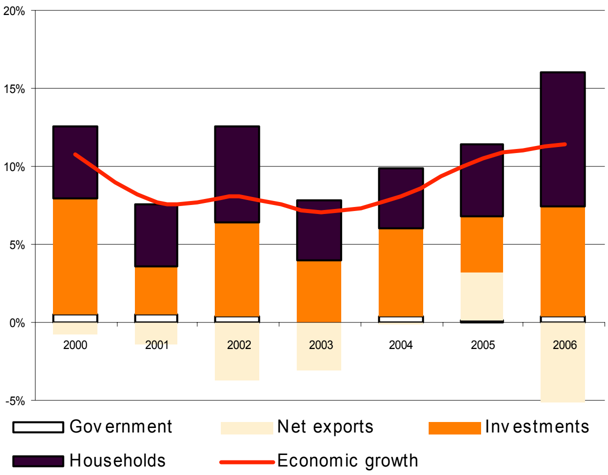
1. Recent Economic Developments

Estonian economic growth in 2006 reached the highest rate ever: 11.4%. 11.7% growth in the 1st half of the year slowed down to 10.9% for the last quarter. Domestic demand with rapidly growing private consumption (15.7%) and investments (19.2%) were the biggest contributors for the growth, while net exports had negative impact of 5.2%. The reason was in rapid expansion of merchandise imports vs. exports (13.8% and 7.8% respectively in constant prices). Due to very rapid increase of domestic demand and existing capacity constraint, imports picked up. As result, the trade and services deficit increased to 9.7% of GDP (6.1% in 2005) and the current and capital account deficit reached 11.3% of GDP.

Falling unemployment (harmonized rate fell from Dec05's 7% to 4.3% in a year), higher activity rate (up from 62.9% in 2005 to 65.5% in 2006) and rapidly growing wages (gross wage by 16.2%) were the main supporters of household consumption. But growing leverage, particularly consumer loans, increased significantly household spending despite the fact that savings also increased (19.4% growth; savings rate 28.7% of GDP). However, developments in the labour market have been a headache for employers as it is increasingly difficult to hire new workers, and growing production costs force companies to look for new opportunities and invest

Rapidly growing demand and capacity problems have also increased inflation, which benefited from stable or falling oil prices in the 2nd half of 2006. Annual average consumer price inflation increased to 4.4% in 2006 (4.1% in 2005), but year-end growth rates pointed clearly to upward pressure: in December annual growth reached 5.1%, and in March 2007 it accelerated to 5.7%. Similar developments could be seen with almost all price indices: in 2006 PPI reached 4.5% (5.4% in March), construction prices 10.3% (12.2% in the 1st quarter) and export prices 3.9% (but 4.6% in March). The exception is the import price index, which in 2006 grew 4.1% (3.9% in 2005), but has shown a slowdown in early 2007 (average was still 3.9% in March) because of falling oil prices.

Formation of Estonian Economic Grow th

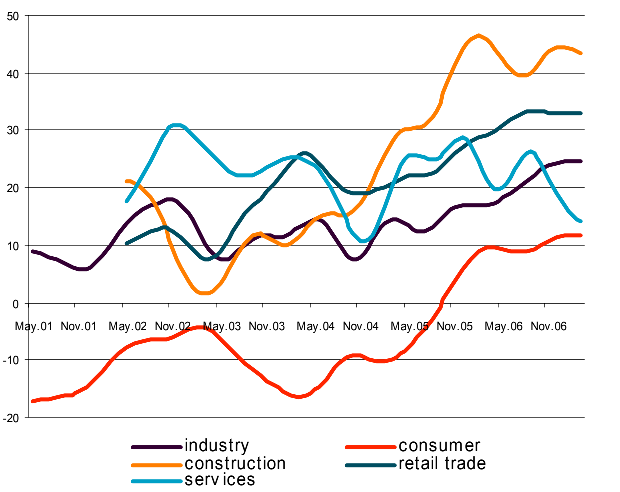


Source: ESA

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic grow th, %	8.0	7.1	8.1	10.5	11.4	8.6	6.9	6.6
GDP, mln EUR	7757	8494	9375	11061	13074	15300	17600	19800
GDP per capita, th kroons	89.3	98.2	108.7	128.6	152.0	178.5	205.0	230.0
euros	5709	6275	6950	8218	9717	11400	13150	14850
Grow th of industrial production, %	8.3	11.1	10.5	10.8	7.1	7.3	7.5	7.0
Grow th of GDP deflator, %	3.8	2.3	2.1	6.8	6.1	7.3	7.5	6.2
Grow th of consumer prices, %	3.6	1.3	3.0	4.1	4.4	4.9	5.2	4.0
Grow th of harmonized consumer price index, %	3.6	1.4	3.0	4.1	4.4	4.7	5.0	4.0
Grow th 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	5.6	4.0	4.2	4.3
Real grow th of average monthly gross w age, %	7.7	8.0	5.2	6.1	11.2	11.0	11.0	10.0
Grow th of exports of goods and services, %	-1.1	9.0	17.8	24.5	18.0	11.0	8.0	6.5
Grow th of imports of goods and services, %	4.1	10.4	17.6	20.9	22.9	12.0	8.2	6.3
Balance of goods and services, % of GDP	-6.9	-7.3	-8.1	-6.2	-10.3	-9.0	-9.0	-8.8
Balance of current and capital account, % of GDP	-9.5	-11.1	-11.7	-9.5	-12.3	-10.5	-9.5	-8.5
Inflow of FDI, % of GDP	4.0	9.7	8.9	20.2	9.7	8.4	7.0	6.0
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	2.2	1.5	1.5
General government debt, % fo GDP	5.6	5.7	5.2	4.4	4.1	2.5	2.2	2.4

Favourable economic developments granted good tax revenues and despite growing spending, the general budget was in a surplus of 3.8% of GDP in 2006. The confidence indices showed a continuous rise throughout 2006 and only this year can we see a stabilisation or slight weakening.

Confidence Indices (trend)



Source: HBM estimates on EKI data

2. Economic Forecast

We have two scenarios for Estonian economic developments in the next couple of years: the base and pessimistic scenarios. The base scenario could be named also as a positive or soft-landing scenario, while the pessimistic one could be valued as a hard landing scenario, albeit not as crisis scenario. We estimate the probability of a soft landing of the Estonian economy ca 55%; with a slight probability of better developments and hence weaker developments have a ca 40% chance to be fulfilled. The hard landing scenario described in the table represents the approximate middle of those weak developments in the economy. However, there is a risk, which could shift the probability for either side - namely, the government policy, which we see as important factor for developments in 2007-2009. The signals from the new government are mixed as explained below, but due to short period in the post (the government was inaugurated in 5th of April) it is currently difficult to evaluate the actual impact of government policy on the Estonian economy.

Our soft-landing scenario also assumes marked corrections in the activity of commercial banks, particularly in the lending policy. But this correction will be not too drastic (see below). However, this self-regulating development might turn out to be short-term or remain as wishful thinking, if the new and more aggressive banks will enter to the market.

There is no clear one trigger for the hard-landing scenario – this might be stronger than expected credit growth, continuously rapid growth of wages, companies' inability to adjust with growing production costs or significantly more expansive government policy.

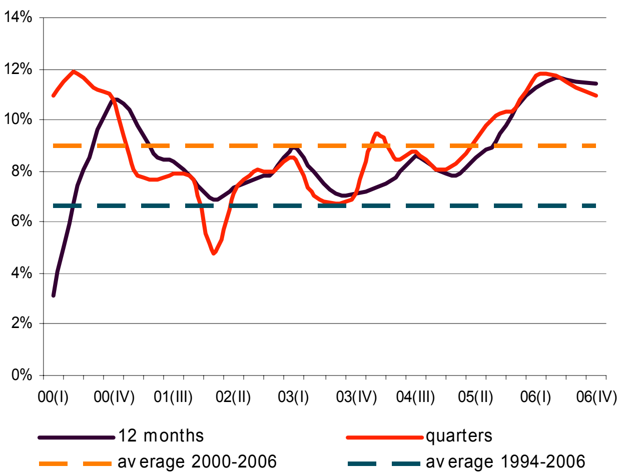
Comparision of two scenarios

	2005	2006	2007f	2008f	2009f
Economic growth, %					
base scenario	10.5	11.4	8.6	6.9	6.6
pessimistic scenario	10.5	11.4	10.0	5.5	4.8
CPI, %					
base scenario	4.1	4.4	4.9	5.2	4.0
pessimistic scenario	4.1	4.4	6.0	6.7	7.5
Current and capital account, % of GDP					
base scenario	-9.5	-12.3	-10.5	-9.5	-8.5
pessimistic scenario	-9.5	-12.3	-22.5	-17.0	-15.0

2.1 Economic Growth

Our base scenario presumes that after the strong 1st half of the year economic growth will start to slow faster than it did in 2006, and economic growth in 2007 will fall to 8.2-8.9%. The slowdown will continue in 2008 and 2009, although the latter will already be a stabilization year, where economic growth stabilizes around 6.5% and then starts to grow slightly. A further decline would be possible if future economic conditions in the EU and Russia are weaker than currently assumed.

Economic Growth



Source: ESA; HBM calculations

The growth will be based on household consumption, but its contribution will fall to ca 5% in 2009 (8.6% in 2006). We forecast a relatively small contribution from investments in this year due to rapid price growth and less active processing of the EU funds, due to the start of the new budgetary period; however, the investments contribution will increase and exceed the 6-year average of 4.9% in 2009. Our forecast assumes stabilization of the net exports in 2007 with possible improvement later, hence the contribution to GDP growth will be around zero (-0.5…+0.5%).

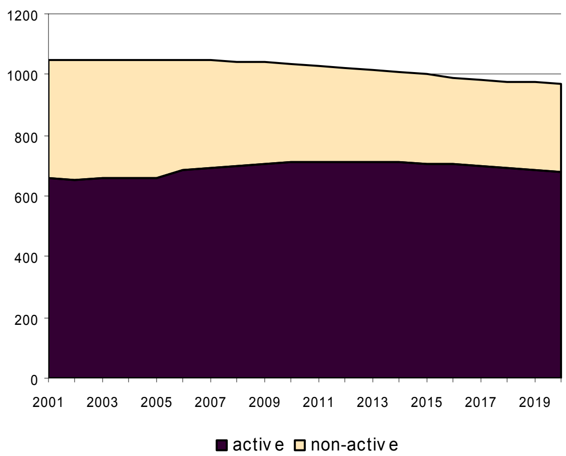
The negative scenario assumes a stronger contribution from the household consumption and a growing negative impact from net exports. The economic growth will be close to 10% in 2007, but will be followed by a fast and steep fall of growth rates in 2008-09 to 4.5-5%. After that a recovery may appear with ca 5.5-6% growth, depending on the mix of reasons for the fall in 2008-09[1].

2.1.1 Supply-side Factors

2.1.1.1 Labour Supply and Labour-related Factors

The Estonian economy is currently adjusting to the **permanent labour supply shortage** – there will be a long-term decline in labour supply due to the decline and ageing of the population. Although the increasing activity is one option for increasing employment, it is only a short-term solution which probably will be exhausted in the next couple of years (see also chart).

Estonian working-age (15-74-years old) population, th



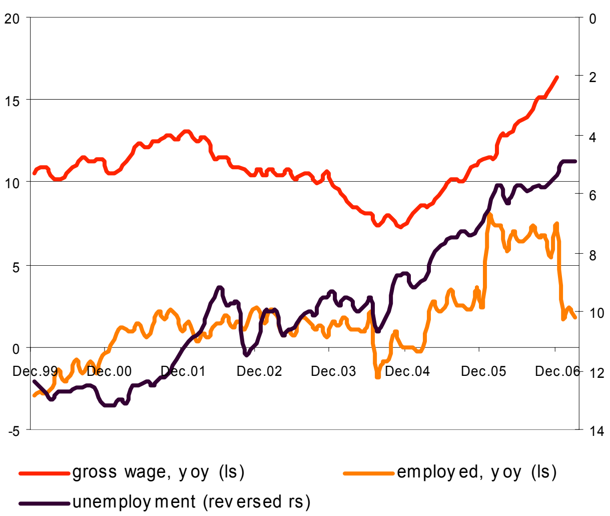
Source: ESA; HBM projections

The actual supply of labour will depend on several factors, which will be difficult to forecast, though some assumptions are possible to make. The activity rate increased significantly in 2006 mostly due to the return of retired persons to the labour market, and we can expect this development to continue further. The growing activity is clearly related to higher wage levels, relatively low pension payments, and increasing part-time employment. Those factors will determine the increase of the activity rate also in future, and if one of those factors drops out, the supply increase could decline and, in the worst case, supply may even diminish.

The other important factor determining the actual supply of labour is migration. We estimate that ca 2-3% of the Estonian labour force is employed in other countries in the EU. The majority of those people have left to work in Finland, and have usually kept their residence in Estonia thus we can expect that they may return to their home labour market. The process has already started, e.g. for construction workers, being helped by the changes in Finnish labour and tax laws. However the more intensive back-flow of labour will occur only if the wage levels in Estonia increase (of course one could also take account the taxes and other benefits). Growing wage levels might encourage immigration, but we are of the opinion that this might happen only in the more distant future.

The government has promised to relax the very tight Estonian regulations for temporary immigration of workers from outside the EU. However, the regulations will still remain tight – the minimum wage limit will be set quite high (an average for certain employment groups) to favour immigrants with high-quality skills. We do not expect significant positive effects from those planned changes, albeit for some companies the impact might be noteworthy.

Labour Market Harmonized Figures (s.a.), th



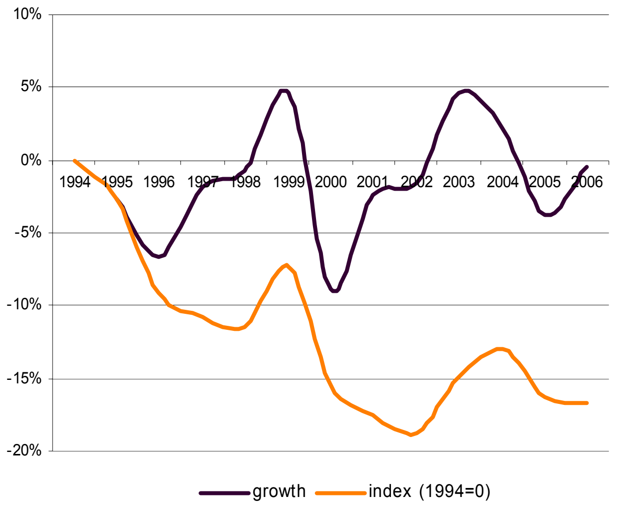
Sources: Eurostat, HBM calculations

[1] Most of all, how adequate and fast will be the reaction of banks, the government and companies to the deterioration.

As natural result, the shortage of labour has caused **wages** to grow rapidly. Companies have been able to tackle the issue relatively painlessly due to a strong growth of turnover and profits. However, there are losers: companies, which have relied on a cheap workforce. We are of the opinion that in the 2nd half of 2006 those companies, which are concentrated in the textile, clothing, timber-processing and machine-building industries, went through an intensive restructuring process, which in some cases still continues and in some cases may still end with a closure of production.

The rapid wage growth raises questions about productivity and competitiveness. It is often assumed that Estonian companies have lost their competitiveness due to the rapid wage growth in export markets. However, analysis belies this opinion. The real unit labour cost has fallen in 2005-2006 and was 16.7% below 1994's level. In the EU only Bulgaria can show a better result (EU average is -4.3%).

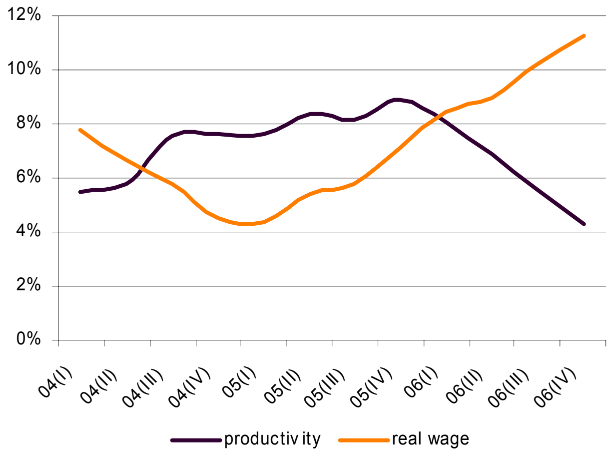
Real Unit Labour Cost



Sources: Eurostat, HBM calculations

Although **productivity growth** (measured with value-added per employee) has declined in Estonia quite rapidly in 2006, the development in the so-called open sector[2] is totally different. Productivity growth in the manufacturing sector is very rapid and exceeds wage growth. This has been achieved with constant restructuring and modernization of production. The situation is totally different in the so-called close sector, which is currently benefiting from strong demand and price growth. The situation in the construction sector is the worst: productivity has fallen dramatically, although wage growth in the sector is one of the fastest in the economy. The situation resembles that in the public sector: productivity growth is falling or is slightly rising, while wage growth is rapid[3]. Still, we are of the opinion that employment growth in the public sector was too extensive in 2006 (9.2%, incl. 11.7% in central government level, vs. 5.5% in the private sector) causing deeper than usual deterioration of the productivity-wage ratio.

Productivity and w age grow th in economy, 12 months average



Source: ESA; HBM calculations

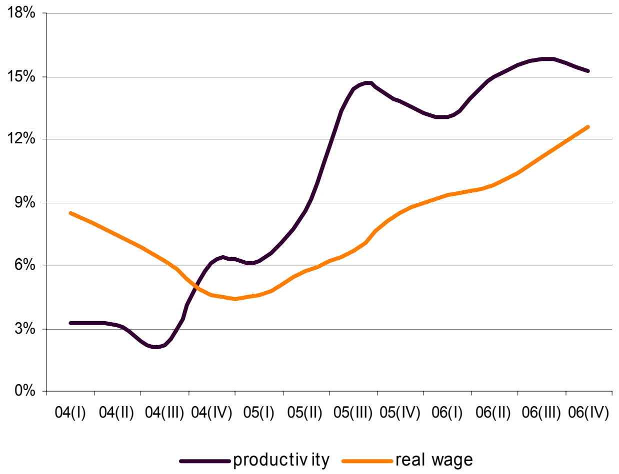
After very rapid employment growth in 2006, we forecast significantly slower employment growth in 2007 (0.5-1%) and 2008 (ca 0.2%). We are of the opinion that extensive employment growth in some sectors (e.g. in construction, retail trade, transport, public sector services) will be replaced with the decline or very insignificant growth already in 2007. Employment in manufacturing will continue to decline slowly due to restructuring process. Employment in services companies will continue to grow, but due to increasing part-time employment, this might negatively affect productivity figures, which are bound to the number of workers. Workers who will loose their jobs in 2007 will find new jobs in sectors witnessing a high shortage. The situation might become more troublesome in 2008; however, due to existence of two leakage possibilities (work

[2] Open sector includes companies, which compete with foreign companies either in domestic or external markets (i.e. those exporting goods or services). This contrasts with the closed sector, which includes businesses which are operating for domestic markets and do not feel competition from foreign companies.

[3] However, one should keep in mind that the measurement of value-added in those sectors are controversial, based on wages. But it is hard to agree with the opinion that Estonian teachers are several times less productive than in Western Europe, because wages here are significantly lower. This in turn is dependent on the overall wage level in the economy and cannot differ in times from those in the private sector.

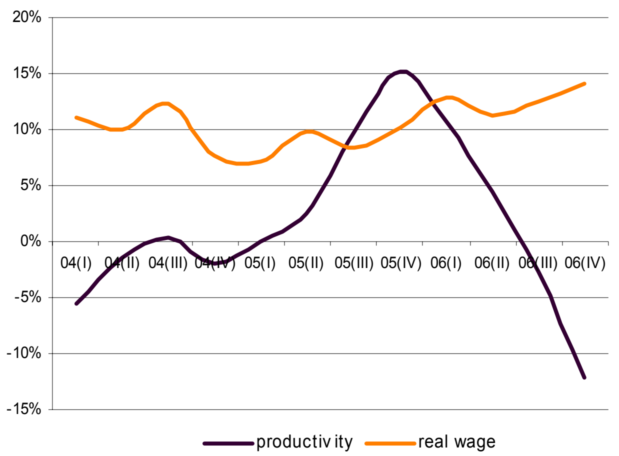
abroad and non-activity) we do not expect unemployment growth. Even with the hard landing scenario the increase in unemployment will be relatively modest.

