The Baltic Outlook

Macro Outlook, The Baltic Region, October 2007

HANSABANK MARKETS

Hansabank Swedbank

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Abbreviations:

CB– central bank

CEE – Central and Eastern Europe

CPI- consumer price index

CSBL - Central Statistical Bureau of Latvia

ECB - European Central Bank

EKI - Estonian Institute of Economic Research

EP – Eesti Pank (central bank)

ESA– Estonian Statistical Office

EU – European Union

HBM – Hansabank Markets

HICP – harmonized index of consumer prices

LaB – Latvias Banka (central bank)

LDS – Lithuanian Department of Statistics

LiB – Lietuvos Bankas (central bank)

MoF – Ministry of Finance

PPI – producer price index

REER – real effective exchange rate

Photo by: Pēteris Strautiņš

Summary

The 3rd quarter brought coldish winds to the global economy. As the Baltic economies are very open to global economic processes, those winds have affected the three countries as well, though fortunately not much so far. Yet the situation may change if economic processes in the global financial markets do not improve and economic processes turn out to be gloomier than now expected. Local economic developments and policy choices have become increasingly important.

First of all, the eroding liquidity of financial markets may affect local economies negatively, as the three economies are seen to be in trouble due to large and still growing misbalances in their economies. This is why the risk assessments given to the Baltic countries have grown, and this has made and will make foreign financing less available and more expensive. Although we can expect that some of foreign capital will leave, we are of the opinion, that this will mostly affect those investors that were hoping to earn profits mainly on the cheapness of local production. Though local production costs are on the rise (and not only because of wage growth), it is still significantly cheaper to produce many products here than in most other EU countries (particularly compared with the EU15). We expect that the shift away from cheap products toward higher value-added products has and will intensify, which is a much welcomed structural change, as it helps the economies to remain competitive. The strong position of foreign financial institutions and foreign capital in the economy should shield the economy of the Baltic countries from global winds. The higher and more reasonable pricing of foreign capital should avoid any build-up of new misbalances in the future.

The outlook for the EU economy remains relatively strong: Sweden, Germany and Finland, as the main trading partners, offer good opportunities for exports growth in the next few years. Even Russia, with its slowing but still strong growth offers plenty of opportunities to extend Baltic companies' activities in eastern markets as well.

Being very open economies, the Baltic countries are naturally open to the risks of global price increases. While being highly dependent on imported energy the price of oil definitely affects local inflation and consumption. More threatening, however, is the very rapid increase of food prices, as food has a rather big share in consumer baskets, and rapid price growth cannot be fought with increasing supply due to production limits set by EU agricultural policy. The weak dollar (and the strong euro) has softened the negative effects of those price rallies, and has not had a strong effect on exports, as all three countries mainly trade with the EU and related countries.

Besides external factors, domestic ones should not be forgotten, and as before they are still dominant in building up the economic future. Fortunately, the most dangerous times seem to be over. Rapid growth of loans and residential real estate prices is over; consumer spending is showing signs of moderation thus bringing down import growth rates and trade deficits. Although inflation continues to grow rapidly, it is increasingly affected by administrative and external factors, while demand pressures are gradually easing. The long-term base for rapid growth of the economy and price levels, as well as wages, is the convergence process with the more developed EU countries. Hence the growth rates will, in the EU context, remain strong for many years, though they may fall below the long-term averages of the Baltic countries for a short period (1-2 years).

The process of economic slowdown has been most intense in Estonia. This is not surprising: as we mentioned in our July Baltic Outlook, Estonia is somewhat ahead of the other two countries in moving along the economic cycle trajectory. In addition to the significant slowdown in economic growth, most of all due to consumer consumption, the slowdown in investment activity is ahead of that in Latvia and Lithuania. We forecast this winter as being the gloomiest period of the current economic cycle as rapid price growth will hit the purchasing power of consumers and structural shifts in the economy will cause a short-term dip in investment activity and exports. The recovery will not be a very rapid one: we expect that after falling from 11.2% in 2006 to 6.8% this year and to 5.5% next year, economic growth will recover to 6.5% in 2009. While economic growth will be brought down by domestic demand, exports are expected to be the main supporting factor in 2008-2009.

Latvia has started to show the first signs of an economic slowdown, but the overall mood is currently rather optimistic though gradually weakening. Still, the same factors as in Estonia – shortage of labour, cost growth, and a tighter monetary environment – are expected to bring growth rates down here as well. We have remained cautiously optimistic in forecasting rather strong growth rates for Latvia: after 10.2% growth this year, the economy is expected to grow about 6.5% in 2008 and 7% in 2009.

Lithuania is forecasted to slightly exceed previous three years' 7.6% average growth in next three years: the economy is expected to report ~9.2% growth this year, but as in Estonia and Latvia, we expect the changed economic environment to bring growth down a bit in 2008 (to 7.5%) and in 2009

(6.5%). Although exports will perform well in the future, domestic demand is expected to remain the main contributor to economic growth in the next few years. Hence Lithuania may avoid a strong downturn in growth rates, but as in the case of the other two countries, the flexibility of the exporting sector to adjust to producing higher value-added products is the key for such a positive development.

With the slowdown of economic growth rates, particularly of domestic demand, we forecast that misbalances in the Baltic economies will start to diminish gradually. The strongest correction in Estonia will mean rather rapid fall of the trade and service deficit, which will be main contributor to the improvement of the current and capital account balance as well. The slower correction of domestic demand growth rates, however, will mean slower improvements of those deficits in Latvia and Lithuania in 2008 and 2009. The slowdown in inflation growth rates will be delayed due to the above-mentioned external, and several administrative, factors and continued rapid wage growth. The latter is expected to slow but remain strong due to tight labour markets, which are about to ease only marginally due to demographic factors, and the opportunities to work in other EU countries.

The importance of government policies has grown in all three countries, as available tools of monetary policy are in short supply. We welcome the governments' aspiration to achieve balanced budgets and surpluses, but are of the opinion that stronger dedication to cutting current spending, (particularly wage spending) and improving overall public sector efficiency, is advisable to improve the situation in the labour market and to slow inflation. We are of the opinion that the adoption of euro in all three countries has shifted farther away as the rapid convergence process will keep inflation rates above the required level of the Maastricht criterion.

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %								
Estonia	8.0	8.2	8.3	10.2	11.2	6.8	5.5	6.5
Latvia	6.5	7.2	8.7	10.6	11.9	10.2	6.5	7.0
Lithuania	6.9	10.3	7.3	7.9	7.7	9.2	7.5	6.5
EU27	1.2	1.3	2.5	1.8	3.0	2.8	na	na
GDP, millions €								
Estonia	7,757	8,693	9,582	11,210	13,234	15,100	16,600	18,100
Latvia	9,911	9,978	11,176	13,012	16,180	20,334	24,255	28,282
Lithuania	15,052	16,452	18,126	20,673	23,721	28,183	33,115	37,383
EU27	9,893,047	10,053,820	10,546,701	10,980,760	11,557,853	12,172,536	12,756,829	na
Harmonized consumer price growth, %								
Estonia	3.6	1.4	3.0	4.1	4.4	6.3	5.0	3.4
Latvia	2.0	2.9	6.2	6.9	6.6	10.0	9.0	6.0
Lithuania	0.3	-1.1	1.2	2.7	3.8	5.6	6.8	4.8
EU27	2.1	2.3	2.3	2.3	2.3	2.2	na	na
Consumer price growth, %								
Estonia	3.6	1.3	3.0	4.1	4.4	6.4	5.2	3.5
Latvia	1.9	2.9	6.2	6.7	6.5	10.0	9.0	6.0
Lithuania	0.3	-1.1	1.2	2.7	3.7	5.5	6.8	4.8
Harmonized unemployment level, %								
Estonia	10.3	10.0	9.6	7.9	5.9	5.9	6.5	6.8
Latvia	12.2	10.5	10.4	9.0	6.9	5.5	5.8	5.8
Lithuania	13.5	12.4	11.4	8.3	5.6	4.5	4.6	4.7
EU27	8.8	9.0	9.0	8.7	7.9	7.2	6.7	na
Goods and services balance, % of GDP								
Estonia	-6.9	-7.1	-7.9	-6.3	-11.6	-7.5	-3.0	-2.0
Latvia	-10.0	-12.7	-15.8	-15.2	-22.1	-23.3	-20.0	-16.5
Lithuania	-5.5	-5.7	-7.0	-7.3	-10.4	-13.5	-13.2	-12.5
EU27	1.5	1.2	1.1	0.6	0.2	0.4	0.3	na
Current and capital account balance, % of GDP								
Estonia	-8.2	-9.8	-10.2	-8.1	-13.4	-11.0	-5.0	-4.8
Latvia	-6.4	-7.5	-11.8	-11.2	-21.1	-23.5	-22.0	-16.0
Lithuania	-4.7	-6.4	-6.4	-5.9	-9.6	-12.8	-12.2	-11.3
General government balance (ESA95), % of GDP								
Estonia	0.4	2.0	2.3	2.3	3.8	1.5	-2.0	-1.0
Latvia	-2.3	-1.6	-1.0	-0.4	-0.3	0.4	1.0	1.2
Lithuania	-1.5	-1.3	-1.5	-0.5	-0.6	-0.5	-0.5	0.0
EU27	na	-3.1	-2.7	-2.4	-1.7	-1.2	-1.0	na

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

General assumptions

1. The Global Economy

1.1. Economic Growth and Demand

Worldwide growth expectations have fallen in recent months, as problems in the US sub-prime mortgage market have brought about a liquidity shortage in financial markets. Pessimism looms in markets and in analysts' heads after rather strong 2Q and forecast upgrades: growth expectations are clearly downward, although the scope of expected downgrading is still unclear as to how serious the losses are in the financial sector. The 50bp cut of interest rates by the US Federal Reserve brought back some optimism, but the underlying opinions are still rather bleak.

The securitization sub-prime mortgages has distributed the risks and made it difficult to understand where and who is about to bear the costs of the fallout. The first biggest losers are now known, and the first real estimates about the scope of the losses will be seen after 3Q results are published, but the final cost will be revealed only when the audited results of 2007 are out, which come in the 2Q of 2008.

In the meantime uncertainty looms, and this affects global economic developments. First of all, risk margins have grown and created a credit crunch where many companies are not able to acquire financing. Business confidence has been hit quite significantly and the more uncertainty prevails, the more confidence will be affected. And thirdly, all this will eventually run into consumers' moods and wealth, and this will directly affect demand and production. These negative effects will mitigate the positive developments in the real economy, which has performed surprisingly strongly, particularly in the euro zone and in emerging markets.

The current mood of most analysts could be termed cautious. While there were upgrades of the growths forecasts in summer (incl. in the Nordic countries), the first, albeit slight, cuts have now been made (incl. for the euro zone). The outlook for next year is overshadowed with liquidity problems and uncertainty. Hence we could expect a less optimistic view for economic growth -- though the outlook could be estimated as positive unless of course, there is more negative news. Most emerging markets will remain strong, particularly in Asia and central and eastern Europe, while showing slightly lower growth rates.

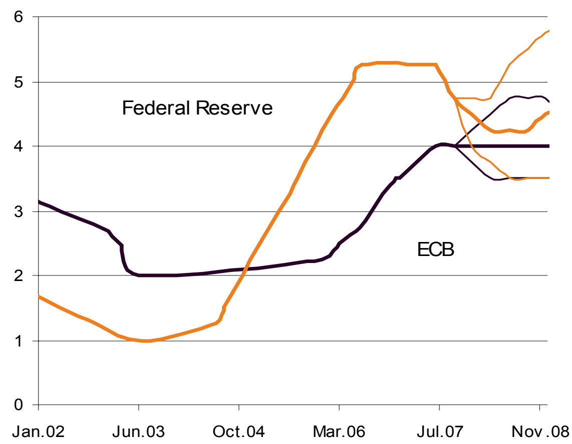
Global economic growth forecast, %

	2005	2006	2007f	2008f
USA	3.2	3.3	2.2	2.4
EU27	1.8	3.0	2.9	2.4
euro zone	1.5	2.7	2.6	2.1
Germany	0.9	2.8	2.7	2.2
Finland	2.9	5.5	4.2	3.1
Sweden	2.9	4.5	3.4	3.0
UK	1.9	2.8	2.9	2.1
Denmark	3.1	3.5	2.0	1.5
Russia	6.4	6.7	7.0	6.5

1.2. Interest Rates

The swift move of the Fed to cut interest rates by 50bp could be a lifebelt, which might save the global economy falling into recession. But it also indicates strongly that a tightening cycle in monetary policy is over. There are expectations that the Fed will cut interest rates more in the coming months to 4.5%, but the ECB most probably will not join in with the easing cycle. The market consensus waits for interest rates in the euro zone to remain in place in the next year or year-and-a-half. The outlook may change depending on inflation and growth dynamics. Even while inflation in the euro zone has remained below 2% until recently, i.e. in the comfort zone for the ECB, inflation picked up to 2.1% in September and base inflation has grown in recent months (September 2% vs. 1.9% in July) and this works against easing. However, the strong euro is hurting European exports and may undermine economic developments in the area.

ECB and Federal Reserve base rates, %



Source: Reuters, EcoWin

1.3. Euro-USD Exchange Rate

The interest rate developments and looming problems in the US sub-prime sector have badly affected to the USD, which fell below the 1.4 euro level and probably will not see a strengthening for some time. Complex factors are working in favour of a weak dollar – interest rates, misbalances in the economy and current economic processes, including troubles in the sub-prime market and financial sector. If the Fed continues with a cut or cuts in November or later, and the ECB keeps rates flat (or less likely increases rates), then we can expect the dollar weaken more.

The economic processes in the US are now clearly weaker than in the euro zone, so there is reason to expect the dollar to be relatively weak, and as more news pours out about the general weakness of economy (e.g. payrolls, consumption, etc), the more the dollar may weaken. Even if the federal budget position has improved in recent years, and the current account deficit has made the same progress in recent quarters, the current situation is still not in balance, which means that there is little reason to expect a significant strengthening of the dollar in the near future.

The adverse effect of a weak dollar is a strong euro, which undermines the competitiveness of European producers and may bring about smaller economic growth than expected. However, while export to the US has weakened, trade with neighbouring central and eastern European countries (incl. EU member states), Turkey, and Russia has grown and balanced out the loss of trans-Atlantic competitiveness.

Interest and Exchange Rates

	22-Oct-07	3M	6M	12M
Fed rate*	4.75%	4.50%	4.25%	4.25%
USD (3M)**	4.94%	4.53%	4.29%	4.27%
ECB*	4.00%	4.00%	4.00%	4.00%
EUR (3M)**	4.63%	4.37%	4.26%	4.17%
EUR/USD**	1.43	1.45	1.40	1.35

* USA Fed and ECB refi rate according to market consensus
** USD and EUR exchange rates and money market rates according to market expectations (based on forward contracts)

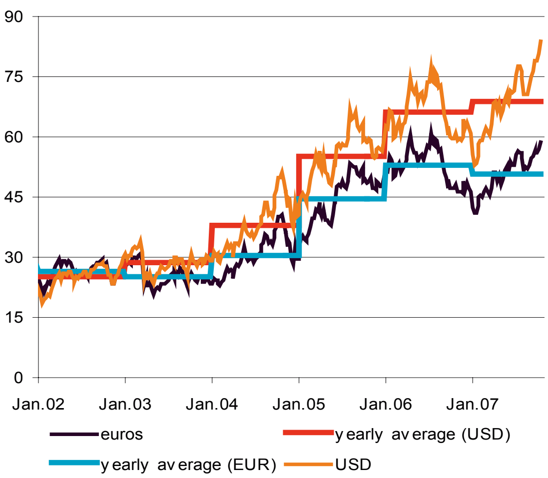
1.4. Commodity Prices

Slower demand growth has affected commodities prices, but as demand itself has remained strong, a substantial fall in prices has been avoided. The recent surge of oil prices is a result of several processes, but based mostly on growing demand and capacity constraints. The weakening of the US dollar has had its impact on oil prices as well. In addition, the constant political turbulence in oil-producing countries is not helping to lower prices. It is reasonable to expect that the price of oil (and other energy products) will continue to fluctuate wildly, but taking into account relatively optimistic growth expectations (particularly in emerging markets) and growing demand, an increase is more likely than a fall. If economic developments deteriorate significantly, then oil prices will certainly fall.

