The Baltic Outlook

Macro Outlook, The Baltic Region, July 2008

HANSABANK MARKETS

Watch out for the rocks

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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: Pēteris Strautiņš

Summary

Prospects of economic growth continue to weaken in the three Baltic countries as global price increases put increasing pressure on local consumers. While we have become more pessimistic regarding economic growth and inflation, the main story remains more-or-less the same. The growing price of oil (and other energy products) and food in global markets have become the major risks for future developments in the Baltic countries by pushing up domestic prices of necessities. Moreover, inflation has become a source of global concern increasing the risk of higher interest rates, including in the euro zone and that affects interest rates in the Baltic countries as well. The deep and long-term recession in countries that are the main export destinations (e.g. Finland, Sweden, Germany, and the UK) is another risk, which would make the situation difficult for Baltic exporters.

For Estonia we have two possible scenarios, with quite equal probability: the optimistic and pessimistic scenario[1]. The major differences between two are bigger unemployment and stronger CPI growth at the end of 2008 and in early 2009 in the latter scenario. We expect the Estonian economy to grow ~2.5% (~2% according to pessimistic scenario) in 2008, with close to 4% recovery in 2009 (slightly more than 2% in pessimistic scenario) and ~5% growth in 2010. We expect domestic demand to fall this year, as household consumption and investments will fall. According to the pessimistic scenario, household consumption will remain under pressure next year as well, but in 2010 we expect consumption to recover and strong growth of investments in both scenarios. The contribution of net exports will be positive in 2008 and 2009, and turn slightly negative in 2010 as growing domestic demand will cause imports growth to exceed that of exports.

The Latvian economy is expected to grow ~1.3% both in 2008 and 2009, followed by ~4% in 2010. Household consumption will fall this and next year as unemployment and declining real incomes will weigh hard on households' ability to increase spending. Investments are expected to fall as well, being pressed down by falling private investments (first of all residential construction) and gloomier growth prospects. However, public investments are expected to grow. The recovery of growth will be export-driven and will become evident in the 2nd half of 2009.

1 Of course, taking into account various risks, even worse developments are possible.

We have not changed our growth forecast for Lithuania yet, though risks are clearly downside now as investments and household consumption may weaken more than our current forecast assumes. Inflation, growing pessimism, lower credit growth and the global environment suggest that domestic demand will weaken as will exports growth. So far relatively smaller misbalances (if compared with the worst times in Estonia and Latvia) and approaching elections in October 2008 with their rather loose fiscal policy are reasons to expect rather good growth rates in Lithuania. We expect the Lithuanian economy to grow ~6% this and 5.5% next year, 2010 will bring slightly stronger growth again[2]. As domestic demand is expected to weaken imports growth will slow and bring a smaller current account deficit.

We forecast higher inflation for 2008 and 2009 for all three countries, as global price pressures, mostly from oil prices, have been significantly stronger than assumed. As food and energy products form quite a significant share in consumer baskets, the effect of these price increases (whether direct or indirect, e.g. through growing heating costs, input prices etc.) on inflation and consumption in the Baltic countries is much stronger than in richer countries. We expect consumer price inflation to be close to 10% in Estonia, ~16% in Latvia and ~12% in Lithuania in 2008. The slowdown of annual consumer price growth is expected as early as this year (with the exception of Lithuania, where stabilization is expected), but the full effect of weaker demand will be seen in 2009 and 2010, when we expect inflation to fall to ~4% (even less in the Estonian pessimistic scenario).

Weak domestic demand has already brought down import growth rates in Estonia and Latvia, and Lithuania is about to follow soon. With relatively good exports performance (which we expect to continue, though growth rates will be somewhat smaller) this means significantly better external balances. Trade and service balances have already improved well in Estonia and Latvia, and we expect the current and capital account deficits to continue fall in following years. We are most optimistic regarding Estonia, as the correction has been the swiftest so far: we expect the deficit to fall to 5.5-6% of GDP in 2009 and 2010 (15.8% in 2007). The Latvian current and capital account deficit will see the biggest correction, declining from 22.9% of GDP in 2007 to 7.5% in 2010. The improvement in Lithuania will be smaller, particularly this year, as the economy will continue to experience relatively

2 Our forecast does not take into account possible closure of the Ignalina Nuclear Power Plant in 2010, which would negatively affect GDP growth rates and add pressures on Lithuanian inflation.

strong growth (from 11.9% of GDP in 2007 to 8.6% in 2010).

In conclusion, although we expect the slowdown to continue in all three Baltic countries and in this process negative growth rates in some quarters are possible, we also see that the period 2008-10 will be years of strong change in all economies. The excessive price growth will slow to normal levels by 2010 allowing the countries to enter the euro zone in 2011-13 (we see this as being more problematic for Lithuania), current account deficits will fall as will foreign debt and companies will go through considerable and significant restructuring shifting away from businesses relying on cheap labour and energy. We expect productivity growth to improve over the next 2-3 years, as economically tighter years will force companies to pay more attention to efficiency and productivity.

Maris Lauri

	2003	2004	2005	2006	2007	2008f	2009f	2010f
Economic growth, %								
Estonia	7.2	8.3	10.2	11.2	7.1	2.5	4.0	5.0
Latvia	7.2	8.7	10.6	12.2	10.3	1.3	1.3	4.0
Lithuania	10.3	7.3	7.9	7.7	8.8	6.0	5.5	6.0
EU27	1.3	2.5	1.9	3.1	2.9	2.0	1.8	na
GDP, millions €								
Estonia	8,693	9,582	11,210	13,234	15,547	16,600	17,200	18,600
Latvia	9,978	11,176	13,012	16,047	19,936	23,730	26,202	28,885
Lithuania	16,452	18,126	20,673	23,721	28,018	32,817	37,046	41,310
EU27	10,079,553	10,580,833	11,024,384	11,621,711	12,276,233	12,864,851	13,461,782	na
Harmonized consumer price growth, %								
Estonia	1.4	3.0	4.1	4.5	6.7	9.5	3.8	4.5
Latvia	2.9	6.2	6.9	6.6	6.7	16.0	7.5	4.0
Lithuania	-1.1	1.2	2.7	3.8	5.8	12.0	8.8	5.0
EU27	2.1	2.0	2.2	2.2	2.3	3.6	2.4	na
Consumer price growth, %								
Estonia	1.3	3.0	4.1	4.4	6.6	9.8	4.0	4.5
Latvia	2.9	6.2	6.7	6.5	10.1	16.0	7.5	4.0
Lithuania	-1.1	1.2	2.7	3.7	5.7	11.9	8.7	5.0
Harmonized unemployment level, %								
Estonia	10.0	9.7	7.9	5.9	4.7	5.0	5.0	4.8
Latvia	10.5	10.4	8.9	6.8	6.0	7.0	9.0	8.0
Lithuania	12.4	11.4	8.3	5.6	4.3	5.3	5.8	5.8
EU27	9.0	9.0	8.9	8.2	7.1	6.8	6.8	na
Goods and services balance, % of GDP								
Estonia	-7.1	-7.9	-6.3	-11.6	-10.8	-6.0	-5.0	-5.0
Latvia	-12.7	-15.8	-15.2	-22.2	-20.9	-13.5	-11.0	-9.0
Lithuania	-5.7	-7.0	-7.3	-10.4	-12.5	-11.9	-11.3	-11.4
Current and capital account balance, % of GDP								
Estonia	-10.8	-11.5	-9.3	-13.2	-15.8	-10.2	-5.5	-6.0
Latvia	-7.5	-11.8	-11.2	-21.3	-20.9	-11.5	-8.5	-6.5
Lithuania	-6.4	-6.4	-5.9	-9.6	-11.9	-11.0	-9.2	-8.6
EU27	0.2	0.3	-0.4	-0.9	-0.9	-0.9	-0.9	na
General government balance (ESA95), % of GDP								
Estonia	1.8	1.7	1.8	3.6	3.2	-1.8	-0.8	0.0
Latvia	-1.6	-1.0	-0.4	-0.2	-0.0	-2.0	-2.0	0.0
Lithuania	-1.3	-1.5	-0.5	-0.5	-1.2	-0.7	0.0	0.0
EU27	-3.1	-2.8	-2.5	-1.4	-0.9	-1.2	-1.3	na

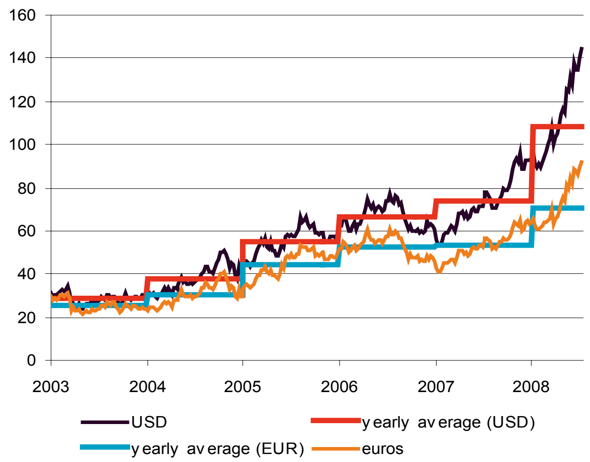
Estonian, Latvian and Lithuanian forecast by HBM; EU27 forecast by EC (Spring forecast 2008)

General Assumptions

1. The Global Economy

Inflation has settled into focus of economic developments all over the world. Rapidly growing oil and food prices are pushing price levels up hindering consumer spending and therefore economic growth. The price growth has sparked public discontent, which in an increasing number of countries has resulted in riots and the expectation of even higher prices is an increasingly disturbing factor threatening the global economic outlook in the short and long-term. Authorities are trying to suppress price growth, but often targeting short-term issues in their country of residence. In the long term and globally those measures will have, however, a contrary effect, incl. in the country introducing the measure (e.g. protectionism, price fixing, favouring bio fuels etc).

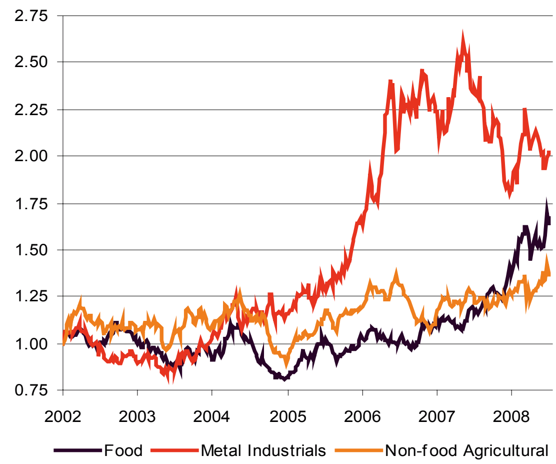
Oil price (Brent)



Source: Reuters EcoWin; HBM calculations

After several years of strong growth, the price of oil in 2008 has skyrocketed and touched a level close to USD 145 in the beginning of July. Approximately a year ago food prices, at first wheat and corn, started to climb fast. This year rice prices have shown rapid increase; the prices of dairy and meat products have grown as well. As global economic growth is slowing, the price growth of some industrials has slowed and some prices are even falling; for instance those for basic metals and timber products. Looking at the main triggers of these prices movements, it is difficult to find reasons to expect a significant fall in price levels. Even though the slower economic growth may slow price growth, and some prices may stay flat, the demand-supply misbalance is the key factor that does not promise better times ahead. Demand in developing countries is growing as their economies are growing and people are getting wealthier. In the case of China and India with their populations of over a billion, this means additional demand for energy and food products in amounts that significantly affect global demand. At the same time the supply of energy and agricultural products is not growing as fast as demand due to capacity constraints, too little investments, government policies, lack of arable land and weather conditions just to list a few factors[1]. Nevertheless, there are good reasons to expect slower growth in prices as the global economy is expected to show smaller growth rates in 2008-2009.

The Economist index (EUR*)



*USD index is adjusted with market exchange rates

After a year of the beginning the sub-prime credit crisis in the USA and the resulting high levels of uncertainty and mistrust, moods seem to be calming down now. The most pessimistic forecasts have been thrown away, as published data stubbornly shows either better than expected (e.g. in the EU) or contradictory (good and bad results at the same time) developments. It seems that the first and direct losses of the crisis are counted up for now, and although speculations about second round effects are still floating around, this still gives a hope that financial systems will start to recover soon.

Most analysts are currently on common ground that the worst times are yet to come, however they also have found a consensus that the US economy will avoid recession, though growth rates of the US economy are expected to be very small for some

1 Other factors could be listed as well, e.g. political instability in producing countries, government policies distorting competition etc.

	GDP, %					CPI, %				
	2005	2006	2007	2008f	2009f	2005	2006	2007	2008f	2009f
USA	3.1	2.9	2.2	1.1	2.3	3.4	2.6	4.1	4.0	2.5
Japan	1.9	2.2	2.1	1.4	1.3	-0.1	0.3	0.1	1.4	1.2
Eurozone*	2.0	3.2	2.2	1.7	1.3	2.2	1.9	3.1	3.5	2.2
Finland	3.1	4.8	4.3	2.7	2.3	0.8	1.4	2.5	3.7	2.0
France	1.7	2.2	2.1	1.7	1.3	1.8	1.7	1.5	3.2	1.9
Germany	1.0	3.1	2.5	2.0	1.5	2.1	1.4	2.3	2.9	2.0
Italy	0.2	1.9	1.5	0.4	0.8	2.1	2.1	1.8	3.4	2.2
Spain	3.7	4.0	3.8	1.7	1.2	3.7	2.7	2.8	4.2	3.0
Other EU countries*										
Sweden	3.3	4.5	2.8	2.1	2.0	1.3	1.4	2.2	3.3	2.6
UK	1.9	3.2	3.0	1.6	1.2	1.9	3.0	2.3	3.4	2.4
Slovakia	6.6	8.5	10.4	7.4	6.3	3.7	4.2	3.4	3.7	3.9
Bulgaria	6.2	6.3	6.2	5.5	5.1	6.5	6.5	12.5	8.1	5.9
Romania	4.2	7.9	6.0	6.1	5.0	8.6	4.9	6.6	6.8	5.2
Emerging Markets										
China	10.4	10.4	11.9	9.8	9.0	1.6	2.8	4.8	6.5	4.3
India	9.2	9.6	9.0	7.6	7.1	4.2	6.1	6.4	6.9	5.9
Russia	6.4	7.4	8.1	7.2	6.5	10.9	9.0	11.8	13.5	10.0

*harmonized consumer prices

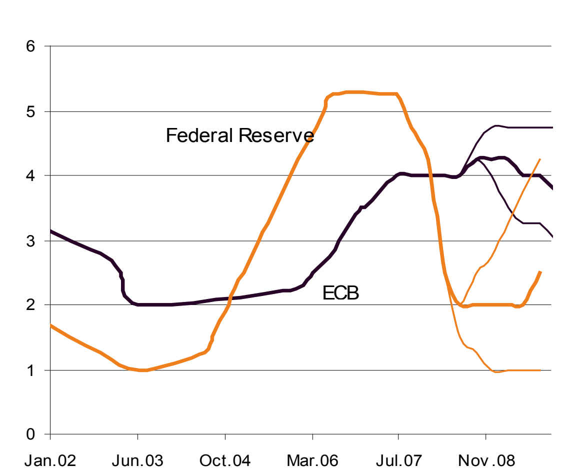
Sources: The Economist, Reuters EcoWin, FocusEconomics

quarters. The euro zone (as well as the whole EU), which so far has been surprisingly resilient despite the strong euro and global slowdown, will face smaller growth rates in 2008 and will start to recover only in the 2nd half of 2009. Economic growth in the developing world will slow as export demand weakens, but domestic demand will at least partly cover the loss of export markets and as a result, growth will remain relatively high.

High and growing inflation indicates that central banks will tighten their monetary policies in 2008, although one could expect lower interest rates as the economy slows. Since the fears of the appearance of stagflation are bigger, markets are expecting interest rates to increase. The ECB started the process of increasing interest rates on July 3rd by 25bp to 4.25% and the Federal Reserve is expected to follow suit in autumn. It is likely that there will be other increases ahead in the next 12 months, however they will be small.

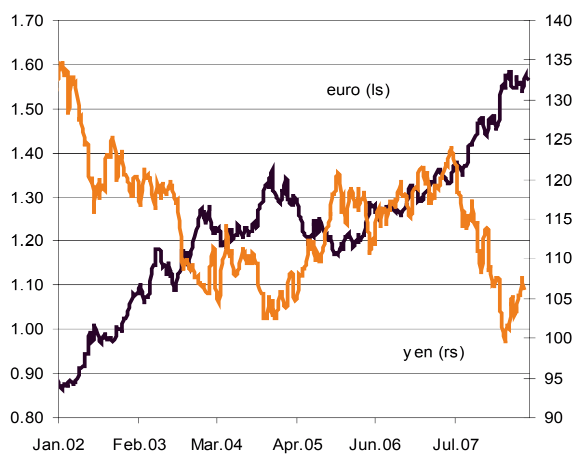
The dollar will remain weak, but slow strengthening should take place if the US economy starts to improve at the end of 2008. The increase of interest rates in the euro zone, however, will weaken it in summer-autumn. Unfortunately, the dollar exchange rate is affecting oil prices as well: a weaker dollar increases oil price in dollars.

ECB and Federal Reserve base rates, %



Source: Reuters, EcoWin

Exchange Rates



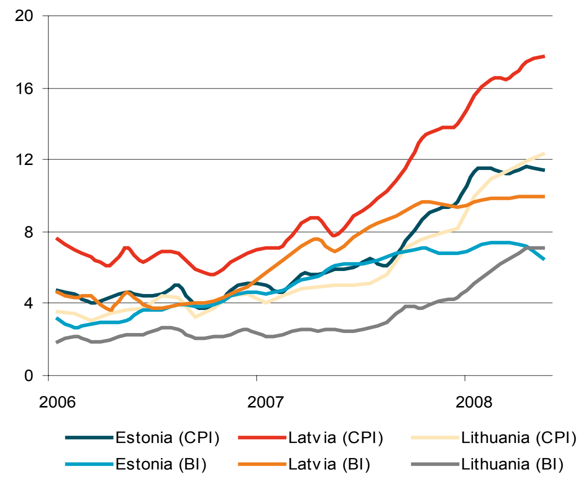
Source: Reuters EcoWin

2. Implications for the Baltic Economies

Global economic developments are not helping the Baltic economies, which are currently going through a correction period with slipping growth rates and a recession in sight.

Slower economic growth in the developing world is threatening the export possibilities of Baltic companies. Moreover, as the competitiveness of many of them has already diminished significantly in recent years (due to rapidly growing production costs), economies are facing the threat of falling exports growth. With weak domestic demand, there seems to be little remaining to support economic growth. However, in the past, exports of Baltic countries have been strongly dependent on local producers – what they are able to supply and sell - and less on demand in exporting countries[2]. In the more difficult economic situation it might be easier to sell products, as buyers will pay less attention to trademarks (i.e. where the product is produced and be more ready to switch to cheaper products). One good factor is that the economic forecasts for the main export partners for 2008-2009 are relatively good and the negative impact of weaker demand growth may be to some extent outweighed.