Productivity and wage growth in manufacturing, 12 months average



Source: ESA; HBM calculations

Productivity and wage growth in construction, 12 months average



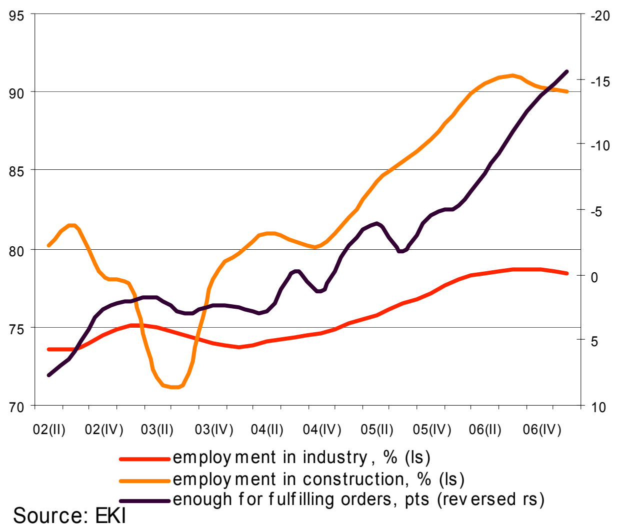
Source: ESA: HBM calculations

Wage growth will remain strong – we forecast extremely rapid wage growth in the 1st half of 2007 as response to the strong profits in 2006 and wage demands. We expect relatively strong wage growth in sectors related with the state budget system (e.g. health, education, security) due to low wage levels and/or strong trade unions. We see a clear danger that trade unions in the private and public sectors may misuse their current strong negotiation power[4]. As this risk is concentrated in specific sectors (e.g. health, education, transport) we fear setbacks for the budget or competitiveness of companies (fall in exports, growth in imports). However, our base forecast is not taking these risks into consideration.

2.1.1.2 Capital Supply

Besides the labour shortage Estonian companies are also facing a **production capacity shortage** – in manufacturing close to 80% of capacities are employed and in the construction the capacity utilization is even higher – over 90%. The biggest shortage was evident in the middle of 2006, but for now the situation has somewhat improved, as due to strong demand, many companies have made investments, and in 2007 the process is expected to continue. This applies particularly to the food (in Oct 07, 66.7% of companies planned to increase capacities), rubber and plastics (62.5%), building materials (68.8%), metalworking (58.3%), electronics (62.5%) and furniture (63.6%) industries.

Production Capacities



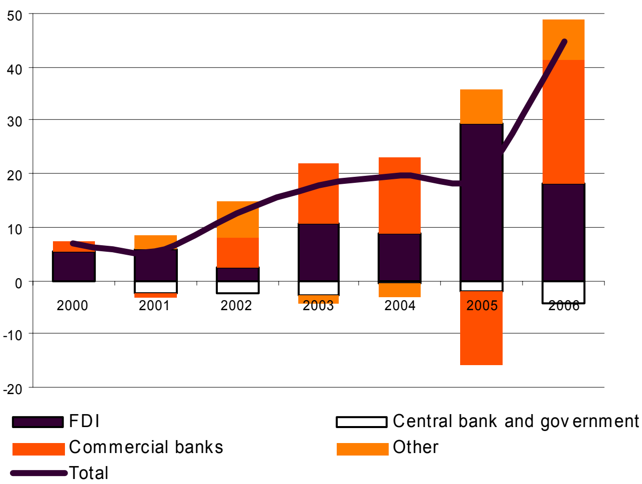
Source: EKI

However the increase of production capacities might be difficult for those companies, which need to make construction or renovation related investments. The capacity constraints are particularly strong in construction, and although this applies mostly for labour, it has made it very difficult to do fast and increasingly expensive investments into land and buildings. Still, we are of the opinion that this constraint will ease gradually during 2007 and the situation will be significantly better in 2008 and

[4] There is also a risk that the employees' negotiation power will turn into cumulative way to the overall increasingly rapid wage growth (e.g. to 20-25% in a year). This settles into our hard-landing scenario.

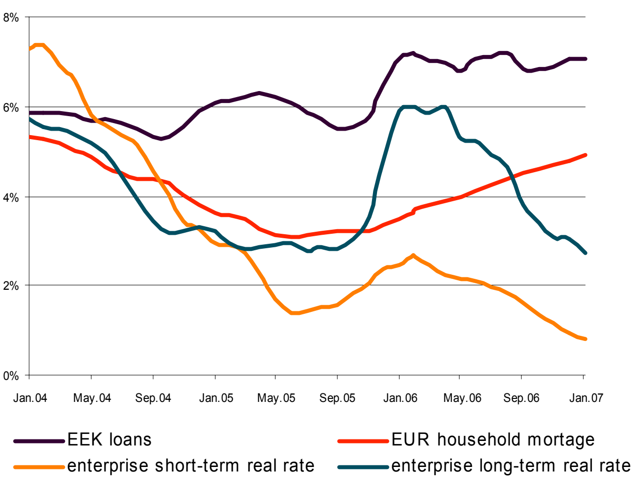
2009. Hence we can expect that the increase and modernisation of production capacities will intensify in 2008-2009.

Net Inflow of Finacial Account, bln EEK



Source: EP

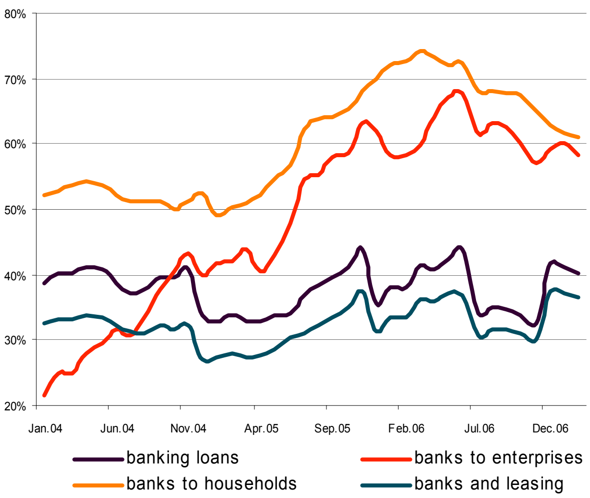
Interes Rates for New Banking Loans



Source: EP, ESA, HBM calculations

One very important factor behind the strong economic growth in Estonia in last two years was the inflow of foreign capital. The ample supply of cheap **financial capital**[5] brought down interest rates and lowered borrowing terms. However, increasing risks to the economy have started to work against this development. We are of the opinion that net inflow of foreign capital will remain approximately on the level of 2006 also in this year, and then a quite slow increase is expected (this is in line with our expectations of a falling current account deficit). We forecast a modest growth of FDI inflows in 2007-08, but FDI outflows will grow faster, hence the net FDI inflow will remain around 3% in 2007, but will slowly decline in the next few years. Other net capital inflows through the private sector will be smaller than in 2006; particularly the decline of banking net inflow is expected.

Annual Growth of Loan Portfolio



Source: EP

Besides the diminishing supply growth we also expect a higher cost of the financial capital. This is related with increasing interest rates in the euro zone, but also with growing interest margins because of higher domestic risks. But despite that, real interest rates will remain small (below 2%) as inflation is picking up. Consequently, investments should remain attractive although the situation continues to tighten faster than in the 2nd half of 2006.

If inflow of financial capital is stronger than we expect in our base scenario, then we forecast strong money supply growth, but in this situation the capacity constraints in construction become more acute. Hence, we forecast a faster growth of prices and money will flow into household hands, which in turn causes rapid growth of imports, together with a significantly higher current account deficit. This development is part of our negative scenario.

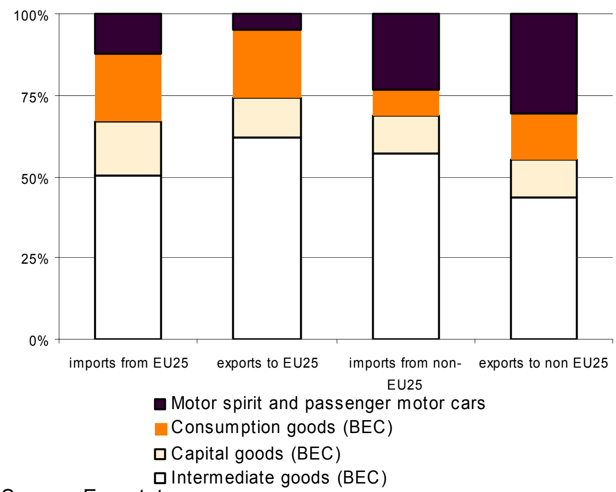
2.1.1.3 *Goods and Services*

The list of domestic raw materials is relatively short: agricultural products (first of all milk), timber and some natural resources (e.g. sand, limestone and the major one - oil shale). A characteristic for those inputs is the growing limits for the use of these

[5] In last two years approximatelly 30% of lending resources were domestic deposits, the remainder is foreign capital inflows through banks, which are owned by foreign banks. We do not expect a significant shift in 2007.

materials: agriculture is limited with production quotas, timber by cutting limits, and mineral resources by the limits of mining (set because of environmental reasons). Hence, we can expect that dependence on imported inputs will increase if Estonian companies do not make a significant shift toward the use of a highly qualified workforce, which produces high quality products not relying extensively on raw materials. Still, we are of the opinion that in 2007-2008, and probably for at least some years more, this significant change will not happen, though the Estonian economy will continue to shift from cheap labour to more expensive labour. Consequently in next years we expect that the dependence from imported production inputs grows.

Structure of Exports and Imports by BEC



Source: Eurostat

Estonian companies are already now highly dependent on imported resources, most exporting companies are relying on imported materials (e.g. metals, timber, electronic details, agricultural products, different energy products etc). This strong dependence also means that if there are problems in exports, imports will fall immediately.

The side effect of strong dependence from imports lays in prices – global price increases are rapidly affecting not only import and export prices, but also domestic prices. Hence, we can talk about a constant risk from price developments in global markets.

The capacity shortage in the Estonian economy has improved the situation of imported goods and services in the Estonian domestic market. The free movement of goods and services (Estonia has opened its services market, not like many "old" EU members) means that there are relatively low entry costs in the Estonian consumer market, and the rapid growth in demand has made Estonia attractive for importers.

We are worried that the strong capacity constraint in Estonian companies may end up with a high concentration in different goods and service markets, and hence work in favour of less competitiveness. This development is supported by the fact that many foreign companies have better and cheaper access to financial capital (this might be especially true in 2007-2009), and they might be ready to buy local companies to eliminate competitors. This is a risk, which probably will not be a big problem in the next couple of years, at least not in a significant way.

2.1.2 Demand Factors

2.1.2.1 Household Demand – Incomes, Spending and Prices

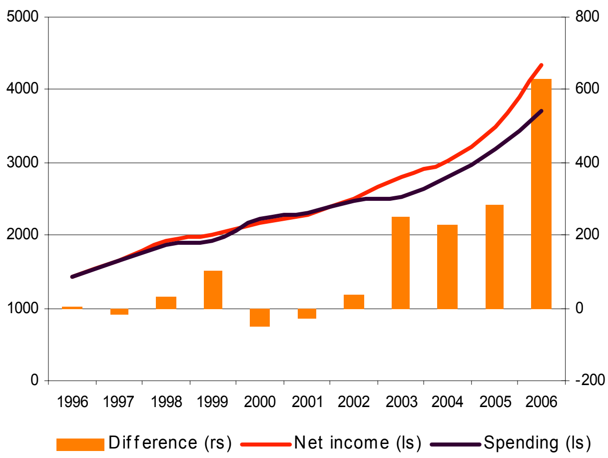
The household demand remains strong although we forecast that the growth of **household spending** will fall this year to below 12% (from 15.7% in 2006), below 10% in 2008 and lower in following years. There are several reasons that allow us to expect strong spending growth to continue, but also good reasons for expecting a slowdown in spending growth rates.

We expect that besides strong wage **incomes** (higher employment, and wages), incomes from various state allowances will grow. The latter is promised by the new government, and as this is backed by the more social approach of government policy[6], we expect it to be fulfilled to a great extent. Hence we expect strong growth of pension payments (and this will be supported by healthy revenues from the social tax) and maternity/paternity leave payments (this is meant for encouraging births), but other state allowances will also be increased, although their effect on total income will be significantly smaller than the aforementioned allowances.

The additional factor for supporting higher disposable income is the income tax cut programme – according to government plans, the income tax rate will be cut by 1% every year until it reaches 18% (it is currently at 22%). There will be changes in tax exemptions (e.g. for every child) which will also support higher disposable incomes.

[6] Estonian governments have been rather tight-fisted for social spending in the past; there is a clear shift towards higher social spending to solve problems in health, social insurance, education, and science spheres already evident in the policies of the last two governments at least; the current government seems to be making significant steps further.

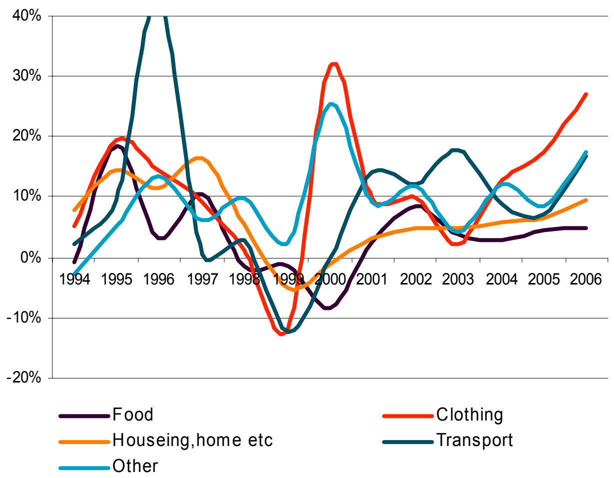
Household Budget Survey,
kroons per household member in month



Source: ESA; HBM calculations

However there are also factors that are working against higher disposable income. Namely, the growing indebtedness of households (both because of growing borrowing and higher interest rates) and growing savings – partly because of forced spending on insurance (related with real estate purchases and the 2nd pension pillar), but also because of voluntary savings for the future (currently relatively low, but with higher interest rates probably growing).

Households' Real Grow th of Spending

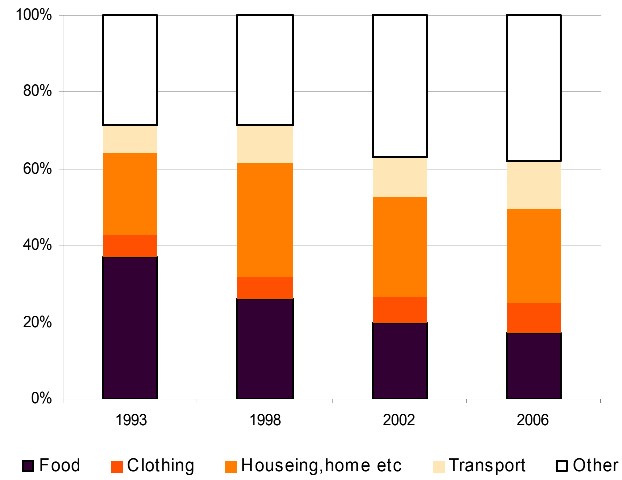


Source: Eurostat; HBM calculations

The growing income level favours spending growth particularly on services, while real spending for food purchases will continue to grow significantly less than spending for other items. However, there is a very important factor in household spending – price developments, which may hit demand quite significantly.

In the last 12 months, the fastest **price growth** has taken place in groups, which belong to first-need goods and services, i.e. food (7.5% in the 1st quarter), housing (14.6%) and transport (6.5%). This price growth affects most of all families with low incomes or with limited financial freedom. So the growth of state allowances might have a relatively small impact on real spending of families who are highly dependent on these payments. The forthcoming increase of VAT on long-distance heating from 5% to 18% (in July) will have a highly negative effect on the spending of households, particularly for those dependent on state allowances. We also expect strong price growth of natural gas in winter 2007/08, which will affect long-distance heating prices in many towns (incl. Tallinn). We also expect an increase of electricity prices in March 2008, due to much higher granted prices for green energy.

Household Consumption Structure



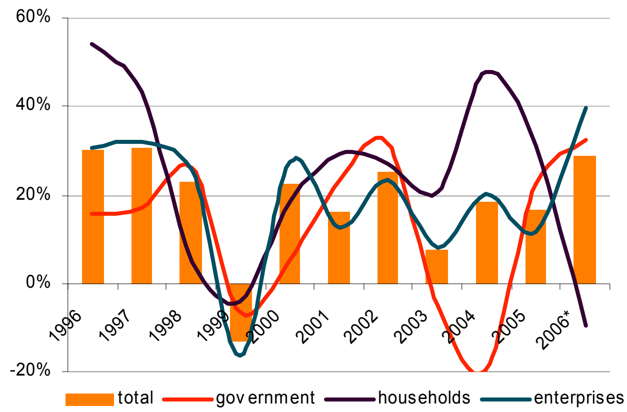
Source: Eurostat; HBM calculations

Currently we are witnessing a strong impact in demand on consumer prices (base inflation is up by 4%, total HICP by 4.6%; 12-months average), but the above-mentioned administrative increases will have a rather significant impact on overall price developments. Although we expect strong income growth, we are also of the opinion that those one-off and extensive price increases will affect the demand of other goods and services, and hence also prices. The negative impact will be especially noteworthy if winter 2007/08 turns out to be significantly colder than the last one, which was an extremely warm one. Still, due to strong administrative price increases in 2008[7], we forecast a fall of consumer price growth only in 2009.

2.1.2.2 Investments

The strong constraint of production capacities encourages **companies** to **invest** and the additional support comes from an increasingly tight labour market. Hence we expect that companies will invest even if investments are significantly more costly than in 2006. The other option is to close production (and this will happen with companies who are active in sectors which are competing with the cheap Asian workforce). We have already explained the other factors which support investments in companies (strong demand, finances etc) above.

Growth of Gross Fixed Capital Formation, current prices

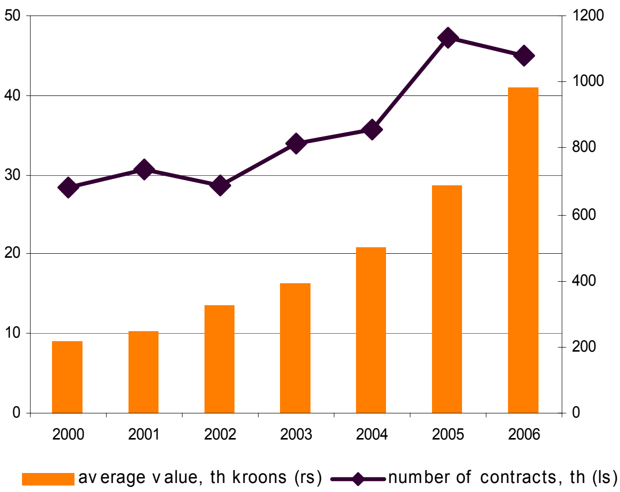


2006* - HBM estimates on households and enterprises

Source: Eurostat, ESA, HBM calculations, estimates

The strong inflow of foreign capital to the banking sector affected most of the **residential real estate sector** and construction thus being also the major factor behind capacity constraint in the latter sector. This ended up with extremely rapid growth of real estate and construction prices. However, very rapid growth of prices meant that many potential borrowers and buyers were effectively pushed out of the market and that ended up with falling demand in the residential real estate sector. So we have been witnessing the calming down process spreading from the Tallinn region to the other regions of Estonia during 2006; the process is about to deepen. The residential real estate market has shifted from a sellers' market to buyers' market, which means that the selling process is lengthy, buyers more demanding and there are increasingly more problematic real estate projects. There have been no big failures yet, and although we do not expect any to occur soon, we are also not denying the high probability of that in 2007 or 2008.

Residential Real Estate Market



Source: ESA, HBM calculations

The process of price differentiation has started and we expect it to deepen in 2007-2009 – so at the same time we can see both a fall of prices (mostly in so called real estate villages, which are badly located and lack infrastructure[8]), and price increases (in highly desirable areas, high quality real estate). We are of the opinion that the general price growth is about to turn slightly negative at the end of this year because many sellers will find themselves in a difficult situation. As a sum, the impact of household investments into real estate will be close to zero or slightly negative in 2007-2008 (and probably in 2009 also). This negative effect will solve a part of the construction sector's capacity problems, and probably layoffs will take place (or at least restructuring inside the sector).

For **public sector investments** we expect quite good growth in the future, although in 2007-08 the growth might be relatively modest. Although Estonia will receive significant EU payments in 2007-2013, the majority of those funds will start to flow into the country only in 2009-2010. And although finances aimed for investments in the budget system will increase, the strong price growth will cut real investments, and probably make it impossible to arrange some of them. The latter happens because

[7] Alcohol, tobacco and fuel excises will be increased to fulfill the EU minimum requirements

[8] This affects of course developers; smaller ones are expected to go bankrupt, while bigger, if envolved in different business sectors (e.g. also in industrial real estate), might survive even with significant losses if they are flexible enough.

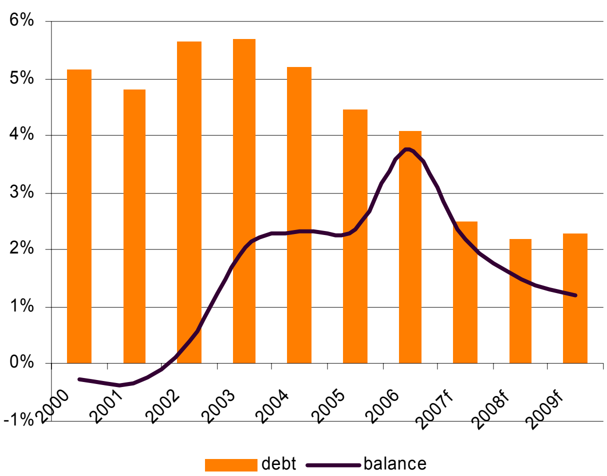
of the lengthy process of budgeting[9]. We are of the opinion that even if the price growth in the construction of buildings will slow (in 2008), the prices in infrastructure will still continue to grow as companies are aware of available money and time constraints (the money should be spent in limited time-frame).