Food prices, which have rocketed this year, (particularly for grain, which also affects other prices) are set to continue growing into the future as they are now subject to similar factors, which also pushed up energy prices some years ago. The wealth effect in the developing world and increasing use of bio-fuels (which is quite an unfortunate and unseen turn for oil producers, which they may have created themselves) has been accompanied with bad weather conditions in several grain producing areas this year. The global price rally has brought to light faults of EU agricultural policy – the production limits and price ceilings have caused domestic prices to skyrocket and created shortages of some products.

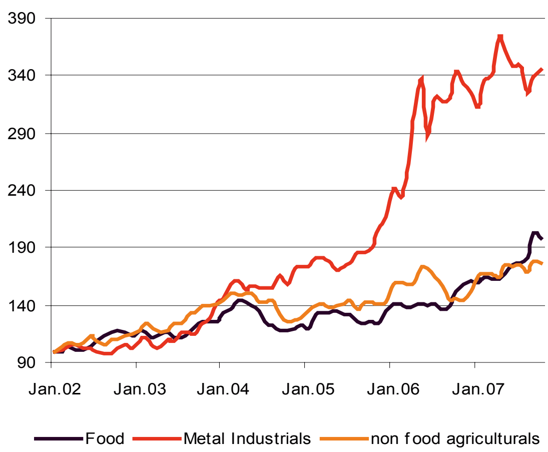
Prices of other commodities have moved in contradictory ways, although the overall trend is to remain high, albeit not as high as previously. The

Oil price (Brent)



Source: Reuters EcoWin; HBM calculations

The Economist commodity price index, USD (100=jan02)



Source: Reuters EcoWin

period of rapid price growth is generally over, the only exception being for food prices. Exchange rate dynamics are negatively affecting US consumers, but price growth in the euro zone and its related economies is usually smaller, and the consequences weaker. As global economic growth has slowed, several prices have also fallen – for example, the prices of most base metals peaked at the end of 2006.

2. The Global Economy and the Baltic Countries

2.1. Impact of Demand

Global economic processes spread rapidly and extensively into the Baltic economies due to their openness. Estonia is more affected by fluctuations in demand than Latvia or Lithuania, as economic growth here is more dependent on exports. The eroding liquidity of financial markets also affects the Baltic countries, but taking into account the mood of foreign investors and the scope of the problems, Latvia is more open to risks stemming from this than the other two countries.

Economic developments in the European Union are most relevant for the Baltic countries. Although growth expectations for the EU next year are weaker than for this and last year, the forecast for the Nordic countries, particularly for Sweden and Finland, are still quite strong, even if those countries' economies are expected to grow less this year. The stabilization and slight recovery of the German economy is also important for the Baltic economies. So the possibilities for growth through exports are good, even if the growth is slower.

Taking advantage of these possibilities does, however, depend on how local companies are able to adjust their production to rapidly growing costs. The time when production (and exports) was based on cheap labour and resources (imported or local timber, energy, etc) is over and the Baltic economies have to make significant efforts to modernize production processes and increase productivity. It is very important to work on finding new products with higher value-added and selling prices. Setbacks during such intensive transformation periods are very likely, and this is confirmed with the export dynamics in recent years in Estonia and Latvia.

The three economies have become more and more tightly connected with each other in recent years and this means that an economic slowdown in one country will affect others too. As we can expect a significant slowdown in Estonia and Latvia, and to a lesser extent in Lithuania, the overall impact on all three countries will be negative.

Of other countries, Russia is the most important for the Baltics and their economic developments. Strong, albeit slowing, growth will give good opportunities, particularly because the growth is more and more based not on exports of raw materials, but on domestic demand. However, one should always keep in mind that political and administrative risks in Russia have grown in recent times. The Russian government is working hard to draw all possible revenues from exports into the hands of the Russian state, and hence we could expect a fall in transit flows (oil, and other raw materials) in the Baltics, as the new Russian Baltic ports are soon to be opened and fully operational. While Estonia is already feeling the fall this year (and in the 1H of next year) Latvia and Lithuania will feel the fall in transit volumes in a few years.

2.2. Financial Markets

Global financial markets are again affecting the Baltic economies more than in the recent past; unfortunately the impact is mostly negative. As the overall sentiment has become cautious, all the news from supposedly troubled markets is scrutinised with care.

The rapid economic growth and the accompanying growth in misbalances in the economy have increased the risk assessments given to the Baltic countries. This affects the availability and cost of foreign financing, which has already become, and will further become, less favourable. Consequently, domestic lending will diminish and interest rates will grow. New borrowers are the most affected, so some of the current investment plans will be not completed.

There is a rather high probability that all types of foreign investments will decline in the Baltic countries. We can also expect some flight of foreign capital – mostly because of rapidly growing production costs. The latter will first affect all those investments which hoped to earn profits mainly on the cheapness of local production. At the same time we expect that inflow of foreign investment will continue, as production costs here are still lower than in most other EU countries (particularly compared with the EU15). This shift – away from very cheap products toward higher value-added production in investments – is welcomed as it follows and supports structural changes in the economy. In the near future the volume of actual investments is quite significantly influenced by economic policy decisions. The hesitation of foreign investors could be diminished with well-balanced and adequate political choices. There is a probability, albeit very slight, that capital flow into the Baltic economies will halt if bad economic policies bring about a full scale economic crisis.

The ending of the monetary tightening period in the euro zone means that debt servicing costs will not be increased any more in the Baltic countries.

Of course, this is true only if loans are taken out in euros (as most are). However, debt servicing costs will continue to grow for borrowers in domestic currencies and consumer loans. Interest rates for local currencies are on the rise.

As Baltic countries are mostly trading with euro zone countries, or with those closely connected with it, they will be rather modestly affected by the strong euro. Of course, some companies may face big losses because of it. The strong euro makes imports cheaper from outside the EU, but this has a relatively small share in total imports. Still, imports from developing economies, including from Russia, will probably grow. For the latter, the quality and the product mix of goods is a problem, as well as restrictions posed by the Russian government on exports (e.g. export tariffs for timber, unofficial economic sanctions, etc). In conclusion, trade with Russia is affected more by political and administrative decisions than by economic issues (incl. the exchange rate).

2.3. Commodity Prices

The strong euro has had a clear positive impact on prices of oil products (and other products traded mostly for dollar) in domestic Baltic markets: despite growing oil prices in dollars, gasoline prices have grown modestly in local markets.

Of other prices, food is the most important one affecting the economy and inflation. The rapid price growth has rolled over to local markets and contributed significantly to the overall price growth (the share of food in consumer baskets are relatively high in the Baltics). Local farmers are among the few optimistic farmers on Earth this year as the harvest has been very good. However, global prices have pushed up local prices as well, as grain, meat and milk are among those most affected. The change in EU agricultural policy (particularly the elimination of milk quotas) could significantly increase the production and revenues of local producers, and could limit local inflation rates.

2.4. The Local Economic Policy

The most important tool for adjusting economic developments in the Baltic countries is government policy, as monetary systems allow a little room for manoeuvre. We can however see some positive developments in fiscal policies, while some common risks exist.

The most important positive development in fiscal policies in all three countries is the movement for budget surpluses[1], even if we can argue that a stronger effort would be better. The instability of domestic policies and the fractured political landscape might inadvertently prove a benefit to the economy. It may happen that in a time of political uncertainty, decision-making processes could be too lengthy (the most likely result) and without any result, or could be driven by popularity ratings instead by need or reason.

The next elections for both Estonia and Latvia will be for the European Parliament in 2009, but Lithuania will face general elections in a year. Political stability in Latvia is the most fragile while Estonia is the strongest now. The biggest economic problems are in Latvia as of October 2007, while Lithuania has the least significant economic problems (but that does not mean insignificant). So the abovementioned risk seems to be the most acute in Latvia and a bit lower in Estonia and Lithuania.

Monetary conditions in all three countries are highly dependent on those of the euro zone. The tightening monetary policy of the ECB had a significant, but not crucial, role in calming the rapid growth in loans and real estate prices. The expected stabilization or easing of monetary policy (i.e. interest rates) combined with growing risk margins for the Baltic countries is favourable for the three economies, as it makes possible to ease growing strains and pessimism (at least in Estonia). However, we cannot exclude the possibility that in the case of bad economic developments, the central banks might find it reasonable to ease monetary conditions. Between a few options, cutting the reserve requirement is the most likely (currently 15% in Estonia, 8% in Latvia and 6% in Lithuania). The most important things to look at are the inflow of foreign investment and the possibility of local companies to invest.

Elections schedule

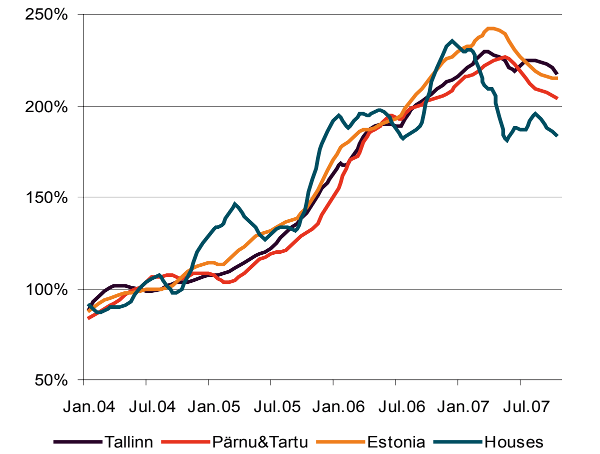
Estonia	
Presidential	September 2011
General	March 2012
Local	October 2009
Latvia	
Presidential	June 2011
General	October 2010
Local	July 2009
Lithuania	
Presidential	June 2009
General	October 2008
Local	2011
European Parliament	2009

Maris Lauri

1 The Lithuanian government plans to balance the budget in 2009, Latvia already has a surplus this year and Estonia continues to have with surplus.

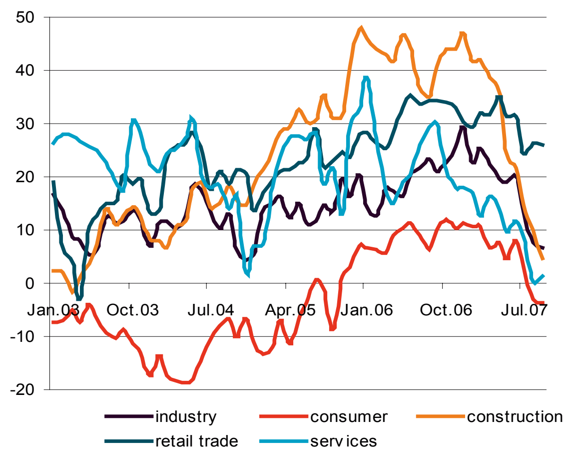
Estonia

Average Price Level of Apartments (2004=100%)



Source: Estonian Land Board; HBM calculations

Confidence Indices (balance; s.a.)



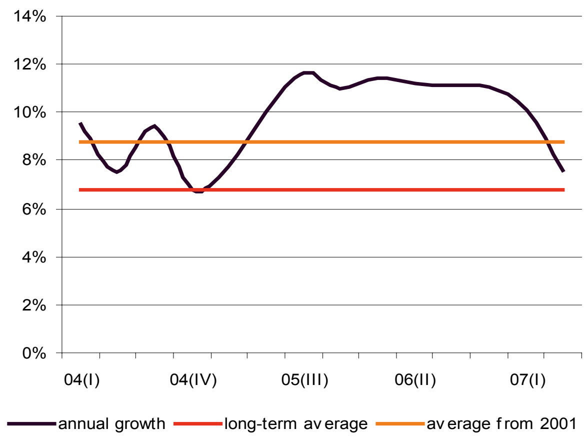
Source: EKI, s.a. by HBM

1. Recent Economic Developments

The Estonian economy has clearly moved into the next phase of the economic cycle: after two years in which growth exceeded 10%, the economy grew by 7.2% in the 2nd quarter. There were two main contributors to the slowdown: household consumption and exports. Growth in household spending dropped from the 1st quarter 16.6% to 12%, although wage growth in the 2nd quarter reached 21.2% supported by bonuses for last year. Exports slowed as oil transit and subcontracting in electronics dropped. As both areas create significant imports and domestic demand growth weakened significantly, imports growth fell even more than exports. The result was a significant improvement of the trade and services balance (-8.6% of GDP vs. -11.1% a year before) and the current and capital account (-14% of GDP vs. -15.2%). The inflow of foreign direct investments was surprisingly strong – 12.6% of GDP, however, Estonian investments abroad were also very big (11.2% of GDP).

The most troublesome of negative trends is the strengthening of inflation in the 2nd and 3rd quarter: in September CPI annual growth reached 7.2% and producer prices were up 9%. Besides demand driven inflation, external factors like food and oil have recently had increasing impact on local price movements. Unemployment started to grow in the summer months, though the Estonian labour market remains tight and companies continue to complain of labour shortages. Currently the reason for unemployment growth is layoffs in some companies that were relaying on cheap labour, and the first cutbacks by railway companies, which are suffering from falling oil transit.

Annual Growth Rates of GDP



Source: ESA, HBM calculations

Starting from May real estate prices have started to fall, but so far they have remained at higher levels than a year ago (our index shows ~10% fall from April's top level[1]). However, activity in the market has dropped dramatically (ca half the number of deals than a year before) and some companies have fallen trouble. The overall mood regarding future developments has deteriorated significantly, as the media has amplified the seriousness of the problems[2] and the global economic environment

1 This may reflect the structural change of purchases: the share of new and more expensive real estate has fallen, while in the secondary market prices have fallen quite modestly. E.g. in Tallinn regions with little new developments, prices have fallen 3.5-4% since April, while in the centre ~8%. Median prices are still up in yearly comparison (between 3.5-22%).

2 The actual market situation clearly indicates trouble in new developments and land together with falling asking prices (up to

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	8.0	8.2	8.3	10.2	11.2	6.8	5.5	6.5
GDP, EURm	7,757	8,693	9,582	11,210	13,234	15,100	16,600	18,100
GDP per capita, th kroons	89.3	100.5	111.1	130.3	154.2	176.0	194.0	210.0
euros	5,709	6,422	7,103	8,329	9,852	11,300	12,400	13,500
Growth of industrial production, %	8.3	11.1	10.5	10.9	7.4	7.0	6.0	7.0
Growth of GDP deflator, %	3.8	4.5	1.8	6.2	6.2	7.0	4.1	2.5
Growth of consumer prices, %	3.6	1.3	3.0	4.1	4.4	6.4	5.2	3.5
Growth of harmonized consumer price index, %	3.6	1.4	3.0	4.1	4.4	6.3	5.0	3.4
Growth of producer prices, %	0.4	0.2	2.9	2.1	4.5	8.2	4.4	2.5
Harmonized unemployment rate, %	10.3	10.0	9.6	7.9	5.9	5.9	6.5	6.8
Real growth of average monthly gross wage, %	7.7	8.0	5.2	6.1	11.2	12.2	8.5	6.5
Growth of exports of goods and services, %	-1.1	9.0	17.4	24.6	18.4	9.5	3.5	6.5
Growth of imports of goods and services, %	4.1	9.7	17.9	21.6	25.7	5.0	-2.5	6.0
Balance of goods and services, % of GDP	-6.9	-7.1	-7.9	-6.3	-11.6	-7.5	-3.0	-2.0
Balance of current and capital account, % of GDP	-8.2	-9.8	-10.2	-8.1	-13.4	-11.0	-5.0	-4.8
Inflow of FDI, % of GDP	4.0	9.5	8.1	20.1	10.1	11.0	9.0	10.0
Foreign gross debt, % of GDP	57.9	64.5	76.6	85.3	96.4	100.0	94.0	100.0
General government budget position, % of GDP	0.4	2.0	2.3	2.3	3.8	1.5	-2.0	-1.0
General government debt, % of GDP	5.6	5.7	5.2	4.4	3.9	2.7	3.0	3.2

has become highly uncertain. In this context it is not surprising that business and consumer confidence has fallen considerably in recent months[3].