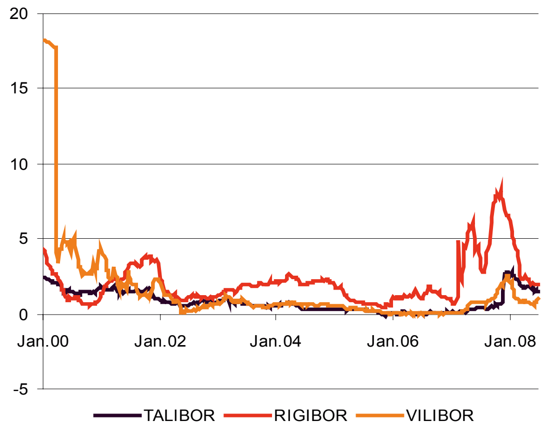
Annual Counsumer Price Inflation, %



Source: Eurostat

Globally growing prices of oil (energy) and food (agricultural products) have already increased inflation more than expected in all three countries, and they will remain a major threat for the future as well. While we can already see in Estonia or could expect in Latvia and Lithuania other prices to fall,

6-month Money Market Rates (difference from EURIBOR), %



Source: Reuters EcoWin

food and oil have been keeping overall price growth high and/or increasing[3], but with slowing growth of demand, the increase of export prices is becoming more and more difficult as prices of investment goods and several commodities (e.g. base metals, timber products; they form a significant share in Baltic exports) are falling. As production costs grow (e.g. due to energy, labour) enterprises are losing profits and are increasingly in a more difficult financial situation. This may hinder their expansion and restructuring process.

The monetary conditions, which are already unfavourable to Baltic countries, are posing additional risks. Higher interest rates (imported from the euro zone as Baltic currencies are pegged to the euro) will increase the debt servicing costs of existing loans (most of mortgages have floating interest rates dependent on Euribor) and make new borrowing more costly. The threat of increasing risk margins as economies slow will make economic recovery more difficult, as borrowing becomes even more restricted.

We are also concerned about the excessively negative attitude toward Baltic economies, as this may make the transformation process even more difficult and lengthy. Attitudes toward Baltic countries have shifted from highly positive in 2004-2006 to highly negative in 2007-2008. We are of the opinion, that both were/are not good for the Baltic economies. Too high levels of optimism in 2004-2006 is one reason behind the problems the Baltic countries are facing now as this brought too much cheap money into these economies, lowered risk margins too much, encouraged excessive investments in

2 One explanation is that the share of Baltic countries export in destination markets' demand is rather small and they can successfully "hide" themselves from the worst. It also makes it important to find good partners in exporting countries (not all companies are doing equally badly in difficult times).

3 However, administrative factors have also been important in 2008, and are expected to affect price levels in future as well (see country texts). But they are at least partly triggered by oil (energy) price increases (e.g. heating, transport).

some domestic demand sectors and too little in export sectors, and all that in turn resulted in high misbalances in the economy (e.g. price growth, current account deficit, debt growth), which finally started to hinder economic developments. Too high pessimism now has increased risk margins to levels, which are comparable to the early years of the century, but the Baltic economies are definitely in a better situation now than then and fundamental risks are significantly lower (e.g. financial system is stronger, production is more sophisticated, fiscal policy is stronger).

Elections schedule

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

Maris Lauri

Annika Paabut

Ieva Vyšniauskaite

Jurijs Masans

Estonia

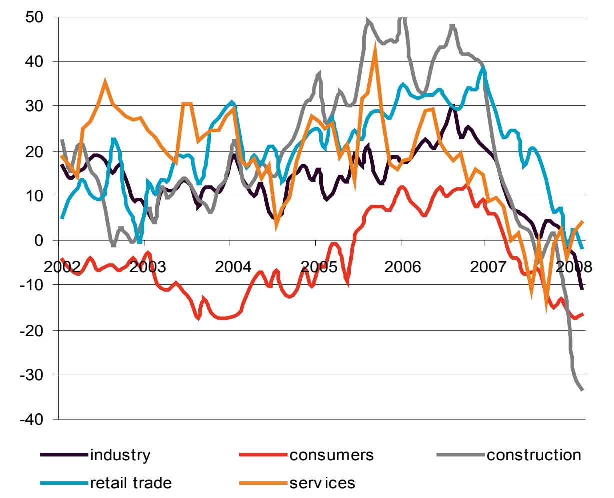
1. Recent Economic Results

The official GDP growth in the 1st quarter was surprisingly low at 1.4% yoy (s.a.; n.s.a. 0.1%) as domestic demand declined 0.7%[1] yoy (up 12.8% in 1Q07) and net real exports contributed negatively to GDP growth (-0.8%)[2]. Although in nominal terms exports grew (3.1% yoy) and imports declined (0.6% yoy), in real terms both exports and imports declined (5.4% and 3.8% yoy, respectively) as exports' deflator was up 8.9% yoy, while imports' deflator only 3.3% yoy. But the results of exports-imports in GDP calculation conflict with those in the balance of payments; underestimating services exports 22.5% and service imports by 8.7% (the usual difference has been ca ±1% and ca ±1.5% due to methodological differences). We are of the opinion that this will lead to the upgrading of GDP figures for the 1st quarter[3],[4].

The 1st quarter balance of payments showed stronger than expected improvement: the current and capital account deficit fell to 10.3% of GDP (22.8% a year before, 14.2% in 4Q). That included a strong improvement of the trade and services balances as exports grew 7.7% yoy, while imports declined 1.2% yoy because of faltering domestic demand. April's preliminary balance of payments confirms that positive developments in the trade and services trade have continued (in 4 months exports up 7.9% yoy, imports down 0.7% yoy). FDI net inflow covered 65% of the current and capital account deficit and inflow of FDI was 13.6% of GDP as investments into main capital grew 3.2 times and reinvested earnings were up 5% yoy.

Tax revenues started to improve in May after very weak revenues in February-April (particularly from VAT and excises). May brought better incomes, and June was better than February-April, but the hole that emerged in previous months was significant and forced the government to make cuts in the budget. The supplementary budget approved in June 19th cut revenues by EEK 6.1bn and spending by EEK 3.2bn, keeping the state budget in surplus and the general budget in balance.

Confidence Indices, s.a.



Source: EKI; HBM calculations

Price growth has become the major theme in the economy, though the GDP deflator slowed in the 1st quarter to 8.1% yoy (11% in 4Q). Consumer price growth in June reached 11.4% yoy (due to oil prices), which is the same as in April and more than in May (11.3%), and producer price growth continues to decline (7.2% yoy in May, 9.1% in October 2007). Construction price growth has weakened significantly (6% in 1Q, 15.6% a year before) and we would not be surprised if in the 2nd quarter it would have fallen. The deflator of investments fell 0.6% in 1Q having fallen 4.3% in 4Q07. Early 2008's price growth had a strong administrative contribution (as was with 2H of 2007), however external factors (first of all oil, but food prices as well) are putting increasing pressure on consumer prices and through that on administrative prices as well. Base inflation has started to slow (7.5% yoy in February, 6.5% in May), as consumers have had to cut their spending and hence a faster slowdown of consumer price inflation is expected in coming months.

2. Highlights of the Forecast

We have revised our forecast for 2008-2010, expecting slower growth and higher inflation due to strong external pressure (oil and food first of all). We are of the opinion that the 2nd quarter was quite a similar to the 1st one, but smaller growth rates are

1 Data is non-seasonally adjusted if not stated otherwise.

2 The build-up of 1Q GDP real growth (0.1%) was as follows: households -0.1%, investments (incl. inventories) -0.9% (gross fixed capital formation contributed positively with 1.8%), government +0.3% (domestic demand combined -0.8%), exports -4.6%, imports +3.8% and errors +1.7%.

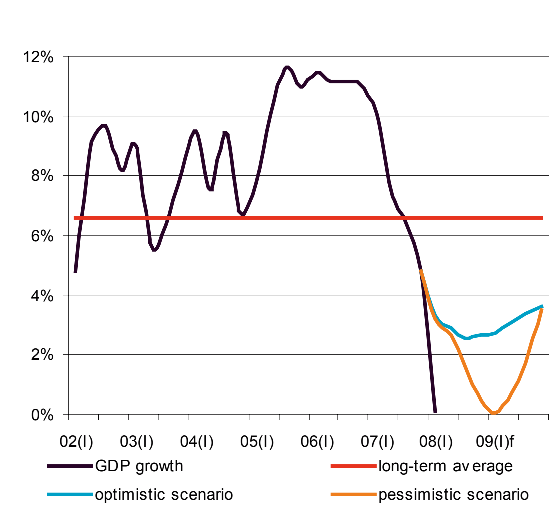
3 If the same deflators, usual differences etc. are assumed, one could expect GDP growth to be approximately 3.5% yoy in 1Q.

4 ESA is about to change the methodology of calculating GDP when releasing the 2nd quarter results (and those starting from 2000). The change replaces deflators: all real growth rates will be calculated in previous year's prices, while currently 2000's prices are used. The preliminary estimate (only real growth) will be published on August, 13th, and detailed data on Sept., 8th. The change will most likely bring down high growth rates of recent years. Expected changes make forecasting difficult; hence our forecast figures should be taken as indicators for expected developments and proposed growth rates will not be comparable to those which will be published officially (as we use the old figures, and the forecast is also based on them). The full effect of methodological change will be seen in our next planned Baltic Outlook in late October-early November.

	2003	2004	2005	2006	2007	2008f	2009f	2010f
Economic growth, %	7.2	8.3	10.2	11.2	7.1	2.5	4.0	5.0
GDP, EURm	8,693	9,582	11,210	13,234	15,547	16,600	17,200	18,600
GDP per capita, th kroons	100.3	111.0	130.2	154.2	177.0	195.0	200.0	220.0
euros	6,422	7,103	8,329	9,851	11,590	12,400	12,900	14,000
Growth of industrial production, %	11.1	10.5	10.9	10.1	6.8	1.0	3.5	6.5
Growth of GDP deflator, %	4.5	1.8	6.2	6.2	9.7	4.0	0.0	4.0
Growth of consumer prices, %	1.3	3.0	4.1	4.4	6.6	9.8	4.0	4.5
Growth of harmonized consumer price index, %	1.4	3.0	4.1	4.5	6.7	9.5	3.8	4.5
Growth of producer prices, %	0.2	2.9	2.1	4.5	8.3	7.0	2.5	3.5
Harmonized unemployment rate, %	10.0	9.7	7.9	5.9	4.7	5.0	5.0	4.8
Real growth of average monthly gross wage, %	8.0	5.2	6.1	11.2	13.0	3.0	0.0	2.0
Growth of exports of goods and services, %	9.0	17.4	24.6	18.4	7.8	6.5	3.5	6.0
Growth of imports of goods and services, %	9.7	17.9	21.6	25.7	8.0	0.0	2.5	6.0
Balance of goods and services, % of GDP	-7.1	-7.9	-6.3	-11.6	-10.8	-6.0	-5.0	-5.0
Balance of current and capital account, % of GDP	-10.8	-11.5	-9.3	-13.2	-15.8	-10.2	-5.5	-6.0
Inflow of FDI, % of GDP	9.5	7.5	20.1	14.0	11.7	12.0	8.0	8.0
Foreign gross debt, % of GDP	64.5	76.6	85.3	96.4	110.3	102.0	105.0	104.0
General government budget position, % of GDP	1.8	1.7	1.8	3.6	3.2	-1.8	-0.8	0.0
General government debt, % of GDP	5.5	5.1	4.4	4.0	2.9	3.0	3.2	3.3

expected due to weak domestic demand and less working days. Starting from the 3rd quarter we see the possibility of different scenarios developing. We have two likely scenarios unfolding with approximately the same probability: an optimistic and a pessimistic scenario. Our optimistic scenario forecasts stabilisation of growth rates in autumn (slowly declining growth in the 2nd and 3rd quarter) and a slight pickup of growth rates at the end of 2008. 2009 will be a year of gradual strengthening of growth rates, which will continue into 2010. Prerequisites to this scenario are as follows: (1) a relatively mild pickup of unemployment in 2008 and 1st half of 2009, as exporting companies will be able to absorb most of people laid off, (2) a sufficiently rapid correction of consumer price inflation, which will allow consumers to increase spending in 2009, and (3) a swift adjustment in production companies – changes in the production mix, production process, productivity etc. The lower comparison base will help growth rates as well.

GDP Annual Grow th



Source: ESA; HBM calculations

The second, pessimistic scenario could also be called the mild recession scenario. This second scenario sees the possibility of a second slippage of the growth rates in autumn-winter after stabilisation in summer-autumn, as companies operating in the domestic market will begin more pronounced layoffs than assumed in the optimistic scenario. This will cause an additional fall in domestic demand as real income will drop and consumer confidence will tumble. The fall of domestic demand will bring 2009's growth rates down even more and a short-term recession (i.e. negative growth rates in some quarters) is likely.

The major difference between two scenarios is that the GDP growth in 2008/09 will be smaller according to the mild recession scenario and the current account deficit as well. This scenario would bring more takeovers and hence bigger FDI, but would create a stronger labour outflow, higher interest payments and deeper problems in financial markets, the budget and consumption. The difference between numerical outcomes of two scenarios would be not very big, but the optimistic scenario would bring an earlier recovery, though the recovery will be slower than according to the pessimistic scenario. The year of 2010 would be quite similar in both scenarios.

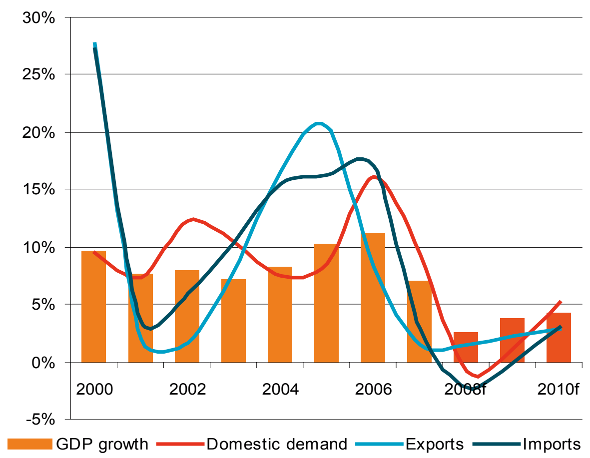
The biggest threat to the Estonian economy (and the global economy) is inflation, particularly the rapid growth of oil and food prices. If those prices continue to grow rapidly, then the fall of other prices in the consumer basket will be significant as household incomes are forecast to remain flat or negative in real terms in 2008-2009 (see discussion below). Falling prices will seriously hit domestic producers and cause unemployment to grow, which in turn will negatively affect incomes, consumption and production. The second hit could come from exports, as a long-term and deep fall in demand would eventually affect Estonian exporters as well[5]. If this process starts, it will end up with the long-term stagnation of the Estonian economy (and this applies to the global economy as well[6]).

Although Estonia's main export markets are performing relatively well, growth there is slowing and this will eventually affect Estonian exports opportunities. Consequently, any long-term or deeper than assumed stagnation in Estonia's main export markets is a threat to Estonian economic developments.

2.1. Economic Growth

We forecast that Estonian real GDP will grow ~2.5% in 2008 according to the optimistic scenario. Growth will slowly strengthen during 2009 and 2010. Domestic demand will decline in 2008, then in 2009 grow approximately 2.5% but in 2010 growth may reach 10% (~8% is more likely). Household consumption and investments are expected to decline this year, and the first will grow relatively modestly in 2009-2010. Investments, however, will show quite strong growth in 2010, and probably in the 2nd half of 2009 as well. The fall in domestic demand in 2008 will cut imports, though in nominal terms the growth may be slightly positive. Imports will strengthen together with domestic demand, but

GDP: Demand Components Growth Rates



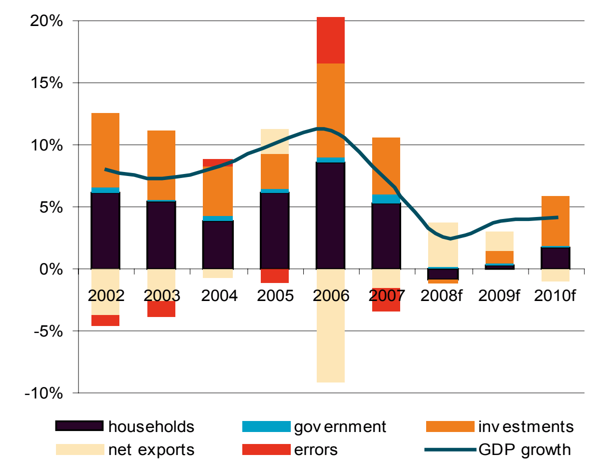
Source: ESA; HBM calculations and forecast

its growth will exceed exports growth only in 2010-11.

The pessimistic scenario expects approximately 2% growth both in 2008 and 2009 (it might be smaller in 2009) as domestic demand will fall ~2% in 2008 and ~1% in 2009. Household consumption will fall strongly in winter and the 1st half of 2009, which means that overall growth of consumption in 2009 will remain negative. After a fall in 2008 investments are expected to grow in 2009 and grow strongly in 2010.

Government consumption will grow 1-1.5% in 2008 and approximately 0.5% in 2009 according to both scenarios. Net exports contribution to the growth will be positive in 2008 and 2009, but will turn negative in 2010 as domestic demand recovers.

Components of GDP Growth



Source: ESA; HBM calculations and forecast

3. Household Incomes and Consumption

3.1. Labour Market

Employment developments have been surprisingly strong in the 1st half of 2008 but we expect weaker developments in the 2nd half of the year. One of the major differences between two scenarios – the optimistic and the pessimistic – lies in the employment in the 2nd half of 2008 and in 2009.

Unemployment has continued to decline in the 1st half of 2008, though recent months suggest a stabilisation of unemployment as the biggest layoffs are taking place in some companies[7]. Layoffs have taken place in companies that relied on cheap production, but also in residential construction, where demand has fallen significantly. So far those

5 Estonian exports are not only dependent on demand but also on supply (i.e. what goods are provided), as history shows. Weaker growth in exporting countries may increase the competitiveness of cheaper (and lower quality) products (see General Assumptions)

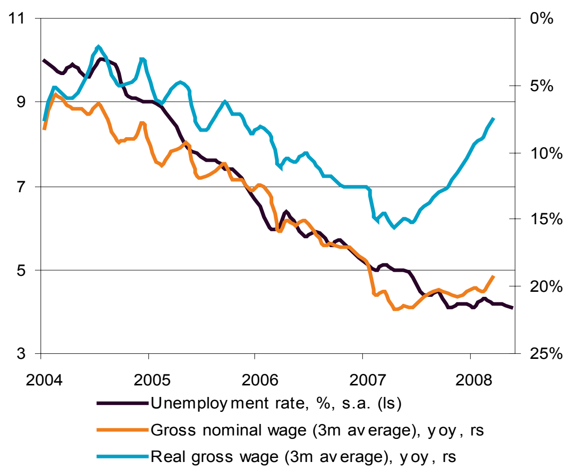
6 This is not the main scenario for the global economy. But the Estonian economy (like the Latvian and Lithuanian) is more open to global developments than most other countries due to their openness. The share of energy and food in consumer baskets is higher than in more developed countries, which means that the price growth of those items affects the local economy more than in e.g. the German economy. This means that the risk of adverse economic developments is higher.

7 The textile company Kreenholm laid off over a thousand workers in the 1st half of 2008.

laid off have been able to find new job relatively easily in companies and budget institutions that previously had difficulty in finding labour. The data from Labour Board shows an increasing number of people finding a job through the institution but also a diminishing number of vacancies. That means that the turning point is close and unemployment will start to grow soon. The additional factor to keep in mind is highly probable layoffs in public services due to tightening of budget spending.