As a sum, the investments in the public sector will grow relatively slowly in 2007-08, and the growth is about to strengthen only gradually in 2009-2010. As household investments will remain flat or declining, the only contributor for investments growth will be in the corporate sector. This is the reason why we expect a rather sharp fall of investments' real growth in 2007 (from 19.2% in 2006 to ca 8-9%, incl. inventories).

2.1.2.3 Government Spending and Policy

The story with government spending will remain as it was in the past: despite strong revenue and expenditure growth the real growth of spending (in GDP accounting system) will remain very small (ca 1-2%) because of an extremely rapid price growth (10.6% in 2006). We are not expecting to slow down this price growth significantly in 2007-08 due to planned (and agreed) wage increases.

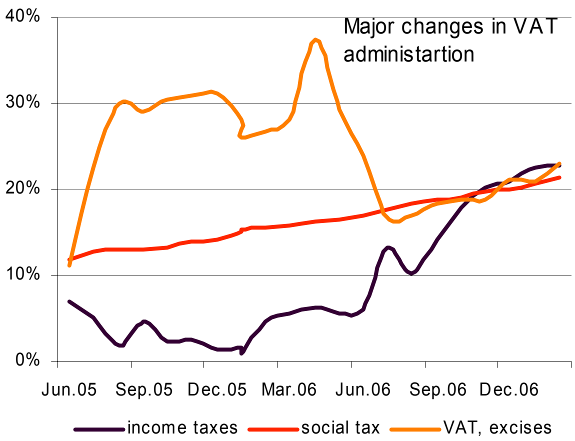
Public Sector Finances, % of GDP



Source: ESA, HBM calculations

We remain in a waiting situation in estimating the new government's economic policy because, besides a promise to keep the budget in balance or in surplus, there is very extensive social programme and the government is planning to continue with income tax rate cuts. We are of the opinion that the increase of VAT on long-distance heating (see above) and excises on tobacco and alcohol (from 2008) will not compensate the fall of income tax rate.

Annual Grow th of Major Tax Revenues, 12-month-rolling



Source: ESA, Estonian MoF, HBM calculations

Hence we are of the opinion that there are many factors, which make the government's **economic policy** inclining toward **expansive** one even if it ends with the budget surplus. The first test will be in the middle of this year, when the government can make a supplementary budget for spending extra tax revenues collected so far (and expected to be collected in the 2^{nd} half of the year). We are of the opinion that there will be the supplementary budget, at least for retargeting the spending (the current budget was made by previous government). However, we would like to see that the government will not increase this year's spending in the supplementary budget, and that extra revenues will form a healthy surplus for the budget. Still, we are not very optimistic on this and forecast that the government will increase spending somewhat, although the surplus will be bigger than currently planned (ca 2.2-2.5% of GDP).

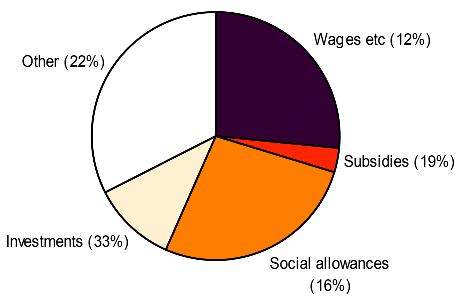
The question is more worrisome with **next year's budget**, because we are of the opinion that the Ministry of Finance made a too optimistic economic forecast for the next year. Hence they are suggesting that the revenue will grow very strongly. As the government's social programme is very ambitious and requires significant finances, we see a risk that next year's budget will be too optimistic also on the spending side. In the case of weaker than expected economic developments the state budget might run into deficit. We hope that the Ministry of Finance will make a more conservative

[9] E.g. the budget plan is made in 1H of year x, the budget approved in December year x, but actual spending would be made only 2H of year x+1, when construction prices have probably grown strongly.

economic forecast for 2008 and thus avoid revenues shortfall.

The new government is planning extensive spending in the social sphere – in the health and education system, the increase of state allowances, spending growth in domestic and military defence, environmental protection, etc. The first years of the governance (2007-2008) are most promising for making extensive reforms, as there are no elections forthcoming. However, the reform programme is too extensive for making all or most of them quickly, consequently we are of the opinion that those which require a longer preparation period and are more expensive to carry on might not be started or at least finalised. This includes reforms in the health system, education (particularly in professional education) and R&D, which we consider the most important for long-term economic development. We are also of the opinion that the new government has yet no clear idea what to do in some of those areas, where they promise changes; so nothing may happen soon.

General Government Expenditures, 2006



Growth rates in parentheses ; total growth 18.4%

Source: ESA, HBM calculations

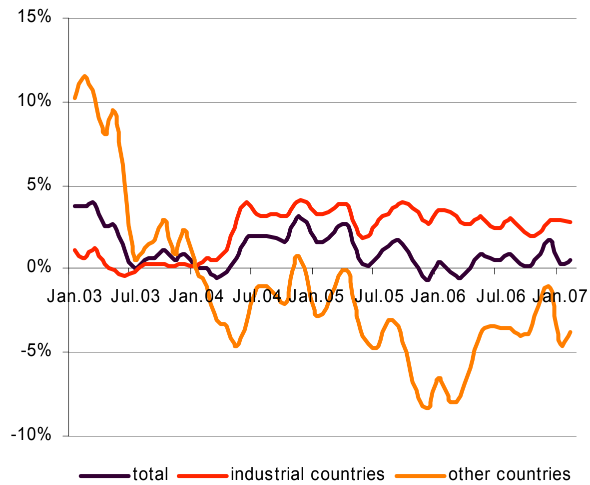
Due those factors we are a bit conservative regarding expected changes in the government's policy and expect only minor developments in those areas. Although those reforms would affect economic developments mostly in the future, the preliminary effect will also be delayed and that might worsen future expectations regarding the business environment and economic developments, diminishing long-term capital inflows and increasing the cost of the capital.

2.1.2.4 External Demand and Balance

As written in the *General Assumptions* we expect that the global economic growth will remain healthy, albeit smaller than in 2006. This applies particularly to the EU, but also for Russia. Hence there should be **good opportunities** for Estonian companies to increase exports. The other question is how companies will succeed in increasing exports.

As was written above, Estonian exporting sectors have generally kept their **competitiveness** – the productivity growth is strong and remains above wage growth. This has been achieved through constant restructuring, which will continue to affect Estonian exporting sector also in future. As written above, we expect a decline of production in companies, which have to rely on a cheap workforce and compete with cheap Asian producers. We also expect increasing dependence on imported inputs, which support growing integration with the rest of the world, and probably growing involvement of foreign companies in the Estonian manufacturing sector (but also exporting services industries). However, this also increases the risks deriving from price developments.

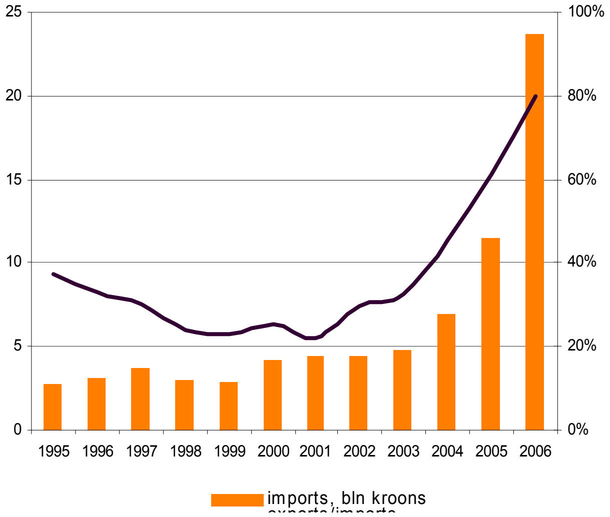
Annual Growth of REER index



Source: EP

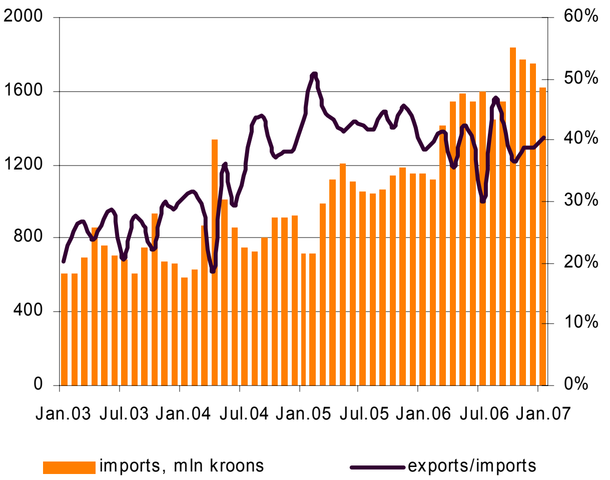
The very important factor in Estonian foreign trade is **transit**. The sad story is that with EU statistics it is impossible to distinguish between Estonia's own exports and transit exports. According to our very brief calculations, Estonian manufacturing exports probably take ca 45-50% of total merchandise exports reported by the Statistical Office. The rest of the exports are non-manufacturing exports and transit, where the latter dominates heavily. Those transit volumes affect Estonian exports (and imports) volumes very significantly – not only through service revenues, but also trade balance, turnover and short-term economic data (e.g. monthly balance of payments).

Foreign Trade of Mineral Products



Source: ESA; HBM calculations

Foreign Trade of Passenger Cars etc.

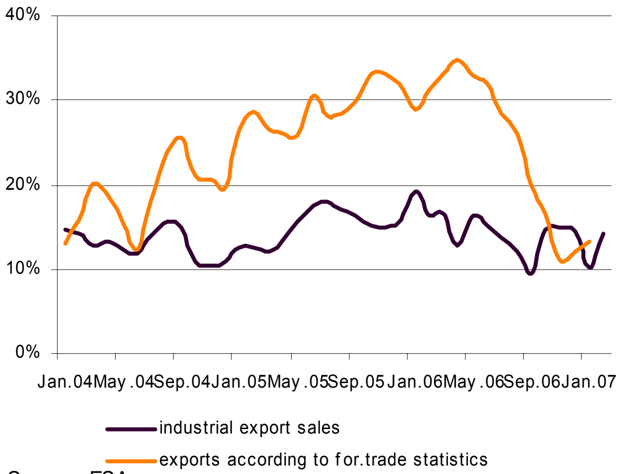


Source: ESA; HBM calculations

There are three types of transit which pass through Estonia, as we have also mentioned in our previous *Baltic Outlooks*. The "**traditional**" **transit** of Russian raw materials or little-processed production inputs to the rest of the world (mostly Western countries) includes first of all oil products, but also metals and timber. The past has shown that growing prices are encouraging this type of transit, but they are also subject to hardly-predictable administrative decisions. The good point is that these interferences have diminished since 2004. The rapidly growing transit of Western goods **to Russia** includes both investment goods (e.g. machinery), but also consumer goods (incl. durables and passenger cars). The growing wealth of Russians and the underdeveloped Russian manufacturing industry are supporting this type of transit in the future. The problem is that this type of transit is hard to separate from imports to the Estonian domestic market, especially if it is not compared with exports. This has brought about some odd explanations, e.g. Estonians buying many passenger cars (although Estonians buy lot of passenger cars, this is not 50-55% more than in 2005, but more like 13-15% according to 4Q figures). The third type of transit – strictly speaking not transit at all – involves the development of a **common Baltic market**, where distribution centres are located in one country but serve all three.

The problem with transit is that the import and export of transit goods does not take place in the same month- very often even not in consecutive months (especially if talking about transit to Baltic or to Russia). The build-up of new businesses also affects the import-export pattern (e.g. the above-mentioned passenger cars). We are of the opinion that due those above-mentioned factors, it is wrong to make conclusions based on the information of a few goods and one should be very careful when talking about the exports of Estonian companies (see also added chart).

Annual Growth of Merchandise Exports
(3 months average)



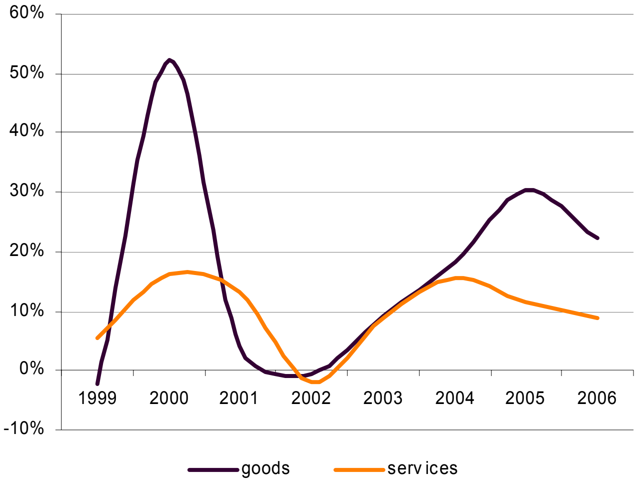
Source: ESA

Still, we are of the opinion that the impact of the transit business should start to diminish in the future, if Russian economic developments stabilize. However, the share of transit probably will not decline, at least not significantly if the Russian economy does not collapse[10]. We are also of the

[10] Even it this case, the transit to Russia is most likely to suffer and others will more or less survive; traditional transit might even grow.

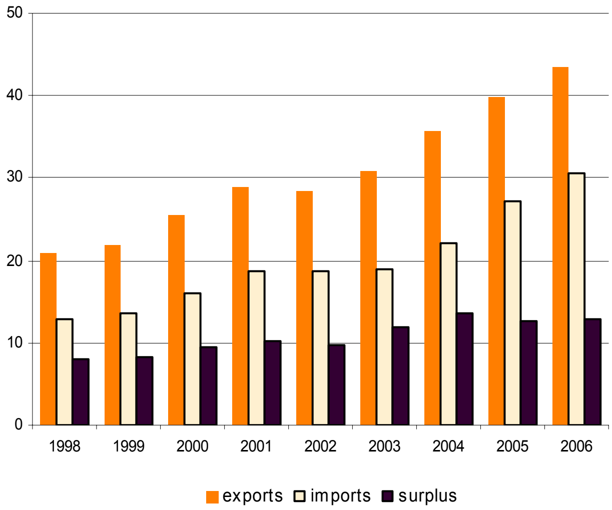
opinion that imports will continue to grow faster than exports in 2007, and maybe even in 2008.

Exports of Goods and Services



Source: EP

Services Trade, bln kroons

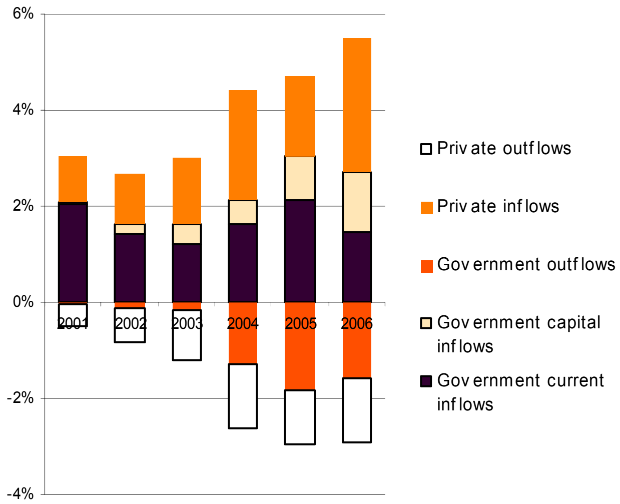


Source: EP

The question remains open for the services trade. We expect that the situation will improve for exports - if not in 2007, then in 2008. We see at least one important contributor – passenger transport, particularly marine and railway transport. The number of Finnish tourists might fall, but we expect that they will increase their spending, as they will stay in Estonia for longer periods. The same applies for other tourists as well (first of all from Russia and Germany). However, Estonians will increase their holiday spending abroad due to growing incomes.

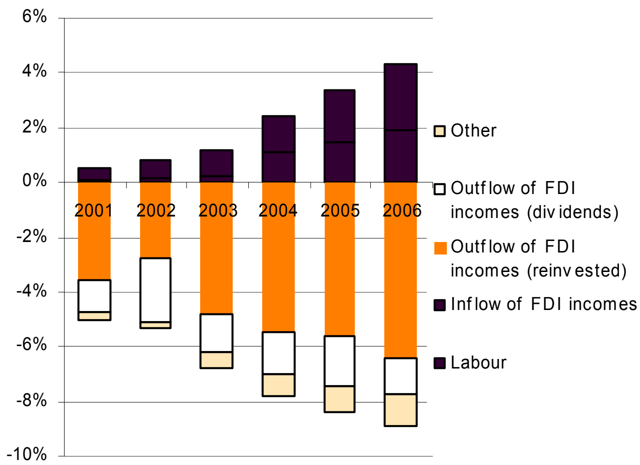
We have several times failed to make correct forecasts for the transport of cargo, i.e. how it splits between exports and imports or domestic and foreign companies. This is of particular concern, as it is very difficult to forecast at the company level, but due to the smallness of the Estonian economy, single companies might have a significant effect on the outcome. Still, we are of the opinion that at least the turnover of cargo transport services will increase in 2007-2008 quite healthily.

Current and Capital Transfers, % of GDP



Source: EP; HBM calculations

Income Account Flows, % of GDP



Source: EP; HBM calculations

The trade and services deficit will decline only gradually in 2007-2008 and onwards; the same applies to the current and capital account deficit. Still, we see that there are better chances for the decline of the latter. We forecast that interest net payments will remain stable – i.e. close to zero – but the investment incomes from abroad will grow faster than investment incomes in Estonia. However, as the latter are significantly bigger, the deficit in the income account will decline relatively slowly.

The current and capital transfers disappointed us in 2006; particularly the 4th quarter was very weak as the state transfers fell far behind expectations. This has forced us to take a significantly more pessimistic view – we expect that the surplus of transfers will increase in 2007 (as a ratio to GDP) as the final flows from the previous budgetary period will be transferred. However, the above-mentioned preparation period for using the EU funds means that the increase of inflows from the EU budget will be rather modest in 2008.

Our hard-landing scenario, which forecasts strong capital inflows to the economy and continuation and intensification of wage growth, expects strong imports growth and a very rapid deterioration of the trade and services balance (hence also the current and capital account).

2.2 Monetary Policy

We do not expect changes in Estonian monetary policy until Estonia enters the euro zone. However, the outlook for the euro zone membership has shifted to the distant future. There is a slim chance that it may happen in 2010 – if prices of raw materials fall, and wage growth diminishes significantly in 2008-09. However, as we explained above, it is not a likely scenario. The more realistic is to expect membership in 2012 – probably for this time, the Estonian economy has gone through extensive restructuring and the labour shortage is not dramatically affecting the local price levels any more. This also assumes a tighter fiscal policy than is currently run and stable or somewhat lower prices of raw materials. Weaker global developments would benefit the Estonian euro zone membership, as this would ease the capacity constraint and bring down global prices.

2.3 Inflation

As we explained above we expect consumer price growth to accelerate in 2007-2008 due to strong demand, and administrative increases to 5.2%. The same development is true for other price indices, particularly producer prices (4.8% in 2007). Although export prices will increase, we see this as the result of the improving quality and structure of exports. However, import (as well as export) prices will remain subject to external factors (first of all oil, but also metals).

Maris Lauri

Latvia

1. Recent Economic Developments

In 2006 Latvian GDP grew by 11.9% (10.6% in 2005), registering its fastest growth ever. On the back of overall optimism, economic growth was buoyant throughout the year, peaking at 13.1% yoy in the 1st quarter and moderating to 11.7% in the 4th quarter. Growth was domestic demand-led as consumption and gross fixed capital formation expanded by respectively 20.0% and 18.3% (11.6% and 23.6% in 2005) but exports by only 5.3% (20.3% in 2005). Employment rose by 4.9% and labour productivity by a healthy 7% (1.5% and 8.7% in 2005, respectively).

Economic environment in 2006 was shaped by:

- expansionary fiscal policy as extra revenues were used to boost incomes prior to general government elections in October 2006;
- swift credit growth biased towards residential real estate;
- tightening labour markets due to emigration and strong domestic demand;
- accelerating wage growth and widening wage–productivity gap;
- strong investment growth in response to demand growth and also as businesses aimed to limit their labour dependency and boost productivity;
- stubbornly high inflation largely due to demand pressures and rising administratively regulated prices;
- negative real interest rates and strong positive wealth effects boosting optimism and consumption (through residential real estate price growth);
- low savings levels by households in contrast to good business savings[11].

Under these conditions economic growth overshot sustainable levels and supply side constraints became increasingly evident, e.g. in slowing of construction growth from 17.4% yoy in the 1st to 10.3% in the 4th quarter due to straightforward capacity constraints.

Strong domestic demand spilled over into imports and current account deficit widened to a record 21.1% of GDP (12.6% in 2005), shooting up from 14.6% in the 1st to 26.3% in the 4th quarter. Exports growth considerably lagged behind that of imports (14.5% vs. 28.6%) as rising production costs reduced competitiveness and producers found selling in home markets increasingly attractive due to high demand and prices. Bias towards domestic demand sectors strengthened (e.g. wholesale and retail trade up by 17.4% whereas manufacturing by 6.8%).