2. Economic Forecast

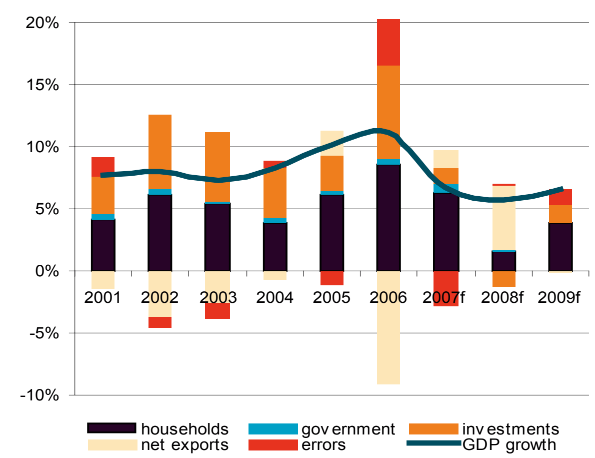
We have made significant revisions in our forecast, taking account the stronger than expected slowdown in the growth of GDP in the 2nd quarter and the changed situation in the global financial market. We expect economic growth to fall to 6.5-7% this year (previous expectation 8.2-8.9%) and to 5.3-5.7% next year (6.5-7%). While in this year real gross wage growth will most probably exceed 12% and next year reach ~8.5% due to wage increases in the public sector, the unemployment rate may increase to 7% in 2009. However, we are of the opinion that the actual growth in unemployment will be less than this, as more people will move to non-active status (e.g. pensioners) or abroad. Hence the top unemployment rate may reach only 5.8-6%.

We expect consumer price inflation to reach 6.3-6.5% this year, 5-5.5% next year and 3-3.5% in 2009. We are of the opinion that though there are many administrative increases in the pipeline and food prices are in the up flow, the tight financial situation of consumers will not allow demand factors to influence price levels strongly in 2008-2009. We also expect relatively modest and perhaps negative effects from global price movements as the world economic situation deteriorates.

2.1. Economic Growth

The economic slowdown will deepen in the 2nd half of 2007 and will be steepest in the 1st half of next year, if global economic processes do not deviate significantly from current expectations (see General Assumptions). The slowdown in growth is mostly attributable to weaker domestic demand: 15.3% growth in 2006 will be replaced with 7-7.5% growth this year and a marginal increase of ~0.5% next year. We expect growth in household consumption to fall to 2.5-3% with investment growth being negative next year, as after trouble in residential real estate sector we expect quite similar developments, (but not as serious) in the office and retail sub-sectors as well. Industrial investment may fall for one or two quarters, but we expect investments in infrastructure to remain relatively strong in 2007 and at least in the 1st half of 2008. Later, budgetary

Components of GDP Grow th



Source: ESA; HBM calculations and forecast

20%): the secondary market is in a significantly better situation, however newspaper cover stories tend to discuss cuts of asking prices of new developments, and extend the troubles of one or two companies to the entire sector.

3 The political troubles at the end of April and in the beginning of May have also had a negative impact on the general mood, particularly as the troubles of transit companies have received overly big attention. It is quite common to say transit having 10-15% (in Russian media even higher figures) of Estonian GDP, but we estimate that the actual share of Russian-export related transit might be 2-3% of GDP.

problems will most likely lead to budget cuts mostly in the area of budget-financed investments, which cannot be financed with loans or from EU funds (e.g. schools).

The slowdown in major export markets will affect export growth modestly according to our base scenario, while the structural changes in trading flows will have a far stronger impact this year and next year than in past. Weaker domestic demand will help the imports growth rate to fall significantly, and as a result, the current account deficit is set to improve significantly in 2008 (~5% of GDP). The deficit will start to widen as domestic demand starts to recover.

We have taken a quite conservative view regarding exports due to uncertainties in the global markets. The rapidly falling confidence indicates that developments in the near future might be worse than current foreign trade results promise. Rapidly growing costs and increased speculation will probably frighten some companies into leaving and make the creation of business contacts more difficult. Hence we expect a slowdown in the investment and restructuring process, which will eventually also affect exports. However, export developments this year suggest that exports may turn out to be more resilient to economic slowdown and cost growth, which means a stronger advancement of exports, domestic demand and GDP than our base scenario expects. Nevertheless, it would also support imports and work against any rapid slowdown of the current and capital account deficit.

Scenario comparisons

	2006	2007f	2008f	2009f
GDP growth, %				
base scenario	11.2	6.5-7.0	5.3-5.7	6.0-6.6
negative scenario		6.5-7.0	3-4	3-4
positive scenario		6.8-7.2	6-6.5	6.2-6.8
CPI, %				
base scenario	4.4	6.3-6.5	5.0-5.5	3-3.5
negative scenario		6.5-6.8	4-5	2-3
positive scenario		6.3-6.5	5.8-6.3	5.5-6.0
Current and capital account, % of GDP				
base scenario	-13.4	-10.5..-11.5	-5..-6	-4.5..-5
negative scenario		-10.5..-11.5	-4..-5	-2..-4
positive scenario		-9..-10	-8..-9	-8..-9

The more pessimistic outlook is that due to an extended and deeper recession in the EU (and other export markets) exports will not recover as expected. Also the outflow of labour may at first be more intensive but as it will be just as difficult to find jobs abroad, many will return and the burden on the economy and budget will be stronger. This scenario expects prolonged slow growth in 2008-2009 at levels of 3-4% (or less) with much more modest wage growth and inflation levels, but also with higher unemployment and a troubled budget.

2.1.1. Labour Market

The long-term background for labour market developments is still the same: a diminishing and aging population, which will result in a fall in the labour supply within the couple of years and higher social and health costs a little further into the future. However, the economic slowdown is about to ease the situation for some years. Still, this bears the risk that in the more distant future the situation may became even tighter than assumed now, as higher unemployment will encourage an outflow of labour and this will distort the age structure of the population still more.

We expect a marginal increase in employment this year, which is a dramatic change compared with 2006, when employment increased 6.4%. We forecast a fall in employment in 2008-2009, and then in 2010 it will start to increase gradually. In contrast, unemployment is expected to increase in the next three years. We have already witnessed unemployment growth from summer and the process is expected to intensify in the 4th quarter, as an increasing number of troubled companies will make layoffs. Although this year people will find a new job quite easily, the increased labour movement will create higher short-term unemployment and this will increase overall unemployment as well. A short-duration factor is the numerous generations of those born in late 80's[4], who now have started to enter the labour market.

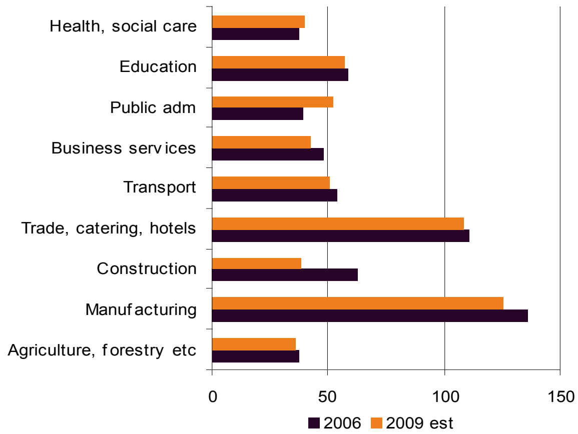
However, in the next year layoffs will became more intensive, as we forecast a relatively significant fall in employment in some sectors (e.g. construction, real estate, transport and manufacturing) due to export problems and weaker domestic demand. The layoffs will help those companies that are currently struggling to find workers, but many of them are active in domestic-demand-driven sectors and hence the employment in those sectors may remain short-term. The public sector will attract significantly more people next year, as wage growth will be strong and there are many vacancies (e.g. government plans to increase employment by 2,500 people). We are of the opinion that a deteriorating budgetary situation will also cause layoffs at the end of 2008 and 2009 in public institutions.

According to a more positive scenario we see a chance that increased labour supply and relatively weak wage pressure in the private sector will help intensify the restructuring process and expansion of production in some sectors that currently cannot grow because of a lack of labour. The rapidly growing labour costs in construction, which has halted some investment projects in the public sector

4 During the so-called singing revolution of 1988-90, the birth rate picked up for 3-4 years: thereafter it fell extremely sharply.

(incl. those financed with the help of EU funds) in 2005-2007, may now become workable and offer additional employment for low-qualified or currently construction-involved labour. This process is most likely to appear in late 2008, and would benefit domestic demand and faster recovery of economic growth rates.

Employment in Major Sectors in 2006 and 2009, th people



Source: ESA, HBM estimate

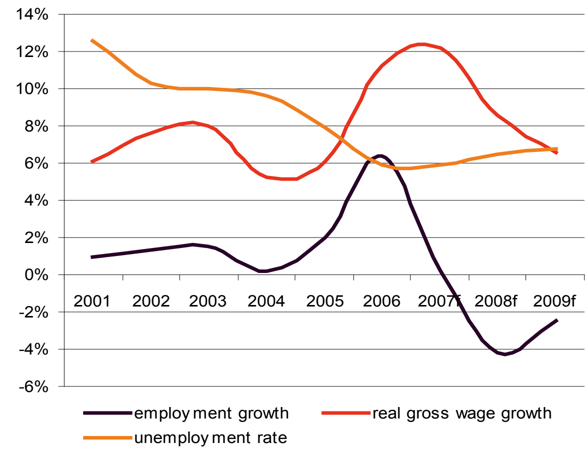
The positive change brought by lower employment is improved productivity growth and, unlike last year when economic growth was mostly based on higher employment, productivity will again become the main contributor to growth. This of course means significant changes in the production and economic structure in this and following years. The change is important for the competitiveness of the economy.

The Build-Up of GDP Growth: Productivity vs Employment Growth

Source: ESA, HBM calculations and forecast

Wage growth will remain strong this year, reflecting the strong pickup of wages in the 1st half and inertia. While companies will try to cut wage growth next year, and most probably will succeed in the 2nd half of the year, strong wage growth will take place in the budgetary sector: at first at central government level and then in the municipalities. As around ca 25% of people are employed in the public sector, overall wage growth will remain relatively strong. The average wage will also grow due to structural changes in employment: there will be less low-wage employees on payrolls, as layoffs will mostly affect this group of workers; moreover, structural changes in the economy encourage employing higher qualified workers.

Labour Market



Source: ESA: HBM forecast

The increase in unemployment will not place any immediate pressure on the budget, as most employees have unemployment insurance, which has a quite healthy payment scheme[5]. However, growing prices of first-need goods and services will soon force former low-income earners to turn to municipalities for social assistance and that will mean pressure on budgets in the 2nd half of 2008 and 2009.

2.1.2. Capital Supply

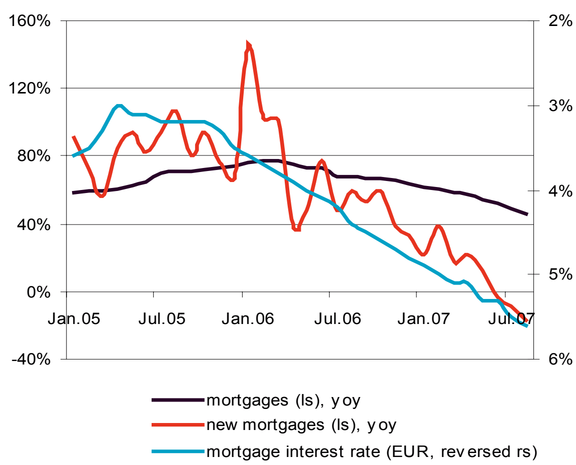
Favourable monetary conditions – high and cheap loan supply – have been important contributors to economic growth in the last 2-3 years. The tightening of monetary conditions is one important factor for the slowdown in household demand: higher interest rates were among the reasons (along with rocketing prices) why households' access to mortgages has fallen. Increasing misbalances in the economy and too great a share of mortgages in the new portfolio in 2006, has made banks increasingly cautious in

5 During first 100 days of unemployment 50% and then 40% of the wage; the length of payment depends on how long a person has worked prior to that (180-360 days). The maximum of the payment is limited to 3 times the average daily payment of all insured in the previous year (in 2007 EEK 11,884 in a month). The unemployment insurance payments are subject to income tax and those unemployed have health insurance. The unemployed person has to be registered officially, and must look for a job actively; there are limits to refusing offered jobs.

lending to construction and real estate companies, which has, as a consequence, brought down lending rates.

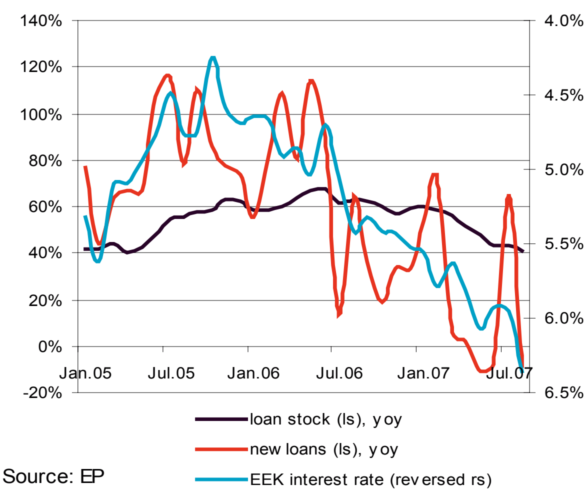
In construction, 93% of capacities were employed in the 3rd quarter (same as in 3Q05, 95% in 3Q06) and in manufacturing the corresponding figure was 79% (79% and 80% respectively in 3Q05 and 3Q06). Hence the demand for capital should be quite strong, especially taking into account the fact that to maintain their competitiveness, companies ought to invest in new technologies, and that the restructuring of businesses also requires financing. However, it seems that uncertainty in the face of the expected slowdown has made potential borrowers and lenders cautious of making investments and has brought lending activity down more than expected. Of course, the financial situation of an average company is still strong and many companies do not require additional financing.

Household Loans



Source: EP

Enterprise Loans



Source: EP

Households are also cutting their borrowing both for consumer loans and mortgages. The latter is affected by the situation in the real estate market: as the supply has increased while demand has fallen, potential buyers are waiting for prices to decline. Consumer borrowing has diminished probably because of weaker confidence and after the extensive debate in the media this summer of regarding related risks.

Domestic lending has been based mostly on external savings in the last two years, but we expect this to change, at least in part, in the next 2-3 years. We expect domestic savings to increase (the process is already ongoing), while external financing will be smaller and more expensive. The risk margin for Estonian financial institutions will increase, to cover economic risks more effectively, and local loan interest rates will became more differentiated by risks of sector and business.

One important factor, which may help the Estonian economy out of the recession it is heading into, are disbursements from EU funds. Estonia can get up to EEK 53.3bn from the EU structural funds in 2007-2013. The actual disbursements will take place in 2008-2015, and we forecast that it will be distributed unequally during those years with most falling in the period of 2010-2013. However, in 2008 the first projects to which those funds apply, will be initiated and we are of the opinion that the co-financing and loans to those projects will be rather easily available. Hence, we expect that the positive impact of the EU funds on the economy will be seen from the 2nd half of 2008.

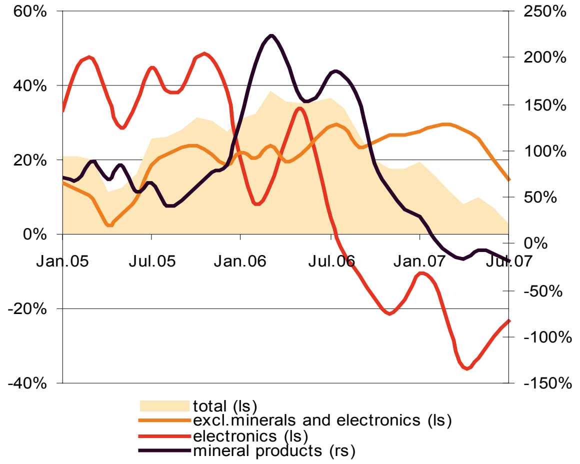
2.1.3. Goods and Services

As expected the slowdown in economic growth has brought about significant correction with regard to import volumes and has increased the importance of domestic companies in satisfying supply. Weaker domestic demand is behind the slowdown in imports of vehicles, food, chemicals, and machinery other than electronics. Electronics imports have fallen due to restructuring in the sector, which has lost its competitiveness due to increased production costs; exports related to this business have also fallen. Imports of mineral products fell because of diminishing transit flows[6] and this type of fall has also affected export volumes.