The optimistic scenario assumes that people laid off will find jobs, but the unemployment period will lengthen. This will lead to increased unemployment level in 2008, but not significantly as exports continue to grow and thus create jobs. The decline in the working age population will also benefit unemployment level figures.

Labour Market



Source: ESA; HBM calculations

The pessimistic scenario foresees the possibility that companies targeting the domestic market will increase layoffs significantly in the 2nd half of 2008 as domestic demand continues to weaken and companies' profits fall to very low levels. As more people lose their jobs, domestic demand will weaken even more and cause additional lay-offs. That will lead to over 7% unemployment level in 2009-2010 and will also cause a bigger outflow of labour from the country, which means that in 2011 and beyond the shortage of labour (as the number of working age population declines as well) will cause very strong wage growth.

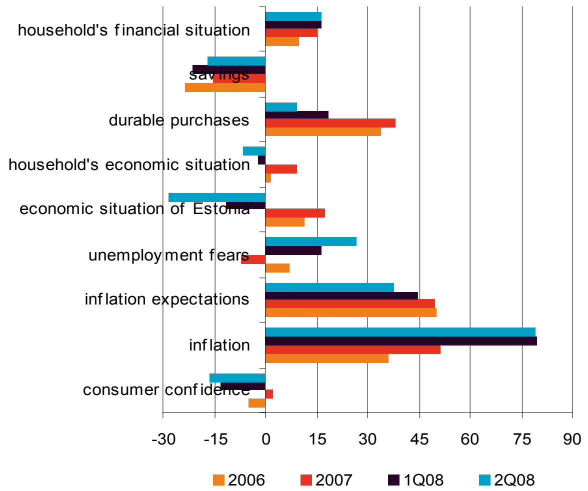
After over 20% nominal gross monthly wage growth in 2007, this year's wage growth will decline substantially and even more in 2009. We expect ca 3% real growth of gross wages in 2008 (ca 13% in nominal terms) and 2010, but in 2009 real wage growth will be close to zero.

Wage growth (19.5% yoy) was strong in the 1st quarter due to (1) bonuses paid for 2007 and (2) a strong increase in the public sector salaries (e.g. 21.4% yoy in 1Q in public administration, 23.9% in education and 34.4% in health and social care). Although there is no published data yet, wage growth in the private sector has slowed significantly for now (the revenues of social tax are slowing). The diminishing number of working hours and smaller bonuses will mean that in some companies wages may even fall. The factor that will keep wages growing is structural change: usually less qualified (and lower-paid) workers are let go and the big layoffs are taking place in sectors relying on cheap labour. There are still professions and sectors (e.g. IT), where demand will be stronger than supply and wage growth will continue.

3.2. Household Spending

Household spending is determined by incomes (where wages and employment play a crucial role), prices and savings. Our optimistic scenario forecasts approximately 2% real growth of incomes in 2008-10, which would allow households to increase spending. However, the spreading pessimism and high inflation expectations will support an increase of savings and hence spending growth in 2008 and 2009 will fall behind income growth. Improving incomes, lower inflation and a better future outlook will make households increase their borrowing and hence consumption will get boost from higher leverage as well (however, borrowing will grow significantly more slowly than in the recent past).

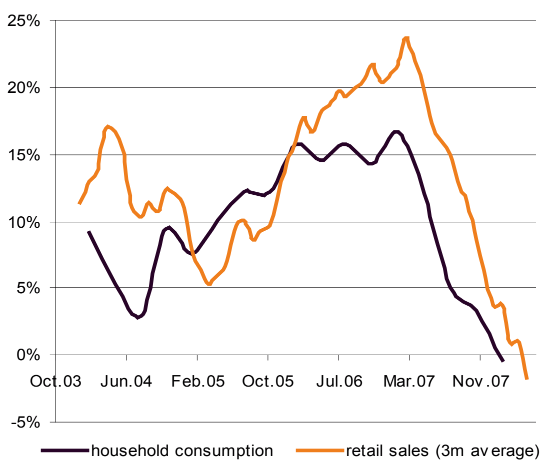
Consumer Confidence Survey: current situation, s.a.



Source: EKI

The mild recession scenario forecasts flat real revenues in 2008 and a fall in revenues in 2009. But in 2010 incomes are expected to improve rather significantly. As domestic demand will be weak according to this scenario, inflation is forecast to be lower than according to the optimistic scenario in 2009-10. Hence weak real growth rates hide very slow nominal growth. With high uncertainty (due to high unemployment) consumer confidence is expected to be very weak and this will affect spending as well. Hence we would be not surprised if households' consumption growth would be still smaller than income growth (i.e. households will not turn to using their savings). The more pessimistic economic developments briefly described in the part of Highlights of the Forecast would bring into play the use of savings.

Household Consumption, annual growth



Source: ESA, HBM calculations

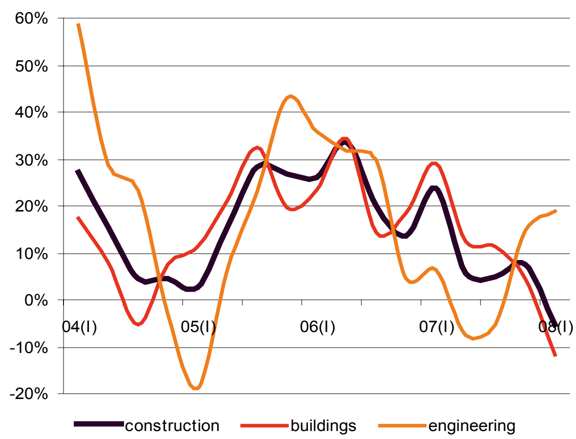
The very important factor, which has already significantly affected household spending in 2007 and this year, and will not lose its importance, is inflation. As prices of first necessities have grown the most (energy, food; see our previous Outlook as well), households have been forced to cut their spending on other items. In this situation prices of those items usually start to fall. The process in Estonia has been not as immediate as we expected, because in nominal terms sales growth rates remained strong till March and retailers did not feel the consumption squeeze. The response to falling demand could be seen only in recent months: many prices have started to fall[8] and retail companies are not very eager to increase their already high inventories. The falling prices may bring customers back to the stores (and recent statistics on payments confirms this) and services, however, the times of booming sales are definitely over for some years now.

We are very cautious regarding consumption growth – it might well be that this current surge of spending is related to one-off factors (e.g. longer midsummer holiday season: 4 days vs. 2 days in 2007; and use of short-term savings collected in winter when actual heating cost were lower than expected due to mild temperatures). There was a slight improvement in consumer confidence in June as household expectations strengthened (but not opinions about the existing situation), which may continue till the end of summer. However, with the prospect of a 20-40% increase of heating tariffs in September-October (and more if oil prices continue to grow), and increasing unemployment, we expect that consumption spending may fall again in 4Q and in early 2009. Very much is dependent on the weather – this determines the actual use of heating, and in last two years heating use has been extraordinary low[9]. Heating prices have grown the most (50.2% yoy in May) and are expected to grow the most in the 2nd half of the year as well. The increase of transport costs (mostly due to fuel prices), incl. public transport tariffs, will affect households' spending as well.

3.2.1. Investments

Our optimistic scenario forecasts a relatively mild (~1%) decline in investments in this year, small (~2.5%) growth in 2009 and close to 10% growth in 2010. The pessimistic scenario expects a deeper fall in investments this year, and milder growth in 2009. However, 2010 would be quite the same as the base scenario envisages (likely more).

Construction Works in Estonia
(annual growth of volumes)



Source: ESA, HBM calculations

One may see our investments forecast as too optimistic. However, investments have performed better than expected for two quarters already. We expect deterioration, but it may remain relatively modest. Although investments fell in 1Q,

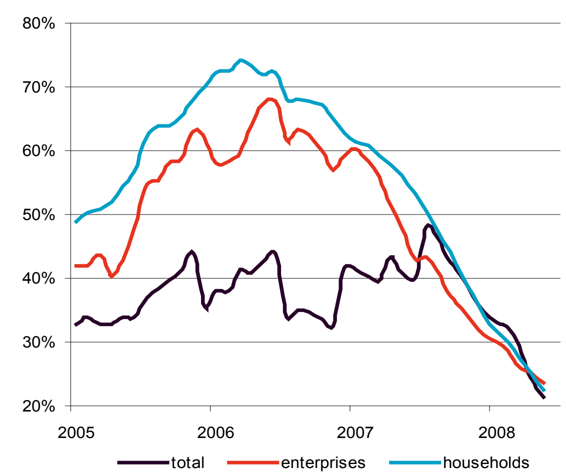
8 E.g. the price of cheese has fallen recently as one of major producers announced a 20% cut in price. But the price is still some 30-35% higher than a year ago (it was over 41% yoy in 1Q).

9 In the period Sept-April production of heating energy fell 0.8% yoy in 2007/08 but 10.5% in 2006/07. This last winter the production of heating energy was 22% lower than in winter 2002/3, which was extraordinarily cold. Some of those falls could be explained by better insulation, but not all.

gross capital formation continued to grow as in 4Q. This happened because of strong growth of non-housing construction and modest growth of other investments (i.e. machinery etc.). Housing construction contracted approximately 6% yoy, which is a rather significant improvement after the ~25% fall in 4Q. The change in inventories was smaller than a year before: 3.5% of GDP vs. 6.8% in 1Q of 2007. This suggests that companies are already correcting their inventories – a process we expected to happen only in the 2nd half of this year. The confidence surveys indicate that inventories have not grown much in the 2nd quarter; hence the change in inventories may contribute negatively to growth, and this probably will last in the 2nd half of the year.

We expect housing construction to continue to fall in 2008 and at least in the 1st half of 2009 (particularly in the pessimistic scenario) due to strong supply and household distress. Although the first signs of stabilisation have emerged in the residential market[10], we do not expect activity growth and vivid recovery until the 2nd half of 2009. Construction of business real estate will slow significantly in the 2nd half of 2008, as current projects will be finalized and few new projects will be started afterwards. Private sector investment in machinery and equipment will be hindered by business pessimism and worsened access to financing. Although EU funds will support investments in some sectors, they will mostly work for public investments and infrastructure. We expect those investments to continue to grow. We were not expecting that all plans to use of EU funds would be fulfilled punctually; hence the investment cuts in the supplementary budget passed in May did not affect our expectations. However, next years' budgets will be significantly smaller than had been assumed before, and that may affect the processing of the EU funds more than we expected.

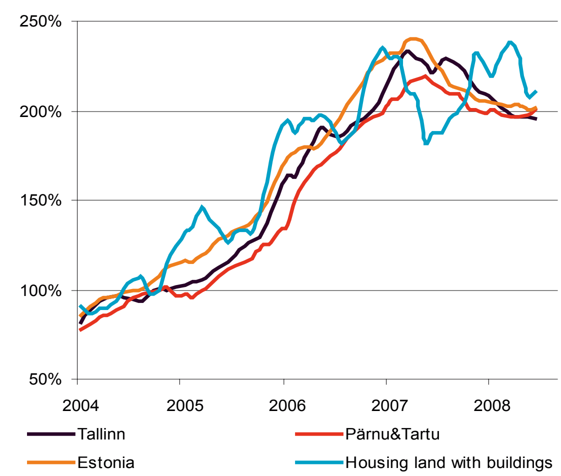
Annual Grow th of Loan Porfolio



Source: EP

The very important factor in investments is financing. In the 1st quarter, FDI in the Estonian economy (13.6% of GDP) was bigger than we expected and most important, investments into main capital increased significantly (3.2 times). This might indicate that the expected process of increased foreign takeovers has already started. The extent of the process will depend on actual economic developments: this means that our pessimistic scenario foresees a bigger FDI inflow than the optimistic scenario. This will work first as investments into capital, and then bring loan investments from mother companies. However foreign loans to finance domestic borrowing will be more expensive according to the pessimistic scenario (see below for more about financing). This means that investments by domestic companies will be hindered more in the pessimistic scenario than in the optimistic scenario. This will not necessarily mean less investment in the period 2008-2010, only that the financing of those investments will be different: the optimistic scenario foresees more investment from domestic sources, while the pessimistic scenario expects more foreign (direct) investments.

Median Price Level of Apartments (2004=100%)



Source: Estonian Land Board; HBM calculations

3.2.2. Government Spending

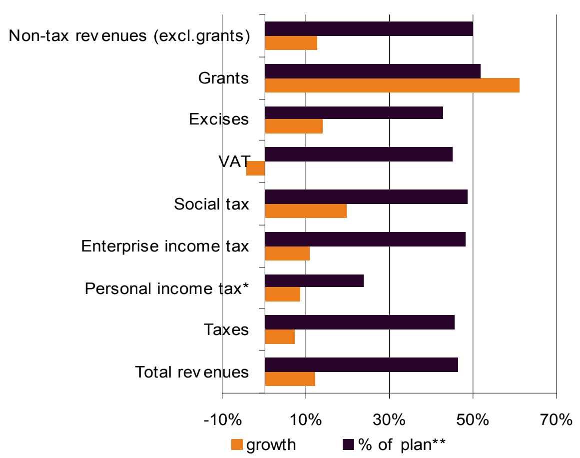
We expect government spending to grow rather modestly in 2008-2009, with a slight pickup of growth rates in 2010. Although government targets a balanced public sector budget (instead of a surplus), we still see more likely that the general budget will be in a slight deficit in coming years. There are several factors that lead us to this conclusion.

10 Annual fall of average contract price of apartments has started to diminish; price growth has emerged in some regions. This suggest that the price level has not continued to fall in May-June, compared with April. Data is from the Land Board.

● Budget tax revenues are dependent on economic performance of the country. With smaller growth rates, tax revenues will also be smaller. The Estonian state budget is relatively strongly dependent on cyclical taxes, i.e. VAT and excises. These tax revenues were smaller than expected in the 1st half of the year. If the revised budget expectations are close to those we expect in our optimistic scenario, then in the negative scenario we expect significantly lower revenues from these taxes than government does. Income tax revenues will be affected with a time-lag to the economic developments. Hence at the end of 2008 and in 2009 one could also expect weaker revenues in municipalities (but in central level as well). Weaker revenues will result in smaller spending as well.

● Increasingly more EU funding is becoming applicable; however additional funding is required to use most of those funds and in some cases in quite significant amounts. While the private sector can acquire this from banks (probably with somewhat higher costs than some years ago), public investments with the help of EU funding are under threat. The government has so far promised not to make cuts in these investments: however, they already admit that postponing some of the projects to later years is being considered (and will happen). We are more pessimistic, particularly in our pessimistic scenario, as the finding of additional financing may become very difficult in times of falling domestic demand (and tax revenues).

Annual Grow th of Major Revenue Items, 1st half of 2008



*growth incl municipalities part; ** compared to rev ised Budget Plan

Source: Est MoF; HBM calculations

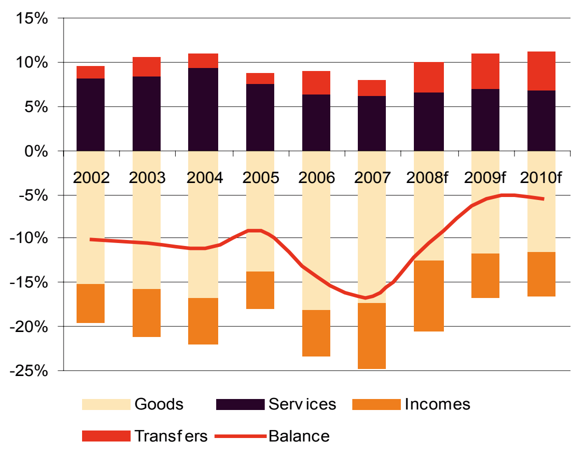
● It seems that the government has decided to keep the general budget in balance, which means surpluses in the state budget (deficits are planned for social funds and municipalities budgets). This target may be difficult to attain, especially if the economy diverges from our optimistic scenario toward the pessimistic one. There is a possibility that in times of more serious economic slowdown, the government will abandon its surplus-targeting, however, this probably requires much bigger problems in the economy than we expect in our two scenarios[11].

● As construction prices are falling and more companies are taking part in public offering processes, investing has become cheaper. This means that the government (and municipalities as well) may be able to make more investments than planned (budgets are planned at current prices).

3.2.3. Current and Capital Account

We expect improvement of the current and capital account balance in 2008-2009. The major factor is diminishing imports, while exports continue to grow. We expect a 10-11% deficit of the GDP in the current and capital account in 2008. Then in 2009 the deficit is expected to diminish to 5-6% of GDP and grow slightly in 2010.

Current and Capital Account Balance, % of GDP



Source: EP; HBM forecast

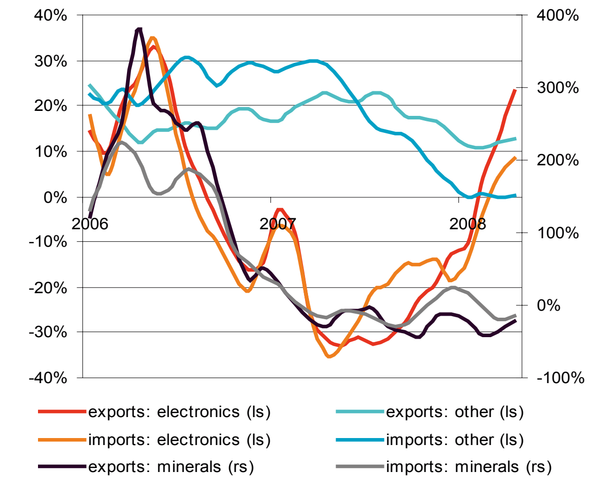
The trade and service deficit will fall to 5-6% of GDP this year and slightly more (to ~ 5%) next year, but together with the strengthening of domestic demand, imports will grow and the deficit will increase afterwards.

We expect exports of goods and services to grow approximately 6% in 2008, while imports will

11 We are not expecting any change in the government coalition. EU elections in June 2008 and local elections in 2009 probably will not bring much extra spending, but rather delays of some unpopular decisions (e.g. price increases of public transport before local elections etc). The budget cuts in April-May did not bring any public discontent with government or the Ministry of Finance, but rather approval.

remain approximately at the level of 2007. Next year exports growth will slow to ~4%, but then in 2010 it will recover. Imports, however, will grow 2-3% in 2009 but then in 2010 and onwards will reach or exceed the growth of exports. The pessimistic scenario expects smaller growth rates for exports and imports, particularly in 2009 and 2010, as due to more expensive and poorer access to financing the restructuring process will be slower and exports will grow rather modestly. Imports, however, will be affected by weak income growth and lower consumption and investments. But the trade and service deficit will diminish more than in our optimistic scenario.

Annual Growth of Merchandice Exports and Imports (3m average)



Source: ESA; HBM calculations

The importance of exports has grown and is expected to increase during times of economic slowdown and probable recession. With domestic demand falling, exports are expected to keep economic growth positive in 2008-2009. We are of the opinion that there are good reasons to expect exports to grow in this and following years.