As pointed out in our previous reports[12], these imbalances must be addressed swiftly to limit the hard landing risk. Lately these issues were also increasingly commented on by international observers. On February 19th, 2007 the rating agency *Standard & Poor's* published a report in which it retained Latvia's sovereign rating of A-/A-2 but decreased its future outlook from stable to negative, pointing to internal and external imbalances and urging that "timely and effective government policy response and a well coordinated approach from the private sector" is necessary for a soft landing. It triggered a sharp rise in financial markets volatility via devaluation pressures (see section 4 for details). The currency pressures have eased since then but the lats' interest rates have climbed from 4–5% to 9–10% as the central bank has restricted the lats' liquidity. LaB actions have effectively closed forward market and any sizeable speculative flows thus making devaluation of the lats extremely unlikely through forex speculation. Equity and debt markets are too thin to have potential for significant speculative flows[13]. Furthermore, as capital inflows are predominately from Nordic parent banks that view Latvia as their home market, abrupt capital outflows or abrupt freezing of inflows that may induce a sharp contraction in the economy is not likely, as it would be purely value-destroying.

Soon after the *Standard & Poor's* report the government approved its anti-inflation plan aimed at reducing macro imbalances, i.e. setting a base for a soft landing with moderating GDP growth towards sustainable medium run levels of 6–8% p.a.

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[11] Gross savings amounted to 17% of GDP (21.8% in 2005). For details, see Kazāks M., Stikuts D. [2007] "Savings – wiser future for households and country", Hansabanka Analytical Discussions (full text in Latvian available at www.hansabanka.lv; an executive summary in English is available from the authors upon request).

[12] For instance, see The Baltic Outlook, November 2006.

[13] For instance, capitalization and turnover of the Riga Stock Exchange in 2006 were a mere 11.2% and 0.5% of GDP, respectively.

	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	9911	9978	11176	13012	16180	19753	22848	26,109
GDP per capita, euro	4238	4291	4832	5656	7070	8788	10256	11792
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	15.0	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	9.0	8.0	7.5
Growth of exports of goods and services, %	8.7	14.4	21.2	31.4	14.5	18.6	18.0	16.4
Growth of imports of goods and services, %	9.1	19.5	26.8	27.4	28.6	13.3	10.0	9.2
Balance of goods and services, % of GDP	-10.0	-12.7	-15.8	-15.1	-21.0	-17.6	-13.8	-10.5
Current account balance, % of GDP	-6.6	-8.1	-12.9	-12.6	-21.1	-19.3	-16.0	-13.2
Current and capital account balance, % of GDP	-6.4	-7.5	-11.8	-11.2	-19.9	-15.4	-11.9	-11.6
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	115.0	115.0	115.0
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	13.6	14.6	14.5	12.1	9.1	9.2	9.5	8.4

Implementation of the anti-inflation plan

Measure	Planned activity	Planned to come 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 1st 2007
	Differentiated higher fees for RE and collateral registration in Land Register	Apr 16th 2007
	Additional tax on car purchases	Jun 1st 2007
Credit expansion	State Revenue Service confirmed income to receive a bank loan	Jun 1st 2007
	Confirmed income for certain purchases above 100 min wages	Jun 1st 2007
	10-15% down payment for a loan	Jun 1st 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, * RE - real estate

2. Economic Policy and the Anti-inflation Plan

On March 6th, 2007 the government approved its anti-inflation plan drafted by the group of experts under the auspices of the Ministry of Finance. The group was formed back in December 2006 by the government's mandate in order to develop an action plan to curb inflation. The group comprises representatives of the economy's key decision makers – MoF, LaB, the Association of Latvian Commercial Banks, the Public Utilities Commission, and the Employers' Confederation of Latvia to name a few – and represents a consensus view strongly supported by all counterparties. The plan sets out activities to tackle Latvia's internal and external imbalances by aiming to constrain domestic demand growth, increase economic flexibility, and boost exports. Activities in the areas of fiscal policy, taxes and credit expansion contain immediate measures with legislative changes either already approved by the government on March 6th or currently being discussed. These activities were assigned the urgency procedure and either already have or are expected to come into force on June 1st, 2007.[14] We expect them to have a swift effect on moderating domestic demand growth. Activities in the labour market, energy, and competition areas cover medium to long term issues that are being drafted with no specific implementation dates set yet (for a more detailed outline of the plan, see Appendix).

Although we are of the opinion that the anti-inflation plan is somewhat belated, we fully support it and see it to be adequate to tackle the country's imbalances. Namely, higher taxes and slower credit growth will reduce internal imbalances by crowding out speculative element from the real estate sector and reducing domestic demand growth. Stabilizing or moderately decreasing real estate prices will reduce positive wealth effects, thereby stimulating savings, lowering optimism and thus spending. It is expected that funding and labour will be redistributed away from domestic demand (particularly construction) towards exports sectors. This in turn shall reduce external imbalances with imports decelerating due to slowing domestic demand growth and improving exports. The strength of stabilizing measures shall be continuously monitored and adjusted if necessary. This implies tightening the conditions if demand growth remains excessively high and easing them up if there is a risk of too abrupt contraction in domestic demand that may induce a self engineered recession.

3. Economic Forecast

3.1 Assumptions and Summary of the Forecast

Our forecast is based on the following assumptions:

- External environment remains quite favourable (see General Assumptions)
- The anti-inflation plan is implemented in a swift and comprehensive manner, and clearly communicated to domestic and foreign stakeholders

Due to rising capacity constraints and predominately due to domestic demand growth restrictions introduced in line with the anti-inflation plan, we expect GDP growth to slow to 8–9.5% in 2007, 6.5–7.5% in 2008–09. We expect residential real estate prices to stabilize or moderately decrease in 2007, which will reduce positive wealth effects and thus private spending growth. Our CPI forecast has been revised to 7.5–8.5% for 2007; we expect inflation to slow to 5–6% in 2008 and 4–5% in 2009. In view of labour market tightening, we forecast the harmonised unemployment rate to reach 5.2–5.8% in 2007, 5–5.5% in 2008, and 4.8–5.2% in 2009, while real net wage growth is expected at 8–10% in 2007 slowing further to 7–9% and 6.5–8.5% in 2008–09, by then largely eliminating positive wage–productivity gap. With consumption, investment and thus import growth decelerating in the 2nd half of 2007, the current account deficit is likely to improve to 18–20% in 2007 and further to 15–17% in 2008 and 12–14% in 2009. The central government budget is likely to be balanced in 2007 and achieve a surplus of 1–3% in 2008–09.

It must be noted that we still expect very high consumption growth in early 2007 driven by strong consumer optimism and economic inertia, as well as stabilisation measures being introduced only in the 2nd quarter. Therefore, the 1st half of 2007 data will still show strong domestic demand growth and widening macro imbalances, e.g. current account deficit perhaps close to 21% of GDP in the 1st quarter of 2007 compared to 14.6% a year ago. We expect the slowdown to become evident in the 3rd quarter data (reported in November).

GDP Growth Rates, %

	2004	2005	2006	2007f
GDP	8.7	10.6	11.9	8-9.5
Private consumption	9.5	11.5	19.8	8.5-10.5
Government consumption	2.1	2.7	4.0	1.5-2.5
Investments	23.0	8.5	18.9	5-6
Gross fixed capital formation	23.8	23.6	18.3	5-6
Exports	9.4	20.3	5.3	7-9
Imports	16.6	14.8	17.5	4-6

Source: Eurostat, Hansabanka forecasts

This is our base or soft landing scenario. The hard landing scenario assumes 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 delayed or being too soft and macro imbalances strengthen 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.

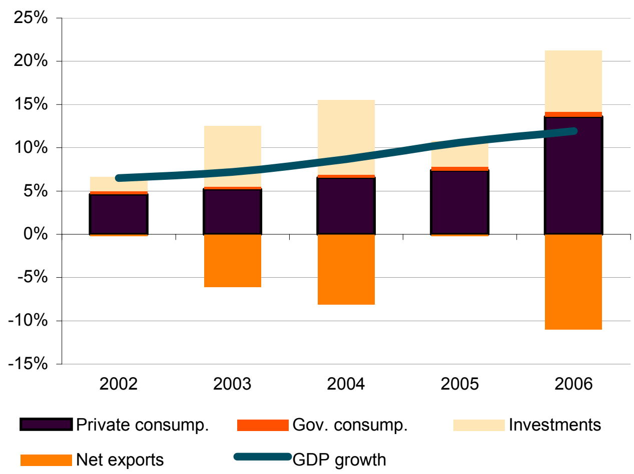
[14] Urgency procedure means that to accept the proposed legislative changes requires two Parliamentary hearings instead of the standard three hearings. On April 16th regulations came into force setting higher duties for registering real estate and mortgage in the Land Register.

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

3.2 Domestic Demand

Economic growth in 2006 was mainly based on domestic demand. It contributed 21.3% to GDP growth of which private consumption comprised 13.6%, gross fixed capital formation 6.9% and government expenditure 0.6%. In perspective of the anti-inflation plan, we expect domestic demand growth to decelerate in 2007–09 due to lowering optimism and a shift in businesses' preferences towards exporting sectors.

GDP by Expenditure: Contributions

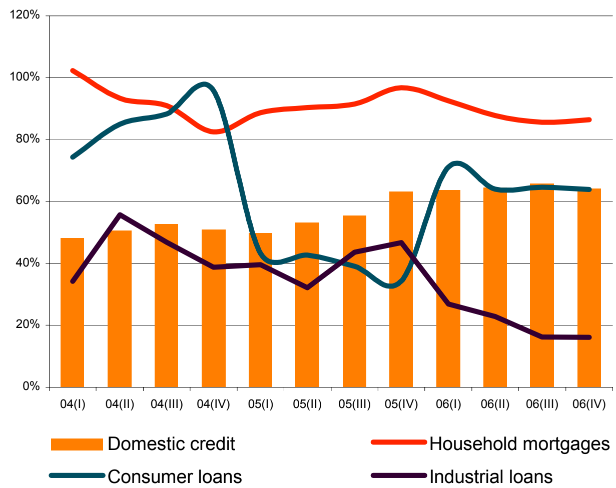


Source: Eurostat

3.2.1 Credit Expansion

Domestic credit[15] stock grew by 57% in 2006 (64% in 2005), extending to nearly 80% of GDP.[16] Currency composition is heavily biased towards foreign exchange with nearly 80% of the credit being issued in euros (predominately due to lower interest rates and so far disregarded currency risk) and only about 15% in lats. While this means that borrowers have taken on currency risks (household liabilities are rarely hedged), it also means that the lats' rising interest rates have a limited direct effect on those that have already borrowed, since their monthly payments do not increase along with the lats' rates[17]. It stabilizes the deceleration of domestic demand by not harming the current borrowers while discouraging prospective borrowers[18]. Further, such debt composition clearly shows devaluation to be an inadequate response to the macro imbalances – albeit it would cut imports, domestic demand would suffer greatly as liabilities would rise and purchasing power would dwindle proportionally. Given free labour mobility, any potential gains from devaluation would be considerably reduced as rapid decrease in relative incomes would foster emigration.

Annual Growth of Banking Loans



Source: FCMC

Credit growth was strongly biased towards consumption. Albeit slowing from 103.1% yoy in December 2005, in 2006 mortgage lending growth remained high at 92.1% (86.5% for household mortgages), supporting residential real estate price growth and consumer confidence (via wealth effect). Consumer loans accelerated to 63.9% (34.3%

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15 Credit to resident households (including NPISHs) and non-financial corporations.

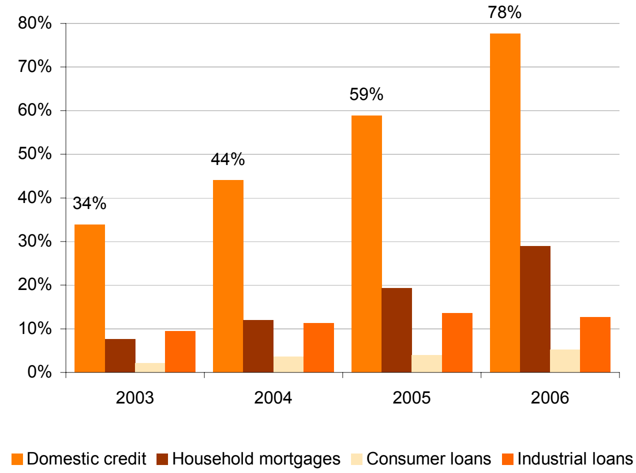
16 Latvia's credit stock rapidly approaches levels comparable to those of the EU15 economies (e.g. 95% in the euro zone, 106% in Sweden, and 141% in Ireland in 2005). A number of studies (e.g. Deutsche Bank [2006], Égert et al [2006]) suggest that optimal domestic credit to GDP ratio given Latvia's development could be at about 80%. However, those estimates do not account for a largely missing stock exchange. Given that businesses therefore finance themselves almost entirely via banks, optimum credit stock must be higher than that. Also, market penetration is still very low for a number of major credit aggregates, e.g. there are only about 15% of households that have mortgages. Thus, there is still a potential for credit growth, yet the growth rates must certainly decrease.

17 Consumer loans are issued in the lats, though those interest rates are fixed. If mortgages are taken in the lats, they are predominately issued with interest rates fixed (currently for 2 years, 5 years before).

18 Through higher interest rates in the lats and also in the euros, as margins would increase due to higher risk assessment under the current market conditions.

2005). Growth of industrial and commercial[19] loans more than halved to 16.1% and 26% yoy from 46.7% and 57.2% in 2005, respectively.

Bank Loans, % of GDP



Source: FCMC

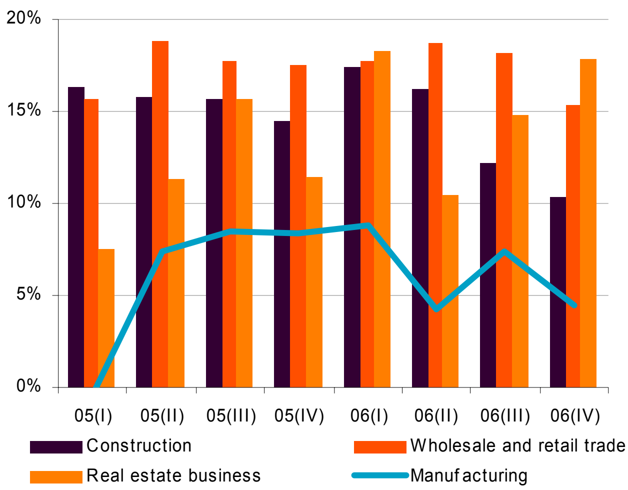
In the first 2 months of 2007 domestic credit growth remained high, reaching 56.8% yoy. In view of banks' lending policies turning more conservative[20] (and clients gradually becoming more risk aware), we expect to see a clear slowdown trend in credit growth to set in from the 2nd half of the year. For the soft landing scenario we expect lending growth to moderate to 30–40% in 2007, 20–30% in 2008 and 10–20% in 2009, i.e. domestic credit to GDP ratio stabilizing at about 100%. Credit growth must slow sufficiently to moderate domestic demand growth, though not too abruptly to avoid instigating a recession. Given changes in the risk profiles of business sectors, we expect credit growth shifting more towards exports sectors.

3.2.2 Private Consumption

In 2006 real private consumption grew at record 19.8% (11.5% in 2005) in constant prices, speeding up from 17.2% yoy in the 1st quarter to 23.6% in the 4th quarter. Consumption was driven by historically high consumer confidence, wage growth, and cheap credit. Residential real estate price growth produced strong wealth effects thus boosting consumer optimism. Negative real interest rates[21] shifted incentives further away from savings and towards consumption. Household gross saving rates have been very low (e.g. 0.7% of GDP in 2005) and our analysis[22] does not find evidence of a considerable improvement in household saving behaviour during 2006.

Driven by high consumption demand, the fastest growing sectors in the economy were real estate, renting, and business services (17.6% in 2006 and 10.3% in 2005) and wholesale and retail trade (17.4%; same in 2005). An outstanding consumption growth in 2006 was reflected in retail car sales' volumes rising by 95.2% (sales of passenger cars registered for the first time rose by 50.3%, one of the highest rates in the EU).

Annual Growth of Value-added in Some Sectors



Source: Eurostat

A strong consumption-driven boom was also registered in construction that grew by 13.6% despite capacity constraints visibly mounting throughout the year and slowing its growth from 17.4% yoy in the 1st quarter to 10.3% yoy in the 4th quarter. Strong (also speculative) demand for real estate boosted residential real estate prices by 40–60% p.a. creating positive wealth effects for the majority of households (about 80% of households

19 Industrial loans finance machinery, equipment, etc; commercial loans finance working capital.

20 Both as banks themselves recognize higher risks and the central bank restricts the lats' liquidity making it increasingly difficult to meet reserve requirements and thus grow lending portfolios.

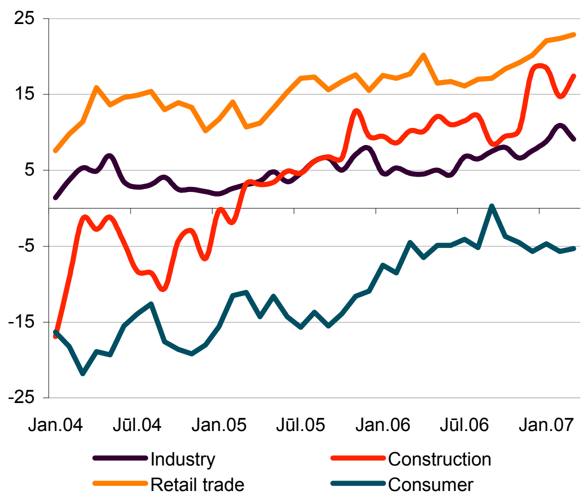
21 In 2005–06 average real long and short term interest rates were negative at about 2–3% for the lats' deposits; average real long and short term interest rates on the lats' credit were respectively at 3–4% and about zero. The real euro rates were negative for both deposits and credit. In calculations ex post CPI inflation is used as a deflator (also applicable to the euro because of the exchange rate peg).

22 For details, see Kazāks M., Stikuts D. [2007] "Savings – wiser future for households and country", Hansabanka Analytical Discussions (full text available in Latvian at www.hansabanka.lv; an executive summary in English is available from the authors upon request). Data on gross savings by institutional sectors for 2006 will be published only in spring 2008.

own real estate via privatisation, the gain is predominately illusionary as it is typically the sole dwelling of a household, which it occupies).

Confidence indices have remained high also in early 2007. Consumer confidence so far seems to be the only to show signs of stabilizing. The available statistical data for the 1st quarter of the year show continuation of strong spending growth (retail turnover up by 28% yoy), which indicates that private consumption growth in the 1st quarter remained high (17–19% yoy according to our forecast). Driven by inertia, 2nd quarter consumption growth will be still high at 12–14% with a stronger decrease in the 2nd half of the year as the anti-inflation plan starts to yield its fruits. Consumption growth is also expected to slow as stabilizing or moderately decreasing residential real estate prices will diminish positive wealth effects.[23] Hence, we expect private consumption to grow by 9–11% in 2007. Albeit wage growth will still be considerable and employment will grow slightly (see section 3.2.5), consumption growth is expected to shrink to 6–8% in 2008–09 due to rising savings.

Confidence Indices, s.a



Source: Eurostat

3.2.3 Investments

Investment figures were significantly revised for 2005 and 2006 by LCSB. According to the revised data, in 2006 gross fixed capital formation increased by 18.9% in constant prices (8.5% in 2005). Investments share in GDP has risen to very high levels (at 37% of GDP in 2006, while EU average is 20.5%, in Estonia 33.8%, in Lithuania 23.1%), thus we do not see a large scope for its further growth.

Non-financial investments (NFI) accounted for 51.8% (63.6% in 2005) of gross fixed capital formation. The fastest growth in NFI was registered in real estate, renting and business services (up by 78.4%; 34.3% in 2005), public administration and defence (37.5%; 14.7% in 2005).

We expect slowdown in investments growth to come from domestic demand sectors. For instance, wholesale and retail trade, construction and real estate activities account for nearly 30% of NFI. These are sectors to see perhaps the strongest cooling effects from the anti-inflation plan, and as investment flows in these sectors moderate from the very high level of 2006 or grow very slowly, it will significantly reduce overall investment growth. In contrast, we expect investment activity to pick up in exporting sectors such as manufacturing, as they benefit from easier access to labour and financing resulting from the cooling of domestic demand.

EU funds will retain a strong influence. Over 2007–13 inflows are expected to reach about 4% of GDP equal to 15–20% of annual total gross fixed capital formation. Albeit only a part of EU funds is used for investment purposes, they have a strong augmenting effect due to required private co-financing. In 2007 and 2008 funds from the previous EU budgetary period will still dominate, while funds from the current budget period of 2007–13 will become available earliest at the end of 2007.

As for public investment, we expect the government to focus on infrastructure projects and postpone other large-scale projects such as the Riga Concert Hall. It must be done to avoid exacerbating already overstretched labour markets, as such projects would create more demand, further driving up wages and draining labour from other sectors.

Consequently, we forecast gross fixed capital formation growth to slow to 6.5–8.5% in 2007 and 3.5–4.5% in 2008, and then pick up to 4.5–5.5% in 2009.