The very modest growth in tourism services imports (3.3% yoy, incl. 1.2% for private tourism) was a bit of a surprise, especially taking account the increased prices of those services. Also, the imports

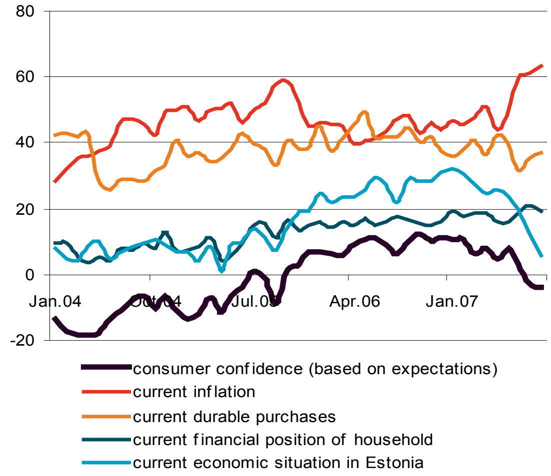
6 Besides fall of direct transit (or pure transport of products, which is not reflected in foreign trade figures), Estonia has made improvements in certain mineral products during the process of exporting from Russia to other countries.

Annual Grow th of Imports (3 months average)



Source: ESA; HBM calculations

Consumer Cofidence: Expectations vs Current Feelings, s.a.



Source: EKI; s.a. by HBM

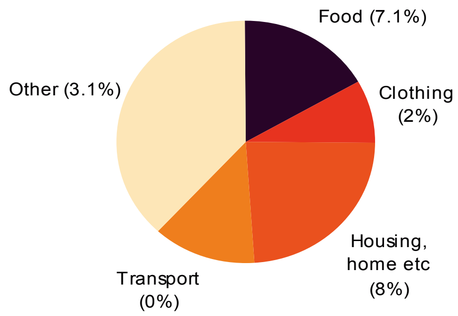
of transport services grew less than expected in the 2nd quarter. We are of the opinion that both these developments will continue in the 2nd half of this year, and continue at least into the 1st half of next year. The cuts in the transit of Russian raw materials (oil products, coal) mean that there is no need to import many related services (e.g. railway, logistics). Moreover after the events of the end of April, several Russian quasi-state companies have left Estonia, particularly those involved in transit and transport. Hence the dependence on Russian supplies has diminished and Estonian companies have taken their place.

We are of the opinion that households' relatively strong current financial position is about to change. As written above, we expect unemployment to grow and although wage growth will remain relatively strong, this will eventually affect household incomes. There will be no support from borrowing: we forecast that the volume of new loans will be smaller than last year, at least until the 2nd half of 2008. Although government disbursements will increase in 2008 and income tax will be cut, growth in household spending will decline strongly.

2.1.4. Household Consumption: Income, Costs and Prices

The sharp slowdown in the growth rate of household consumption (from 16.6% to 12%) in the 2nd quarter was a surprise, as wage growth exceeded 21% and employment growth was 1.3%. This can explained by several simultaneous processes which eroded household confidence: higher mortgage payments; distress from the so-called Bronze Night at the end of April and its fallout in May; the start of rapid price increases (at this time a government plan to increase taxes was published); and the fall in the residential real estate market started. The situation has not improved: an increasing number of collective layoffs have received attention in media; distress in the real estate sector has deepened, and global and domestic news is increasingly less optimistic. Notwithstanding this bad news, the actual financial situation of households has remained strong: so far expectations have been the most seriously hit, and this applies first of all to employment and inflation expectations, but also to opinions regarding Estonia's economic future.

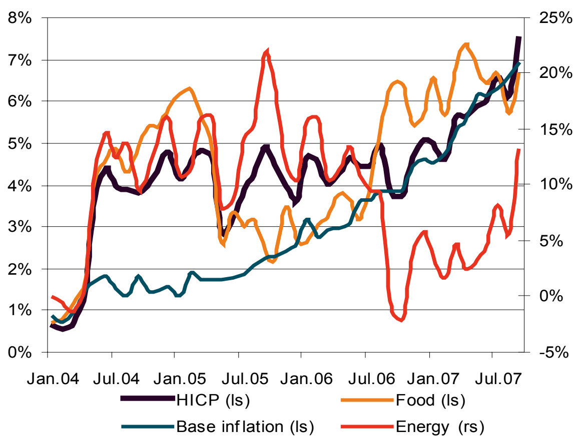
Household Consumption Structure, 1st Half of 2007 (numbers indicate price grow th)



Source: Eurostat, HBM calculations

The expected strong growth in costs this coming winter will affect household spending substantially, as most prices of first need goods and services will rise. Food prices have already been growing rapidly for more than a year, but the growth has accelerated in recent months due to supply shortages and price growth in global markets. The EU's production quotas and price limits make the situation worse as they do not allow market correction and favour price growth[7]. As food has rather a big share in the Estonian consumer basket (19.8% in HICP, 21.7% in CPI), its impact on overall price growth is significant. The other important group of prices that are about to increase and cause bigger cost growth, are those related to housing (12.8% share in HICP, 14.35% in CPI). The increase of VAT from 5% to 18% on heating from July has not affected consumers yet, but it will do so in October, and November when bills arrive. Heating prices are also growing because of the higher price of energy (e.g. natural gas, timber, and heating oil). It is hard to expect that this winter will be as warm as the last one, so the consumption of heating will increase bringing significantly bigger bills than last year. The third group of prices that will affect households significantly, is transport. While gasoline prices will be approximately at the same level this year as in 2006, the increase in excises in January will increase transport costs in 2008. Public transport prices have grown due to wage growth and investments (e.g. this year transport by road has become 8.4% more expensive than in Dec06 according to HICP details), and we expect this process to continue. Transport costs will be affected by growing vehicle insurance and maintenance costs (already 14.6% this year).

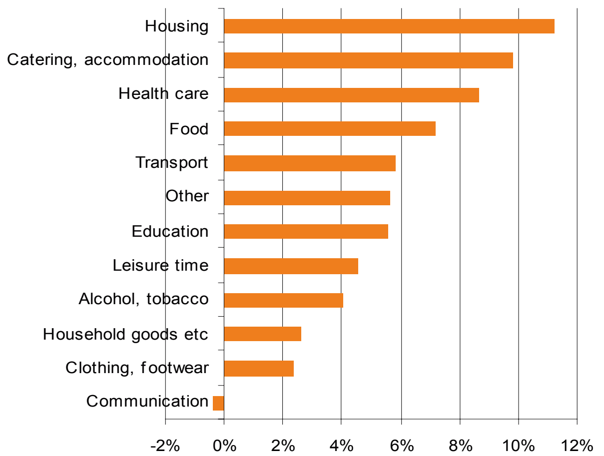
Annual Growth of Harmonized Index of Consumer Prices



Source: Eurostat

These three groups of goods and services make up over 50% of an average consumer basket: but in low-income families their share is significantly higher. For pensioners, and others, growing health costs (8.7% in 9 months) are quite a big problem. Families with children are affected by rapidly growing education costs (5.6%). Consequently, the first-need goods and prices are growing faster than incomes and this sets limit on the consumption of other goods and services. We expect that weaker demand will rather seriously affect prices of these goods and services. Along with falling communication prices, we forecast that prices of construction and renovation will also fall in this winter: other prices will witness a fall in 2008-2009. We are also of the opinion, that some tax increases will not necessarily bring an increase in prices (at least not exactly of the extent of the tax increase because of weak demand). Tobacco and alcohol excise are the most likely candidates for such developments.

CPI Growth Compared to December 2006



Source: ESA; HBM calculations

Due to very weak demand growth we expect inflation to slow sharply in the 2nd half of 2008, and this will lead to 3-3.5% inflation in 2009-2010. We are of the opinion that even if the economic growth starts to strengthen in 2009, it will not create excessive money supply (as happened in the past) and hence we do not expect any strong acceleration of price growth in 2010. However, this forecast is based on the assumption of only moderate price growth in global markets (energy, food; also taking into account exchange rate movements).

2.1.5. Investments

Somewhat surprisingly, investment growth accelerated from 10.8% to 17.1% in the 2nd quarter, including for gross fixed capital formation from 15% to 21.8%. However, this growth was at least partly attributable to the low comparison base: in the 2nd quarter 2006 growth was only 13.3% and 9.8% respectively. The build-up of inventories diminished to 5.2% of GDP in real terms (6% a year before).

The acceleration of investments was mainly the result of the completion of residential real estate projects – the process is also expected to affect investments in the 2nd half of this year. However, as the financing of residential real estate developments has diminished considerably in 2007, we expect that

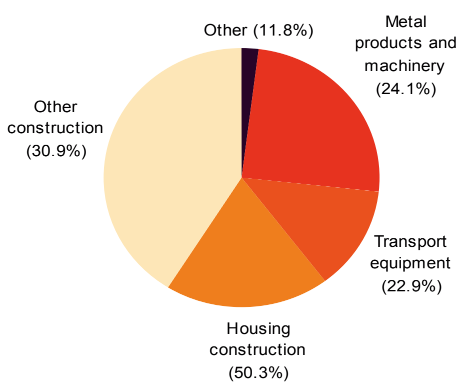
7 E.g. the milk production quota prevents farmers increasing supply in times of shortage causing prices to grow extremely rapidly (our estimates suggest for different dairy products a 20-50% mom increase in October alone).

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

Factor	Nature and scope
VAT on long-distance heating	from 5% to 18% from July 2007
Long-distance heating prices (heating energy)	mostly Oct 2007 - beginning 2008; depending on municipality 0-25% (more possible, but unlikely)
Natural gas price from Gazprom to Estonia	unknown, probably up to 50% in the begining of 2008
Natural gas price to consumers	unknown, probably 10-50% (Oct 2007 - Dec 2008)
Water, sewerage	depending on municipality: (0)5-15%; mostly Jan 2008
Garbage collection	depending on municipality up to 50%; 2007-2008 (once a year?)
Electricity, etc	Transformation prices in March 2008 (~3-5%), electricity itself in July 2008 (~10-20%)
Local (bus) transport	depending on municipality; price or subsidies growth; prices 15-30%; depends on wage demand, oil price; during 2007-2008
Global oil price	unknown, rapidly transfered to local prices
Alcohol excise rates	10% in Jan 2008, 20% in July 2008
Tobacco excise rates	in Jan and July 2008 up to EU minimum (ca 50%)
Excise rates on motor fuels	Jan 2008: ~25% for gasoline, ~29% diesel
Excise rates on heating fuels	Jan 2008: heating oil ~39%, will be implied to natural gas and electricity* (156 kr per th m3 and 50 kr per MWh)
Different environmental taxes and duties	2008 and later; unknow; mostly indirect impact
* replaces CO2 duty	

this type construction investment is about to fall in 2008 and probably in 2009 as well. Other types of construction investments continue to grow in 2007, but here also the lagging effect exists. We cannot yet see oversupply in the area of office, retail or industrial real estate, but if the economic situation worsens and all current construction projects are finalised, the situation may turn in 2008. Government-financed investment in infrastructure will continue, and with increasing EU funds we can expect that investments in production development and infrastructure will grow in 2009.

Structure of Investments (3Q 06-2Q 07)
(numbers indicate annual growth in current prices)



Source: Eurostat; HBM calculations

Investments for the purchase of vehicles grew relatively modestly (23% in current prices), but most worrying is the increase of only 10% in investments for purchase of machinery. We are of the opinion that many companies are in a waiting position: looking forward to more certain times and good ideas. At the same time many investors, incl. foreign investors, have been frightened away by growing misbalances in the economy and production costs. However, as production in Estonia is still cheaper than e.g. in Finland or Sweden, we expect foreign investment to continue to remain strong. However, such new investments are expected to support structural change in the economy and will not look for cheap production and real estate development as in 2004-2005 and before. The more troublesome times may initiate takeovers and merges, both from foreign and domestic investors.

To conclude, the overall outlook for investment in the near term is negative: due to the troubles in the residential real estate sector, construction in the sector will fall significantly and this will cause overall investments growth to fall into the negative side at least in 2008.

2.1.6. Government Consumption and Policy

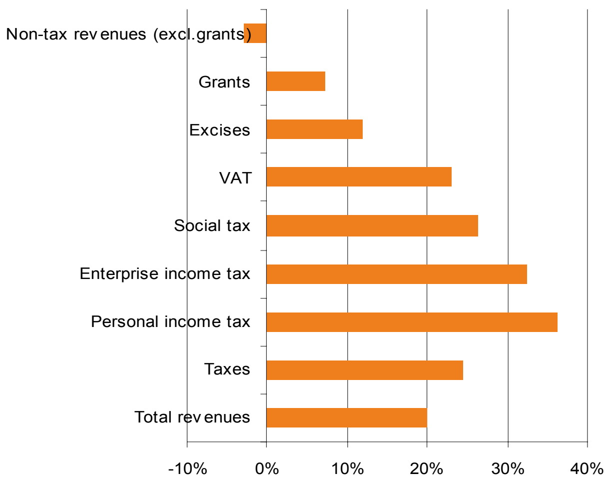
Our estimates suggest that the growth in government final consumption this year will be the biggest for the last 12 years: approximately 4-5%. The strong real growth in consumption has been achieved in spite of very high price growth in the government sector (~15%; increased wages, services prices etc), as tax revenues are very good. Although the monetary transfers from the EU will be relatively small and fall seriously below budget expectations[8],

8 In 9 months of 2007 the inflow has been extremely bad (ca 34.4% of that budgeted) and although inflow may improve in the 4th quarter, we are highly sceptical the fulfilment reaching the levels of previous years (4 year's average 74.6%, worst in 2004 – 59.2%, the best in 2006 – 89.6%).

their impact on government consumption and economic development is quite significant.

The situation is set to change in 2008-2009: we expect quite modest growth of government real consumption, and though in 2008 price growth in the sector will remain strong, it will fall in 2009. Our forecast is based on the assumption that the slowdown in economic growth will have a delayed effect on the budget and government policy.

Annual Growth of Major Revenue Items, 9 months of 2007

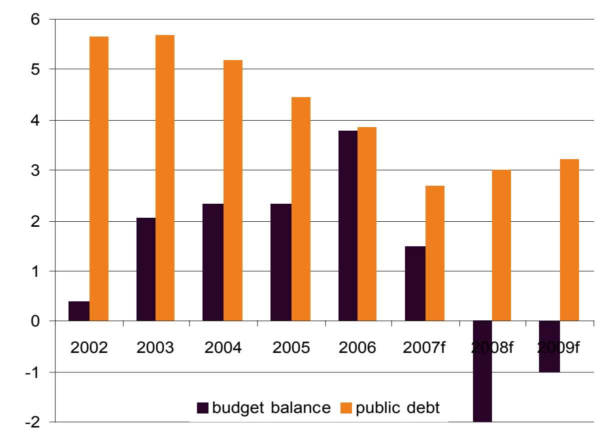


Source: Est MoF: HBM calculations

The economic slowdown and particularly the slowdown in domestic consumption will result in smaller than budgeted tax revenues. Next year's budget plan is clearly too optimistic in forecasting revenues at the level of EEK 96.3bn, incl. EEK 79.4bn tax revenues (this is respectively ~20% and ~17% above our expectations for 2007). The most worrying is the overly optimistic expectation of tax revenues, which builds up base for major spending. We are of the opinion that the government will make necessary adjustments in the budget (probably in summer-autumn) if the revenues start to weaken significantly. But the government's options are quite limited, as significant increases in spending on wages and social payments (e.g. pensions 22%) are planned in 2008. The need of co-financing EU funded projects may force the government to use reserves or take loans. We forecast up to 3.5% of GDP deficit in the state budget and up to 4.5% deficit in general government level. Municipalities will run into serious financial trouble, as regular tax incomes (mostly from personal income tax) will fall, but the borrowing restrictions will away exclude them from big deficits.