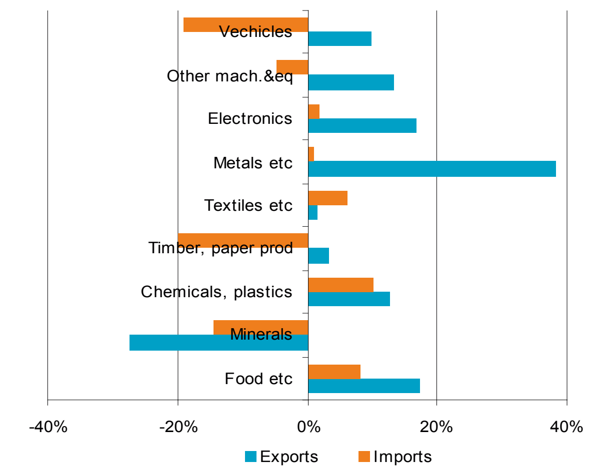
- Economic growth in Estonia's main exporting countries will remain relatively good. As we mentioned before – economic development of countries to which Estonia exports is important, but it is not crucial. For Estonian exports the supply, i.e. what particular products and services are offered, is the most important (see also General Assumption).

- The restructuring process in the economy and industry has already been taking place for some time now, which means that production and exports in some sectors is falling strongly. As the restructuring process ends, export volumes in these sectors are expected to stabilize at least. The restructuring process suggests that exports will continue, as companies will be able to improve their competitiveness. This process affects both merchandise trade (e.g. electronics, timber industries) and services (e.g. oil transit is (partly) replaced by container transport).

- The growth rates in the 2nd half of 2008 and in the beginning of 2009 will be affected by the lower comparison base – in 2007-2008 Russian oil transit fell significantly (also affecting imports)[12].

- During times of very rapid growth of domestic demand (2006-2007) many companies preferred to sell products in the domestic market (due to higher price growth and profitability), but now with very weak and falling domestic demand they prefer to sell their products in exports markets (i.e. the share of exports in industrial production is growing).

Exports and Imports Annual Growth, Jan-April 2008

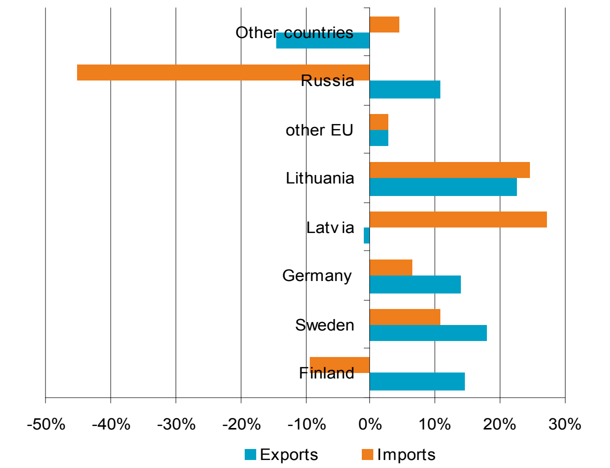


Source: ESA; HBM calculations

Imports are expected to fall in 2008 and most of 2009 as well. Weaker domestic demand is the main factor behind falling imports, but price developments also play a role. As import prices are now growing faster than those of exports (prices of oil products, natural gas etc.) the real growth of imports will be diverging more from the exports' real growth. We can expect bigger imports of cheaper products (e.g. dairy products from Latvia and Lithuania) as domestic demand weakens and consumers are becoming increasingly stressed by prices: but as transport costs are growing because of oil prices, the transportation of cheaper products may not pay-off in long-term. In some areas, domestic companies have taken over markets from foreign owned companies and hence the need for imported services has diminished (e.g. in marine passenger transport) and export opportunities have grown. However, there have been also opposite developments: due to

12 The base effect will be seen in other annual growth rates as well, but will be less pronounced than in exports and imports.

Exports and Imports Countries (Jan-Apr 2008), annual growth



Source: ESA; HBM calculations

Annual Growth of Services Exports

Source: EP; HBM calculations

high CO_2 quotas it is cheaper to buy electricity from Nordic countries from time-to-time than produce it in Estonia. At the same time, the same factor has made exporting electricity unprofitable.

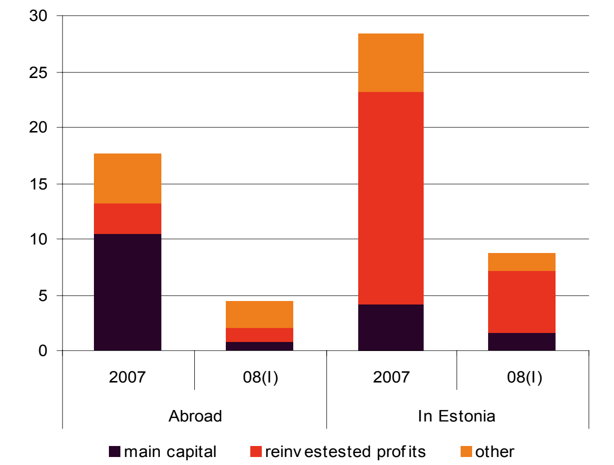
Although the income account deficit slightly improved in the 1st quarter, we still expect it to increase in 2008. Interest rate payments are expected to increase and investment revenues (as well as workers' remittances) are expected to fall. We expect that the income account deficit will fall significantly in 2009 as profits fall, and that means smaller net outflow of earnings from FDI[13]. The bigger outflow of labour that we forecast in the pessimistic scenario would bring a bigger inflow of workers' remittances, but higher interest rates will result in bigger interest payments. Yet this scenario would also mean smaller foreign borrowing at first and hence lower interest payments later; but bigger FDI inflows would create bigger outflows later (in 2010 and beyond), including in the form of reinvested earnings. This would mean an increase of the income account deficit at that time.

The inflow of capital and current transfers is expected to grow significantly in this and following years, as more EU funds will increasingly be used. We also expect private transfers to increase – but government sector transfers will exceed the private ones from 2009 as the latter will grow more slowly.

3.2.4. Foreign Financing

The need for foreign financing will diminish in 2008 and 2009, as the current and capital account deficit will fall. We expect foreign debt to stabilize and fall in 2008, but a better growth outlook would bring a stronger need for foreign funds and foreign debt will start to grow. The pessimistic scenario forecasts a stronger fall in foreign debt and its growth only in 2010 (or the end of 2009).

Foreign Direct Investments in 2007 and 1Q 2008, EEK bn



Source: EP

Net FDI inflows are expected to diminish in 2009, as reinvested earnings will fall due to lower profitability and bigger losses in 2008-2009. In the pessimistic scenario we expect a bigger inflow of new FDI, but the reinvested earnings will be smaller and net FDI inflows will be smaller compared to the optimistic scenario.

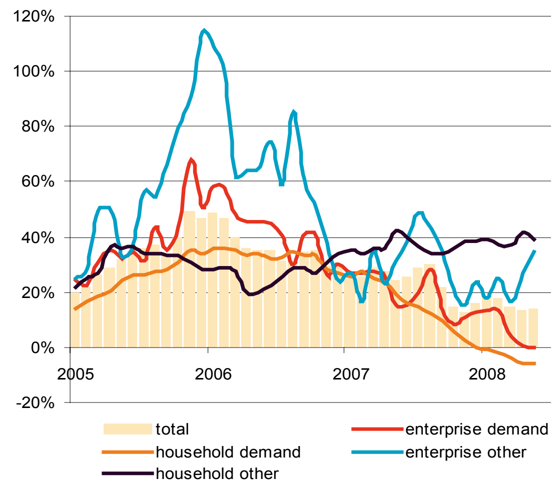
We expect a significantly smaller inflow of other capital inflows into the Estonian economy, and the outflow will also be smaller. In 2009 the picture may turn, as with improving global economic developments Estonians will increase their investments abroad (one should not forget pension funds), and foreign investments in Estonia will start to increase as well (mostly in the 2nd half of the year,

13 This will not be seen strongly in 2008, as profit distribution of 2007, which was economically a good year, took place in the 1st half of 2008.

and very slowly). These developments will result in a lower foreign gross debt level at the end of 2008 at least as a ratio of GDP, while a year after that the gross debt level will be higher again.

One reason for expecting lower foreign debt is poorer access to foreign financing due to high unpopularity of the Baltic economies (see also in General Assumptions). Hence interest rates have grown for Baltic economies, as has a reluctance to lend money. A significant part of domestic lending is made from foreign financing (this comes mostly from Swedish, Finnish and Danish banks through their local subsidiaries) and that has made the local economy vulnerable to foreign lending. As interest rates for those banks have grown because of Baltic business, local lending rates are also up, making investing significantly more costly (however, as seen in the interest rate chart, the average interest rate of new long-term loans is practically stable). The increase of interest rates in the euro zone does not help, as most mortgage lending has been made with fluctuating interest rates bound to Euribor.

Annual Growth of Deposits

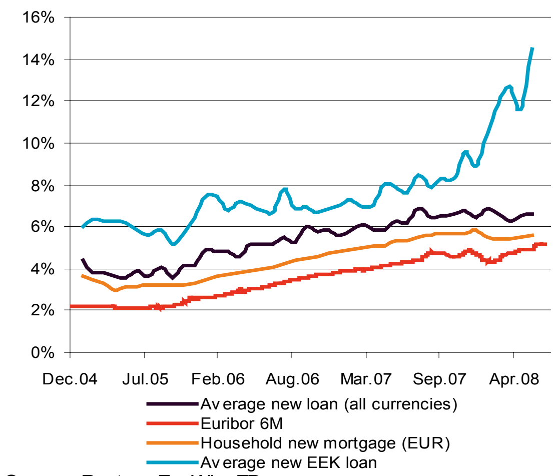


Source: EP

If interest rates continue to grow – because of euro interest rates and, most of all, because of higher margins for Baltic businesses – the Estonian economy may face bigger problems than we currently assume (modest increase of euro interest rates would have a relatively mild effect). Our current forecast expects stabilisation of loan margins to Estonia, and a slight increase in the case of the pessimistic scenario. Such developments would enable the restructuring of the economy continue, while a stronger increase of borrowing costs would make investing problematic and would increase troubles in the economy as the distress currently experienced by companies with domestic market orientation will spread to exporting companies.

As mentioned above, households have increased savings recently. Yet domestic savings are growing slower and slower. However, their importance in loan resources is growing. As domestic resources are more costly, the lending margins of banks are about to fall and profits as well. The increase of savings is related to higher interest rates but also to future uncertainty, which encourages households to build up reserves for possible bad times.

Money Market and Loan Interest Rates



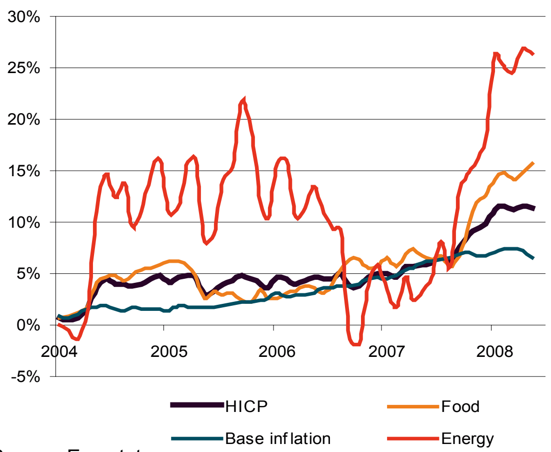
Source: Reuters EcoWin, EP

3.2.5. Inflation

Inflation has become the major problem for Estonian economic development. We expect inflation to slow in 2008 and onwards, but at first it will be not fast. The average price increases in 2008 will be higher than in 2009: we forecast CPI growth to be close to 10% (in the pessimistic scenario over 10%) and for PPI close to 7%. Construction prices are expected to fall in 2008 with slight growth in 2009. However, consumer price growth will fall strongly in 2009 – 2-2.5% yoy growth in 2009 would not be a surprise, particularly in the pessimistic scenario. Our expectations are based on the following.

- The main drivers of price growth are energy and food. The latter have been showing signs of stabilisation and fall recently, at least in the areas of domestically produced products. We expect some external pressure for food prices to remain. We expect energy prices (first of all gasoline, diesel, natural gas etc.) to continue to grow. The fall of the price of oil would be of great benefit for inflation and economic growth as this would allow households to increase their spending, as well as lowering the production costs of exporting companies: however, that is not what we expect in either of our two main scenarios.

Annual Growth of Harmonized Index of Consumer Prices

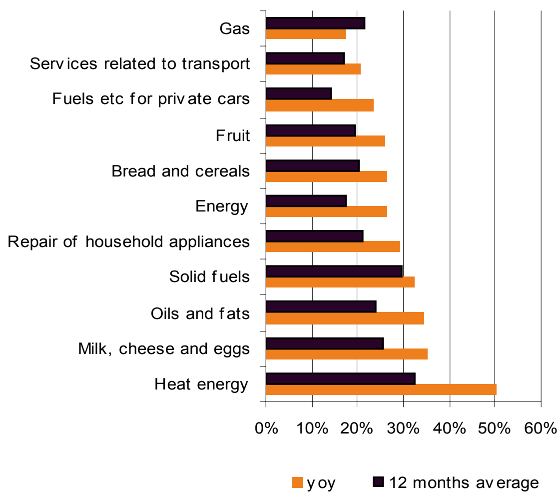


Source: Eurostat

- There will be administrative price increases, but mostly because of higher energy prices. The 2nd half of 2008 will bring significantly higher central heating prices and that probably will continue into 2009. Prices of some public services will increase, but not much due to coming local elections (many of these prices are decided at local government level[14]). We do not expect tax increases (the cutting of income tax will probably continue) after the recent increases of excises on tobacco and alcohol (in July).

- Growth of other prices will continue to slow and we expect that some prices will fall, with only a few remaining positive as household spending declines (see above).

Price Growth of some items as of May 2008



Source: Eurostat

14 E.g. local public transport, water, sewage, and garbage collection.

Our pessimistic scenario foresees a deeper fall in consumer prices, but it may affect the overall price level mostly in 2009. We are not expecting price growth to strengthen in 2010 according to this scenario, while the optimistic scenario foresees a slight pickup of prices before moderation in 2011 as consumers return to spending.

As we have mentioned before, the fulfilment of the Maastricht inflation criteria would be easier in the more difficult times (the pessimistic scenario expects inflation to fall to ~2.5% in 2010), while smoother economic developments would make the fulfilment of the criteria dependent on price movements in other countries (i.e. what the value of the criteria will be).

Maris Lauri

Latvia

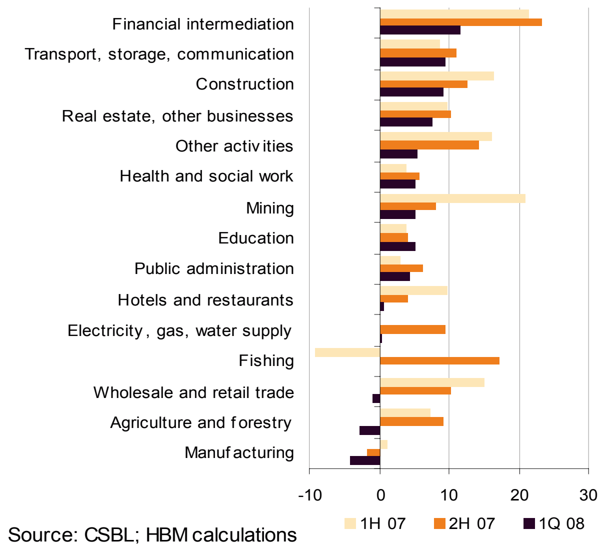
1. Latest Economic Developments

The slowdown continues. Official real GDP growth in the 1st quarter of 2008 moderated to 3.3% yoy (from 8.1% a quarter before),[1] which is significantly below our and the market forecast. Domestic demand contracted by 0.3% yoy driven by a 6.8% yoy contraction in investment activity. Investment decreased due to changes in inventories, which fell by 40% yoy, while gross fixed capital formation surprised us with a pick up of 5.1% yoy. According to CSBL, growth of non-financial investments was solely due to the public sector (11% yoy) as the private sector recorded its first decline (3%) since the year 2000. The strongest contraction of non-financial investments took place in domestic demand sectors of financial intermediation (38% yoy) and real estate, renting and business activities (34%); strong growth was observed in public administration and defence and mandatory social security (27%), and building export capacity – in transport, storage and communication (15%) and manufacturing (14%). Household consumption expenditure grew by 2.4% yoy. Consumption was supported by rising employment (4.2% yoy, n.s.a.), a temporary stabilisation in consumer confidence, strong nominal wage growth (30% yoy) and depleting real stock of household savings (deposit growth below inflation since January 2008).

Weak domestic demand translated into a real contraction of goods and services imports by 1.6% yoy (up 6.2% in current prices). Real exports growth of 6.5% (up 15.6% in current prices) was below our expectations; we expect it to be revised upwards by a few percentage points, which would raise GDP growth by close to a percentage point.[2] The trade and services deficit improved as expected and stood at 18% of GDP (24.3% a year ago), while the current account deficit improved to 19.4% (26.6% a year ago). The current and capital account deficit amounted to 18.3% of GDP as the inflow of EU funds was slow at 1.1% of GDP. Indicators and industry interviews imply a further cooling of domestic demand and an improvement in external imbalances in the 2nd quarter.

All NACE sectors reported lower annual growth rates than in the 4th quarter of 2007 with the exception of education, health and social work. Of major sectors, contraction was recorded in manufacturing (4.1% yoy) and retail and wholesale trade (0.8%).[3] As expected, the slowing propagates through weakening domestic demand while external demand and the public sector cushion the decrease in economic activity.

GDP Real Growth by NACE Sectors, yoy, %



Source: CSBL; HBM calculations

Inflation remains the key challenge. Consumer price inflation has been slightly above the forecast driven by administratively regulated price increase (electricity prices up 39% yoy in April), external pressures (food and oil, see General Assumptions) and retailers applying less aggressive price cuts than we expected to revive their dwindling sales.[4] Yet, the pace of price growth gradually slows as weakening domestic demand takes its toll (e.g. unlike in previous years, clothing and footwear prices decreased in May) and quite as expected inflation retreated from the peak of 17.9% yoy in May to 17.7% in June. Faster price adjustment has

1 CSBL has released revised GDP data on publishing Latvian National Accounts 2006. While the overall annual and quarterly GDP growth rates have been revised trivially (e.g. 4Q 2007 growth to 8.1% yoy from 8%) and the overall trend of a slowdown starting in 3Q 2007 remains, there are significant changes in the dynamics of GDP aggregates. Most notably, household consumption is revised to have slowed more abruptly from 13.7% yoy in 3Q 2007 to 0% in 4Q 2007 (previously from 14.5% to 4.3%) while gross fixed capital formation has adjusted more gradually from 11.5% in 2Q to 6.9% in 3Q and 2.6% in 4Q 2007 (previously 14.4%, 12.7% and 0.5%). Exports growth has been redistributed within 2007 with a swifter growth of 17.1% yoy in 4Q 2007 (13.3% before) but imports growth is redistributed to shrink by 1.8% yoy in 4Q 2007 (positive growth of 2.6% before).

2 It is difficult to explain a 2.3pp rise in the growth of annual exports deflator compared to that in 4Q 2007 while growth of exports unit value deflator has remained the same in both periods. Moreover, PPI inflation for exported goods has even fallen. There are increasing concerns that CSBL underestimates the real growth of exports as increase in quality is mistaken for increase in prices as industries improve the value added of their output mix.

3 Contraction in these two sectors may explain some of the observed drop in inventories growth, as they typically need considerable intermediate goods investments to operate.

4 One reason is that retailers measure their sales performance in nominal rather than real prices. With this high inflation it requires a deeper and more prolonged decrease in real sales to trigger price cuts.