3.2.4 Government Consumption

In 2006 final consumption expenditure of the general government grew by 4% in constant prices, reaching the highest growth rate since 1998. While over the first three quarters government consumption grew by about 2% yoy, in the 4th quarter it jumped by 9.2% reflecting fiscal expansion as excess revenues were spent (largely due to general government elections in October). The

[23] Our analysis shows that following rising financial market volatility and in expectation of higher taxes on real estate set out in the anti-inflation plan, the supply of dwellings for sale in Riga increased by 50–60% in April, compared to that before the February events. Price stabilization has not yet been registered, but indications suggest that it may soon set in.

central government basic budget ended 2006 with a deficit of 1.7% of GDP whereas the general government budget was in surplus of 0.4%[24] (on account of surpluses in municipalities' and social security budgets).

In the 1st quarter of 2007 the general government has accumulated a consolidated budget surplus of LVL 151m (c.a. 1.1% of forecasted annual GDP), a typical seasonal pattern early in the year. The main part of that is the central government surplus of LVL 97.4m. Also municipalities' budgets are in surplus of LVL 53.1m[25]. Net revenues grew by 29.9% yoy (to LVL 1180m), net expenditures by 31.2% (to LVL 1029m). Booming economic activity is reflected in good receipts of VAT, corporate and personal income taxes. Total tax receipts are 10.4% above those planned for the period.

General Budget, Annual Growth Rates in %

	2004	2005	2006	1Q 07	2007*
Net revenues	19.9	26.7	25.7	29.9	23.2
Tax revenues	13.6	26.3	30.3	35.0	21.6
Personal income tax	18.6	16.9	29.1	34.0	16.0
Social tax	14.1	17.1	28.1	36.8	14.4
Corporate income tax	36.1	41.3	40.5	64.7	31.5
VAT	6.0	39.1	37.4	34.8	33.0
Excises	11.7	31.2	16.6	18.0	18.5
Customs	-8.7	12.2	7.6	36.6	7.8
Non-tax revenues	32.7	19.3	13.1	42.9	9.4
Foreign aid	208.2	63.3	52.1	17.8	54.5
Net expenditures	17.1	25.7	24.4	31.2	24.8
Current expenditures	18.2	33.8	23.3	21.1	23.6
Capital expenditures	23.2	31.3	63.1	9.3	21.5

Source: State Treasury, State Revenue Service
*according to budget plan

Albeit the central government budget deficit for 2007 is planned at 1.4% of GDP, as a measure of the anti-inflation plan (see Appendix for details), it has been decided to use any extra revenues to cover the deficit. In the following years the budget is planned to be balanced or with a surplus. Hence, we expect the general government budget to be in a surplus of 0–1% in 2007 and 1–3% or slightly above that in 2008–09. It will result in moderate growth of the final consumption expenditure of the general government at 1.5–2.5% p.a. in 2007–2009.

3.2.5 Labour Market and Productivity

In 2006 and early 2007 we saw a continuation of labour market tightening. Employment grew by an unprecedented 4.9% in 2006 (1.5% in 2005). The harmonised unemployment rate decreased to 6.2% in February 2007 from 7.8% a year ago. The level of officially registered unemployment in February 2007 stood at 6.5% or 68.9 th. people (7.5% a year ago). The officially registered vacancy rate by the end of 2006 climbed to 2.1% from 1.4% in late 2005. As a result, the wage–price spiral strengthened with net wages up by 23% in 2006 (15.5% in real terms)[26]. The real wage/productivity gap widened from about 0.5pp in 2005 to nearly 9pp in 2006. An obvious cause of wage growth is the booming domestic demand; also easy emigration opportunities play a part (also as a threat in wage bargaining). Wage growth is excessive and strengthens macro imbalances.

Yet, it must also be noted that there has been a structural shift in the market. While until the early 2000s it was clearly an employers' market, lately it has reversed into employee's market, as capital has become more abundant and labour increasingly scarce. Hence, to some extent wage growth simply represents a redistribution of income from capital to labour and must not affect costs and harm competitiveness. Since 2002 the share of wages and salaries in GDP increased by 4.6pp to 35.9% in 2006. This is about 92% of the EU15 average level, and thus there is still some wage growth potential through such structural effects.

Any further increase in labour supply from domestic sources is fairly limited. In Riga (where close to 2/3 of Latvian GDP is produced) unemployment is below 4% and the number of officially registered unemployed and vacancies had virtually converged by late 2006. Thus the unemployment pool can by and large be reduced only in the regions. Currently, activity rates are relatively low at 64.5% (the age group of 15–74). This represents a considerable source of labour supply, which may add nearly 40 ths to the labour force (if the Lisbon strategy target of 67% by 2010 is met). More labour may become available as domestic demand sectors cool off (construction, retail and wholesale, as well as real estate, renting and other business services sectors hire 1/3 of total employees).

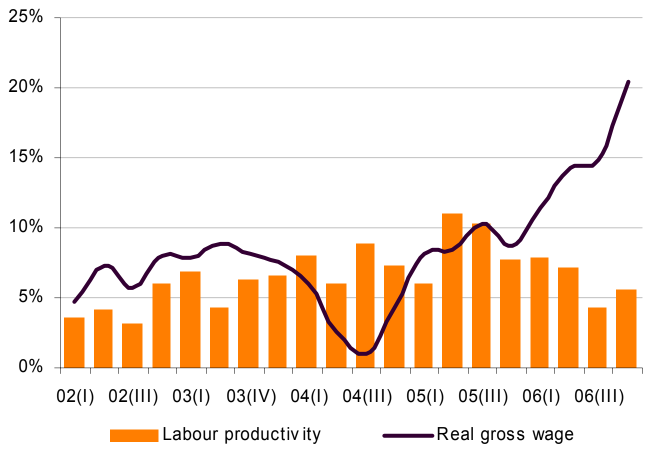
Average labour productivity (as value-added per employed) grew by a healthy 7% in 2006 (9% in 2005). We expect productivity to grow at 6–8% p.a. in 2007–09, closely matching the sustainable GDP growth rate.

[24] According to LCSB (ESA methodology; on accrual basis). MoF calculations show a deficit of 0.3% (cash flow method).

[25] Gross data for individual budgets, therefore the sum of their surpluses differs from that in the consolidated general budget.

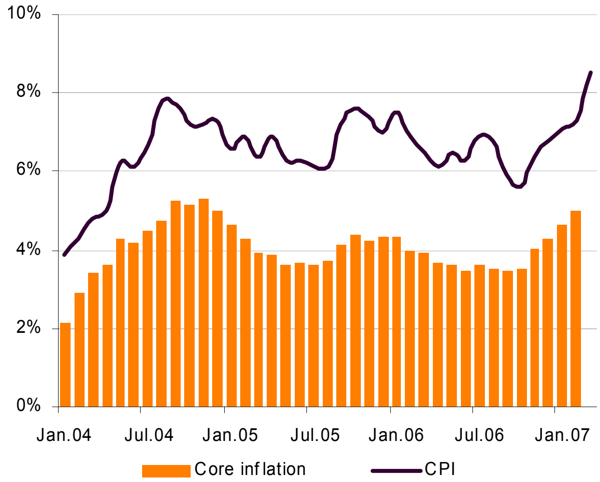
[26] Official data may somewhat overstate the growth due to income legalization, e.g. private consulting firms estimate wage growth at about 15%, which is still very high.

Annual Growth of Labour Productivity and Real Gross Wage



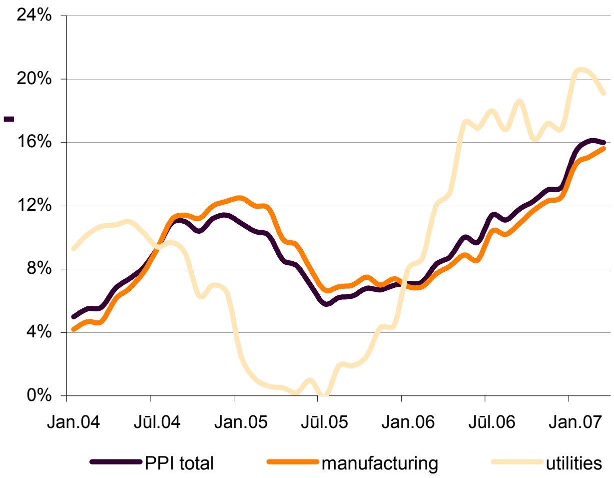
Source: LCSB, Eurostat

Annual Growth of Consumer Prices



Source: LCSB, LaB

Annual Growth of Producer Prices



Source: LCSB

We expect employment growth to decrease to about 2.5% in 2006 and 0.5–1% in 2007–09 as a result of rising activity rates, emigration, and shifts in demographic structure. We forecast the average harmonised unemployment rate to be at 5.2–5.8% in 2007, 5–5.5% in 2008, and 4.8–5.2% in 2009. Real net wage growth is expected to reach 8–10% in 2007, slowing further to 7–9% and 6.5–8.5% respectively, and a part of this will be due to income legalisation. To ease the medium to long term labour supply issues, immigration must be considered.

3.2.6 Inflation

Average CPI inflation in 2006 was 6.5% reflecting strong domestic demand and a strengthening wage-price spiral. In early 2007 rapid price growth ensued. Consumer prices rose by 1.4% mom in March 2007, reaching an annual growth of 8.5% (6.5% in March 2006). In addition to standard factors (e.g. food and clothing price seasonality), price growth might be partly explained by the lats' depreciation by about 2% in the 2nd half of February as it moved from the strong to the weak edge of the +/-1% fluctuation band.[27] Such an exchange rate fluctuation means more expensive imports, which is seen in the data – prices of goods grew by 1.6% mom and services by 0.9% mom, while in annual terms prices of services continue to rise faster (11.8% vs. 7.3% yoy). If this hypothesis is true, the pass-through into prices has been very swift, perhaps, reflecting high optimism and inflationary expectations (i.e. consumers are ready to accept the price growth).

Producer price inflation remained high, reaching 16% yoy in March 2007 (8.3% a year ago). Prices of goods sold on local markets continued to rise faster than those of exported goods (16.9% vs. 15% yoy). Such a rapid producer price growth suggests that businesses are indexing their costs, expecting price rises and thus stimulating further inflation. The price growth seems exaggerated and exceeds the underlying cost base (e.g. the rising electricity tariffs). It seems that businesses exploit every opportunity to raise prices, and strong domestic demand permits them to do so.

The key factors expected to drive inflation are:

- Administratively regulated prices. For instance, as of May 2007 natural gas tariffs for

[27] CPI inflation is measured in mid-month, i.e. March inflation reflects the price level comparison of mid-March to mid-February.

households are expected to rise by 20–30% and yet another increase is planned in 2008 as *Gazprom* aims to equalize its natural gas delivery price to Latvia to the EU average. *Latvijas Gāze* claims that the 2008 tariff rise will be the last substantial one due to this effect, as by then the prices will have reached EU levels. Gas tariffs with a short lag affect heating (most probably to rise in autumn by 8–9%) and electricity prices.

- Tax harmonization with the EU directives. For instance, the electricity tax rate[28] for industrial users is to be raised in January 2008 and 2009; the excise tax rate on diesel oil and petroleum most probably in 2008. An increase in tobacco excise rates will be larger than expected previously and will take place in July 2007, January 2008 and 2009.

- Traditionally, world energy prices have a substantial impact on domestic inflation due to a large share of transport and housing expenses in the consumer basket.

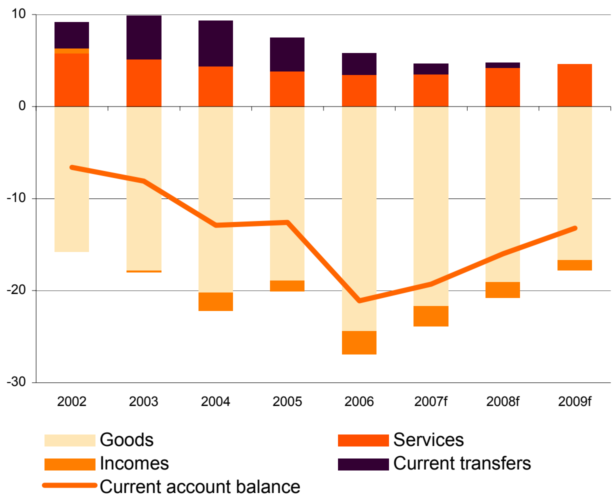
- Inertia of wage-price spiral and demand growth. The effect is still expected to be considerable in the 1st half of the year, while starting to diminish gradually towards the end of the year.

Future inflation depends on the extent to which the government anti-inflation plan will be implemented (and also timing). If there are no unpleasant surprises in global oil prices, we expect inflation to slow down in the 2nd half of 2007 (partly due to high base of 2006). However, due to exceptionally high March inflation that pushed annual rates up, we have revised our CPI forecast upwards for 2007 to 7.5–8.5% (6.2–6.6% before). If demand pressures and wage–price spiral do not ease, in certain months inflation may reach 9–10% yoy. We expect consumer price inflation to diminish to 5–6% in 2008 due to the slowing consumption boom and further to 4–5% in 2009. In a view of expected inflation exceeding Maastricht criterion, accession into the euro zone is postponed to perhaps 2011–12.

3.3 External Demand and Balance of Payments

Accelerating domestic demand spilled over into imports, widening current account deficit to 21.1% of GDP (12.6% in 2005). The rising trade in goods deficit (24.4% of GDP in 2006) contributed 5.5pp to the increase, while the remaining 3pp were due to worsening services' trade (surplus decreased to 3.4% of GDP), income (deficit of 2.5%), and current transfers accounts (surplus of 2.4%). The combined current and capital account (which includes EU funds effect) deficit stood at 19.9% of GDP (11.2% in 2005). The deficit is financed via FDI and bank loans. Dependence of economic growth on stable foreign financing has increased, and susceptibility to swings in investor sentiment has risen as trade deficit has approached unsustainable levels. Consequently, Latvia has experienced close attention from international observers in the 2nd half of 2006 and especially in the beginning of 2007.

Current Account, % of GDP



Source: LaB. Hansabanka forecast

Over 2006 goods and services imports grew by 28.7% (17.5% in constant prices, remaining high throughout the year) whereas exports growth slowed to 14.9% (5.3% in constant prices with constantly shrinking growth rate from 12.1% yoy in the 1st to negative growth of 3% in the last quarter). Divergent fortunes of exports and imports industries were shaped by the following factors:

- High optimism and strong domestic demand boosted overall imports demand (e.g. for consumer durables) and made home markets increasingly attractive due to rapid price growth, inducing businesses to sell to domestic market.

- Rising labour, energy and other production costs undermined competitiveness by making exports more expensive and imports cheaper: in 2006 unit labour costs increased by 2.4% (e.g. by 0.2% in Lithuania and fell by 0.4% in Estonia) whereas CPI (PPI) deflated real effective exchange rate of the lats against main trade partners appreciated by 4.3% (7.3%).

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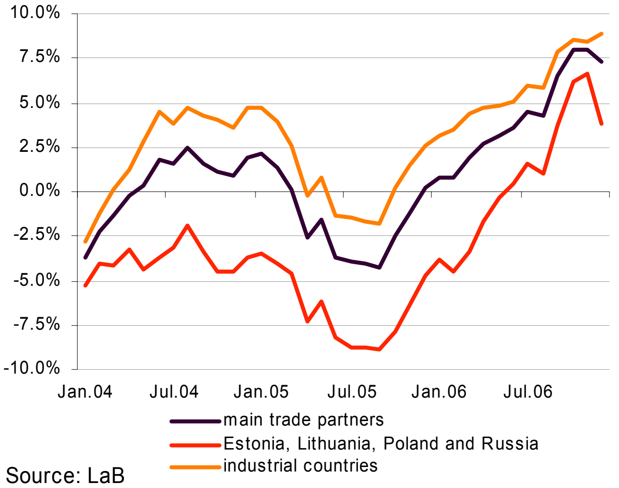
[28] For electricity supplied to final users (excluding electricity produced from renewable energy resources and in combined power plans that is in line with particular efficiency criteria)

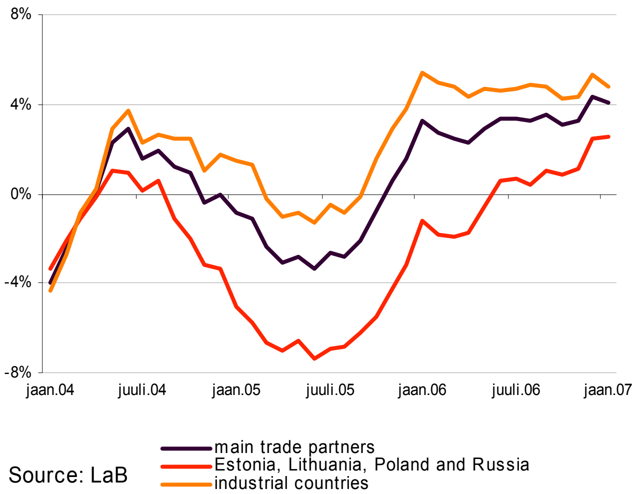
Annual Growth of Real Effective Exchange Rate of the Lats (PPI-based)



Source: LaB

We expect the current account to worsen in the 1st half of 2007 compared to that in 2006 driven by still strong domestic demand. The improvement should come through later in the year as demand growth slows; current account deficit may gradually improve and reach 18–20% of GDP in 2007, 15–17% in 2008, 12–14% in 2009.

Annual Growth of Real Effective Exchange Rate of the Lats (CPI-based)



Source: LaB

3.3.1 Foreign Trade

In 2006 the growth of merchandise exports declined to 13.6% in current prices (34.3% in 2005). Exports to EU10 experienced the most pronounced slowdown – to 22.2% from 72.3% in 2005. To a lesser extent the same applies to EU15 exports, which growth shrunk to 4.5% from 16.2%. Among product categories the fastest growing were transport vehicles and accessories (by 76.1%), chemical products (37.1%), and plastics (35%). The largest declines were observed in exports of mineral products (down by 31.3%) and pulp and paper (by 12.4%).

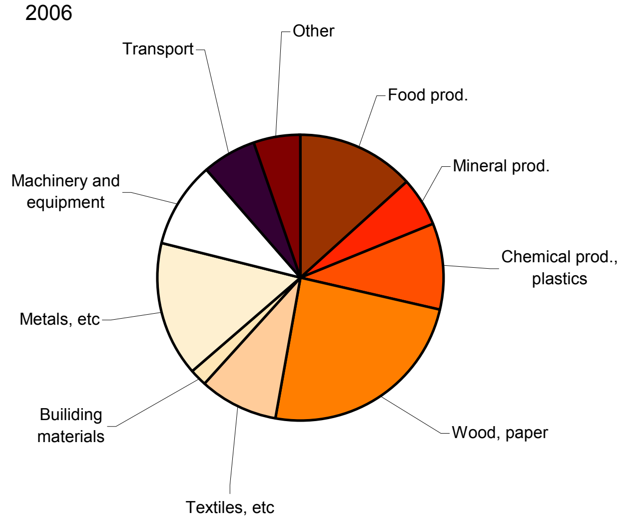
Current Account Deficit, % of GDP

	1Q	2Q	3Q	4Q	Year
2005	-10.4	-10.9	-12.8	-15.2	**-12.6**
2006	-14.6	-17.6	-23.5	-26.3	**-21.1**
2007f	-21.2	-17.5	-18.3	-20.3	**-19.3**
2008f	-	-	-	-	**-16.0**
2009f	-	-	-	-	**-13.2**

Source: LaB, Hansabanka forecasts

Despite the poor results of 2006, we expect that exports performance will improve in 2007–2009. One of the reasons is that the attractiveness of local markets will be reduced by weaker domestic demand. It is also expected that domestic demand industries will slow down through lower optimism and credit growth, and thus more labour and capital will become accessible to exporting businesses.

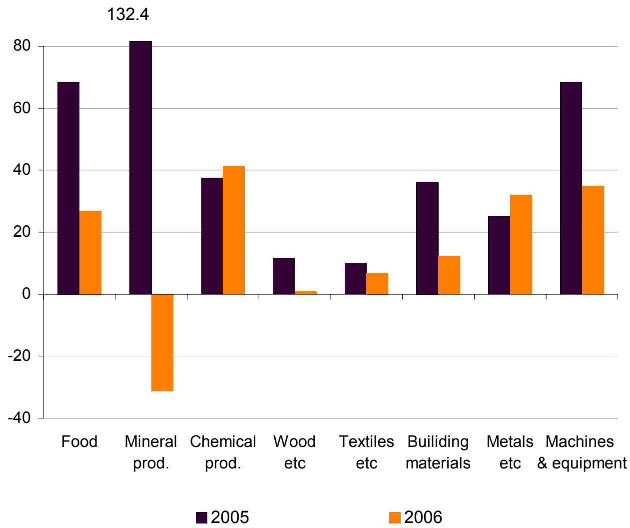
Structure of Exports by Main Commodity Groups, 2006



Source: LCSB

The early 2007 developments have shown that our expectations regarding growth rates are realistic. Namely, total merchandise export growth in the first two months accelerated to 18.6% yoy. Although exports of mineral products continued to shrink (by 15.2% yoy, which is a smaller decrease than in 2006) and food products grew by only 6.3%, wood products and pulp and paper picked up by 7.4% and 19.6%, respectively. In addition, the results achieved by producers of machinery and equipment (exports up by 46.2%) and metals (49.8%) were excellent.