We are of the opinion that after a rather optimistic 2008 budget, the 2009 budget will be significantly more conservative, as government will try to bring the budget out of deficit[9] and will limit all wage increases. The pension increase will continue (as it is dependent on CPI and social tax incomes) but at a slower pace, however other social payments will most probably remain flat or grow only marginally. The difficult budgetary situation may force the government shelve planned income tax cuts, at least temporarily. Radical changes in budget spending will bring the budget more-or-less into balance in 2009, but this creates serious setbacks in long-term development, as several serious structural problems will face spending cuts (e.g. support to science, higher education, health and social issues).

General Government, % of GDP



Source: ESA; HBM forecast

We are of the opinion, that despite budget surplus, the government is running quite an expansionary policy and is doing little to limit rising inflation. We do not see the increases of tax rates in the beginning of 2008 as a big threat to inflation as we expect that those increases will be distributed between consumers and enterprises. The extent to which it will be carried by consumers depends on the overall mood and income growth. We see that government's message so far has been that this burden will be laid entirely on consumers, which means that this may actually happen as companies will definitely try to keep their profits, especially if the economic situation starts to eat into their profitability. We do not object to the need to increase the wages of many professions, as for some of them their last wage increase was many years ago and/or very small, and this has started to negatively affect the functioning of society and the economy: but we do object to the overall plans to increase wages in every almost category of public official, including those who already have competitive wages, and the

9 We assume that the government will keep to the general policy line of surplus budgets irrespective of the makeup government.

strong increase of employment in the state sector. We are of the opinion that the increase in wages and employment in central government budget will encourage wage increases in local government as well, but this government level is already too big and inefficient. This would create additional demand and spending and hence allow companies to increase prices, while otherwise we would expect a correction of price levels. There are additional negative effects, including strong pressure on private sector wages, and the stronger negative effect of inflation on the consumption of other consumer categories (incl. pensioners).

Scenario comparisons

	2006	2007f	2008f	2009f
GDP growth, %				
HBM base scenario	11.2	6.5-7.0	5.3-5.7	6.0-6.6
Estonian MoF	11.4	8.1	7.3	6.8
CPI, %				
HBM base scenario	4.4	6.3-6.5	5.0-5.5	3-3.5
Estonian MoF	4.4	6.1	7.4	5.3
Current and capital account, % of GDP				
HBM base scenario	-13.4	-10.5..-11.5	-5..-6	-4.5..-5
Estonian MoF	-13.4	-15.3	-14.3	-13.7
Unemployment, %				
HBM base scenario	5.9	5.9	6.5	6.8
Estonian MoF	5.9	5.3	5.3	5.3
Real wage growth, %				
HBM base scenario	11.2	12.2	8.5	6.5
Estonian MoF	10.9	13.5	7.3	7.5
Budget balance, % of GDP				
HBM base scenario	3.8	1.5	-2.0	-1.0
Estonian MoF	3.7	2.4	1.3	1.6
Public debt, % of GDP				
HBM base scenario	3.9	2.7	3.0	3.2
Estonian MoF	4.0	2.8	2.3	2.0

We would be glad to see a more responsible government spending plan and most of all a responsible attitude and the abandonment of baseless optimism. Having a clear action plan to ensure the rapid response of government policy in the case of adverse economic developments would be a very good signal to economic agents and foreign investors.

2.1.7. External Demand and Balance

Foreign trade turnover has remained low since February, as significant changes in the trade structure have continued and deepened. The fall in turnover is attributable to two commodity groups: mineral products and electronics. In 7 months of 2007 trade in mineral products fell 15% and in electronics fell 28.4% yoy; the overall 7% turnover growth picks up to over 23% if these commodities are excluded. Trade in services has developed surprisingly well in recent months. We are of the opinion that these processes will continue in 2007 and to a lesser extent in 2008.

1. The trade in mineral products is, to great extent, influenced by Russia, and as the political and economic relations between Estonia and Russia are (and will remain) bad, we cannot expect a recovery of those flows. The other aspect is that with the development of its own ports Russia would have taken those cargo flows in 2-3 years anyway. The exports of mineral products have fallen by 14% in 7 months and imports by 16%: the difference comes from Estonia's own mineral resource – oil shale – from which oil is produced and exported. We do not expect trading volumes to recover soon, but the base effect may start to benefit the growth rate in the 2nd quarter of 2008.

2. The trade in electronics has fallen mostly because of one big company (and maybe some smaller ones), which did cheap sub-contracting work for international giants. As labour costs have picked up rapidly and a labour shortage has emerged, the old business line has ceased to be profitable. Electronics exports (and related imports from June 06) have been falling since Sep06 and we expect this to continue in 2007-2008 and probably beyond, depending how successful the company is in finding new and more profitable products to produce in Estonia.

3. Exports of other products have been strong. The rather stable 24.8% annual growth for 2007 indicates that other sectors are not suffering, at least not seriously, from cost growth. Of course some products are more promising than others, but the most risky business area seems to be exports of imported vehicles to Latvia, which may suffer if the economic growth there weakens significantly. Exports' resilience is the result of constant change in the product mix[10].

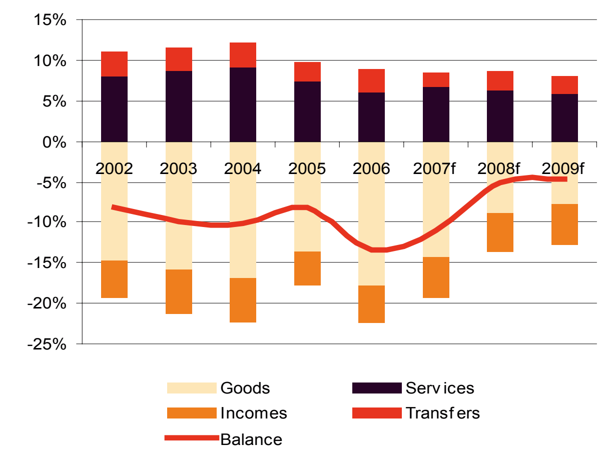
4. As expected, the fall of transit flows has not caused any immediate and significant fall in services exports and imports, but will rather have a belated effect (the preliminary August data show 6.7% growth of services exports and 0.2% fall in imports). We are not surprised that imports have been

10 Probably the best example is the clothing and textile industry. It started with cheap and simple sub-contracting in 90's, faced a fall for many years, but now has some highly sophisticated exporting companies competing well in international markets (in June-July yearly export growth 11.5%).

affected more than exports: several Russian companies (incl. in the transit business) have left Estonia, giving up their market share, sometimes in shrinking business. Also, domestic demand has affected service purchases abroad, while higher prices and political turbulence has reduced the number of Finnish guests[11]. Still, the exports of transport and other services have been strong (20% and 50%, respectively) and although this may take a turn for the worse, we remain relatively optimistic.

We are rather optimistic regarding the exports of goods other than electronics and minerals, but we expect that the slowdown of demand in the EU will affect export growth rates in Estonia. Estonia is most vulnerable to developments in Finland, Sweden, Germany, Latvia and Lithuania. Our forecast may look a bit conservative in that respect, but we are of the opinion that until the uncertainty regarding global developments recedes and Estonian companies show clear restructuring processes (incl. investment in technology) we remain cautious regarding growth in merchandise exports, which we expect to be 7-10% in 2007 and 3-5% in 2008. The same should be said about services exports: while for this year we expect ca 14% growth, for next year we expect rather modest 3-5% growth, as exports of transport may, and tourism services will, fall. There are some other types of services that are about to suffer from higher costs in Estonia (e.g. call centres) and the slowdown of economic activity in neighbouring countries (e.g. business services).

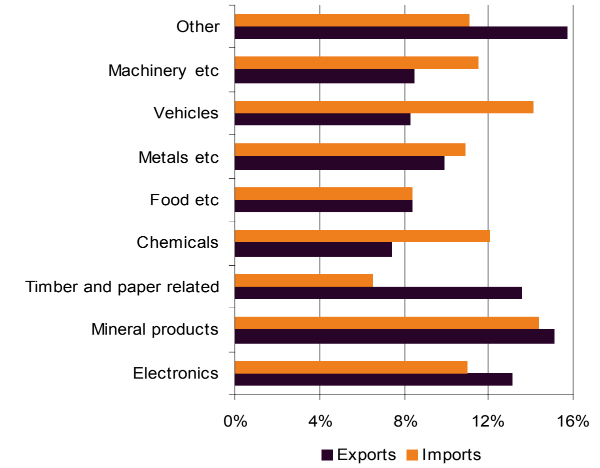
Current and Capital Account Balance, % of GDP



Source: EP: HBM forecast

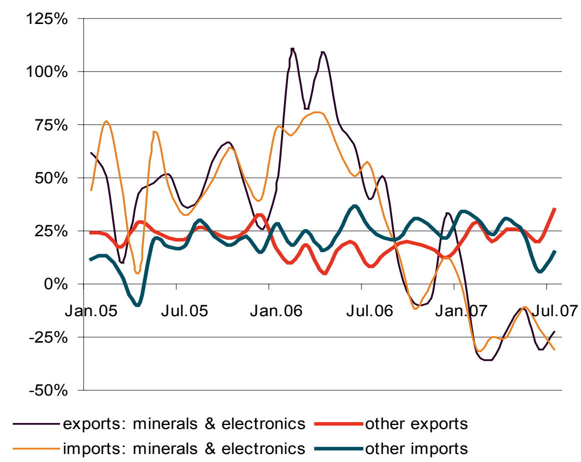
Despite the rather modest growth outlook for exports (~10% this and 3-5% next year), we expect the trade and services balance to improve, as

Structure of Foreign Trade, 7 months of 2007



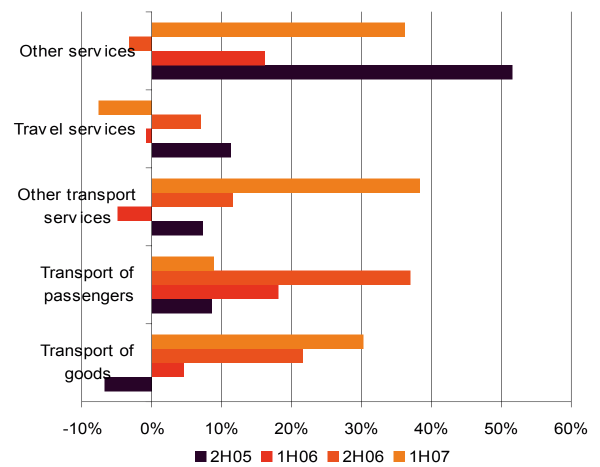
Source: ESA; HBM calculations

Annual Growth of Merchandise Exports and Imports



Source: ESA; HBM calculations

Annual Growth of Services Exports



Source: EP; HBM calculations

imports are about to grow at a lesser rate (~5% growth this and a ~3% fall next year). We are of the opinion that the trade and services balance

11 Finnish visitors account ca 86% of total foreign visitors of Estonian tourism companies and 53% of accommodated guests.

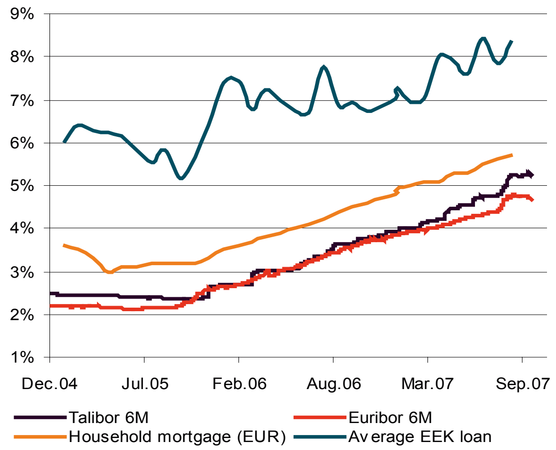
will diminish to 7-8% of GDP in 2007 and to 2-5% in 2008, depending on the seriousness of the economic slowdown (lower growth would mean a smaller deficit). This development will contribute significantly to the improvement of the current and capital account balance. We forecast that it will be ca 11% of GDP in 2007 and 5-6% in 2008 and at an even lower level in 2009. The stronger improvement in 2007 is countered by the extremely weak inflow of EU funds (1.5-2% of GDP), which we expect to improve in 2008. The outflow of income will be rather significant in 2007 (over 5% of GDP), and will fall relatively modestly in 2008-2009 (below 5% of GDP). The high profitability of FDI and growing interest rates (incl. higher indebtedness) will be the reasons behind the relatively high outflow; at the same time inflows suffer from smaller labour outflow, though gets a boost from the profitability of investments.

2.1.8. Monetary Policy and Financial Markets

We do not expect any changes in monetary policy, though we are of the opinion that in the case of really bad economic developments the Estonian central bank may consider of easing monetary conditions. Estonia will be not able to meet the Maastricht inflation criterion in the next few years: although our base scenario forecasts relatively low inflation rates in 2009-10, the comparable inflation rate (i.e. criterion) will be too low for Estonian inflation rates to meet the criterion.

Monetary conditions have gradually tightened throughout 2007 and we expect this process to continue. One thing is that economic processes have weakened in Estonia, but the other and more important factor is that opinions and attitude towards the Baltic countries have turned from being highly positive to cautiously negative and we see this process deepening until there is proof that the Baltic economies can resist the increasing pressure of raising costs and cut current account deficits.

Money Market and Loan Interest Rates



Source: Reuters EcoWin. EP

However, a more realistic attitude might help balance the economy and avoid misbalances in the future. This would help the economy converge faster and in a more balanced way with that of the euro zone. That in turn should help inflation to slow in the more distant future and acquire membership of the EMU. The other way to accession is through serious economic recession with very modest (in Estonian terms) 3-4% economic growth and with 2-3% inflation rates, yet that may mean ~1% budget deficit.

Maris Lauri

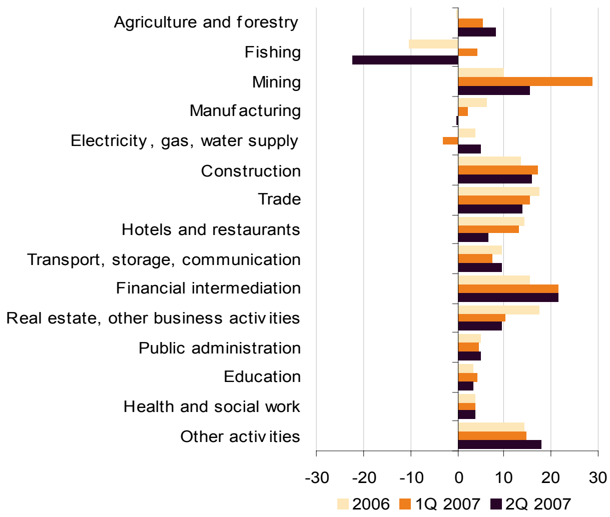
Latvia

1. Recent Economic Developments

The 2nd quarter of 2007 still registered GDP growth of 11% (11.2% in 1Q), but the data undoubtedly shows that the Latvian economy has entered a slowing phase. All major domestic demand sectors saw their growth rates moderate in the 2nd quarter, e.g. construction to 15.9% yoy (17.1% in 1Q), wholesale and retail to 13.7% (15.3%), real estate, renting and business activities to 9.3% (10.3%). Support for domestic demand is weakening and a further slowing of its growth is on the way driven by (see below for details): (i) weaker wealth effects as residential real estate prices continue to fall; (ii) slowing credit growth; (iii) decreasing consumer and business optimism. Strong decrease in the growth rates of imports and retail trade turnover was registered in August. Car sales in September showed marginal annual growth of 6%, down from the whopping 90% in January. We are of the opinion that slowing (to 9-10%) will be seen in the 3rd quarter GDP data.

Internal and external imbalances remain strong however. CPI inflation picked up sharply to 11.4% yoy in September and will rise further in the next few months. The current account deficit showed first signs of growing less than in the 2nd quarter (23.5% of GDP vs. 26.4% in the 1st quarter), but remains at unsustainable levels. The key export sector, manufacturing, declined by 0.1% yoy (up by 2.4% yoy in 1Q), shrinking to the lowest ever at 11.2% of the economy's total value added. Continued stagnation in manufacturing (single digit growth, 3rd consecutive quarter of diminishing growth) is an important risk factor for the success of a soft landing[1]: because of its small size, the external sector may find it very challenging to compensate for slowing domestic demand in terms of income and employment creation. Further tightening of the labour market most recently driven by public sector is most worrying – unemployment further decreased to 5.1% in August and wage growth topped at 33.6% yoy in the 2nd quarter. The latest governmental initiative to limit wage growth in the public sector to cut the wage-price spiral is a welcome proposal, but its efficacy is still to be seen. The overall public mood regarding future developments has recently weakened but remains positive.