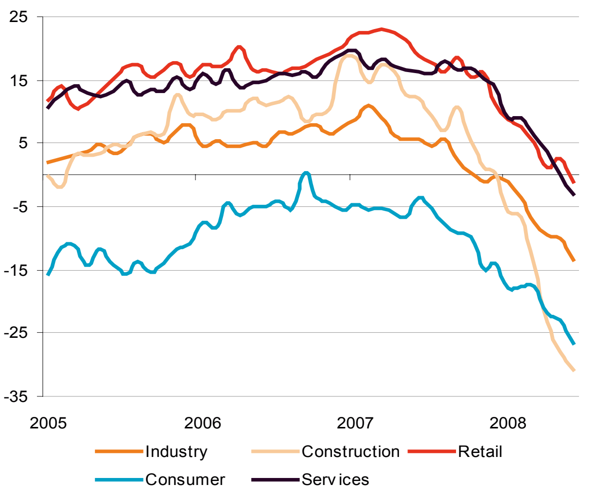
	2004	2005	2006	2007	2008f	2009f	2010f
Economic growth, %	8.7	10.6	12.2	10.3	1.3	1.3	4.0
GDP, mln euro	11,176	13,012	16,047	19,936	23,730	26,202	28,885
GDP per capita, euro	4,846	5,671	7,034	8,779	10,481	11,635	12,895
Growth of GDP deflator, %	7.0	10.2	9.9	13.3	17.5	9.0	6.0
Growth of consumer prices, %	6.2	6.7	6.5	10.1	16.0	7.5	4.0
Growth of harmonized consumer price index, %	6.2	6.9	6.6	10.1	16.0	7.5	4.0
Growth of producer prices, %	8.6	7.8	10.3	16.1	na	na	na
Harmonised unemployment level, %	10.4	8.9	6.8	6.0	7.0	9.0	8.0
Real growth of average net monthly wage, %	2.8	9.4	15.5	20.0	-2.5*	-1.5*	3.0*
Growth of exports of goods and services, %	21.2	31.4	15.3	23.5	12.0	10.0	12.0
Growth of imports of goods and services, %	26.8	27.4	31.3	21.4	0.0	5.0	9.0
Balance of goods and services, % of GDP	-15.8	-15.2	-22.2	-20.9	-13.5	-11.0	-9.0
Current account balance, % of GDP	-12.8	-12.5	-22.5	-22.9	-13.5	-10.0	-9.0
Current and capital account balance, % of GDP	-11.8	-11.2	-21.3	-20.9	-11.5	-8.5	-6.5
Net FDI, % of GDP	3.8	3.6	7.5	7.2	4.5	4.5	4.5
Foreign gross debt, % of GDP	93.3	99.4	114.0	134.2	130.0	127.0	120.0
General government budget, % of GDP (ESA)	-1.0	-0.4	-0.2	-0.0	-2.0	-2.0	0.0
General government debt, % of GDP	14.9	12.4	10.7	9.7	8.5	9.0	9.0

** without undeclared wage legalisation effect*

been delayed by the still strong labour market – although unemployment is rising, it has not had the expected restraining effect on income growth yet as employment has continued to rise via falling vacancy rates.

Tax revenues have benefited from high inflation and the strong labour market as excellent personal income and social tax revenues (7.8% and 8.1% above January-June target) have allowed the revenue target to be met and to accumulate a general budget surplus of 1% of GDP despite the striking shortfall in VAT revenues (18.1% below target). However, we reinstate our warning that revenue plans are overly optimistic and sizeable expenditure cuts will need to be made if the government aims to reach at least a balanced budget in 2008.

Confidence Indices, s.a.



Source: Eurostat

Consumer and business confidence continued to weaken being overshadowed by unfavourable developments in the global economy (more expensive funding and weakening demand) and slowing domestic demand. There is no sign that the fall in market confidence has bottomed out yet – the labour market is only about to start to adjust to the slowdown and the global environment continues to worsen. Stagnation in the residential real estate market continues as prices continue to fall by ca 2% per month (cumulative decrease close to 30% from the peak in May 2007). Credit growth continued to decelerate driven both by more conservative lending policies and shrinking demand. The latter is caused mainly by weakening optimism, slowing income growth and tighter budget constraints (e.g. rising inflation leaves less income to be saved for down payments on a mortgage or monthly loan repayments).

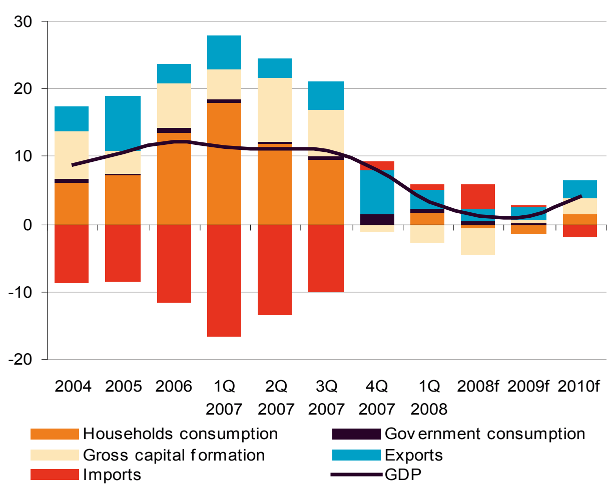
2. Highlights of the Forecast

We have revised our forecast for 2008-2010 expecting a deeper slowdown and slower recovery due to: (i) unexpectedly weak 1st quarter GDP growth which lowers the entry point for growth calculation, and (ii) the worsening global environment (i.e. somewhat slower growth, higher price growth and interest rates, see General Assumptions) which lowers growth potential. Downside risks remain strong.

Latvian GDP is forecast to grow by ca 1.3% in 2008 (4% before). We expect the low-point in the cycle to be late 2008 and the 1st half of 2009 with a significant probability of economic growth slipping below zero for two to three quarters, i.e. technically having a recession, as positive net exports contribution may be outweighed by the contraction in domestic demand. Driven by the restructuring of the Latvian economy, global recovery and rising confidence we expect growth to gradually improve in the 2nd half of 2009 achieving ca 1.3% in 2009 and ca 4% in 2010 (respectively 3% and 5.5% before). Recovery will be export driven as the contraction in domestic demand is expected to be deeper and more prolonged, and register robust positive growth only in 2010. Domestic demand growth will be hampered more than previously by household consumption, which is expected to contract in 2008-2009 as the slower fall in inflation (i.e. delays in administratively regulated price increases and stronger external pressures) and higher unemployment (i.e. weaker economic activity) will hold down real income growth. Investment activity will be weaker due to globally slower growth (i.e. squeeze of profit margins reduces own funds available for investment) and globally higher interest rates (i.e. borrowing costs rise). As the slowdown becomes more pronounced and elections approach, fiscal policy is likely to become more expansionary than currently asserted by the government.

Slower global growth will mean less dynamic export growth, but deeper domestic demand contraction will cut imports more. Hence we expect the current account deficit to improve slightly faster than in our spring forecast, i.e. to ca 13.5% of GDP in 2008, 10% in 2009 and 9% in 2010.

Contributions to GDP Annual Growth, pp



Source: CSBL; HBM forecast

The recovery of economic growth in Latvia is highly dependent on the global environment. A more prolonged and deeper economic slowdown would reduce the export sector's growth and profit margins via tighter competition. An extended period of globally high inflation (particularly for food and energy) would hit prices of other goods, as consumers would struggle to pay for first necessities with shrinking real incomes. Both effects would hit export and domestic demand sectors causing unemployment to rise, which would put a downward pressure on incomes, consumption and production thereby increasing the risk of prolonged stagflation, i.e. a period of high inflation and negative or very low economic growth.

3. Economic Growth

The Latvian economy is going through a restructuring process, which includes a significant fall in domestic demand (i.e. non-tradable) sectors, whereas export (i.e. tradable) sectors gradually become relatively more attractive for investment (e.g. easier access to labour, export demand grows while domestic demand declines or grows considerably slower than that of exports). A return to a sustainable growth path requires that growth becomes export driven as it has less demand constraints.[5] The fact that inventories are falling and gross fixed capital formation is growing in export industries and falling in domestic demand sectors indicates that restructuring is underway. Some industries have been flexible in finding other output markets to cushion contraction in their main market, and we expect this to continue.[6] The adjustment, however, will take time and in 2008-2010 growth will temporarily slide below the medium term sustainable growth of 5-7% yoy.

3.1. Household Consumption and Incomes

We expect contraction of consumption to be deeper and longer than our previous forecast expected. Following 2.4% yoy growth in the 1st quarter of 2008, we expect 2nd quarter growth to be close to zero and contract by 1-3% yoy in the final quarters of the year. The contraction will continue into 2009 by 1-3% (previously 2% recovery). Robust growth at ca 2% yoy is expected in 2010.

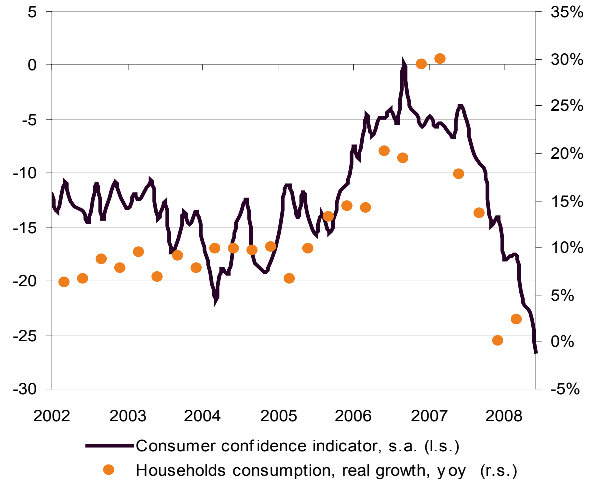
Household consumption (s.w.d.a., constant prices) reached its peak in the last quarter of 2006 as consumer spending virtually exploded during the year, growing on average by 7% qoq (historic average is 2% qoq; 3.5% qoq in 2005). Growth drivers started to run out of steam (i.e. slowing credit growth, weakening confidence, rising inflation, less tight labour market) and during 2007 consumers were only able to maintain their consumption at the level of late 2006 and average quarterly growth was zero. Given that consumption grew very rapidly quarter-on-quarter in 2006, simply maintaining the level of late 2006 was sufficient to register very fast annual growth rates for the first three quarters of 2007. In the last quarter of 2007 it hit zero annual

5 I.e. given the smallness of the Latvian economy external demand is virtually infinite. Domestic demand is capped by income and credit growth.

6 E.g. in 1Q 2008 construction of residential and trade space shrank by 17% and 33% yoy whereas that of industrial and office projects rose by 33% and 28%, and the construction industry reported growth of 9.1% yoy.

growth, as consumers had been unable to boost their expenditure above that of late 2006. Given that all key support factors were to weaken (i.e. credit growth to slow, confidence to fall, inflation to remain high and labour market to ease) it was clear that growth rates would shrink.

Consumer Confidence and Households' Consumption



Source: Eurostat

Recent developments suggest that support factors will weaken more than expected when spring forecast was made thereby further reducing households' ability and willingness to consume.

- **Lower real wage growth**: we expect real average wages[7] to contract in 2008 by 1-4% as inflation remains high longer and nominal wage growth slows rapidly. Inflation will decrease slower than expected as external price pressures are stronger and certain administratively regulated price rises have been delayed (see the section on inflation). Nominal wage growth will fall behind inflation as profit margins tighten, e.g. in some sectors wages have decreased in nominal terms, e.g. for low skilled construction workers. The public sector is typically more generous (i.e. forced by trade unions) in raising wages in difficult times than the private sector, but the Prime Minister has stated that public sector wages in 2008 are likely to grow only to compensate for inflation. Negative real wage growth is expected in 2009, as higher unemployment will exert a downward pressure. Hence, households will be forced to live through a longer period of high inflation and slowing income growth, which will reduce their real incomes. The most difficult period will start in late 2008 with a new heating season and significantly higher heating tariffs.

- **Lower employment**: unemployment is expected to rise to 8% in late 2008, peak at ca 10% in the 2nd half of 2009, and with economic activity picking up to retreat gradually. Rising labour demand (employment up by 5.6% yoy and 0.4% qoq in 1Q 2008, s.a.) is not set to last – vacancies continue to fall across the board[8] and companies are increasingly announcing layoffs. Negative productivity growth registered in the 1st quarter of 2008 (for the first time since the early 1990s) confirms that labour demand is to slacken as companies experience rising pressure on profitability and their ability to hoard labour wanes.[9] Labour will be most extensively shed in the sectors where growth was especially excessive during the recent domestic demand boom (e.g. residential construction and related industries), as well as in sectors that used to rely on cheap energy and labour (e.g. textile industry) or serviced the previously booming foreign residential housing sector (e.g. low value added wood industry). Unemployment is expected to rise also via higher participation rate,[10] which reduces the bargaining power (i.e. wage growth) of those employed even when total employment is still rising. The recent rise in credit overdue for resident households (i.e. exposure from overdue of above 30 days at 4.8% of household loan stock in 1Q 2008 up from 2.1% in 3Q 2007) is likely to be a strong incentive for the participation rate to rise.

- **Higher interest rates**: The ECB raised the euro base rate by 25bp to 4.25% in July and

7 Here we speak of wages net of income legalisation, as this is what matters for consumption. Official data reports higher growth rates due to income legalisation, e.g. the effect of income legalisation has been estimated to amount to ca 10pp of 30% official nominal wage growth in 2007.

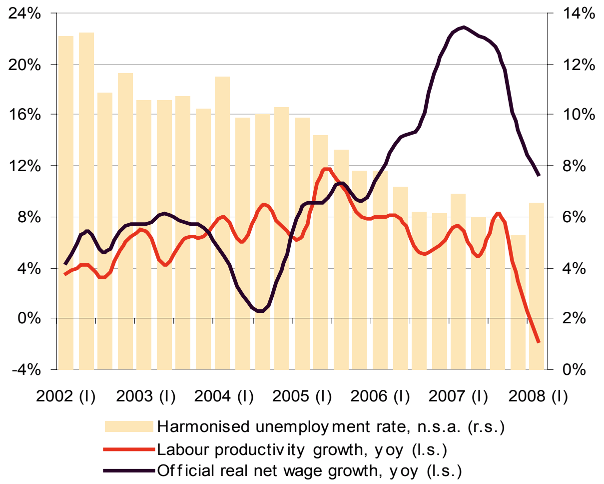
8 At 1.5% of total labour demand in March 2008 down from 2.1% in March 2007 and 1.6% in December 2007. Public sector vacancy rate stands at 2.7% whereas that of the private sector only at 0.9%. Public sector vacancies are soon expected to fall significantly with the recent budget expenditure cuts initiative.

9 Labour hoarding is a natural short term response in view of extensive labour shortages that had been experienced over the last few years – it has been difficult to hire and businesses had been investing in employee training. Firing would therefore take place only when companies realise that cost cutting is imminent.

10 Participation rate has risen to 67.8% in 1Q 2008 (64.5% in 1Q 2007, 67.3% in 4Q 2007). While in the past participation rate has certainly risen due to active labour market policies and high wage growth, in times of a slowdown it is likely to rise at first as households aim to maintain their living standards and/or improve their financial health. E.g. a single earner may no longer be able to ensure an earlier living standard as inflation is high, loan servicing costs rise as interest rates rise and nominal incomes fall (e.g. for those employed in residential construction related industries) thus forcing other members of the household to enter the labour market. Of course, some may decide to leave the labour market when it becomes more difficult to find work, but it is likely that willingness to exit the market will become strong only in the later stages of a slowdown when disappointment about the inability to find work has grown. Hence, we expect the participation rate continue to rise at first and then retreat (which would also cut unemployment rates).

further hikes are expected during 2008-2009. Given that above 80% of issued credit is euro-denominated, the cost of new borrowing and servicing of already issued loans rises (e.g. interest rates on mortgage loans are linked to EURIBOR) thereby reducing the willingness and ability to consume. Rising interest rates will prolong the contraction of the housing market (i.e. expensive borrowing encourages people to delay purchases) considerably reducing consumption – mortgages are the largest channel by which households borrow and flood money into the economy.

Labour Market Indicators

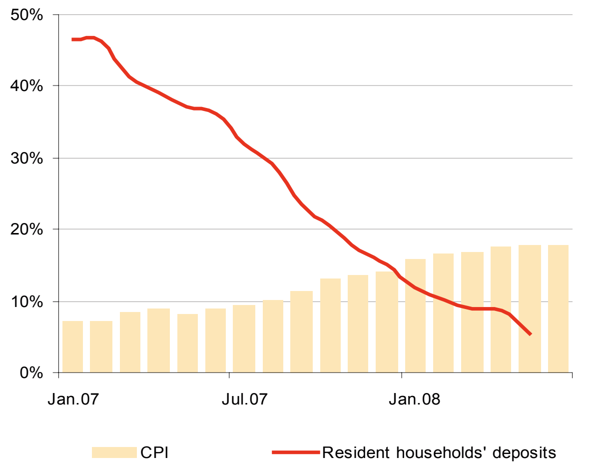


Source: CSBL, Eurostat; HBM calculations

- **Fewer transfers from emigrants**: globally easing labour markets and rising inflation means that emigrants[11] are unable to support their families as generously as previously. This particularly relates to those employed in the stagnating UK and Irish construction sectors that used to be the key destination of emigrants. The value of their financial support is greatly reduced by high inflation in Latvia and adverse exchange rate movements (e.g. pound sterling has depreciated by ca 14% vis-à-vis the lats over the past year).

- **Falling savings**: since early 2008 households have been financing their consumption by running down their real savings,[12] i.e. growth of resident household deposit stock has constantly fallen short of consumer price inflation (average growth of 9% vs. 16.9% yoy for 5M 2008; total resident household deposits account for about a third of annual household consumption). Willingness to rebuild their stock of real savings will slow down consumption growth in the early stages of recovery.

Resident Households' Deposits and CPI, yoy



Source: CSBL, LaB; HBM calculations

However, the above changes in market conditions are unlikely to induce a very deep contraction in household consumption (say, a drop of 5-10% yoy). The rise in unemployment is to a significant extent expected to be driven by a rising participation rate, while employment is forecast to decrease to the level of 2006-2007, hence not a large drop. We expect that export sectors will be able to absorb a substantial part of those laid off.

3.2. Government Spending and Policy

With a deeper and more prolonged slowdown in sight (including the significant probability of a recession) we expect fiscal policy to turn more expansionary than the government currently argues for.

For 2008 the government still asserts at least a balanced budget. Anticipating that excise and wage taxes are unlikely to continue compensate for a shortfall in VAT revenues,[13] the government has drafted a supplementary budget suggesting a cut in expenditures by LVL 82m. With the downward revision in revenues by LVL 235m, the government expects to attain a surplus of LVL 8m or 0.05% of GDP (earlier target 1% of GDP). There were no guidelines set on how and which expenditures each ministry was to cut – early indications show that the process was chaotic and there is a risk of cuts being applied to expenditures crucial for long term growth. This supplementary budget proposal is to be reviewed by the Parliament in July, hence it is not known yet in detail what the cuts are and whether they will be accepted. It is clear, however, that a balanced budget will be impossible to attain with such a minor "window dressing" and more

11 The LaB estimates that transfers from emigrants reached ca 2% of GDP in 2007.

12 Savings rate has abruptly decreased to 10.3% in 1Q 2008 from the average of 14.9% in 2007.

13 For a more detailed discussion on revenue trends, see The Baltic Outlook (April 2008).

extensive cuts would be necessary (particularly if employment growth stops and unemployment rises swiftly). A very small chance of the government implementing more extensive expenditure cuts by the end of the year makes us revise the forecast and expect 0-2% of GDP deficit in the general budget of 2008.