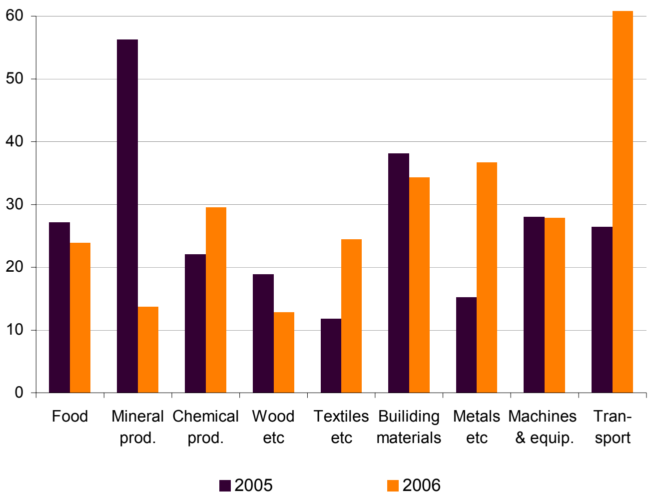
Exports' Growth by Main Commodity Groups, %



Source: LCSB

Consequently, we forecast growth of merchandise exports at 17–20% for 2007, holding up the pace achieved during the first two months (partly explained by the low base effect). These favourable changes for exports industries are expected to continue in the following years; we forecast exports to grow by 15–19% in 2008 and 2009. In addition, the share of exports in GDP is 44%, which means that there is quite a substantial potential for growth (e.g. for Estonia and Lithuania at 80% and 60% respectively).

Imports' Growth by Main Commodity Groups, %



Source: LCSB

In 2006 imports grew by 30% in current prices (28% in 2005). This was mainly on account of rapid imports growth from EU15 (33.6% vs. 19.3% in 2005), whereas imports from CIS slowed substantially (10.9% vs. 30.5%). Reflecting strong domestic demand, the fastest growing were imports of transport equipment (63.6% vs. 27% in 2005), followed by furniture (45%), metals (37%), and building materials (34%).

Imports volumes in 2006 can be broken up in three large aggregates[29]:

- Consumption goods comprised 34% of imports[30], which is 2pp higher than in 2005. It is largely on account of motor vehicles (incl. accessories), the share of which in imports, according to our estimates, rose from 7% in 2005 to 9% in 2006. We estimate that “luxury”[31] imports grew by 56%, contributing 4pp to overall imports growth. “Luxuries” share in imports grew from 11.1% in 2005 to 13.3% in 2006. With consumption growth starting to decelerate, these would be the first imports that would be reduced substantially. Given their sizeable share the overall impact on imports would be significant.
- Intermediate goods stood at 46% of imports; they are used as production inputs for further consumption or exports. The share of intermediate goods fell by about 2pp in 2006. It seems likely that more than half of intermediate imports are related to domestic consumption, so there is a scope for a reduction of this import category, too.
- Capital goods constituted 16% of imports and their share was stable during 2005–06. Purchases for several large investment projects can be identified, e.g. for TEC-2 (a large combined heat and power plant in Riga), South Bridge across the Daugava river in Riga, ships for the *Latvian Shipping Company*, municipal transport vehicles, several large car purchases for *Latvenergo*, *Latvijas pasts*, and the NATO summit. These add up to nearly 3% of total imports for 2006.

In the first two months of 2007 imports growth has accelerated further (36.3% yoy) driven by still strong

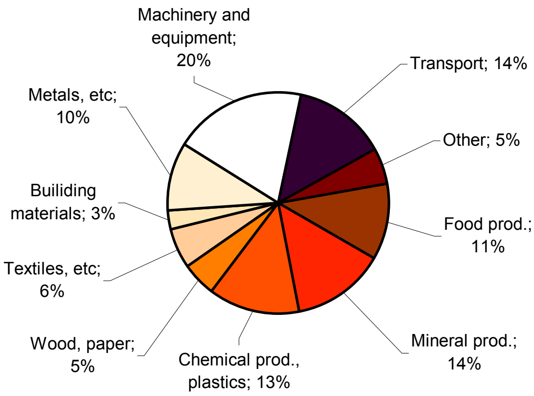
[29] Eurostat Broad Economic Categories (BEC) data.

[30] Our estimates reveal somewhat larger share of 35–45%.

[31] By “luxuries” we understand the following goods: private motor vehicles and accessories, household domestic appliances (electrical equipment, etc.), pieces of art and antiquities, jewelry and bijouterie, selected alcohol. These are not luxuries in the narrow sense, but rather non-primary goods (e.g. consumer durable), which are expensive and the purchase of which can be postponed.

consumption and investment. Growth was especially rapid for machinery and equipment (69.1%), building materials (47.3%), wood products (44.9%, shortage of local timber supply due to unfavourable weather conditions), and metals (44.1% yoy). Vehicle imports slowed marginally to 58.9% yoy and mineral products stagnated at 3.3% due to the high base of 2006.

Structure of Imports by Main Commodity Groups, 2006



Source: LCSB

Expected narrowing of consumption and investments growth in the 2nd half of 2007 attained by means of the anti-inflation plan measures will have an immediate effect on imports. Slower growth of household loans and smaller demand for expensive non-primary goods (e.g. TV sets), which are mostly imported, will cause a substantial decline in import growth[32]. Consequently, we forecast imports growth to slow to 14–16% in 2007 and 9–13% in 2008–2009.

3.3.2 Trade in Services

In 2006 services' exports expanded by 21.6% (27.6% in 2005), while imports slowed to 25.4% (38.8% in 2005) thus decreasing services' account surplus to 3.4% of GDP (3.8% in 2005). The main reason of the exports slowdown is the underperformance of transportation services (mostly on account of freight by sea and railway). The prospects of freight transportation by railway are undermined by rising tariffs (e.g., infrastructure) and capacity constraints (e.g. large share of single track railways).

In contrast, travel services continued to flourish (exports up by 43%) as the number of foreign visitors to Latvia increased substantially (especially for business purposes). We expect swift growth of tourism also in the future, also due to Riga Airport becoming a regional hub. On the other hand, growth of travel imports slowed down due to the high base of the previous year (21% vs. 62.4% in 2005). With domestic demand weakening, outgoing travel is likely to decrease and imports growth will continue to slow down even further.

Services Balance, % of GDP

Source: LaB

Preliminary data on the first two months of 2007 showed that slowing in services' exports continued reaching 15% yoy whereas imports picked up to 44% yoy.

3.3.3 Income Account, Current and Capital Transfers, and FDI

Income account deficit widened to 2.5% of GDP in 2006 (1.2% a year ago). This was mainly on account of higher reinvested non-resident earnings that grew by 98% to 3.5% of GDP. In turn, compensation of residents employed abroad increased by only 25% due to the high base of the previous year (staying at 2.4% of GDP).

Current transfers were also lower at 2.4% of GDP from 3.7% a year ago. Although Latvia's transfers to the EU budget rose by 20%, transfers to Latvia remained at the previous year's level. Current transfers of other sectors diminished to 2.2% of GDP.

Capital account worsened marginally to 1.2% of GDP as EU disbursements (structural funds especially) lagged behind the plan. We expect the

[32] For instance, assuming that "luxury" imports fall by 50% in 2007, but other imports grow as rapidly as in 2006, import growth would slow down to 15% in 2007.

capital account surplus to improve in 2007–08. The flow of EU funds will accelerate, as the resources allocated to Latvia for the period of 2007–13 will by far exceed the resources allocated in 2004–06.

Net foreign direct investments reached 7.4% of GDP in 2006 (3.7% a year ago). FDI inflows to Latvia expanded by 124%, the largest part being reinvested earnings. Most of FDI went to financial (43.7% of total) and real estate sectors (15.6%), while a mere 3.6% were invested in manufacturing (8.2% in 2005). With economic activity diminishing, we expect FDI to slow to 5–6% of GDP in 2007 and 3–5% in 2008–09.

4. Financial Markets

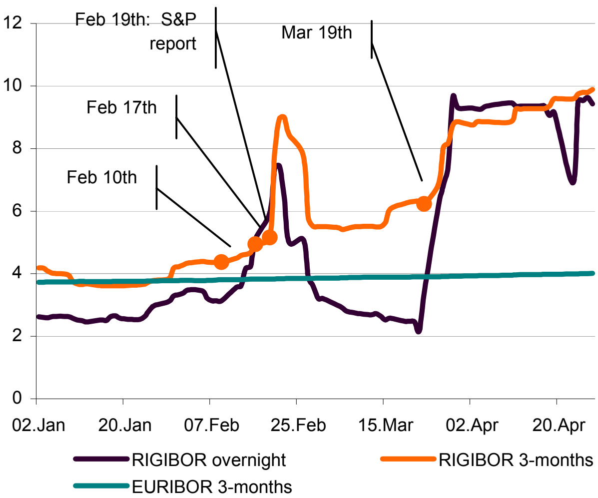
As of January 2005 the lats is pegged to the euro[33] at the parity 1EUR=0.70284LVL and a fluctuation band of +/– 1% where the LaB stands to support the band by passive interventions as market participants call in. Namely, it buys the euro at the rate of 0.6958 and sells the euro at 0.7098 per lats. Throughout 2006 the rate was close to the band's lower edge (i.e. a strong lats). The interest rates were gradually rising throughout 2006, following the central bank's refinancing rate. Three month interbank rates were quite constantly above the respective euro rates, with shorter rates occasionally slipping to about 2% in cases of very high liquidity of the lats.

Macroeconomic imbalances spilt over into financial markets in February 2007. Two triggers sharply raised market volatility.

First, an article in the local press published on February 10th reviewed the issue of current account deficit as being unsustainable and pointed to the necessity to reduce imbalances in order to avoid medium to long term risks to exchange rate stability. It created a discourse in the local media resulting in a statement by the Governor of the central bank on Friday, February 16th that devaluation of the lats is counterproductive in solving the economy's structural problems and will not be allowed (see section 3.2.1). Yet, devaluation rumours spread over the weekend via SMS messages. Most banks' branches were closed for the weekend, and those few that were open held only a limited amount of cash in euros. This allowed non-bank currency exchange offices, looking for quick profits, to raise their euro cash price to levels outside the band secured by the LaB. The following Monday, February 19th saw a continuation of euro buying by households, plus banks faced their new short EUR/LVL positions[34] – as a result the lats' spot rate moved from the strong edge to near the weak edge of the band. The strain ended almost the same day, as banks met all the demand for cash in euros. No shift out of the lats deposits or refinancing of the euro liabilities into the lats in excess of any typical volumes has been observed since then.

Second, on Monday, February 19th *Standard & Poor's* published its regular report on Latvia. It retained Latvia's sovereign rating at A-/A-2 while reduced its outlook from stable to negative – noting overheating and expansionary fiscal policy, and urging that a "soft landing requires urgent action". It spurred hedging and speculative interest from foreign banks and enterprises, some of them never seen in the lats market before. From February 19th the forward market started to stretch as the small market had to absorb large volumes it was unused to, which in turn caused a sharp rise in interest rates from about 4.5% to 9%.

Interbank Interest Rates, 2007



Source: LaB, Reuters

The rise in interest rates was fostered by reserve period[35] seasonality and a requirement to keep the reserves in lats. Given the threat of withdrawal of the lats' liquidity in case the LaB had to intervene[36], banks were reluctant to give up their lats to intervention – they would risk not filling their reserve requirements in the actual period which was about

[33] Prior to that pegged to SDR (since February 1994) with an identical fluctuation band of +/-1%.

[34] Maximum permitted open currency position is 10% of a bank's capital.

[35] Banks are required to hold 8% of the attracted non-bank deposits with the Bank of Latvia.

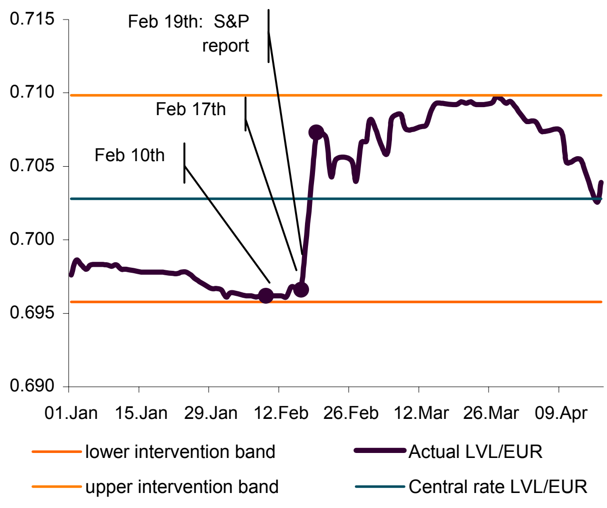
[36] Banks would sell the lats to the LaB in return for the euro if their permitted open forex positions (10% of their capital) would be breached and/or the spot rate hit the weak edge of the band.

to end on February 23rd. Since most of the interest in LVL selling was coming via forward deals, interest rates went up to discourage these flows. The LaB soon came out with a solution (short-lived, however) that provided more lats' liquidity to the market via one and three month forex swap deals. As banks became confident that the central bank would help with liquidity, interest rates fell to the benchmark of 5.5%.

The following weeks saw quite active trading in the lats' forwards, whom banks could at least partly cover via swaps in the central bank and soon the EUR/LVL spot rate hit the weak edge of the band. The LaB faced a situation where banks borrowed the lats from it to immediately sell them and buy the euro. Within three weeks of passive interventions the LaB sold about 10% of its forex reserves[37]. On March 24th the LaB stopped its liquidity operations and since then has provided only short term one-week swaps. That meant an end to the forward market – it left banks with virtually no spare LVL resources and there is nowhere banks can cover their interest rate exposures and provide liquidity for forward operations without the central bank providing the lats resources. Given that the stock exchange and debt market is largely non-existent, this strategy has effectively insulated the lats from speculative attacks in the short to medium run.

Since then the lats rate has strengthened, entering the band's strong side in late April. Interest rates have moved up to about 8–10% and largely are expected to remain at these levels as the lats' supply remains scarce. Such interest rates fairly adequately reflect the current economic situation, i.e. they provide positive real interest rates.

LVL/EUR Spot Rate, 2007



Source: LaB, Reuters

Given the current market structure, devaluation of the lats in the short to medium term is extremely unlikely and provides time to correct built-up macro imbalances. Medium to long term exchange rate stability will depend on the success of a soft landing, which we see to be the most likely outcome, given that the implementation of the government's anti-inflation plan is continued in a swift and comprehensive manner.

Mārtiņš Kazāks
Lija Strašuna
Dainis Stikuts
Pēteris Strautiņš
Pēteris Strazdiņš

[37] Via passive interventions at the strong edge of the band during 2006 the LaB bought around EUR 900m, thus selling LVL to the market and increasing central bank forex reserves by about 40%.

Appendix. The government anti-inflation plan

Measure	Current situation	Planned activity	Timing
		Fiscal responsibility and budget	
Balanced budget	Deficit planned at 1.4% of GDP in 2007	No budget deficit in 2007 if actual revenues exceed planned outlays (i.e. any extra revenues not used as expenditures) No budget deficit in 2008, surplus in 2009-10 Cut basic budget expenditures by 1-3%	Ministries are assigned to draft plans on cutting basic budget expenditures; must be implemented for 2008 budget
Medium term budget planning	No medium term budget planning	Introduce 3 year medium term budget planning	Starting from 2008
Fiscal responsibility	Large construction projects planned; rapid wage and employment growth in public sector	Plan public construction outlays to limit supply bottlenecks Stop employment growth Slow down wage growth	
		Taxes & duties	
General outlook		No tax cuts during a period of fast economic growth	
Tax on capital gains from real estate (RE) sales for private individuals	If sold within 1 year of ownership and it is not the main living place	If sold within 3 years of ownership and it is not the main living place	Necessary amendments submitted to Saeima's Budget committee (SBC); expected to come into force on June 1st, 2007
Tax on capital gains from RE sales being a part of equity (>50%) for businesses	na	If sold within 3 years of ownership	Necessary amendments submitted to SBC; expected to come into force on June 1st, 2007
Fees for RE registration in Land Register	Flat rate of 2% of RE value	Differentiated by category of credit taker (e.g. private or corporate, relations), number of RE units owned (diversified to 2%, 3%, 4% and 6% of RE value according to particularities)	Amendments came into force on April 16th, 2007
Fees for collateral registration in Land Register	0.1% of loan value	Differentiated by category of credit taker (private or corporate), number of mortgages owned (0.1% for the 1st mortgage, 3% for the 3rd and further mortgages)	Amendments came into force on April 16th, 2007
Tax on car purchases	Differentiated according age of car	Introduce additional tax depending on engine size (e.g. tax for a new car with 4.2L engine rises from LVL250 to LVL2350)	Amendments are submitted to SBC; expected to come into force on June 1st, 2007
		Credit expansion	
Confirmed income to receive a bank loan and/or leasing	Financial institutions are not required to verify a person's income with records at State Revenue Service	Issued only if reference from State Revenue Service is submitted. A person may submit other documents certifying income. The financial institution has a right to decide on the credit amount, taking into account all documents about a person's income	Necessary amendments submitted to SBC; expected to come into force on June 1st, 2007
Certain purchases above 100 min wages (currently LVL 12000)	na	Income certificate from State Revenue Service required	Expected to come into force on June 1st, 2007
Down payment for a loan, loan-to-value	na	10-15% down payment for a loan (also maximum loan-to-value to be set)	Draft of legislation submitted by FCMC by April 19th, 2007; expected to come into force on June 1st, 2007
Enhancing savings		To be specified	
Common credit register	na	Comprising all financial institutions, both mortgages and consumer loans	Amendments not prepared yet. Principles and forms for reporting are being discussed with the LaB. Expected to come into force by January, 2008.
		Labour market	
Labour mobility	Various domestic and EU programs	Increase labour mobility and economic activity in regions	
Immigration policy	Introductory plan at Min of Interior	Develop and implement adequate immigration policy	
Productivity	Various domestic and EU programs	Improve productivity (investments, education, innovations)	
		Energy prices	
Energy prices	Rapid price growth, major part of energy resources imported	Enhance energy efficiency in the country (incl. using EU funds)	
Regulation of administrative prices	PUC, many regional regulators	Public Utilities Commission (PUC) takes over regional regulators	
		Competition	
Competition	Various activities	Enhance competition particularly in construction and trade sectors	

A detailed account of the plan is available from the Ministry of Finance web page (www.fm.gov.lv)

Lithuania

1. Recent Economic Developments

Lithuanian GDP growth in 2006 was 7.5% (6.9% in 4Q), which is exactly in line with our forecast and only 0.1 percentage points lower than it was a year before. GDP in current prices was LTL 82bn (EUR 23.7bn) and GDP per person reached EUR 6,996. GDP growth per person was 8.1%. The most vigorous growth rates were observed in construction (19.8%). Rapid growth took place in transport and communications (10.7%), real estate and other business activities (9.3%), manufacturing (9.3%) and hotels and restaurants (7.9%). In the 4Q the value added of agriculture and fishery augmented by just 0.7% yoy (compared to a decline of 7.4% in 2006). However, this means a considerable improvement when compared to the 3Q negative growth rate of 18%. In 2006 household spending increased vigorously by 13.5% in real terms, being driven mostly by rising incomes (compensation to employees went up by 17.1% in nominal terms). Exports and imports of goods and services grew at the same speed in real terms (15.4%), thus, net exports were negative again. Investments grew vigorously (excl. inventories – 11.9%) as did public spending albeit slower (7.3%).

The latest economic indicators show a continuing good growth this year with preliminary first quarter growth of GDP at 7.1%, which is only a bit lower than the average GDP growth in 2006, but higher compated with the second half of the year. The most vigorous growth of value-added was still observed in the areas of construction, trade, financial intermediation and real estate. Reportedly, industrial sales this year declined by 1% over the first quarter compared to a year ago (grew by 15.5% excluding refined petroleum products), while retail sales grew even much healthily 22.1%.

In the 4Q 2006 average gross salaries in Lithuania (excluding sole proprietorships) rose by 19.1% yoy reaching LTL 1,731 (EUR 501). Average net salaries in the entire economy soared by 25.6% to LTL 1,294 litas and real average wages rose by 20.5%. This was partly stimulated by the cut in personal income tax from 33% to 27% and the increase in minimum monthly wages to LTL 600 since the 1st of July last year.

Consumer price inflation accelerated to 4.6% yoy in March with rather worrying developments in the prices of foodstuffs (9.1% yoy) and utilities (housing, water, and electricity etc. 10.9% yoy). The average annual inflation for the last 12-month period was 4%.

According to revised data, in 2006 Lithuania's current account deficit, driven by rising goods imports, widened by 73.7%, accounting for 10.8% of GDP, much higher compared to a deficit of a mere 7.2% in 2005.

2006 was a good year for government finances. Lithuania's general government fiscal deficit was only 0.3% of GDP, narrowing by 0.2 percentage points compared to the year before. The general government debt to GDP ratio shrank to 18.3% from 18.6% in 2005 and remains one of the lowest among the EU Member States.