Annual GDP Growth by NACE Sectors, %



Source: Eurostat

2. Economic Policy and Anti-inflation Plan

So far the implementation of the anti-inflation plan has been partial, almost entirely focused on measures to reduce overheating by cutting growth in domestic demand[2]. Implementation of the supply-side measures has been weak at best. The plan has been successful in slowing credit growth, lowering secondary residential real estate market prices, and subduing optimism. Acknowledgement must also be given to the banking sector as the slowing of credit growth had begun before the anti-inflation plan measures came into force[3] and to the central bank for its tight monetary policy. Total credit growth shrank from 56.2% yoy in January to 49.3% in August. In May, July and August less credit was issued than in the corresponding months of 2006.

Fiscal policy has, however, remained expansionary and general budget surpluses of 0.4-1% of GDP

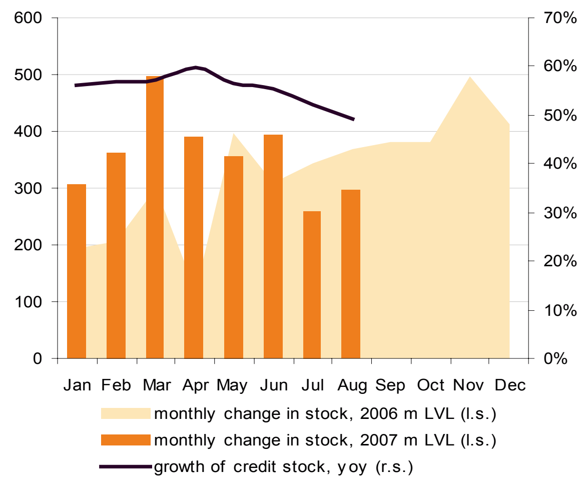
1 Medium term sustainable GDP growth rate is estimated at 6-8% pa. By soft landing we mean adjustment towards a sustainable level during which GDP growth does not dip significantly below 4% (it does not exclude negative growth in certain sectors). Hard landing means about zero or negative GDP growth rates, i.e. recession. GDP growth in the 0-4% interval could be characterised as a "grey area" and it is very unlikely that it would remain there for a prolonged period of time without swinging in one direction or the other. If GDP growth falls significantly below 4%, the negative impact on expectations and real estate prices may become overwhelming and risks of slipping into a hard landing significantly rise, as it may become impossible to support reasonable domestic demand growth. Growth of less than 4% in Latvia was observed previously only following the 1995 domestic banking crisis and the 1998 Russian default.

2 The key measures implemented include: (i) introduced additional taxes on mortgages and car purchases; (ii) 10% down payment for a loan; (iii) State Revenue Service notice is necessary confirming personal income if a loan of above 100 minimum wages is taken, which increasingly credit constrains those with undeclared income. For details see May and July 2007 issues of *The Baltic Outlook*.

3 For instance, *Hansabanka* reduced its land purchase financing activities already in early 2006. The key gain from the implemented anti-inflation plan measures was to put all banks on an equal footing thereby coordinating the slowdown in credit growth.

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.5	7.2	8.7	10.6	11.9	10.2	6.5	7.0
GDP, mln euros	9,911	9,978	11,176	13,012	16,180	20,334	24,255	28,282
GDP per capita, euro	4,238	4,291	4,832	5,655	7,072	8,934	10,713	12,558
Growth of GDP deflator, %	3.6	3.6	7.0	10.0	11.1	14.0	12.0	9.0
Growth of consumer prices, %	1.9	2.9	6.2	6.7	6.5	10.0	9.0	6.0
Growth of harmonized consumer price index, %	2.0	2.9	6.2	6.9	6.6	10.0	9.0	6.0
Growth of producer prices, %	1.0	3.2	8.6	7.8	10.3	18.0	na	na
Harmonised unemployment level, %	12.2	10.5	10.4	9.0	6.9	5.5	5.8	5.8
Real growth of average net monthly wage, %	6.0	7.8	2.4	9.4	15.7	20.0	5.0	6.0
Growth of exports of goods and services, %	8.7	14.4	21.2	31.4	15.3	24.3	18.0	18.0
Growth of imports of goods and services, %	9.1	19.5	26.8	27.4	31.3	27.2	12.0	12.0
Balance of goods and services, % of GDP	-10.0	-12.7	-15.8	-15.2	-22.1	-23.3	-20.0	-16.5
Current account balance, % of GDP	-6.6	-8.1	-12.9	-12.5	-22.3	-25.2	-22.0	-18.0
Current and capital account balance, % of GDP	-6.4	-7.5	-11.8	-11.2	-21.1	-23.5	-20.0	-16.0
Net FDI, % of GDP	2.7	2.4	3.8	3.6	7.4	8.5	6.5	5.0
Foreign gross debt, % of GDP	72.7	79.6	93.2	100.7	112.8	120.0	120.0	120.0
General government budget, % of GDP (ESA)	-2.3	-1.6	-1.0	-0.4	-0.3	0.4	1.0	1.2
General government debt, % of GDP	13.5	14.4	14.5	12.0	10.0	10.2	9.5	9.0

Commercial Banks' Total Credit Growth



Source: FCMC

planned for this year and 2008 are clearly not sufficient. On the supply-side, the government has decided to widen the anti-inflation plan by adding the previously missing detailed description of measures related to exports promotion, labour market, competition policy, etc. to support the transition from domestic demand to exports led growth. By mid December proposals are to be submitted to the Prime Minister by a group of economists and the augmented plan is to be re-branded as the Stabilisation Plan. A Stabilisation Fund is to be created along the lines of the Estonian Stabilisation Fund where budget surpluses are accumulated to be used in bad times.

The swiftness of such supply-side reforms may be hampered by the recent rise in political instability[4]. Short-lived governments are an unfortunate characteristic of Latvian politics, but it has never brought major changes to economic policy as there is broad consensus on the key economic principles among major political parties. The anti-inflation plan has put the economy on the slowing path and we are of the opinion that a soft landing remains the most likely scenario even if the government does not tighten its fiscal policy further and does not implement supply-side reforms efficiently. However, such inactivity on the part of the government would certainly increase uncertainty and the volatility of the slowdown in terms of GDP growth rates dipping lower (i.e., raising the risk of a hard landing) and making any soft landing unnecessarily bumpy.

3. Economic forecast

3.1. Summary of the forecast

In terms of forecasting the situation is very uncertain. The turn in trends is evident in micro level data but not yet in macro data and the initial swiftness of the slowdown is very difficult to assess. We made the following changes to the forecast assuming that growth will turn out to be swifter in 2007 and somewhat slower in 2008 than previously anticipated. We raised the 2007 GDP growth outlook to 9.7-10.2% from 8-9.5% but slightly lowered it for 2008 (from 6.5-7.5% to 6-7%, bias towards the bottom of the forecast range) while retaining 6.5-7.5% for 2009. Hence, economic growth is expected to remain strong. The annual inflation forecast is raised to 9.8-10.2% in 2007, slowing to 9-10% in 2008 and 5.5-6.5% in 2009 (from, respectively 8%, 5.5% and 4.5% initially). As the current level of unemployment is driven by unsustainable wage rises and evidently has dipped below its natural level, due to the cooling of domestic demand we expect it to rise from the average of 5.5% in 2007 towards 6% in 2008 and 2009. The current account deficit forecast for 2007 is raised to 24-26% of GDP (20-22% before), driven largely by still very

4 Recently a few ministers have resigned, but the true test to the current government will be the Parliamentary hearings of the 2008 Budget Law in October-November.

rapid growth in consumption. We expect that CAD will fall gradually to 20-22% and 17-20% of GDP in 2008 and 2009. Perhaps even more than the GDP forecast, CAD is subject to severe uncertainty and swifter improvement is very likely in the case of a sharper than expected overall slowdown, yet the improvement will be held back by large differences in the volumes of imports and exports flows.

We anticipate household consumption growing by 15-17% in 2007 (9-11% before) due to the very high optimism that lasted up to the end of this summer, and wage growth. We expect it to grow by a healthy 5-8% in 2008 and 2009. The real wage growth forecast has been revised to about 20% in 2007 (driven by unexpectedly strong public sector wage growth) and somewhat reduced to 4-7% for 2008 and 2008 due to higher CPI inflation. The gross fixed capital forecast is raised to 11.5-13.5% in 2007 (from 6.5-8.5%), as the 1st half of 2007 has been very strong. For 2008 and 2009 the revised forecast is 4-7% (before 3.5-4.5% and 4.5-5.5% respectively), which is only a widening of forecast range due to higher uncertainty. The forecast for growth in government consumption has been raised for all three years to 4-5%, 2-4%, 2-4% for 2007, 2008, 2009 (from 2-3%, 1.5-2.5%, 1.5-2.5%) as currently we do not see political will to limit spending growth more strongly.

This is our base or soft landing scenario. The success of soft landing depends upon businesses' ability to improve their productivity by reducing their labour dependency and moving their product mix up the value added chain. Regarding fiscal policy, we assume fiscal tightening to the degree set out in the 2008 Budget Law draft. Successful implementation of supply-side reforms would improve the scenario. The hard landing scenario assumes a more abrupt decrease in economic activity with very low or negative growth rates and an across-the-board real estate crash.

We see the following key risks for the negative scenario to ensue:

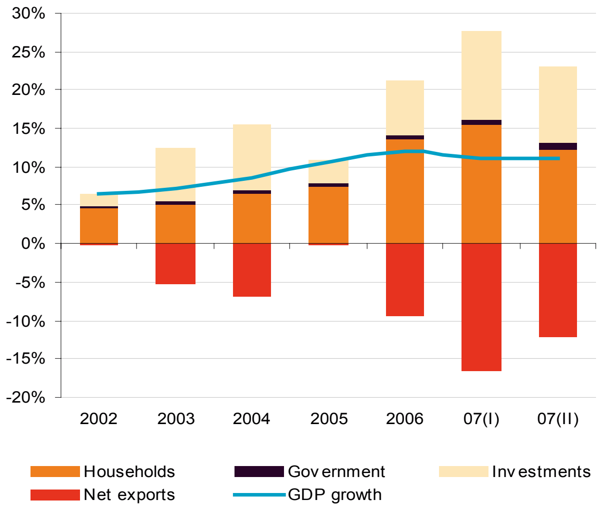
1. Contraction of domestic demand is too swift through:
   - an abrupt slowdown of foreign financing inflows and/or rapidly rising cost of external financing, reacting to unfavourable macro data where the slowing is not yet seen (data is published with a delay);
   - sharp rise in pessimism and unwillingness to invest in a real estate market leading to sharp contraction in construction, related sectors and income from realised capital gains abruptly cutting consumer spending
2. An extended recession in the EU driven by a hard landing in the US (see General Assumptions).
3. A sharp slowdown in neighbouring Baltic economies (e.g. ensuing abrupt slowdown in Estonia) induce trade and sentiment contagion.
4. Reversal of favourable trends in the terms of trade.

We do not see a significant possibility of a speculative currency crisis, as financial markets are thin and sealed off by the central bank. The probability of a soft landing has somewhat diminished since our previous report this summer in view of the recent further widening of internal and external imbalances and negative global developments, but the soft landing scenario still has a higher probability than the negative one. Even under the soft landing scenario certain sectors (like construction, real estate and certain retail trade sectors) are expected to suffer from sudden swings in demand.

3.2. Domestic Demand

Growth remains unbalanced and predominately driven by domestic demand. The momentum of domestic demand, however, is starting to wane – in the 2nd quarter of 2007 its growth ebbed to 18.1% yoy from the historic high of 21.4% the quarter before. Significant slowing was observed in both private consumption and investment, and only general government consumption expenditure registered a pick up in annual growth rates. We may still see brief outbursts of activity and hikes in growth rates in the next few quarters, but the overall trend for domestic demand growth is decreasing being driven by moderating optimism and moderating credit growth. We anticipate domestic demand growing by 13-14% in 2007, and a solid 5-7% in 2008 and 2009.

Contributions to GDP Annual Growth, pp

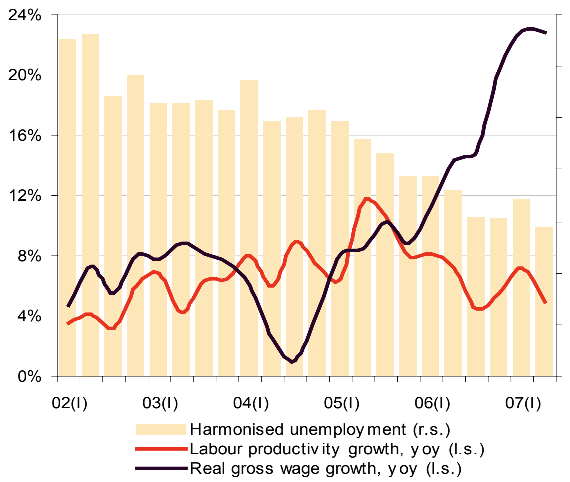


Source: Eurostat

3.2.1. Labour Market

In view of rapid economic growth and high optimism, the labour market has tightened further. In the 2nd quarter of 2007 employment reached the highest ever mark of 1,108 th with growth picking up to 3.4% yoy (2.6% in 1Q; 4.9% in 2006). This is somewhat above our 2.5% target for the whole of 2007 but still within the forecast range. Employment has grown both via higher participation rate and falling unemployment. The participation rate in the age group 15-74 rose to 65.3% from 64.5% in the 1st quarter. Harmonised unemployment shrank to 5.8% in the 2nd quarter from 6.9% the quarter before. Officially registered unemployment (available monthly) has decreased from 6.5% in January to 5.1% in September; in Riga from 3.8% to 3.3%. Unemployment in Riga is certainly below its natural rate and given that nearly half of GDP is produced there, the labour market is very tight and this spills over into wage growth.

Labour Market Indicators



Source: LCSB, Eurostat

In the 2nd quarter of 2007 nominal net wage growth accelerated to 33.7% yoy (real net wage up by 23.1%) from 32.9% in the 1st quarter. Although average labour productivity growth was at a healthy 4.9% yoy, the wage-productivity gap widened further. The state was the key driver of wage growth: the private sector registered 33.3% wage growth, whereas the public sector registered 36.6% (state budget-funded institutions above 40%). As private sector statistics are exaggerated by legalisation of previously undeclared income, the divergence in the public/private sector wage growth is more striking[5]. The public sector also exerts pressure on the labour market via high vacancy rates (e.g. 5.2% in public administration and defence, which is by far the highest among all sectors). It is praiseworthy that in the 2008 Budget Law draft the government has finally taken steps to limit public sector wage growth, yet we do urge the government to proceed swiftly in improving public sector efficiency by reducing its employment as set out in the anti-inflation plan. A gradual unwinding of the labour market via easing public sector pressure and moderating overall optimism is the key to ensure soft landing. Further simple across the board wage growth in the public sector along with maintained pressures via vacancies would destabilise the situation by further sapping export sectors of their competitiveness, i.e. the mismatch between demand and supply side would be exacerbated further thereby raising the risks of a hard landing.

Taking into account unexpectedly strong wage growth and the still tightening labour market, we raise the real net wage growth forecast for 2007 from 8-10% to 20–22%. Wage growth in 2008-2009 is expected to be in the range of 4-7% (6-9% previously) and will support growth in consumption. We retain the earlier nominal wage growth forecasts and the decrease is due to higher inflation. We maintain earlier forecast of harmonized unemployment for 2007 at 5.5% on average (approaching 5.2% late in the year). Although labour markets will remain tight and the natural rate of unemployment has fallen[6], it has become clear that the natural rate of unemployment is considerably above 5%. As economy cools off, unemployment is likely rise[7] towards 6% (previously 5-5.5% in 2008 and 4.8-5.2% in 2009). It must be mentioned that the tight labour market has indeed lowered the natural rate of unemployment in Latvia. People who were earlier considered unemployable have enjoyed a window of opportunity to gain experience after long periods of idleness, to get rid of bad social habits and become more self-confident. Despite that, the current very low level of unemployment is at least partly determined by unsustainable wage rises[8].