General Budget, Annual Growth Rates %

	2005	2006	2007	1H 2008	of 1H plan
Net revenues	26.7	25.7	33.5	18.3	-
Tax revenues	26.3	30.3	34.4	19.1	99.3%
Personal income tax	16.9	29.1	35.1	22.0	107.8%
Social tax	17.1	28.1	37.7	27.5	108.1%
Corporate income tax	41.3	40.5	57.5	26.7	99.8%
VAT	39.1	37.4	29.3	3.2	81.9%
Excises	31.2	16.6	22.3	28.6	108.8%
Customs	12.2	7.6	34.4	3.4	99.2%
Non-tax revenues	19.3	13.1	21.7	36.5	97.7%
Net expenditures	25.7	24.4	28.0	24.4	-
Current expenditures	21.9	23.3	27.5	28.0	-
Capital expenditures	53.8	39.3	40.6	14.4	-
Budget balance, % of GDP	-0.4	-0.2	0.0	1.0	-

Source: State Treasury, State Revenue Service

We see risks for the current rhetoric to change as the slowdown becomes more pronounced and local elections draw closer, i.e. in 2009 a general budget deficit of 0-2% of GDP is likely to be seen. With inflation being high and incomes lagging behind, social issues will be more often voiced and the government is likely to give in to higher wage and pension demands. From the point of economic theory, countercyclical fiscal policy is warranted but it certainly must not act as a disguise for inefficiency in public expenditures. Fiscal policy must accommodate the restructuring of the economy towards tradable sectors to reduce external imbalances. Expansionary fiscal policy supporting previously booming domestic demand industries that are currently shrinking would be clearly inappropriate as it would only slow down structural adjustments, keep inflation high and increase risks of a deep and prolonged recession. As previously, we urge the government to review its expenditures to boost public sector efficiency (e.g. significant labour cuts, administrative reform). Cutting expenditures in areas of crucial importance to long term growth must be avoided, quite the opposite – such expenditures must be encouraged (e.g. exports support, co-financing for EU funds). With domestic demand recovery still being delicate in late 2009 and general elections approaching, in 2010 fiscal policy is unlikely to become clearly restrictive and at best aim for a balanced budget.

In terms of economic policy measures to support growth, there has been little progress since the April issue of The Baltic Outlook. It has been decided to proceed with the construction of the National Library, which will provide slight support to construction industry. A credit guarantee program is about to be launched to reduce borrowing costs for exporting companies (e.g. temporary slowdown in export markets may create liquidity problems; the program helps to lessen borrowing costs by providing insurance). Any changes in tax policy have been delayed till 2009 and will be discussed in autumn when drafting the next year's budget.

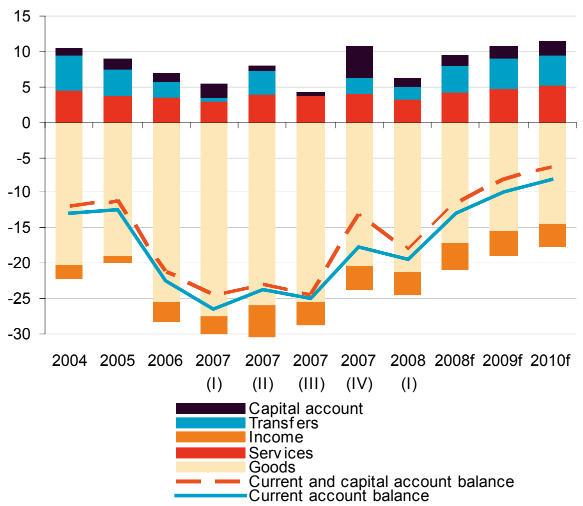
3.3. Investment

The unexpectedly strong recovery in the 1st quarter of the year has made us improve the 2008 gross fixed capital formation forecast to ca -1% (previously contraction of 2-5%). The public sector, however, will be unable to continue to compensate for the reduction in private sector shortfalls and in the 2nd or at the latest the 3rd quarter of 2008 gross fixed formation will see negative annual growth rates. Recovery is expected to be somewhat more subdued than in spring forecast – about flat growth in 2009 and 4-6% in 2010 (1-4% and 6-9% before). Slower recovery will arise from the less favourable global environment: (i) higher interest rates raise borrowing costs, and (ii) slower global growth and higher inflation strengthen competition and squeeze margins leaving less own funds for investment.

3.4. External Demand and Balance of Payments

We expect a somewhat swifter improvement in external balances as contracting domestic demand will cut imports growth more considerably than slowing global economy will reduce export growth. We expect the current and capital account deficit to improve to 12-14% of GDP this year, to 9-11% in 2009 and 7-9% in 2010. The reason behind the decreasing

Current and Capital Accounts, % of GDP



Source: LaB; HBM forecast

external imbalances is the improvement in the trade and services balance to 12-14% of GDP in 2008, 10-12% in 2009 and 8-10% in 2010, and improving net current transfers.

Nominal export of goods and services is expected to grow by ca 10-13% in 2008, while imports will be close to or a few percentage points below their 2007 level (in contrast to goods import, that of services still remains relatively strong, i.e. 2.1% yoy vs. 16.5% in 5M 2008). Exports growth is expected to dip to 8-11% in 2009 and with restructuring bearing its fruits and global demand recovering it is expected to pick up by 11-14% in 2010. Imports growth may slightly pick up in 2009 and be stronger in 2010 as investment and consumption recover, but it depends upon the depth of adjustment in 2008. During 2008-2010 we expect exports growth rates to significantly exceed those of imports.

Export growth will be supported by, e.g.:

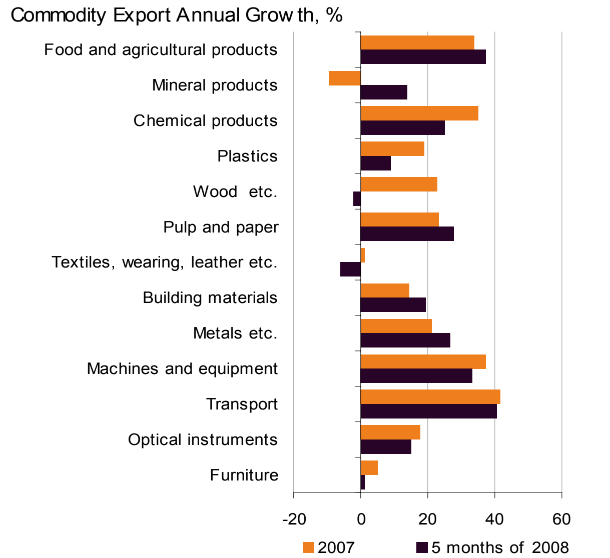
- Economic growth in major Latvian trade partner countries is expected to remain good (with the exception of Estonia and perhaps Lithuania), which will provide good exports opportunities for existing businesses (see General Assumptions).

- Growing export demand and under-explored export markets (e.g. due to previously lucrative profit at home) will provide more profit opportunities than contracting/ very slowly growing domestic demand, which will motivate entrepreneurs to shift away from non-tradable to tradable sectors thus driving the restructuring of the economy. The export guarantee program that kicks off later in 2008 will help penetration of new markets.

- Producer price inflation of exported goods has swiftly decreased allowing external competitiveness to be maintained. The gap is reduced by rising inflation in partner countries.

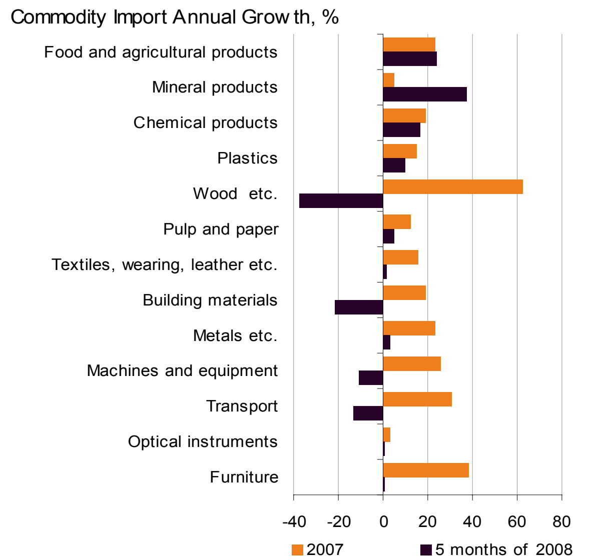
- Over the past few years, Latvian companies have experienced a strong negative shock to their competitiveness via swiftly rising energy prices, which was not affecting competitors in developed countries (e.g. Gazprom raising delivery prices to Latvijas Gaze to bring Latvian prices on a par with those in Western Europe). By 2009 these prices will have about levelled thus stopping the rapid rise in relative costs.

- We see companies increasingly investing to improve their productivity and climb up the value added chain (e.g. in 1Q 2008 real non-financial investment grew by 14% yoy in manufacturing), which improves their resistance to negative shocks. E.g. the worst hit by global slowdown is the wood industry: despite a dramatic fall in prices (by 10-20% yoy in 1Q 2008) and demand for sawn timber (ca 25% of industry exports), the industry has been able to reduce the decrease in trade volumes by increasing exports of higher value added items (plywood and fibreboard production has risen by ca 25% yoy).



Source: CSBL

For all groups of commodity imports we have seen growth rates coming down significantly (except food and mineral products where prices have been rising swiftly) with the largest decrease in imports of timber, passenger cars and building materials. These trends will continue with domestic demand contracting further. Imports of services are driven by strong growth of business services imports (e.g. consulting, accounting, advertising, trade-related services) whereas other major groups have shown



Source: CSBL

significant decrease in annual growth rates.

In the 1st quarter of 2008 net current transfers continued to improve better than forecast as with slowing economic activity outflows decreased by 13.8% yoy (e.g. less VAT transfers to the EU budget). This trend has been robust for six months and we expect it to continue through 2008, and while in 2009-2010 outflows may start to grow, we expect these growth rates to be lower than previously forecast. In contrast, we have increased the income account deficit as globally higher interest rates will increase loan servicing costs. The rise in the deficit, as expected, will be held down by temporarily falling profitability of foreign investment in Latvia. Revisions in the current transfers and income account approximately cancel each other out and do not alter the forecast significantly. The capital account is expected to develop in line with the spring forecast, i.e. surplus of 1.7-2% of GDP in 2008-2010.

We have not made any significant revisions to the financial account forecast. We retain the net inflows of FDI forecast at 4.5% of GDP in 2008 despite very good data for the beginning of the year (7.1% in 1Q 2008) – as profits will shrink along with slowing economic activity, retained earnings (typically ca 2/3 of FDI inflows) will contribute less to net FDI. The forecast of 4.5% of GDP net FDI inflows is retained also for 2009-2010. We believe it to be a fairly conservative forecast, as slowing growth and falling asset prices may induce foreign takeovers and thus raise FDI first through the purchase and then through reorganisation of the business. We expect that additional foreign borrowing will decrease to ca 7%, 4% and 2% of GDP in 2008-2010, respectively.

4. Monetary issues

4.1. Inflation

The average consumer price inflation forecast has been raised to 16% in 2008 (previously 15%) and 7.5% in 2009 (previously 6.5%), which is at the top of the spring forecast range. We retain the spring forecast of 3-5% inflation in 2010.

As before, our estimates show that inflation peaked in the 2nd quarter (17.9% yoy in May) and will gradually decrease thereafter:

- Core inflation has been stable since January 2008, which means that weaker economic growth has translated into weaker price growth pressure. With consumption expected to contract in the 2nd half of 2008 and unemployment beginning to rise, the domestic demand component of inflationary expectations must decrease and interrupt the price-wage spiral.

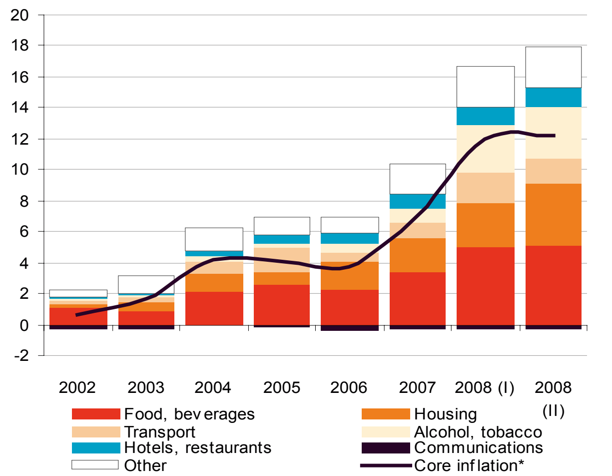
- As domestic demand (and particularly household consumption) contracts, we expect to see pockets of deflation as retailers aim to reduce their inventories and push their sales.

Inflation is expected to decelerate more slowly, which is the rationale for the current revision. There are two reasons for this:

- Global inflation will contribute through higher food and oil prices.[14]

- An increase in gas tariffs by 57% to 71% (the raise depends on the volume consumed) planned for July has been delayed (most likely) till September, which will be followed by an increase in heating tariffs perhaps as late as January 2009.

Contributions to CPI Average Annual Growth, pp



* HBM estimate for 2Q 2008

Given that 2009 is likely to begin with ca 12% yoy inflation, 2009 average annual inflation will be higher than earlier expected (though we expect a faster decrease of inflation rates during 2009 as the slowdown in domestic demand is expected to be deeper and longer). Of course, if domestic demand contracts more abruptly, inflation will come down faster.

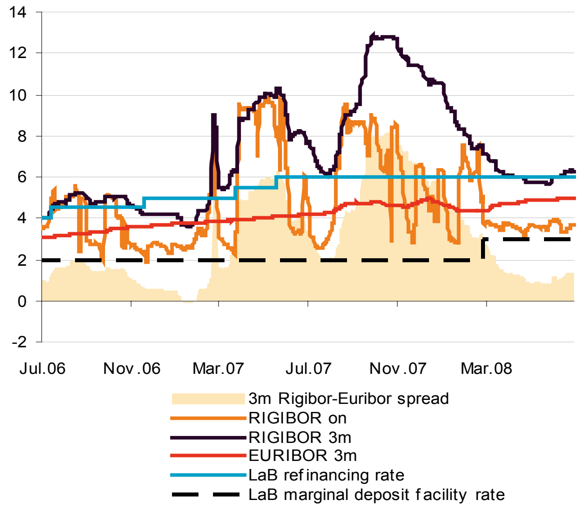
14 Given that Latvia is a net importer of energy, world price increases are soon reflected in domestic prices. Our estimates show that food prices in Latvia are closely linked to those in the euro area. The co-integration coefficient between Latvian and eurozone food inflation is found to be in the range of 1.5 to 2, which means that there is an additional effect of price level convergence.

4.2. Exchange rate, Interest Rates and Credit Growth

The LaB has made no changes in its monetary policy since April.[15] A further decrease in the required reserve ratio is likely to follow in autumn when economic growth significantly slows; especially if the ECB continues to raise the euro base rate and the monetary environment becomes too contractionary to support a gradual slowdown. Given the very narrow currency band,[16] the LaB's ability to ease monetary tightening is very limited. In May, growth of monetary base had fallen to 6% yoy and that of M3 to 11%: both have contracted in real terms since January 2008.

The situation in financial markets remains stable. The value of the lats has slightly declined since April and LVL/EUR rate has risen towards the middle of the currency band. The weakening of the lats has been driven by: (i) the State Treasury decreasing its demand for the lats, (ii) slowing economic growth reducing capital inflows (e.g. credit growth slows) while customers continue to service their loans that are mainly euro-denominated, and (iii) seasonal effects, i.e. outflow of dividends after annual meetings of shareholders.

Interbank Interest Rates, %

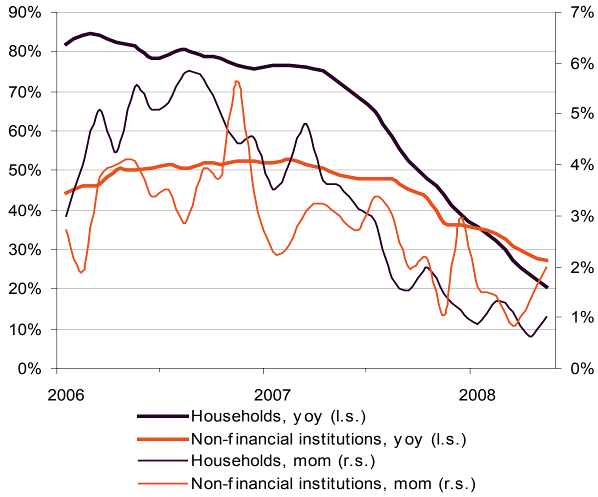


Source: LaB, Reuters

Lats money market rates have been steady since the end of March with minor fluctuations around 6%, i.e. around refinancing rate. 3-month Euribor and Rigibor spread has stabilized at ca 100bp, which is close to the historic average (down from over 500bp at the beginning of 2008). The spread tightened mostly due to the rising euro rates.

With higher euro interest rates, the cost of borrowing has continued to rise and the average weighted euro loan interest rates rose to 7.2% in May; up from 6.5% at the beginning of 2008. Due to higher interest rates and the overall economic slowdown, loan growth continued to slow to 20.5% yoy in May for resident households and 27.4% to resident non-financial institutions (35.6% and 35.4% yoy in January 2008, respectively). Particularly fast slowdown can be seen in loans to households (the pace of monthly slowdown is twice as fast as that for non-financial institutions), which reflects decreasing ability (e.g. seen from rising credit overdue) and willingness (e.g. housing prices expected to decrease further) to borrow. Both factors contain a risk of an excessively abrupt fall in domestic demand.

Growth of Loans to Households and Non-financial Institutions



Source: LaB

Mārtiņš Kazāks
Jurijs Māsāns
Ivonna Slapiņa
Dainis Stikuts

15 So far in 2008 the LaB proactively reduced the required reserve ratio for bank funding with maturity above 2 years from 8% to 6%. It was done in two steps by 1 pp at a time with changes coming into force on February 24th and April 24th.

16 The lats is pegged to the euro with the central parity 1EUR=0.702804 with a fluctuation band of ±1%.

Lithuania

1. Latest Economic Developments

Lithuania remains in a downward phase of the economic cycle. Following deteriorating optimism of households and businesses (in June the overall economic sentiment indicator was 18 pp lower than a year ago), an increasing number of economic indicators point to an economic downturn. Overall economic growth has been relatively strong so far, confirming our "soft landing" scenario. The risk of more negative developments, however, cannot be dismissed if the global environment (world financial markets and EU economy, which accounts for 65% of total Lithuanian exports) appears to be weaker than expected. Moreover, pre-election decisions that disregard the present state of the economic cycle and aim to please the electorate may push the economy into a less favourable situation than we currently forecast.

As expected, the jump in retail sales growth at the beginning of the year was temporary, mainly driven by exceptional sales of transport vehicles. After four months of impressive growth (20% yoy in January-April), retail sales increased by 4.8% yoy in May and contracted by 4.8% compared to April. Consequently, household consumption remained strong in 1Q 2008, but is expected to slow in the upcoming quarters. The revised GDP estimate pointed to 7% annual real growth in 1Q. The main contributor was consumer spending (12.2% yoy), while investment growth (including inventories) of 22.4% was mostly related to the increase in inventories (investment excluding inventories rose by a mere 5.9%, compared to the average of 16.8% in 2007).