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic grow th, %	6.9	10.3	7.3	7.6	7.5	7.0	6.5	6.5
GDP, mln euros	15 018	16 452	18 126	20 621	23 746	27 187	30 750	34 386
GDP per capita, euros	4 329	4 763	5 276	6 040	6 996	8 045	9 136	10 252
Grow th of industrial sales, %	3.1	16.1	10.8	7.1	7.3	6.0	7.0	7.0
Grow th of GDP deflator, %	0.1	-0.9	2.7	5.8	7.1	7.0	6.2	5.0
Grow th of consumer prices, %	0.3	-1.2	1.2	2.7	3.8	4.5	4.5	3.3
Grow th of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8	4.5	4.5	3.3
Grow th 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	5.4	5.3	5.3
Grow th of real net w age, %	3.8	9.3	4.9	7.8	15.2	14.0	10.5	5.5
Grow th of exports of goods and services, %	13.4	6.2	12.0	27.0	17.7	17.0	15.0	12.0
Grow th of imports of goods and services, %	13.1	6.9	14.2	26.1	22.6	19.0	15.3	11.3
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.3	-11.7	-12.1	-11.7
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-12.5	-12.7	-12.0
Current and capital account, % of GDP	-4.7	-6.4	-6.4	-5.9	-9.7	-11.3	-11.4	-10.8
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

2. Assumptions and Delimitations

In the medium term, huge public sector investments into the energy sector are being considered in Lithuania – the construction of two electricity bridges to the West and the most important project – construction of a new nuclear power plant[38]. In our short-term forecast (till 2009) we deliberately ignored the effect of these projects, but the construction phase of these projects, which is starting in or around 2010, will have a significant impact on the whole economy. This construction might require an investment of EUR 4-7 bn (15-25% of 2007 GDP) and will need large related imports (equipment, materials, services of qualified specialists), automatically implying higher current account deficits largely covered with borrowed funds. At the same time, the construction sector will be tightened with a shortage of materials and workers, but there should also be an additional positive impact on GDP growth in investment activities.

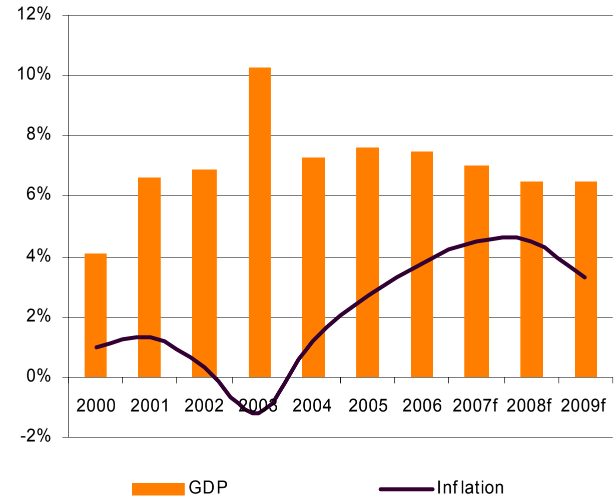
3. Highlights of the Forecast

We retain most of the forecast (except for GDP and unemployment) from the previous Baltic Outlook. Due to strong enough Lithuanian economic growth this year, continuously strong household consumption, growing investments and government spending we increased our forecast from previus 6.5% to 7% in 2007. We retain our 6.5% forecast for GDP growth in 2008. The inflation rates anticipated earlier will be higher than last year, reaching 4.5% on average this year, but the risk is on the upside. Consumer prices are increasing rapidly supported by higher gas and electricity prices as well as higher excise duties for cigarettes from March. Considering the recent development in the labour market and continuous lack of labour force we forecast a slightly lower than previously anticipated unemployment rate (5.4% instead 5.6%) and retain our forecast of real net wage growth (14%). Due to strong domestic demand, which is expected to boost imports further, we forecast the current account deficit to be about 12.5% of GDP this year.

4. Economic Growth

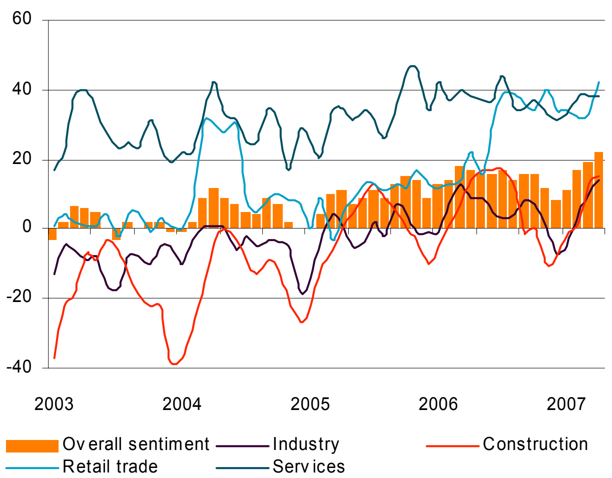
The outlook for growth in 2007 and 2008 remains favourable. GDP growth is projected to gradually slow down but remain robust at around 7% this year and 6.5% next year. Strong household consumption, domestic investments and government consumption are expected to remain the main driving force for economic growth. It will again be supported by higher wages, employment, growth in borrowing, EU support and fiscal spending.

Economic Growth and Inflation



Source: LDS, HBM forecast

Confidence Indicators



Source: LDS

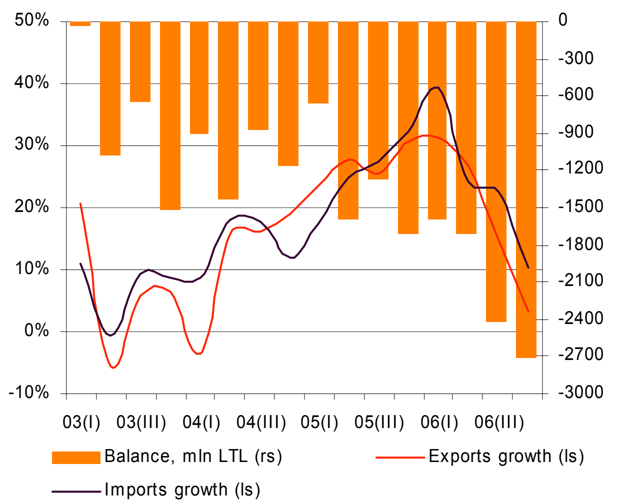
Economic sentiment indicators (hitting the highest levels) also give a positive picture regarding developments and the nearest-term economic outlook of the country. Especially positive improvements are seen in industry and construction with growing estimates of present and future demand. The consumer confidence index hit the highest level for the last five years in consumers' higher expectations of the financial standing of their households and a decline in the number of jobless.

[38] The first reactor of the new nuclear power plant in consortium with strategic partners from Latvia, Estonia and Poland is expected to be built by approximately 2015. The country's power grid connections with Poland and Sweden should be built by 2013. The second and currently the sole working reactor of Ignalina Nuclear Power Plant will be closed down late in 2009, in line with EU accession agreement.

4.1 External Demand

In 2006 Lithuanian preliminary foreign trade data showed a slight slowdown both in export (especially) and import growth figures. Due to a strong domestic demand imports of goods and services surged by 22.6%, while exports expanded by 17.7% yoy. This resulted in the worsening of the trade and services deficit, which increased from a mere 7.3% of GDP in 2005 to 10.3% of GDP last year. The main problems occurred in the second half of the year, especially in the 4Q, when exports of goods rose by only 0.5%, while imports grew by 8.6%, therefore the goods trade deficit rose to 15.5% of GDP. According to preliminary figures so far this tendency has continued during the beginning of this year. The export growth slowed mostly because of smaller exports of mineral products from the biggest exporter, the oil refinery “Mazeikiu Nafta”, which also meant a fall in related imports.

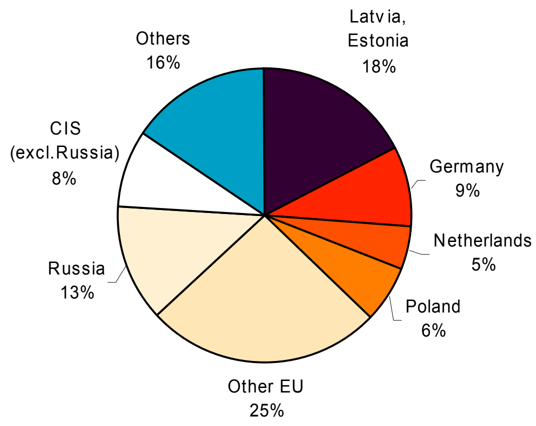
Goods and Services Trade



Source: LiB, HBM calculations

During the whole of 2006 the export of mineral products grew by only 4.3% and consequently their share of total exports decreased from 27.3% in 2005 to 24%. The company reduced production as the crude oil supply from Russia has been cut off due to the “Druzba” pipeline being damaged in July and there was also a fire, which ravaged the refinery in October. However export growth excluding mineral products was still vigorous (23.8%) last year and the latest data points to more stable developments in 2007. The export from “Mazeikiu Nafta”, which has been importing crude oil by sea after Russia halted piped oil supplies, should revive at the end of the year. It is expected that the company will return to its pre-fire refining capacity by this time, and external markets are rather favourable for other Lithuanian exporters. Hence double-digit growth for all exports is expected in the nearest term.

Lithuania's Export Destination, 2006

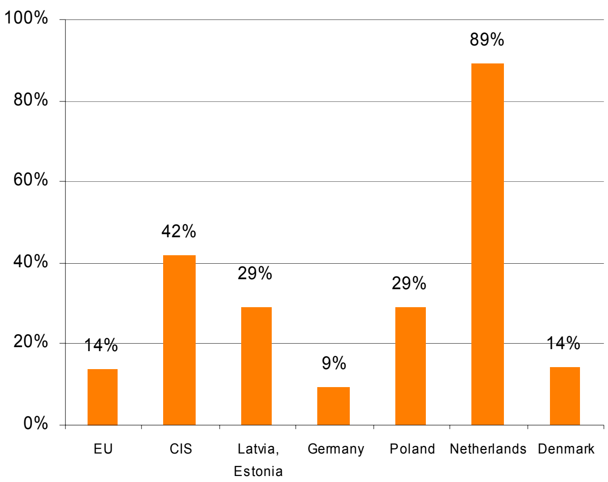


Source: LDS. HBM calculations

- As was the case in 2005, last year’s exports to new EU countries and the CIS increased to a larger extent, than exports to old EU countries. In the total export structure the EU market share declined slightly, while that of the CIS increased. The European Union accounted for 63.2% of Lithuania's total exports (62.4% of total imports) and export growth in this area was 14% yoy last year. The export to the CIS market accounted for 21.3% of the total and rose by 42%. The biggest partners were Russia, Latvia, Germany, and Poland. The outlook for international trade remains favourable and strong demand from Russia and (especially) other CIS countries is expected to continue.

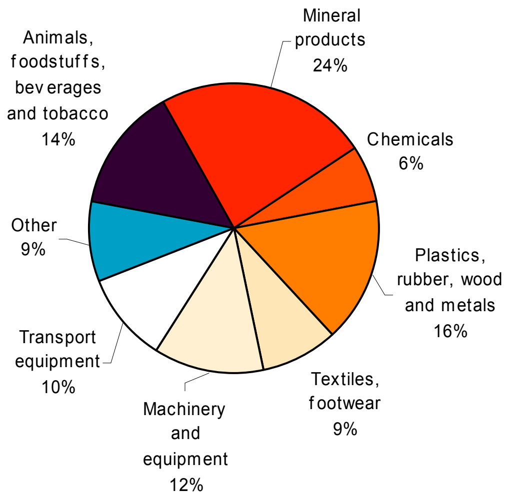
- Export growth is soaring in most categories. Together with the above mentioned mineral products (the largest share), last year the key trade commodities which were as usual machinery and electrical appliances (12.2% of total exports and 17.6% of total imports), and transport equipment (10.1% and 13.9% respectively). A particularly strong export growth was seen in prepared foodstuffs, beverages, and tobacco (32.6% yoy) due to Lithuanian retailers’ expansion into neighbouring markets, which created export opportunities for smaller Lithuanian producers. This followed plastics (70%), and transport equipment (45%). The traditionally strong textile industry revived slightly and indicated 6.1% annual growth last year. Looking ahead we forecast repeatedly strong growth in exports excluding mineral products.

Annual Export Growth in the Largest Markets, 2006



Source: LDS, HBM calculations

Lithuania's Exports Structure, 2006

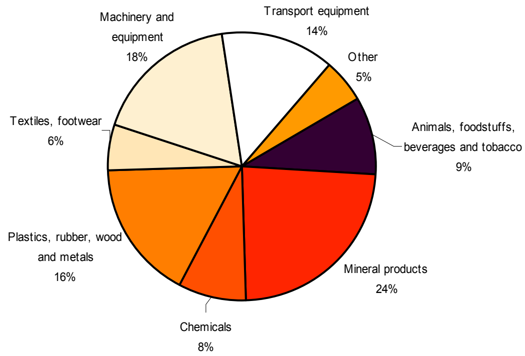


Source: LDS. HBM calculations

- Last year the export of services grew by 15% showing slowdown from 2005, when the growth was 27.1%. As growth in imports of services (21.8%) strongly exceed exports, the surplus of services balance increased by only 1.8% (29.3% in 2005), accounting for 3.6% of GDP. More than half of the total services exported is transportation, which grew by 20.8% last year. The most significant impact was made by export growth of cargo (48% growth), which accounted for about one-third of total exports of services and balance of cargo accounted for approximately 63% of total surplus. Last year the travel sector showed slowdown with export increasing by 11% yoy (whereas business travel rose by 60%). Higher household income and expanding business relationships conditioned Lithuanian travel abroad, so the travel sector surplus decreased by one-third. We expect the cargo will continue to be the engine for export of services followed by tourism services, which will grow at rather a fast pace in the coming years. Lithuania attracts tourists from Western Europe as entertainment, food, drinks and healthcare services are still cheaper.

- In real terms export and import (as input of GDP) growth was the same last year (15.4%). But in nominal terms imports grew faster, as import prices went up more than export prices (6.7% vs. 2%) and this resulted in significant growth of the trade and services deficit.

Lithuania's Imports Structure, 2006



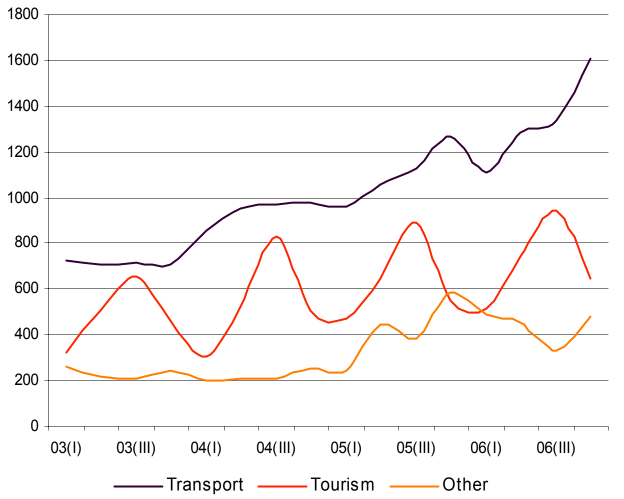
Source: LDS, HBM calculations

Exports Annual Growth

Source: LiB

Over the next couple of years export growth will continue to slightly lag behind import growth causing a bigger trade deficit (~12% of GDP). Import growth is forecasted to remain robust (~19% this year) on the back of buoyant private consumption and investment activity. We assume that growth of Lithuania's exports will be similar to last year (~17%) due to the increase in investment in previous years. Although our expectations regarding exports are positive, we also see a risk due to increasing local production costs (esp. stronger wage demands) and companies' ability to keep their competitiveness.

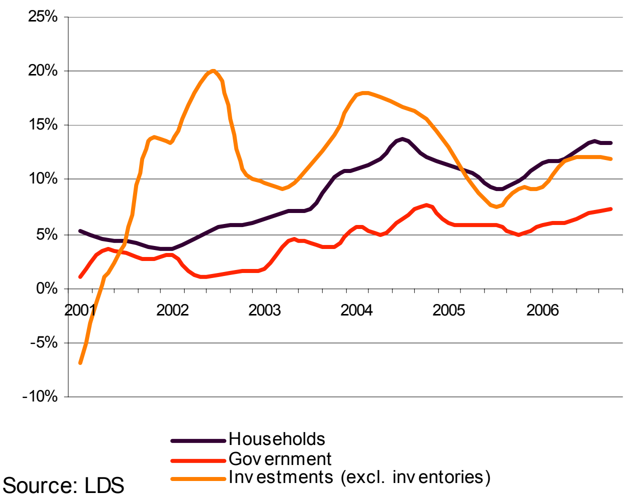
Services Exports, mln LTL



Source: LiB

4.2 Domestic Demand

Domestic Demand (12 month rolling real growth)



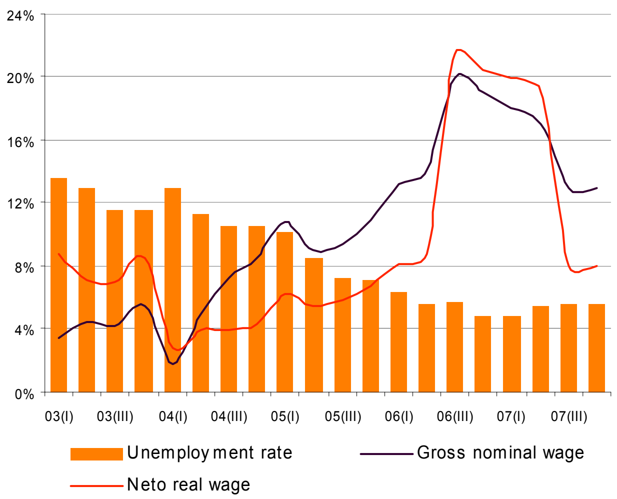
Source: LDS

4.2.1 Household Consumption and Incomes

Household consumption remained very firm on the back of growing income through increasing employment, wages and crediting. Last year, household consumption grew by 13.5%, and looking towards the future it will remain one of the main drivers of economic growth.

- The increasing lack of labour force will continuously fuel **wage growth**. We presume that annual real net (after tax) salary growth will exceed GDP growth reaching ~14% this year and ~10.5% in 2008. Increasing employees' bargaining power and growing profitability (in 2006 the aggregate pre-tax earnings were 25% higher than a year before) will allow companies to increase wages. The tax reform envisages that starting on January 1, 2008, the personal income tax rate will be cut from the current 27% to 24%, which would add ca 3.3% to the average net wage next year or even more in the statistics as an effect from income legislation can be expected.

Labour Market, annual growth rates

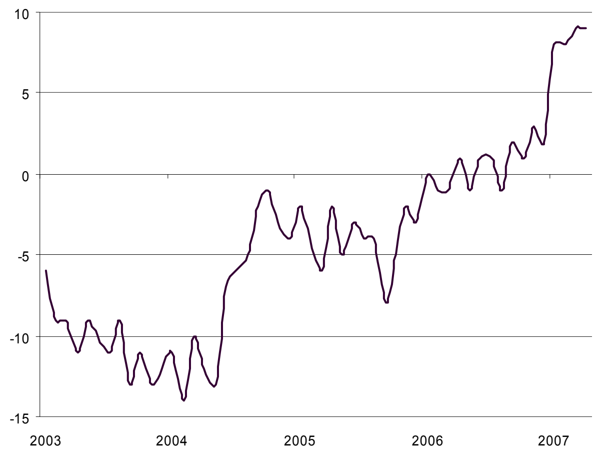


Sources: LDS, HBM forecast

- We expect the **unemployment rate** to decline by only 0.2 percentage points compared with last year as unemployment has reached some kind of bottleneck due to the lack of unemployed with suitable qualifications. Lithuania's unemployment in 2006 contracted to 5.6% , which was the lowest over the last decade (in 2001 it reached 17.4%).

- The **consumer confidence** indicator is at the highest levels ever observed. It is driven by consumers' higher expectation of the financial standing of their households and a decline in the expected number of jobless. Strong confidence means that households are still ready to spend more.

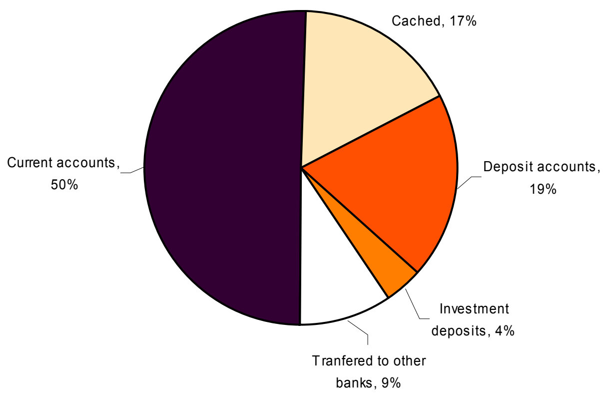
Consumer Confidence Indicator



Source: LDS

- Starting in March of this year approximately 0.5 million Lithuanians got access to a total of ~1bn litas (EUR 329m, worth 1.2% of our projected GDP in 2007) as the government has decided to finalize **restitution for rouble deposits**. In March 2007 about LTL 800m were transferred to private accounts. During one month about one-fifth of all funds were used for saving deposits, approximately 17% was cashed and a half is still in current accounts. The cashed money has already been reflected in retail trade as people used some of the extra money for buying domestic appliances etc. This tendency should also continue in the coming months.