3.2.2. Household Consumption and Incomes

Over the 2nd quarter of 2007 household consumption grew by 18.5% yoy – a moderate slowing vis-à-vis the 20.5% of the 1st quarter and second consecutive quarter of falling growth rates. As before, spending

5 *Remuneration survey 2007* by company Fontes done in June 2007 suggests that actual wage growth in the private sector has been about 20% yoy.

6 E.g. due to retraining, rising labour mobility.

7 Driven by structural employment, e.g. domestic demand industries may start to shed employment but export sector may not be able to absorb them entirely. Our earlier forecast included stronger emigration forecast, which seems to have considerably slowed in 2007. Further structural reforms are expected to boost activity rates (Lisbon target for 2010 at 67%) while not all of them may be able to find a job.

8 This is particularly visible in Riga where we see 3.3% unemployment and number of vacancies extending above those unemployed.

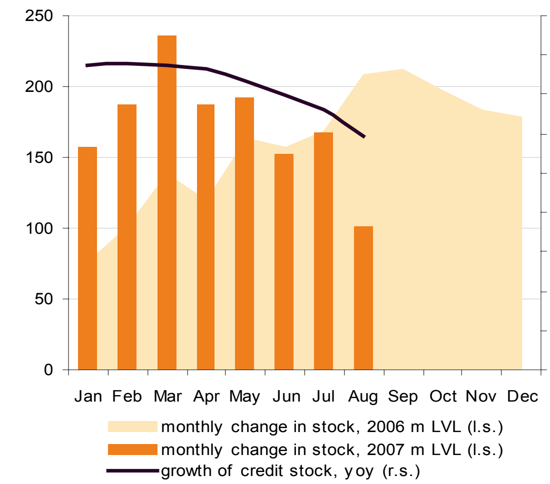
was driven by the strong employment and wage growth, rooted inflationary expectations and the inertia of high optimism and credit growth. Although slowing further, household consumption will remain strong reaching 15-17% in 2007 (revision from 9-11% due to stronger than expected inertia and income growth driven by the public sector). The forecast for 2008 and 2009 is widened to 5-8% (6-8% before) to account for downside risks.

Leading indicators suggest that over the summer consumers have become more cautious and/ or credit constrained, hence a further cooling of demand is to come.

- First, residential real estate prices have been falling since May this year by 1-3% mom[9] and some further correction is expected due to consumers being priced out by earlier swift price growth, being more credit constrained[10] and/or delaying their purchase due to higher uncertainty[11]. These negative wealth effects finally start to kick in reducing households' future expected wealth. Given that most residential sector deals are those in the secondary market of Soviet era dwellings, purchase delay means less funds channelled into consumption (i.e. most of such proceeds are directly available for consumption as dwellings typically have been obtained via privatisation and do not incur costs; it is not so for new developments where e.g. construction costs must be covered).

- Second, slowing credit growth due to the anti-inflation plan measures (e.g. credit constraints on those with undeclared incomes, tax on additional mortgages), banks' more conservative credit policies, the sluggish real estate market and higher interest rates limit funding inflow into consumption. Although the high lats interest rates are circumvented by borrowing in the euro, those rates have been rising too. Consequently, household credit growth has slowed from average 4.2% mom in the 1st quarter to 1.8% mom in August. In every month since June households have borrowed less than in the corresponding month of 2006.

Loans to Households

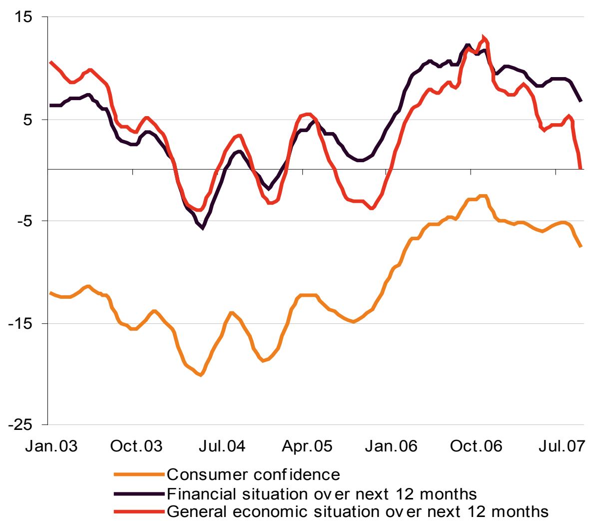


Source: FCMC

- Third, after a brief improvement in June, consumer confidence has been declining, signalling that consumers are likely to reduce their spending growth. Consumers have become less optimistic regarding their financial position and the general economic situation in the country. The government's initiative of limiting public sector wage growth aimed at breaking the wage-price spiral is an additional factor to tame optimism. Business confidence indices show a clear downward trend, too.

- Fourth, inflation in coming months will increasingly bite into consumers' budgets reducing their spending power. Demand is also expected to ease as consumers brought forward their spending before the implementation of the anti-inflation plan in anticipation that

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



Source: Eurostat

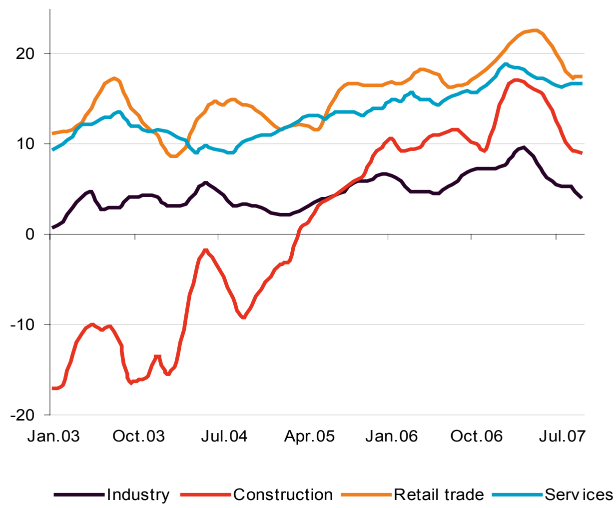
9 Cumulative drop of 10-15%; by October the level of late 2006 was reached. The number of deals made has about halved vis-à-vis late 2006/ early 2007. So far price decrease has been largely contained within the secondary market and thus developer/ construction businesses have not been affected.

10 As of July 10, borrowers must obtain the State Revenue Service notice on their taxable income if their loan exceeds 100 minimum wages (LVL 12 000). Thus, households with undeclared incomes are increasingly credit constrained.

11 Be it unsure of their future income or gambling on further real estate price decreases. Expectations of further price decreases are likely to become an important risk factor, as it may stall the market, see e.g. Estonia. Given that mortgages have been one of the key sources of credit inflow into the economy, sudden shut down of this channel due to consumers unwilling to borrow has a potential of abruptly cutting domestic demand growth and increasing risks of hard landing.

certain goods/ services would become more expensive – this upsurge must be followed by lower demand.

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



Source: Eurostat

Decreasing growth of retail trade turnover (constant prices) to 19.1% yoy in August from 24.7% in July (24% in 2Q and 28% in 1Q) is a good indicator of slowing consumption growth. New car registration is perhaps the most striking early indicator, as it reflects purchases of largely luxury goods that suffer most during slowdowns – in September yearly growth had shrunk to 6% from 90% in January 2007.

While its growth will decelerate, household consumption will remain strong.[12] The key factors to support it are: inertia, the approaching Christmas season, transfers from emigrants[13], income growth due to tight labour market and bonuses due to excellent 2007 profits, slower but still relatively strong public sector wage growth[14], and households reducing their short term savings propensity. The slowing will become steeper from the 2nd quarter of 2008 as the inertia of 2007 will start to fade, inflation takes its toll and labour markets ease up in some segments. Consumption growth is anticipated to stabilise at a solid 5-8% in 2008 and 2009 being closer to the lower edge of the band late next year and then gradually rising.

12 The current strong financial situation is supported by very low share of non-performing loans (see Financial Stability Report published by the Bank of Latvia)

13 It is estimated that they add up to about 2 % of GDP.

14 The 2007 Budget Law draft suggests public sector nominal wage growth at just above 15%. Private sector seems to expect to raise wages by 10-15%, which will be boosted somewhat by 2007 bonus paid out in the early 2008. Of course, in certain sectors such as real estate intermediation, retail of luxury goods or low skilled construction wages are even likely to decrease.

3.2.3. Investment

The slowing of investment growth was more pronounced than that of consumption – gross fixed capital formation grew by 14.4% yoy compared with 17.9% in 1st quarter of 2007. It was the weakest growth since 2003, but still exceptionally strong. Albeit positive, change in inventories was minute, and unable to prop up total investment activity. Hence, gross capital formation growth decreased to 22.5% yoy from 29.1% in the 1st quarter. Due to exceptionally strong investment activity early this year, we raise the 2007 real gross fixed capital formation growth forecast to 11.5-13.5% (from 6.5-8.5%). For 2008 and 2009 we retain the earlier forecast of 4-7% pa.

Breakdown by NACE sectors is available for non-financial investment reported in current prices. Although the data is not strictly comparable (deflators certainly differ across sectors) and very volatile, a few conclusions can be drawn. Following the growth of 60-90% yoy in 2006 and 43% in the 1st quarter of 2007, non-financial investment in the real estate, renting and business services sector decreased by 8.9% in the 2nd quarter. In contrast, after virtually zero growth in 2006 and a 6.3% decline in the 1st quarter of 2007, investment in manufacturing grew by 100% yoy in the 2nd quarter. Investment in construction and domestic trade in the 1st and 2nd quarter remained relatively robust at 70% and 30% yoy. This data reflects investment decisions made long before the anti-inflation plan was adopted, and implies that businesses have been redirecting their investment to sectors that may enjoy less volatile growth during the slowdown phase. We see companies increasingly investing in reducing their labour dependency and improving the value added of their product mix.

The overall slowing of investment growth will continue. Investment will shrink below the current levels in sectors that gained most during the period of exuberant optimism such as retail sales of passenger cars, residential real estate, and production of building materials. In sectors serving everyday consumption such as food retail, investment growth will be subdued but is likely to remain positive. Investment in the construction sector will retain its vitality as the industry is expected to shift towards commercial and infrastructure projects but the transition may not be smooth and immediate – reallocation of resources always involves high costs and timing mismatches. Investment in agriculture, forestry and in exports and related industries (e.g. transport[15], wood processing, and metal industry)

15 Most transport businesses serve EU-Russia trade flows that are to expand. One factor boosting demand for long-haul vehicles is the way licences are issued - we expect the number of them to increase, which encourages companies to invest in new

is set to be the major driver of investment activity mainly constrained by their ability to generate sound ideas and absorb the available funding.

Investment growth is expected to remain strong supported by various sources. Companies' are in a strong financial situation, and excellent profits of 2007 are most likely to be reinvested rather than withdrawn. Despite negative information background due to overheating, we see strong interest by foreign investors in Latvian companies. Household income growth will support spending and thus we expect businesses to invest in widening their activities. Banks are becoming particularly active in lending to export industries and industrial leasing has grown dramatically and the growth plans are ambitious. In 2008 EU funds from the new budget period of 2007-2013 are likely to become available; they are larger than before (about 4% of GDP annually) and the rules regarding their distribution are being adjusted in favour of innovation and export driven growth. Public investment (e.g. public administration, education, health; about 18% of total investment) will remain strong. Given strong cyclicality of investment as well as the delayed inflow of EU funds, it is possible that in late 2008 investment may slip below the forecast interval of 4-7%, but will thereafter improve.

3.2.4. Government Consumption

Fiscal policy has become more expansionary as the real final consumption expenditure of the general government grew by 5.7% yoy from 4.5% in the 1st quarter (4% in 2006) reflecting growing current expenditure (particularly wages). Although this expansion was predefined by the 2007 Budget Law passed nearly three months before the anti-inflation plan (accepted respectively on 19 December 2006 and 6 March 2007), the government was not swift to follow up with reforms in public spending. As a result of strong economic activity revenues grew by 32.8% yoy in 8 months of 2007 (66.9% of the annual plan); expenditures grew by same 32.8% (56.4% of the plan). Current expenditures were about as planned (59.5% of the plan), whereas capital expenditures remained low (38.8% of the plan). By the end of August the general government budget had accumulated a surplus of LVL 347.6m (i.e. 2.5% of forecast annual GDP). To tighten the fiscal stance, in September the 2007 budget was revised to end with a surplus of 0.4% of GDP instead of the planned 1.4% deficit. It will be achieved not by reducing expenditure (in fact, expenditure was increased by 131m LVL or 0.9% of GDP) but thanks to better than planned revenues. It is likely that the year is concluded by somewhat higher surplus than 0.4% of GDP, as by the end of September the surplus had increased by 3.6m LVL.

General Budget, Annual Growth Rates %

	2005	2006	9m 07	2007*
Net revenues	26.7	25.7	31.3	23.2
Tax revenues	26.3	30.3	36.7	21.6
Personal income tax	16.9	29.1	36.0	16.0
Social tax	17.1	28.1	38.9	14.4
Corporate income tax	41.3	40.5	59.0	31.5
VAT	39.1	37.4	32.8	33.0
Excises	31.2	16.6	26.1	18.5
Customs	12.2	7.6	39.2	7.8
Non-tax revenues	19.3	13.1	27.8	9.4
Net expenditures	25.7	24.4	33.2	24.8
Current expenditures	33.8	23.3	18.6	23.6
Capital expenditures	31.3	63.1	35.6	21.5
Budget balance, % of GDP	-0.4	-0.3	2.5	-0.4

*budget plan

Source: State Treasury, State Revenue Service

From next year onwards, 3-year medium term budgeting is being introduced. A draft submitted to the Parliament in October suggests a tightening of fiscal policy, as general budget surpluses are to be raised to 1% (initially planned 0.5%) of GDP in 2008[16], 1.2% (0.6%) in 2009, and 1.5% (0.8%) in 2010. Akin to that of 2007, the 2008 surplus is, gained on the account of Social Security and municipality budgets while the Basic budget is still in deficit at about 2% and 0.5% of GDP in 2007 and 2008, respectively[17]. Extra tightening in 2008 is largely obtained by limiting public sector wage growth – no doubt a necessary move to stop the wage-price spiral, but not sufficient. Sticking only to wage measures is a risky strategy: (i) if the economy slows faster than expected, the budget will be put under heavy pressure as tax revenues fall but current expenditures (including wages) form about 91% of the basic budget (e.g. after the 1998 Russian crisis, general government consumption expenditure soared by 13.2%); (ii) in the absence of a strong social contract, trade unions may force the government to soften its stance on wage growth if economic activity remains favourable. The shortcomings of such a strategy are already showing, as the government already seems giving

trucks. To avoid extensive bottlenecks on the Russian border, railways are likely to take over some of the flows, which will mean additional investment. It is still difficult to estimate its size, but Russia redirecting its trade flows away from Estonia in response to political "freeze" in May 2007 has redirected some of the transit flows to Latvia and sizeable investments to serve them are shortly pending.

16 Total revenues forecast to grow by 21%, expenditures by 19.2%. Revenues are planned with a good safety margin, assuming 7.5% real GDP growth and 6.3% inflation. Given the unreasonably low inflation forecast, even stronger slowing of GDP growth may not automatically result in deficit unless there is heavy expenditure growth.

17 In brief, general government budget consists of (i) central government budget comprising Basic budget and special budget of Social Security and (ii) budgets of municipalities.