Consumer price inflation exceeded our expectations in 1H 2008 and stood at 11.4%. Annual CPI growth has been accelerating since the beginning of the year (from 9.9% in January to 12.5% in June) but is expected to stabilize around 12–12.5% in the coming months. The main reasons for the persistent rise were administrative decisions (higher excise duties for fuel, alcohol and tobacco), prices of food and energy.

The tensions in the labour market continue to ease. The seasonally adjusted unemployment rate started to climb in the last months of 2007 reaching 4.6% in 1Q 2008 (from 4.2% in 4Q 2007). Some businesses already claim that they do not feel any lack of workers. On the other hand, nominal wage growth was still very strong in 1Q: average gross salaries rose by 23.8% yoy reaching LTL 2,151 (EUR 623), while the real average wages increased by 14.2%. This was partly the result of the rise in the minimum monthly wage (to LTL 800) and the cut in the personal income tax rate (from 27% to 24%) from the beginning of 2008. The wage growth in the public sector was also encouraged by the raising of the official base for calculating wages. Wage growth in coming quarters, however, will slow due to cooling economy and rising unemployment.

The general government sector deficit was LTL 179.6m (EUR 52m) in 1Q 2008, accounting for 0.7% of GDP. The deficit is in line with our forecast for the whole year. The central government sector deficit stood at 0.8% of GDP over the first five months of this year and was the main reason behind the widening of the central government sector debt to 15.5% of this year's forecast GDP.

	2002	2003	2004	2005	2006	2007	2008f	2009f	2010f*
Economic growth, %	6.9	10.3	7.3	7.9	7.7	8.8	6.0	5.5	6.0
GDP, mln euros	15,052	16,452	18,126	20,673	23,721	28,018	32,817	37,046	41,310
GDP per capita, euros	4,329	4,763	5,276	6,055	6,989	8,298	9,771	11,080	12,405
Growth of industrial sales, %	3.1	16.1	10.8	7.1	7.3	4.0	7.0	6.3	6.5
Growth of GDP deflator, %	0.1	-0.9	2.7	5.7	6.6	8.6	10.5	7.0	5.2
Growth of consumer prices, %	0.3	-1.1	1.2	2.7	3.7	5.7	11.9	8.7	5.0
Growth of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8	5.8	12.0	8.8	5.0
Growth of producer prices, %	-2.8	-0.5	6.0	11.5	7.4	7.0	16.0	8.0	7.0
Harmonized unemployment level, %	13.5	12.4	11.4	8.3	5.6	4.3	5.3	5.8	5.8
Growth of real net wage, %	3.8	9.3	4.9	6.8	14.9	17.7	8.6	2.5	4.7
Growth of exports of goods and services, %	13.4	6.2	12.0	27.0	17.9	9.5	12.5	10.5	11.3
Growth of imports of goods and services, %	13.1	6.9	14.2	26.1	23.1	14.2	12.3	10.0	11.5
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.4	-12.5	-11.9	-11.3	-11.4
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7	-12.8	-11.0	-10.6
Current and capital account, % of GDP	-4.7	-6.4	-6.4	-5.9	-9.6	-11.9	-11.0	-9.2	-8.6
FDI inflow, % of GDP	5.1	1.0	3.4	4.0	6.1	5.5	3.6	3.6	3.8
Foreign gross debt, % of GDP	39.5	40.5	42.4	51.2	60.9	73.3	75.0	77.2	76.1
General government budget position, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.5	-1.2	-0.7	0.0	0.0
General government debt, % of GDP	22.2	21.2	19.4	18.6	18.2	17.3	16.9	16.5	16.0

** excluding the effect of the shutdown of Ignalina nuclear power plant*

2. Assumptions and Delimitations

As part of the deal to join the European Union, Lithuania agreed to close its perfectly serviceable Ignalina nuclear-power station. In line with its EU accession deal, Lithuania closed one of the Ignalina Nuclear Power plant's two Soviet-built reactors in December 2004 and committed itself to shut down the second unit at the end of 2009. Thus far in our 2010 forecasts we have deliberately ignored the impact plant's closure may have on the economy, as Lithuania's authorities still hope to persuade the European Commission to allow the Ignalina Nuclear Power Plant to operate beyond its scheduled closure. They urge that the life of the Ignalina Plant be extended till 2012. It is expected that new modern units planned to be built at the Lithuanian Power Plant in Elektrenai could help bring electricity prices down. However, the construction of the new units will not be completed until 2012. At the same time the new nuclear facility and power links (with Sweden and Poland) would be switched on at a later stage. Lithuania aims to build a new nuclear power plant, which will replace the Ignalina Plant, in partnership with Latvia, Estonia and Poland, but the new plant is expected to be built in approximately a decade. According to Lithuania's Prime Minister, we can expect a final decision on the extension the Ignalina plant's operation in autumn. We are not sure, however, whether the extension will be granted as the negotiation's steps are currently rather sluggish.

Sooner or later, the shutdown of the nuclear power plant will have a significant impact on the whole economy, as the plant meets ~70% of Lithuania's electricity needs. Lithuania's Power Plant in Elektrenai (6.7% of total needs in 2007) will become the main generator of electricity in Lithuania after the shutdown of the Ignalina nuclear plant – the country's remaining power needs will be imported. In the wake of the Ignalina Plant shutdown electricity prices may double their current levels due to more expensive imported electricity, higher environment requirements and pollution (CO_2) cost for heating oil and the excise duties (will come into force from 2010). That would push inflation up by ~3-3.5 percentage points. Since electricity costs are input costs for practically all goods, the prices of almost everything will go up. There will be an effect from both direct and indirect factors. Rising inflation will "eat" into wage growth resulting in a decline of real wages and reduced consumption. At the same time higher costs could hit the competitiveness of the economy, particularly in the sectors with high electrical power consumption. Of course, the government may take steps to alleviate the possible effect of the price rise for the poorest part of population, but that would increase the budget deficit. With the nuclear power plant shutdown, thermal power plants will need to boost their output and use more fossil fuels, which will result in higher imports growth and automatically imply a negative impact on the current account deficit (~2 pp of GDP). The decline in consumption and higher imports growth is estimated to knock another 2-3 percentage points off economic growth.

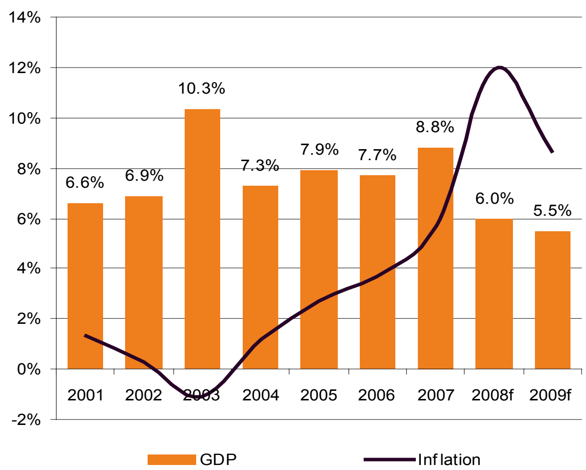
3. Highlights of the Forecast

Our forecasts for main indicators have been largely retained (except for inflation and unemployment rates) from the previous issue (April) of the Baltic Outlook. After still impressive economic growth in the 1Q of this year we expect a more pronounced slowdown in coming quarters. The economic slowdown will be caused by price pressures and rising costs, declining optimism, lower credit growth and negative changes in the global environment. Weaker domestic demand will help the imports growth rate to fall, and as a result, the current account deficit is set to improve in 2008-2009. We maintained our previous 6% GDP growth forecast for 2008 and expect a further slowdown to 5.5% in 2009. Risks for GDP growth are on the downside, as investment and household consumption growth may fall more rapidly than anticipated.

We increased the average annual consumer price growth forecast from the previous 9.9% to 11.9% for this year and from 6.7% to 8.7% for 2009. The rise in the world's food and energy prices pushed Lithuania's up inflation more than we expected. It is unlikely that inflation growth will slow in the 2nd half of the year because of expected higher central heating and hot water supply prices. Weakening demand next year will bring the growth rates of prices down slightly.

We also forecast a higher than previously anticipated unemployment rate: 5.3% instead 4.6% for this year

Economic Growth and Inflation



Source: LDS, HBM forecast

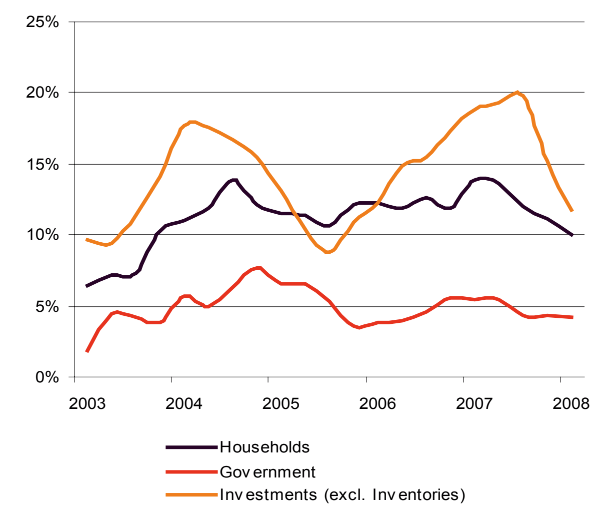
and 5.8% instead of 4.9% for next year. Although the structural mismatch of labour demand and supply still exists in Lithuania, some sectors, which have already felt the impact of weaker demand, have increased the pool of unemployed.

Other forecasts are largely retained from the previous issue of the Baltic Outlook (published in April), while in the following sections we discuss the latest changes in forecasts in more detail.

4. Economic Growth

GDP growth is projected to slow down gradually, but unlikely to be much less than potential (5-6%). We kept our previous economic growth expectations: 6% for this year and 5.5% for 2009. As before, domestic demand will continue to be the growth engine of the Lithuanian economy. The 1Q still showed vigorous growth of household consumption (12.2% yoy) and investment (22.4% yoy, the growth excluded inventories was 5.9%). Still thriving consumption together with the recovery of "Mazeikiu Nafta" has resulted in the surge of imports (18.8% yoy in real terms). We do not expect a big decline in GDP growth in the following quarters as we might see some GDP structural changes: weaker household consumption and lower negative net export contributions to economic growth, i.e. slower growth of household consumption will result in reduced import growth as well.

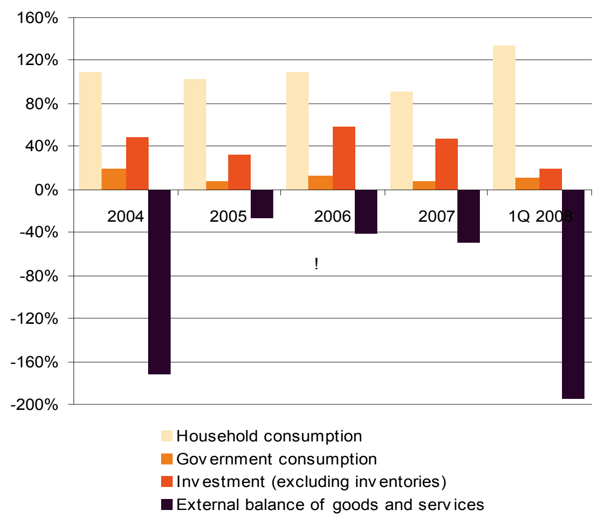
Domestic Demand (12 month rolling real growth)



Source: LDS, HBM calculation

The economic sentiment indicator (not seasonally adjusted) shows much gloomier moods of economic agents, which could lead to much deeper points of the economic cycle. Lithuanian economic confidence worsened in June (-5 pp mom) to 1 with not one of the separate component parts showing any improvement. The biggest decline was in the retail trade (-9) due to lower business activity expectations

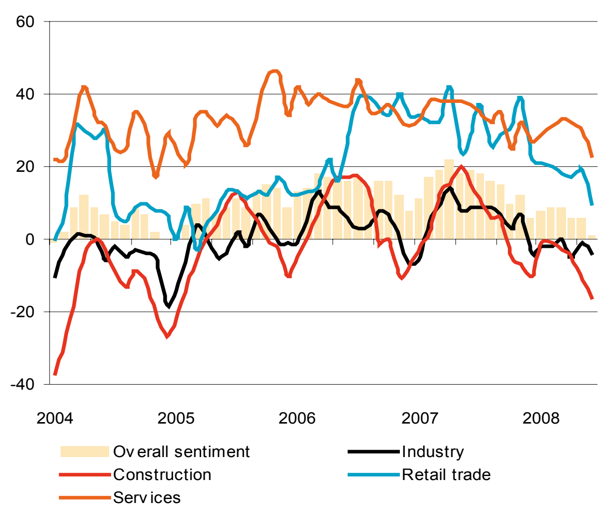
Structure of GDP Growth



Sources: LDS, HBM calculation

and in the services sector (-7) due to worsening demand prospects. We can also observe decreasing demand in industrial (-3) and construction (-5) sectors as well as declining consumer sentiment (-5) due to galloping inflation. The overall economic sentiment is overshadowed by negative changes in the economies of Latvia and Estonia, unfavourable developments in the US economy, global financial markets and difficulties in the real estate markets of developed countries.

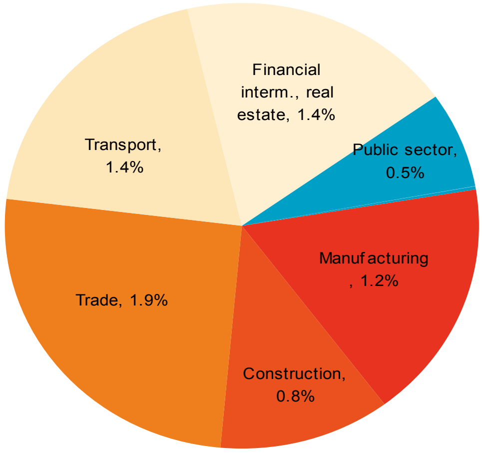
Confidence Indicators



Source: LDS

Manufacturing will provide a sustainable basis for the economy over the year. The share of this sector to GDP is the highest among the Baltic States and is likely to contribute to a much smoother slowdown in economic growth than in Latvia and Estonia. In the 1Q manufacturing grew by 6.1% yoy and accounted for 21.3% of GDP. According to industrial sales statistics over the first five months of this year, sales in the manufacturing sector increased 9.7% yoy, mainly driven by refined petroleum products.

Contributions to GDP Growth, 1Q 2008



Source: LDS, HBM calculation

4.1. Household Consumption and Incomes

While the growth of household consumption is expected to weaken (8.2% growth in 2008 and 7.5% in 2009), it will remain a significant contributor to overall economic growth. Still strong wage growth will continue to drive consumption; however, accelerating inflation and the worsening unemployment outlook will limit expenditure. High prices will be the most important factor at the start of the new heating season in autumn, but the impact of unemployment will increase as more layoffs are made in 2009. Household consumption slowed during the 2H of last year, but temporarily picked up, partly due to vigorous wage growth in the 1Q of this year. Later in the year we expect more limiting factors and slower growth rates for both household consumption and wages.

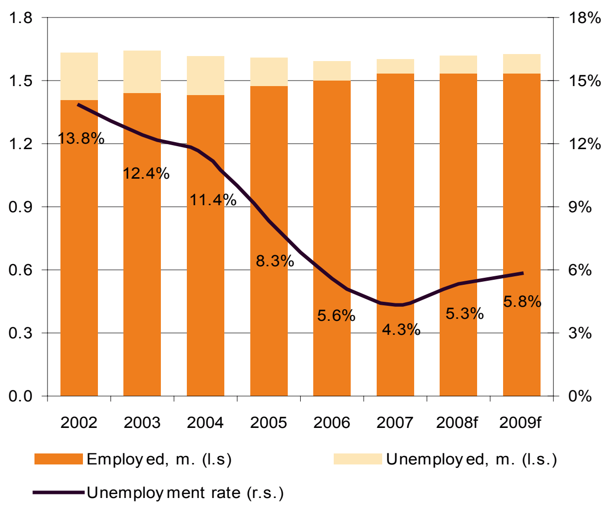
- With economic growth slowing, we expect the labour market conditions to ease. We increased our previous forecast of the **unemployment** rate from 4.6% to 5.3% in 2008 and from 4.9% to 5.8% in 2009.

  - We have already witnessed unemployment growth in 1Q and the process is expected to intensify in following quarters, as an increasing number of troubled companies will dismiss their workers. In the 1Q 2008 Lithuania's unemployment increased more than we expected. The unemployment rate grew to 4.9% from 4.2% in the previous quarter. It went up after the economy started to cool down. Additionally, the creation of new jobs declined (8.4% qoq in the 1Q). The number of unemployed reached 77.5 thousand growing by 15.8% qoq (-2.5% yoy). Increasing unemployment touched pensioners and youth first: the number of working pensioners decreased by 7.8% qoq and the number of 15-24 years unemployed increased by 49.5% qoq.

  - Although people will still be able to find employment quite easily this year, the increased labour movement will create higher short-term unemployment and thus will increase overall unemployment as well. We are of the opinion, however, that the actual growth in unemployment will be less, as more people move to non-active status (e.g. pensioners).

  - The labour market, however, will remain fairly tight with the unemployment rate below the current EU27 level (6.8% in May). As the expected unemployment growth is relatively small and contained within specific sectors (e.g. construction and related sectors) – direct effects on consumption are likely to be small.

Employment and Unemployment



Sources: LDS, HBM forecast

- The misbalance of supply and demand in the labour market remains the main reason behind continued **wage growth**. Higher than expected inflation will hinder real wage growth.

  - Consumers will continue to enjoy increased wages this year. The growth will remain strong, reflecting the strong pickup of wages in the 1Q and inertia. We maintained our previous real after-tax wage growth forecast (8.6%) for this year despite higher projected inflation. Although we expected nominal wage growth to be double-digit in 1Q, we were surprised to see such solid growth (23.8% yoy). Besides administrative decisions, one of the reasons behind such a vigorous wage growth was the bonuses awarded for the previous, highly economically successful, year from December 2007 to 1Q 2008, when personal income tax was cut from 27% to 24%.

- Next year nominal wage growth will retreat and provide less means to increase consumption as economic growth slows and unemployment rises. At the same time inflation will push real wages to a comparable low level: although we retain our previous expectations for the nominal wages (ca 12%), real after-tax wages will decrease to 2.5% growth due to the higher inflation forecast.

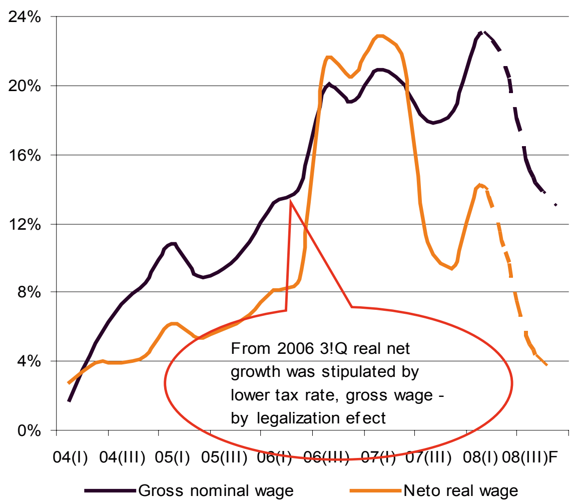
- Some increase in the average wage will occur because of a structural shift in the labour market – there will be fewer low-wage employees on payrolls, as layoffs will mostly affect this group of workers and their share in total employment will diminish.