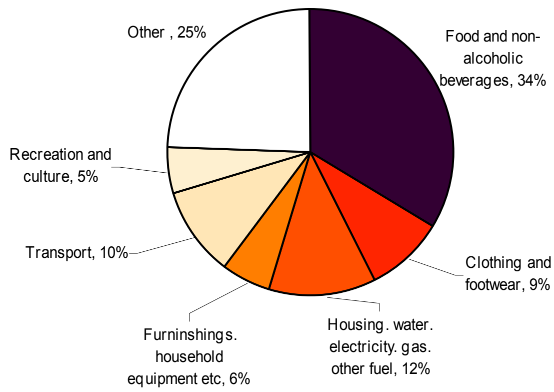
The Structure of the Use of Rouble Restitution Deposits



Source: Hansabankas

- According to a **household survey** monthly disposable income in Lithuania grew by 17.4% in 2006 to reach LTL 681 (EUR 197) per person. Adjusted for inflation the real growth in disposable income reached 13.1%. The major impact on disposable income came from higher income from employment. Disposable income growth was much stronger than consumption expenditure growth, so there was the increase in the share of income used for investment and saving. In 2006 consumption expenditure per one household member was LTL 578 a month, a 12.7% increase from the year before. More than one third of the sum consisted of increased expenditure on furnishings, household equipment etc. and transport. Consumption expenditure on food amounted to 33.7% of the total, a decrease of 2.9 percentage points from the year before. Looking ahead the share of expenditure on food is expected to decline further, and expenditure for transport, better quality goods and services, should increase.

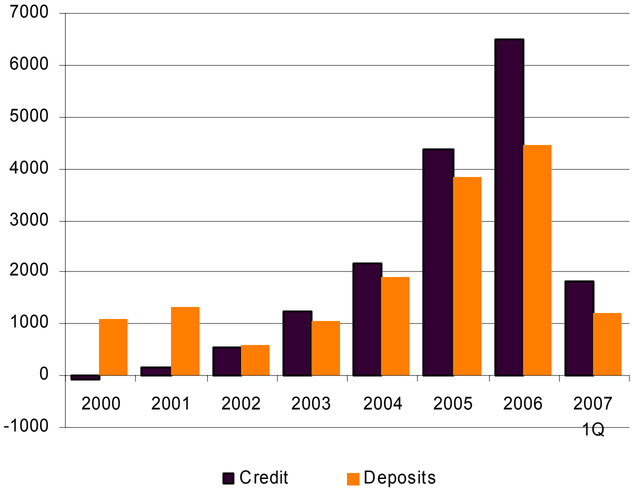
The Structure of Households' Consumption Expenditure



Source: LDS

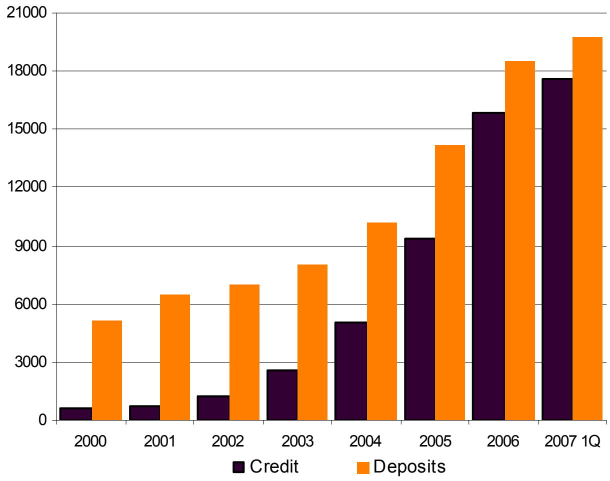
- **Credit growth** continuously and strongly out paces the increase in deposits. That also demonstrates not only the unpopularity of deposits due to the negative real interest rate (deposits offer interest rates below the rate of inflation), but also that the investment products of banks are becoming more popular. Such a tendency will intensify in the future as people little by little start to think more about their savings, meanwhile the statistics of investment products' return points the vigour results. On the other hand, a strong borrowing growth will continue.

Household Finances (transactions), mln LTL



Source: LiB

Household Finances (outstanding amounts), mln LTL



Source: LiB

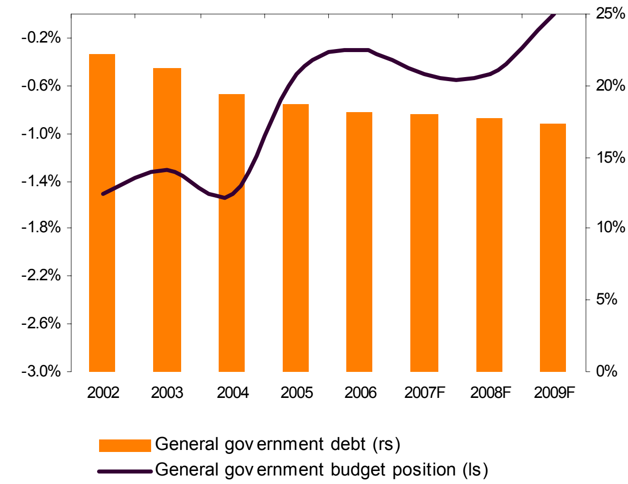
- Lithuanian **retail sales** are a good indicator of household consumption: the retail sales in 2006 increased by 14.1% (in real terms) and the growth was even 22.1% in the first quarter of this year.

Taking into account the growth in wages, employment, good consumer confidence and restitution of rouble deposits, we predict a strong income and a very strong household consumption growth to be sustained this year (~10-12% or even more), which will be beneficial to all domestic demand-driven industries and to importers. However, in the medium-term (3-5 years) consumption growth should be closer to the growth of GDP.

4.2.2 Government Spending and Policy

Strong economic developments have been very beneficial to Lithuania’s public finances and although there was no political will to match spending with income, Lithuania still enjoyed a low budget deficit last year. Lithuania's general government deficit reached 0.3% of GDP in 2006, narrowing by 0.2 percentage points compared to 2005. It was influenced by better-than-expected collection of central budget revenues as well as social funds revenues. The state budget revenues in 2006 grew by 18.7%, largely due to the significant improvement in revenues from value added tax, which soared by 27.1%. Both income tax revenues and corporate profit tax revenues in 2006 were significantly above what was planned, helping to reduce the deficit. Moreover, this year’s collection of the state budget (excluding EU funds) is excellent with preliminary revenues of the first quarter being 14% more than in the same period last year. The collection of VAT (22.7% yoy) was again exceptionally strong. As revenue collection is still good, it presents no risk to the increase of the central government budget deficit. And following the Convergence programme, the government is planning to cut the deficit in the national budget in 2007 and 2008 (0.9% and 0.5% of GDP respectively), and reach a balanced budget for 2009.

General Government Finances, % of GDP



Source: Lithuaniand MoF, HBM calculation

Lithuania's general government debt totalled LTL 14.9bn (EUR 4.3bn) as of late 2006, 12.5% rise versus the year-earlier figure. The rise had mostly resulted from borrowing abroad as well as the supplementation of two Eurobond issues. The debt to GDP ratio shrank to 18.3%, from 18.6% in 2005 remaining one of the lowest among the EU Member States and substantially lower than the reference value set in the Maastricht Treaty (60% GDP). We anticipate the general government debt ratio to GDP to remain low and every year gradually to decline closer to 17-18% of GDP in the forecast period.

Increasing attention towards economic misbalances in the Baltic States encouraged the Lithuanian government to review the situation, and consequently a plan with solutions to inflation was introduced. This includes following actions:

- do not hold high expectations due to the personal income tax rate cut or other tax decreases. The possible personal income tax cut will be decided around the middle of the year subject to the macroeconomic situation and the budget performance;
- to implement an optimal plan for increasing excise duties on fuels and cigarettes to support economy stability;
- restrict unreasonable wage growth (higher than productivity) to avoid a spiralling wage-inflation cycle, i.e. to insure that there is no legal basis created, which would "automatically" index wages according to last year's inflation;

Wage and Productivity Grow th

- end the practice of revising the government sector's budget in the middle of the year, if actual revenues exceed plans as this does not allow automatic stabilizers to work for adjusting economic cycles;
- pursue strict fiscal policy on purpose to secure the stability of the economy and as soon as possible to abolish structural budget deficit;
- continue applying more strict requirements than in the euro zone on the commercial banks' compulsory reserves and capital adequacy; encourage banks towards conservative estimate of credit risk;
- estimate the effectiveness of natural monopoly regulation policy making sure of reasonable price increases in electricity, heating, gas and water sectors.

We see the plan being adequate to the situation provided the mentioned measures are well enforced, although at present a proper enforcement mechanism is still lacking.

4.2.3 Investments

Last year the gross capital formation declined by 6.1% due the depletion of change in inventories. However, gross fixed capital formation growth was vigorous at 11.9%.

In 2006 the investment in tangible fixed assets grew by 18.5% in real terms, attracted by domestic-demand oriented spheres and this will continue in the next years. Rapid growth of investments was seen in hotels and restaurants (doubled), education (52%), trade (35%) and construction (30%). The growth of investments in manufacturing (9.4%) was lower than average and it might have only a marginal positive effect on export growth in the medium term. The Lithuanian construction sector is continuously growing fast and number of complete new dwellings started to increase in 2006. In 2006 construction enterprises own-account work (99% within the territory of Lithuania) increased by 21% yoy. The major part was in new construction (49% in total); reconstruction took 26% and repairs – 23%.

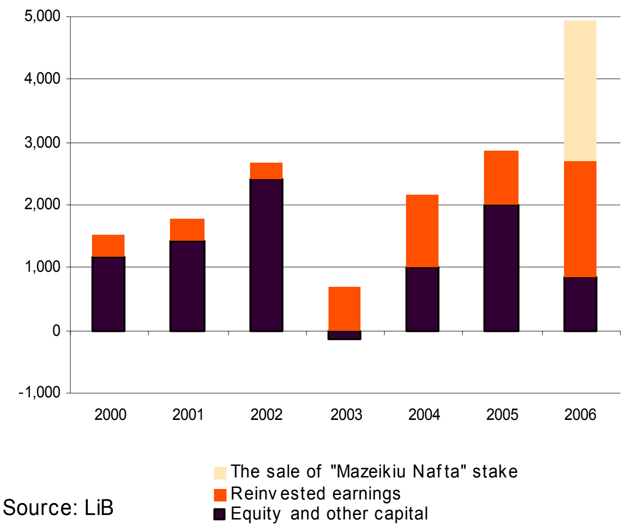
Real Grow th of Investments and Construction

Source:

Growth in foreign direct investment inflow was also good. FDI inflow in nominal terms increased by

72.6% last year and reached 6% of GDP. But that is not a pleasing fact as it could be at first sight, if you take into account, that the half of the FDI inflow (LTL 2.2bn) came from the sale of the state-owned 30.66% of “Mazeikiu Nafta” to the Polish oil concern PKN Orlen in mid-December, and a big share belongs to reinvested earnings (38% of total FDI), not to green field investment. Excluding the sale of “Mazeiku Nafta” FDI inflow decreased by 5%. Looking ahead we forecast the FDI inflow ratio to GDP will return to 2004-2005 level, reaching ~3.5%.

FDI Inflow to Lithuania by Componets, mln LTL

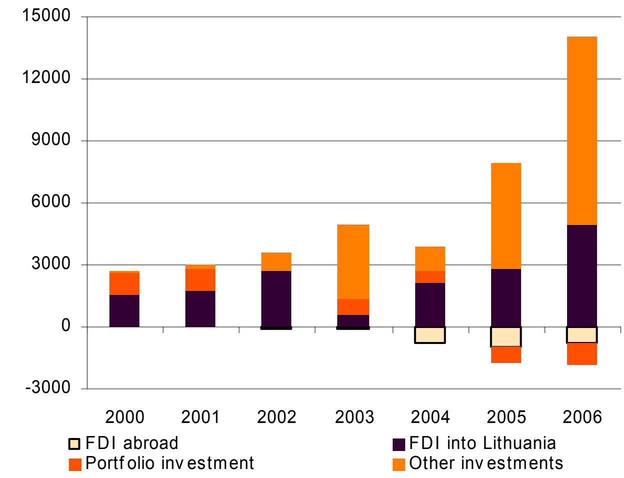


Source: LiB

However, in 2006 Lithuanian businesses decreased their investment flow abroad by 20%, which reached 0.9% of GDP, the decline from 1.3% of GDP in 2005. The majority of Lithuanian companies’ foreign investments are made into the wholesale and retail trade, manufacturing, real estate and other business activities in Latvia and other CEE countries. Looking ahead investments abroad are expected to show healthy growth.

We expect a further increase of investment in Lithuania supported by the expectations of households and companies. Companies need not only to expand production due to strong demand, but also to invest in technologies to increase productivity as the labour force becomes more and more expensive and the shortage of labour more acute. It is an appropriate time to invest as companies are now having rather large profits and prices are set to grow in the future. Moreover, EU funds will also have a strong, positive effect on investment growth.

Financial Account, mln LTL

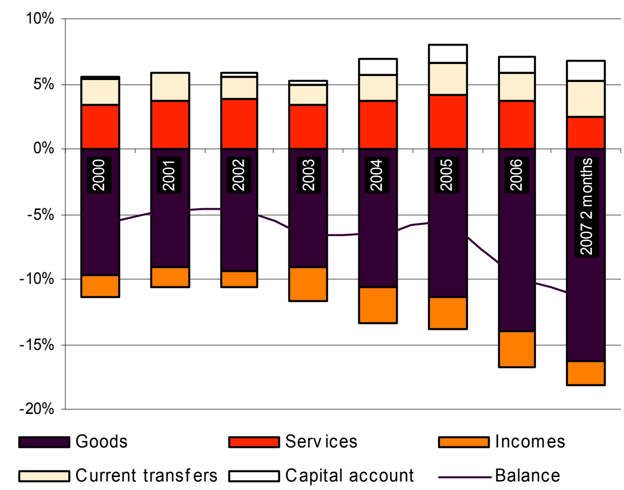


Source: LiB

4.3 External Balance

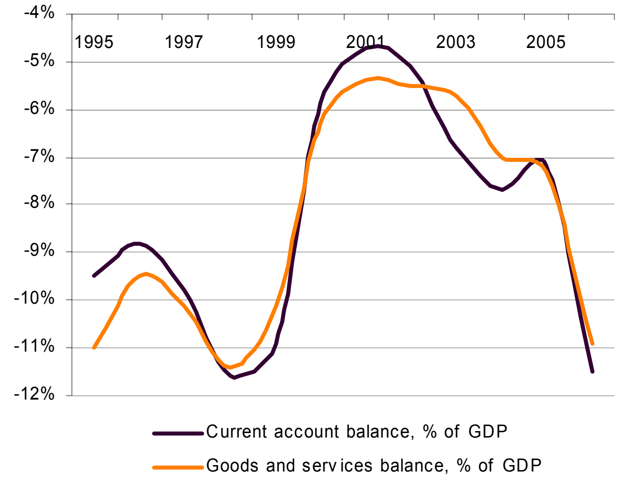
According to revised data in 2006 Lithuania's current account deficit widened by 73.7% yoy and accounted for 10.8% of GDP. The widening of the deficit was due to an increase in the trade deficit (by 40.1% yoy) and a rise in the incomes deficit (31.8%). The services surplus increased by 1.8% and the surplus on current transfers remained almost unchanged over the year. Looking ahead, we forecast the current account deficit being approximately 12.5% of GDP this year. It will be supported by the continuously increasing foreign trade deficit fuelled by strong domestic consumption. FDI, growing borrowing through the banking sector and increasing EU capital transfers will balance the deficit.

Current and Capital Account, % of GDP



Source: LiB, HBM calculations

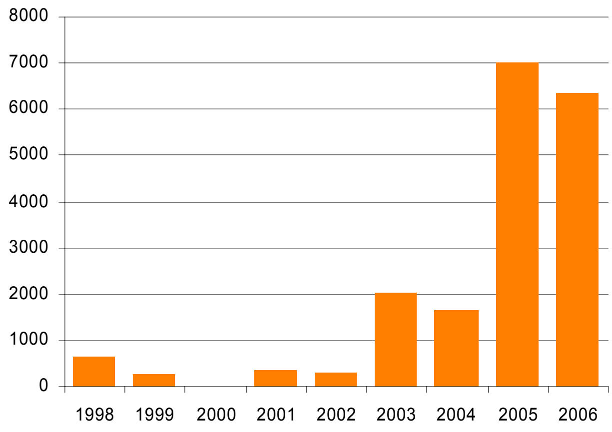
Current Account, % of GDP



Source: LiB, HBM calculations

Increasing CAD shows Lithuania's strong dependence on foreign capital inflow. The majority of foreign capital came in the form of banking loans in 2006. In Lithuania the current account deficit is covered only by a moderate share of FDI (47%, 22% exc. the sale of Mazeikiu Nafta), while the loans from the banking sector (usually from the parent company) equalled with 72% of the current account deficit last year. Foreign loans to Lithuanian commercial banks outpace FDI (excl. the sale of "Mazeikiu Nafta") by 2.4 times and this tendency is expected to continue in the short-term.

Foreign Loans to Lithuanian Commercial Banks, mln LTL



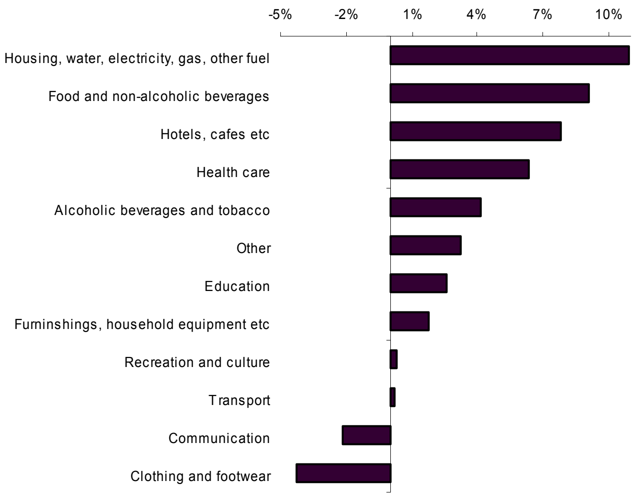
Source: LiB

5. Monetary Issues

5.1 Inflation

Inflation accelerated last year and will continue to do so this and next year. The Lithuanian consumer price index increased by 4.6% yoy in March and the average annual 12-month inflation made up 4%. The dominant drivers of the price growth were housing, water, electricity and gas (10.8%), food and non-alcoholic beverages (9.1% yoy), and accommodation and catering (7.8%). Looking ahead we retain our 4.5% inflation forecast for both years. The growth of prices will be caused by higher production costs, and gas and electricity prices as well as higher excise duties for cigarettes (in 2007) and motor fuels (in 2008). The increasing prices of energy items are the most important factors for higher inflation through the direct effect as well as delayed indirect effects. Furthermore, strong domestic demand should result in faster growth in the prices of various services.

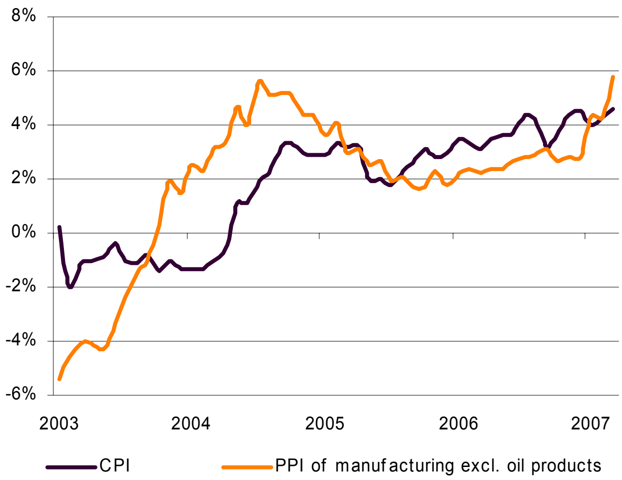
CPI Components, Annual Growth in March 2007



Source: LDS

After one year when the European Commission and the ECB rejected Lithuania's request to join the euro zone there is no official euro entry target date. The Lithuanian authorities are of the position that the most favourable conditions for euro introduction in Lithuania could be in place starting in 2010, which supports our forecasts that any date prior to 2010 is not proper for euro adoption due to the fact inflation is expected to be above the required levels.

Annual Growth of CPI and PPI excl Oil Products



Source: LDS

5.2 Monetary Policy and Interest Rates

The Central Bank of Lithuania is of the opinion that the Lithuanian economy has “warming” symptoms (but definitely not “overheating”) and consequently we expect only marginal changes in Lithuania’s monetary policy. But having evaluated the risks related to the strong growth of borrowing, the Bank of Lithuania said commercial banks must be more conservative when performing evaluations of the financial situation of their clients. Moreover, with the aim of limiting the possibility for commercial banks to boost their loan portfolio at the expense of the current year profit, the Bank of Lithuania imposed restrictions on inclusion of current year profit for calculation of the Tier II capital.

The interest rate rise in the euro zone also results in higher interest rates in Lithuania due to the currency board and fixed exchange rate. Despite recent ECB tightening and plans for a future increase, looking ahead we are of the opinion that the mortgage loan portfolio will grow rapidly, but at a slower pace than before. Rising wages and other income will offset the growing interest rates for household mortgage loans. Also fast growth will be observed in consumer credits and other loans.

Following the discussions about the risk of overheating the local interbank market reacted with somewhat widening spread between the interest rates of litas compared to the euro rates. The spread between 6-month VILIBOR and 6-month EURIBOR currently reaches around 55 basis points, compared to the lately observed 4-6 basis point level.

Interbank Borrowing Rates: Spread Between 6-month VILIBOR and EURIBOR, %

Source: Bloombergs, HBM calculations

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