- Despite companies' efforts to cut labour costs this and next year, strong wage growth will take place in the public sector. As around ca 25% of people are employed in this sector, overall wage growth will remain relatively strong.

- Next year the pace of legalization may decrease, as with rising inflation and cooling demand companies may try to ease their cost squeeze by less active income legalisation. With a rising rate of unemployment, employees' ability to bargain (to increase social security payments) may slightly diminish.

- The weaker profits of Lithuania's companies allow us to expect slightly lower wage growth compared to the previous period. In the 1Q 2008 the profits of Lithuanian companies started to dwindle. Although revenues surged by 28% yoy, due to increasing costs, the aggregate pre-tax earnings edged up by only 1% yoy. The average profitability, measured as a ratio of pre-tax profits to revenues, decreased to 5.2% in 1Q 2008 (9.9% in 4Q07) from 6.7% in 1Q 2007.

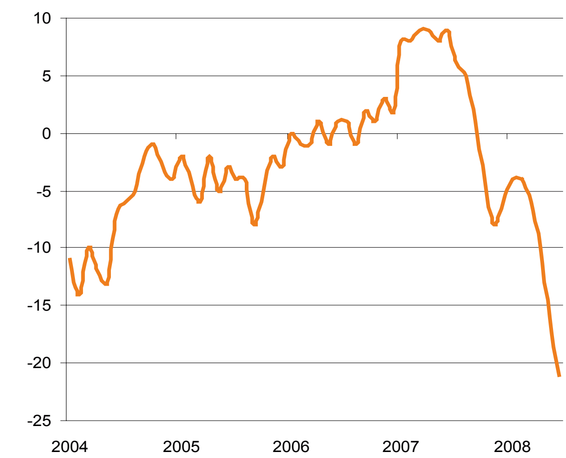
Wages, annual growth rates



Sources: LDS, HBM forecast

- The main factor currently influencing consumers' decisions is **confidence** – and that is falling rapidly (–5 pp mom in June) due to high inflation (and its expectations) and unemployment fears. We can also observe a decrease in consumers' expectations of their financial standing and general economic situation. With rapidly growing food, energy and regulated prices, households are left with significantly less money for other purchases.

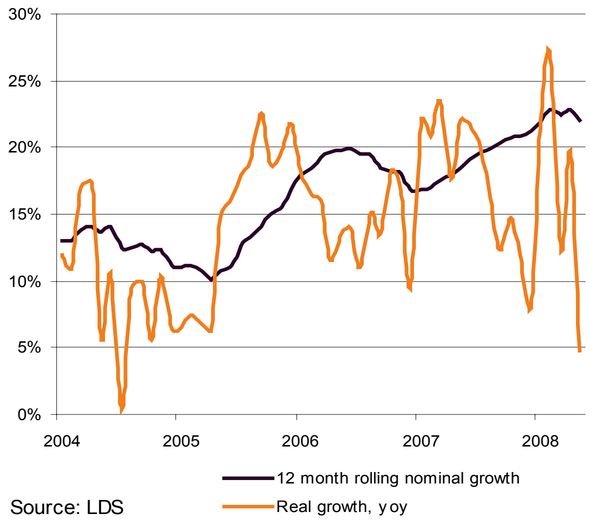
Consumer Confidence Indicator



Source: LDS

- **Retail trade** real turnover growth, which reflects household consumption, showed the first signs of slowdown only in May after four impressive months of growth this year. In the first five months, retail sales grew by 16.8%. In May retail sales grew by 4.8% in real terms compared to May 2007, as sales in the motor-related sector (i.e. sale of motor vehicles and motorcycles, their maintenance and repair, retail sale of automotive fuel) increased by only 3% yoy. This year we expected lower retail sales growth compared to last year as inflation will curtail consumer purchasing power and decrease optimism. More pronounced cooling of demand is anticipated later in the year, although it does not seem very likely that retail sales growth will fall dramatically this year. In the beginning of next year, however, we might see more empty shopping centres.

Retail Sales

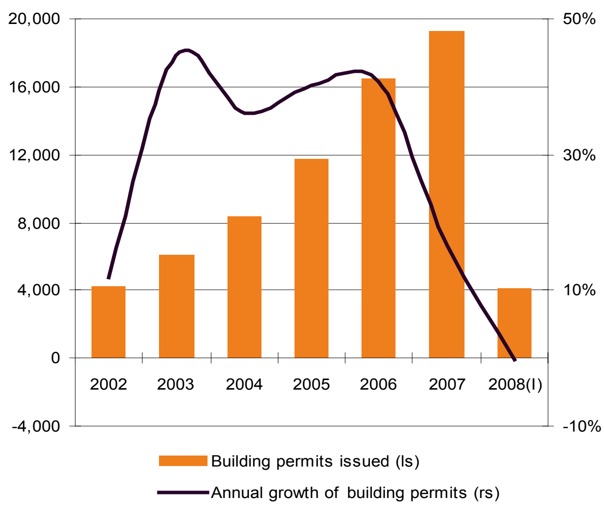


Source: LDS

4.2. Investment

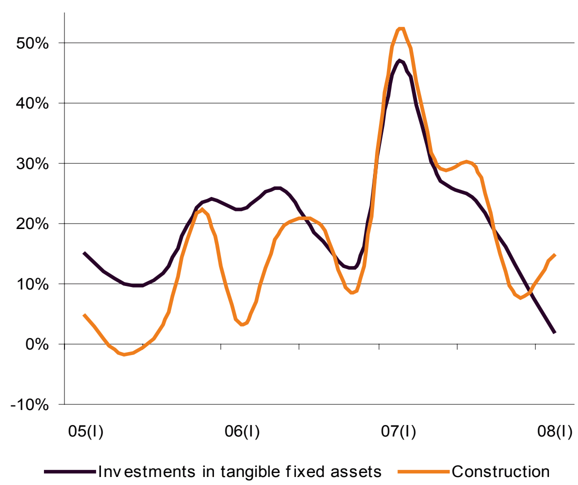
After being one of the key drivers for economic growth for the past several years, the construction sector is bound to slow down in the upcoming quarters. 2007-2008 marks a transition period: while before 2007 and during 1st half of 2007, developers were competing for the best slots in the city and projects had already been sold before they could be advertised, this is no longer the case. 1Q 2008 building permit results reinforced the fact that developers are realizing it is no longer a seller's market. The number of building permits issued declined by 2.8% yoy in 1Q 2008. 2% of all permits were issued for the construction of apartment houses (3.6% yoy increase), the rest (98%) – for the construction of private houses (-4.7% yoy). The 1Q data continues the trend observed during 2007, when permits rose by 18%, which, although high, was a significant slowdown from the 36.4% annual growth in 2006. We expect the issuance of building permits to continue to decline in the upcoming quarters, as borrowing conditions continue to be stringent and the housing market more subdued (in the first four months of this year, the number of contracts for apartments declined by 8.4% yoy, and by 23.8% yoy for single family homes throughout Lithuania. The total value of transactions in the capital region, where the rise in house prices had been most evident, declined by 60% for single family houses and 11.9% for apartments during 1Q 2008). A more pronounced downturn in investments in the construction sector will affect other domestically orientated sectors as well, and therefore construction is one of the main reasons for the projected slower GDP growth rate.

Permits For New Residential Buildings, # of flats



Source: LDS

Real Grow th of Investments and Construction



Source: LDS

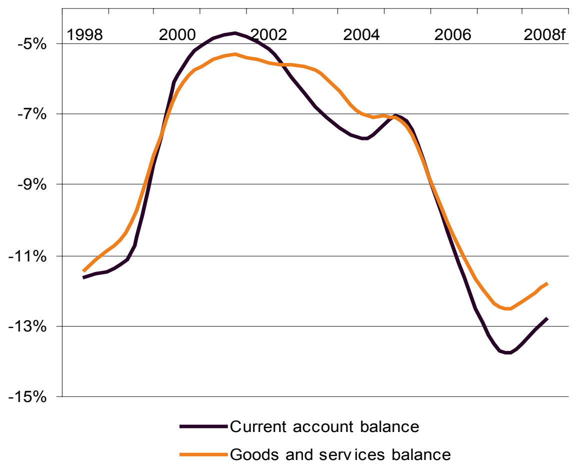
Due to inertia in 1Q 2008, residential real estate construction volumes increased by a strong 40% yoy, mostly driven by construction of apartments houses in major cities (52% yoy); construction of private houses grew by 16.7%. The figures reflect expectations that prevailed a few years earlier. Several of the planned real estate projects, given vast uncertainties still prevailing in the market, are being written-off and thus will not be delivered to the market. Some of the developers are trying to sell projects that have already been started; nevertheless, potential buyers are well aware of the uncertainties and the fact that the object may not deliver an expected return. The construction costs are considerably high as well: in May, wages in the construction sector were up by 17.6% yoy, whereas all costs were 12.3% higher than a year earlier.

For the private investor, investment in residential real estate market is a taboo now. Demand for residential real estate property is likely to continue to be weighed down by slower real wage growth rates and tighter credit conditions. The prevailing expectation of a further fall of real estate prices may be partially offset by a government proposal to eliminate tax concessions starting the year 2009. This measure, if introduced, will make the purchase of property relatively more attractive before 2009 and, if approved, may help developers to sell existing properties quickly. According to the Finance Ministry, although the existing concession was approved in order to help buyers to get on the property ladder, it also contributed to galloping real estate prices.

4.3. External balance

CAD widened by 54.9 % yoy to EUR 1.2bn, accounting for 17.9% of the GDP in 1Q 2008 due to an increase of the trade deficit (by 26.4% yoy to EUR 1.2bn) and the income account deficit (22.6% to EUR 0.3bn). The 1Q increase of the current account ratio to GDP was temporary, as strong import growth driven by still solid domestic demand is unlikely to continue, and a boost to mineral product exports will come from the return of the Mazeikiu Nafta refinery to full production in the upcoming quarters. According to the preliminary data, in April-May the current account deficit decreased by 23.1% yoy. The main reason was improved balance of good and services: the deficit declined by 24.5% yoy as exports surged by 29.8%, while imports – by 17.8%. We consider our previous forecasts of CAD measuring at 12.8% in 2008 (and improvement from 13.7% of GDP in 2007) and 11% of GDP in 2009 realistic, nevertheless, there is a risk that CAD could be more than we currently forecast. We continue to maintain that the goods and services balance is projected to reach ~11.8% this year and ~11.3% of GDP for 2009 (an improvement from 12.5% in 2007).

Current Account and Goods and Services Balance, % of GDP

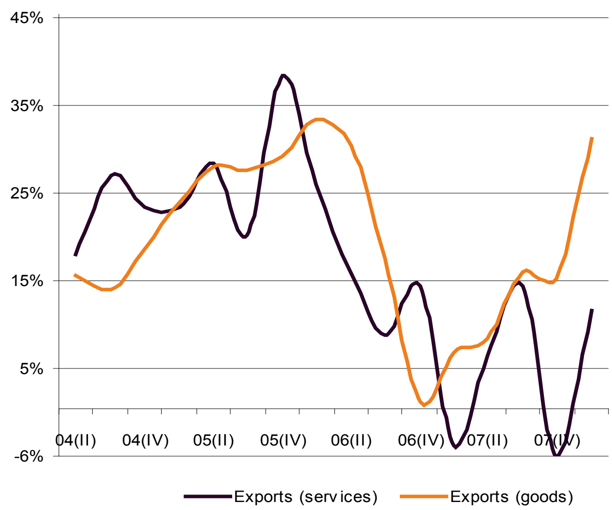


Source: LiB, HBM calculations

We maintain a positive outlook for exports of goods, as some important product groups will experience a solid growth in demand in spite of the global economic downturn (such as chemicals, plastics, and food products). However, excluding mineral products, risks are still on the downside. Weakening domestic demand in the EU, Latvia and Estonia (the latter two absorb about one-fifth of Lithuanian exports) might result in slower export growth than currently anticipated. We reiterate the importance of strengthening the competitiveness of Lithuanian economy (elevated inflation, for instance, is a big limiting factor) and stress the fact, that currently the CIS countries might provide a growing market for Lithuanian goods due to the favourable inflation differential and still strong domestic demand. During 1Q 2008, exports to CIS countries continued to grow faster (33.9% yoy) than to the EU (21.3%), which remains the largest market for Lithuanian exports of goods.

1Q results have been satisfactory: exports of goods increased by 30.7% yoy, driven as before by mineral products (148.5% yoy increase, due to recovery of Mazeikiu Nafta and partly due to high oil and natural gas prices). High overall prices indirectly contributed to the export growth for several product groups during this year, such as chemicals, mineral products, and agricultural products. During the five months of this year, exports of grains increased 12.8 times compared to the same period a year earlier. Timber, textiles, and transport were, unsurprisingly, drags on export growth. Vehicle export growth is likely to be negative in the upcoming quarters; plastics growth rate was more subdued as well due to a high comparison base at the beginning of the year 2007.

Goods and Services Exports, yoy



Source: LiB

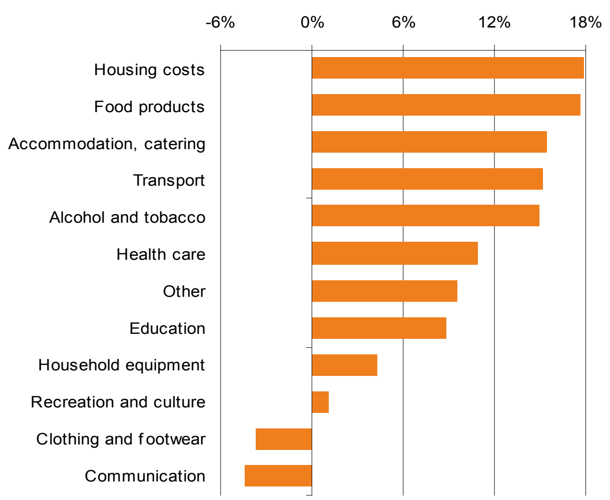
We expect weakening growth in imports during this year, although import statistics are boosted by the return of Mazeikiu Nafta to full production capacity (imports of crude oil). During 1Q 2008 imports of goods went up by 30.2% yoy driven by trade in mineral products (121.3% yoy). Excluding mineral products, the growth rate was more subdued: imports went up by 12.7%. Imports growth for investment goods was significantly lower than in the previous quarter (4.5% yoy in 1Q 2008 compared to 19.2% during 4Q 2007), which suggests a change in expectations by Lithuanian companies about future business prospects and signals slower investment growth in upcoming quarters. The growth rate for consumer goods was more subdued as well (16.8% yoy). Over the first five months, excluding mineral products, imports increased by 13.6% yoy, while exports growth stood at 19.2%, yoy: during May, imports declined (s.a) –by 1% yoy, while exports increased by 3%.

An accompanying measure that contributed to the widening of the current account deficit in 1Q was a significant narrowing of the services account surplus. During 1Q 2008, exports of services increased by 11.1% yoy, while the import of services grew by 19.6%. Faster growth of the import of services was due to an increase in the import of travel services, i.e. the growth of expenditure by the country residents during their foreign travel and business trips. During the period under review, the export of travel services increased by 12.4%, and the import of these services grew by 33.1%. Export and import of transport services grew respectively by 14.3 and 13.3%. We still expect the services account to remain in surplus in 2008: however, in the longer term, demand for foreign skills and services might offset the growth in transport services and tourism.

5. Inflation

Soaring global prices of energy and food have increased Lithuanian inflation to higher-than-expected levels and were the main reason for higher inflation forecasts that were raised from 9.9% to 11.9% in 2008 and from 6.7% to 8.7% in 2009. Energy and food (including alcohol and tobacco) accounts for almost 46% of total the consumer basket, hence uncertainty regarding world price developments remains the key risk to Lithuania's inflation outlook.

Annual CPI Component Growth in 1H 2008



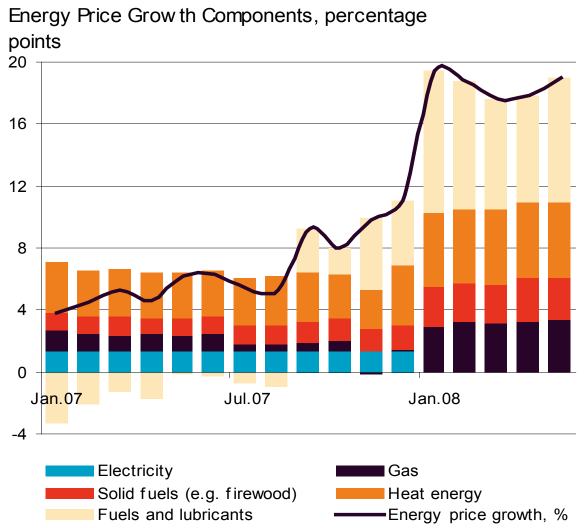
Source: LDS

Inflationary pressures remain one of the main concerns, especially in the light of upcoming elections. Lithuanian politicians have not shown the political will to implement anti-inflationary measures. For example, there are ongoing discussions to introduce additional VAT exemptions for food products (e.g. dairy and meat products) despite an official opinion of National Audit Office of Lithuania that such measures have not reached the final consumer in the past. The debates to change the law on fiscal discipline, which aims to balance the budget in 2009, have also occurred. In July the Lithuanian Parliament passed the law[1] on the automatic indexation of the minimum monthly and hourly wage and social payments (e.g. pensions). According to the law, the indexation on the basis of inflation will be carried out once a year if the average annual inflation of the two previous years exceeds 3%. This decision will not only legalize the wage-price spiral, but also contribute to higher levels of unemployment and put additional pressures on the public sector budget, especially when budget income collection is expected to slow due to slowing economic growth.

After the elections in October the country will experience an energy price shock. First, the heating season will start with significantly higher central heating prices. Although the price increases will vary significantly among municipalities (the estimations show a wide range of 6–60%), the average stands at ~40% (e.g. ~53% increase in Vilnius municipality). This will increase CPI inflation by ~1.5 percentage points. Furthermore, the only gas importer to Lithuania, the Russian company "Gazprom" mentioned another gas price increase from 2009 to reflect higher global prices of heating oil. The head of the Lithuanian National Control Commission for Prices and Energy, Mr. Poderys forecasts that under current conditions gas prices for 1000 cubic meters may jump from the current USD 450 to USD 550 in January of next year. Furthermore, we see a high probability of an electricity price rise from 2009, although no estimates have been announced so far. Currently most estimations focus on the closure of the Ignalina Nuclear Power Plant in 2010 because the expected electricity price jump is significantly higher. According to the calculations of the Lithuanian Energy Institute, if the Ignalina Plant

1 After a veto by Lithuanian President the Parliament passed the law in its second reading on 15th of July.

is closed, the price of electricity may increase by as much as 100%, stimulating another price shock from 2010 and raising inflation by an additional 3–3.5 percentage points.



Source: Eurostat, HBM calculations

We anticipate the current double-digit inflation, led by food and energy prices, undermining the purchasing power of households; this should be more evident in autumn. Slowing consumer spending and surging costs will add negative pressures to slowing business activity and squeeze profit margins. For example, workers in the transport sector have already faced serious problems and organised several strikes in different cities to attract the attention of politicians and society in general. The cooling economy and rising unemployment allow us to expect single-digit inflation in 2009.

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