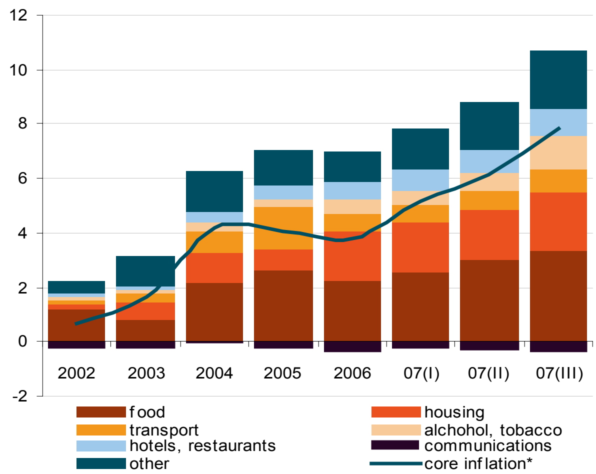
in to trade union pressure. Larger surpluses must be aimed for and current tightening measures must be supplemented by structural reforms improving public sector efficiency, e.g. shedding its employment, and outsourcing some of its functions to the private sector.

We expect general government final consumption expenditure for 2007 to grow by 4-5% (close to the top of our forecast range), reflecting a more expansionary fiscal policy than a year ago. In 2008 and 2009 fiscal policy is expected to turn more restrictive and government consumption is expected to grow by 2-4%. It is above the previous forecast of 1.5-2.5%, as the fiscal tightening and restructuring has been weaker than expected. Undoubtedly, a more restrictive fiscal policy is needed. Without the active participation of the government both in slowing the growth of domestic demand (particularly improving public administration efficiency[18]) and strengthening the supply-side (particularly exports) any soft landing may become bumpy indeed.

3.2.5. Inflation

We underestimated the stubbornness of price growth. In September inflation picked up to a record high for the past ten years – CPI grew by 11.4% yoy and 1.9% mom. Average annual inflation rose to 8.2%. Core inflation (i.e. excluding direct effect due to fuel, administratively regulated prices and unprocessed food) climbed to 10.1% yoy comprising 7.7pp of the total CPI. Although global effects such as oil and grain prices have certainly contributed, strong domestic demand and the wage-price spiral are the key drivers[19]. Price growth of goods reached 10.1% yoy whereas that of services reached 14.9%: the difference to some extent being explained by services typically being non-tradables where overheating effects are priced in more easily due to weaker foreign competition than that for goods which typically are tradables. Of product groups a traditional strong inflationary factor was the excise tax on tobacco due to EU tax harmonisation adding 1.01pp to annual inflation. The swift increase in the price of grain caused exceptionally high growth in prices of grain products (adding 0.93pp to yoy inflation), and meat products (0.89pp). Given that grain prices globally have more than doubled over the last year, the full effect of these global shocks is yet to be seen and price growth of principle foodstuffs will remain an important inflation driver this winter. Housing expenditures contributed 2.2pp, of which administratively regulated heating energy (driven by Gazprom raising its natural gas delivery price to Latvijas Gaze and rising oil prices globally) added 0.8pp. Catering services contributed 1.05pp.

Contributions to CPI Annual Grow th, pp



* HBM estimate for 3Q 2007
Source: LCSB, LaB

Producer price inflation reached 15.5% yoy in September (16.8% year average so far; 10.3% in 2006). The price growth of goods sold in the local market accelerated to 18.9% yoy, while those of exports slowed to 10.8%. Such a difference in prices of locally sold and exported goods is yet another indicator that producers are using their pricing power to raise prices on the back of strong domestic demand.

CPI inflation will remain strong into the early 2008. A number of "usual suspects" of which we wrote at length in the May issue of The Baltic Outlook will continue to be important factors behind the price growth. For instance, Gazprom is expected to raise natural gas delivery price by about another 40%, also tobacco excise will be raised. Inflation expectations are strong – about 90% of respondents expect that over the next year consumer prices will increase at least as fast as over the past 12 months, which will keep up the self-fulfilling element of inflation. Producers and retailers have warned that prices of grain products will be raised by 5-35% in October in response to the global increase in grain prices – if a midpoint of 20% is taken, this single effect will contribute close to 1pp mom inflation in October. In view of factors like this and spill-overs into other product groups through inflation expectations, there is a risk of inflation hitting the 14-15% mark late this/ early next year. In the 2nd and 3rd quarter

18 Of course, average wage levels are still very low in certain public sector segments (e.g. health care, interior affairs) and further increases are necessary, but it must be complemented by reforms boosting efficiency, which would permit capping government spending growth at relatively low rates.

19 *Remuneration survey 2007* by company Fontes provides evidence of this. When asked what will be the likely effect on their profits from them raising employee remuneration, 47.8% of respondents chose to answer that their profits will grow, 38.4% chose to answer that their profits will not be affected and only 13.8% of respondents chose to answer that their profits will decrease. This clearly shows that businesses can easily pass their costs on to consumers perhaps due to high overall optimism, high inflationary expectations and weak competition.

of 2008 inflation is anticipated to start slowing as the economy cools off[20] and most of major planned administrative price increases have been made. Average annual inflation for 2007 is forecast at 9.8-10.2% and 9-10% for 2008. For 2009 we expect that the average inflation will reach 5.5-6.5%.

3.3. External Balances

The current account deficit growth slowed in 2nd quarter, and the level of the deficit was 23.5% of GDP (26.4% in 1Q). The development was brought about by the positive efect in goods and services trade (21.7% vs. 24.1% of GDP) and the healthier surplus of current transfers (3.1% vs. 0.4% of GDP). As anticipated, in the 1st half of 2007 external imbalances, however, widened vis-à-vis those of the corresponding period of 2006, as CAD reached 24.8% of GDP (17.7% in 1H 2006). The major cause of this is goods imports.

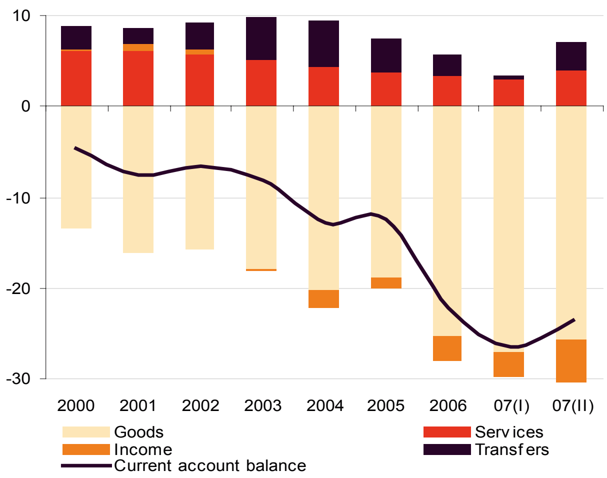
Preliminary data for August shows a solid, long awaited and welcome decrease in goods and services imports growth to 13.3% yoy (the weakest since April 2005; 7-month average growth was 33%) thus reducing monthly CAD growth to 3.6% yoy compared to average growth of 84% in the first 7 months of the year. It is too early to say how persistent this slowing will be, but it is certainly the beginning of a downward trend. In contrast, exports annual growth has remained strong, fluctuating in the neighbourhood of 20%.

For 2007 we expect imports and exports of goods and services to grow by 26-28% and 23-25% respectively, which corresponds to CAD of 24-26% of GDP. In 2008 and 2009 we expect further moderation of imports growth to 10-14% and still strong exports growth of 16-20%, thus CAD will decrease gradually to respectively 20-22% and 17-19% of GDP. This will mean further worsening of the net foreign assets position from -70% of GDP in 2006 to about -90% in 2009, which is high but not extreme internationally[21]. These imports contraction estimates are relatively gentle and could easily turn harsher (e.g. if the economy slips in its GDP growth rate below 6% p.a.), and therefore CAD may improve swifter than has been suggested here.

3.3.1. Foreign Trade

Goods export expanded by 23% in 8 months of 2007 – nearly twice last year's growth. Expansion into the EU15 markets increased to 12% (4.6% in

Current Account, % of GDP



Source: LaB

2006) and high growth was maintained in CIS markets (36.4% vs. 32.3%). Further specialisation and concentration is seen in transport vehicles and accessories (up 41%), chemical products (34.9%), machinery and equipment (32.5%), metal products (27.2%), and wood products (23.8%) as they enjoyed the swiftest growth and their shares in total exports strengthened. Except for mineral products, all commodity groups registered positive annual growth. Export of services picked up by 20%, which is virtually the same pace of growth as last year.

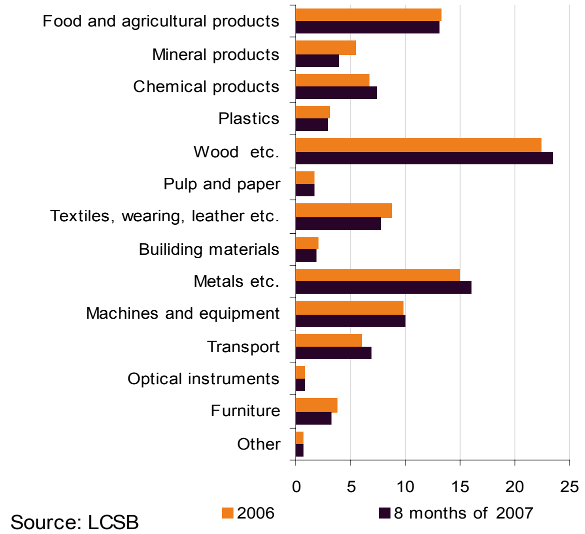
We expect export growth to continue at around the current rates until the end of the year and sustain a strong (but somewhat slower) pace into 2008 and 2009. We see the potential for industries' to boost their output, value added, and export shares in their output. For instance, the wood industry association (23% of total goods export) aims to double the value added it obtains from a cubic meter of timber within 5 years. Though it sounds and is ambitious, it is a realistic target as current level of value added in the production is low. The sector has been investing heavily to reduce labour dependency, boost production capacity and reach into higher value added products (e.g. two large plants *Verems* and *Bolderāja Ltd* came into operation this summer specialising in plywood and chipboard production; work at full capacity expected by 2009). Reportedly, high domestic demand had made companies reduce the exports' share to 60-70% of their sales, which is now being moved back towards 80-90%.

The dynamics of imports forecasts a solid cooling of consumer spending. In 8 months of 2007 goods imports growth remained largely at the level of 2006 (30.5% vs. 32.5%, respectively), whereas services imports grew almost twice as fast (29.9% vs. 16.9%). Of goods, the fastest growing were imports of wood (75.2%), furniture (40.3%), transport

20 It relates to effects like weakening demand and inflation expectation factors, strengthening competition and diminishing Balassa-Samuelson effects as economic growth moderates, etc.

21 E.g. in 2006 net foreign assets reached -116.8% of GDP for Hungary, -109% for Estonia, -97.4% for Greece, -53.1% for Lithuania. The 2005 average for EU 12 was -46.7%.

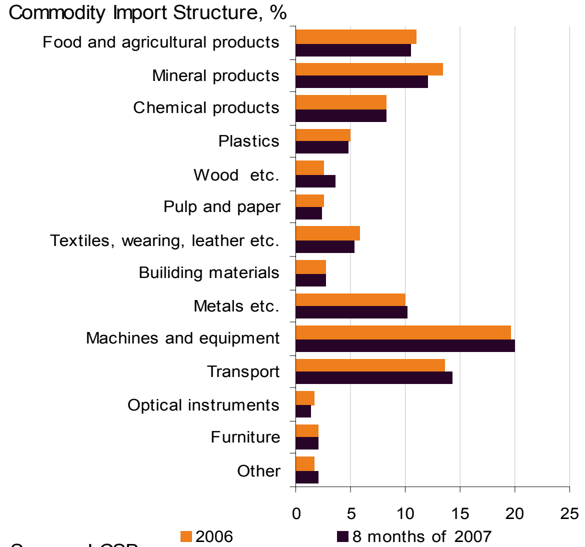
Commodity Export Structure, %



Source: LCSB

vehicles (38.3%), and machinery and equipment (37.1%). While cautious slowing of growth in certain product groups has been seen since the 1st quarter, all groups have so far registered positive volume growth. The first solid sign of the economy slowing was seen in August when a sharp drop in growth of imports of goods (to 12.7% yoy from 39.8% in July) and services (to 16.9% from 26.2% in July) was registered. Growth of imports of transport vehicles dropped from 47.8% yoy in July to 5.5% in August and imports of household electric appliances from 33.5% in July to 7.4% in August.

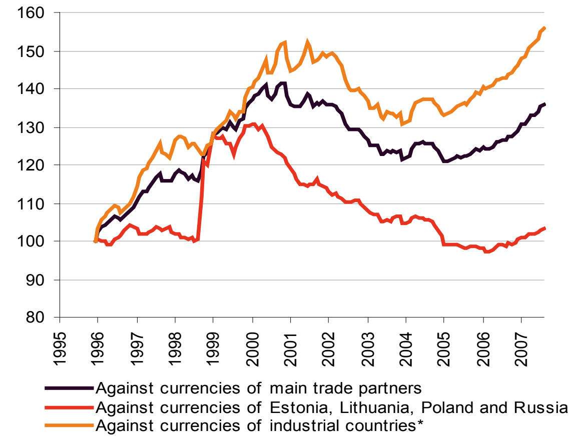
Commodity Import Structure, %



Source: LCSB

Though a rebound is likely to follow, the cooling will continue. We expect imports growth to slow particularly strongly in 2008 and retain subdued growth rates in 2009. The slowing is to come through weaker investment and household consumption, whereas strong exports growth will boost imports. For instance, luxury goods[22] form about 14% of total imports. With consumption starting to decelerate, these would be the most likely to fall substantially; their growth has already been slowing from 55.6% yoy in the 1st quarter to 35.3% in the 2nd quarter of 2007 (still above the average growth rate of imports, though). Given their considerable share in imports, a 50% drop in volume of luxuries would permit the rest of imports to grow by 10% and growth of total imports would still remain at zero percent. Hence the current structure of imports includes relatively flexible possibilities for the adjustment of CAD.

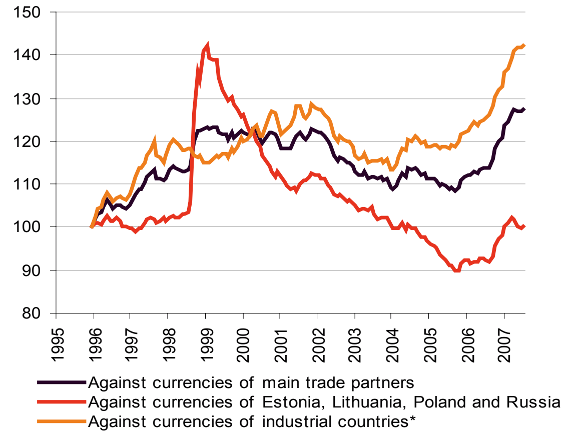
Real Effective Exchange Rate of the Lats
(CPI-based, index: December 1995=100)



*Denmark, UK, Sweden, USA, Finland, France, Germany, Italy, Netherlands

Source: LaB

Real Effective Exchange Rate of the Lats
(PPI-based, index: December 1995=100)



* Denmark, UK, Sweden, USA, Finland, France, Germany, Italy, Netherlands

Source: LaB

Any improvement in CAD, of course, also depends on strong exports growth. Rising PPI has translated

22 By "luxuries" we understand the following goods: private motor vehicles and accessories (about 70% of all luxuries), household domestic appliances such as electrical equipment (about 25%), pieces of art and antiquities, jewellery and bijouterie, selected alcohol. These are not luxuries in the narrow sense but rather non-primary goods, the purchase of which can be, by and large, postponed (for more details see May 2007 issue of *The Baltic Outlook*).

into real exchange rate appreciation, making exports less competitive in foreign markets and rising CPI has translated into real exchange rate appreciation, making imports more competitive in home market. The current levels of real effective exchange rates are about the same as in 2000 and are perhaps still manageable, but sustained further raises will certainly hurt competitiveness[23].

3.3.2. Income Account, Current and Capital Transfers, and FDI

In the 1st half of 2007 the income account deficit rose to 3.8% of GDP (3.0% a year ago) due to the increasing outflow of income. The capital account surplus reached 1.4% of GDP. The combined current and capital account deficit rose to 23.5% of GDP (16.2% a year ago). Although net FDI rose to 9.8% of GDP from 9% in 1H 2006, CAD coverage decreased to 39.7% (50.6% a year ago) due to wider CAD. The rest is covered by banks' foreign borrowing.

FDI has not directly supported the exports sectors, as 40% of it was invested in financial intermediation, 20% into real estate, renting and business activities, while only 7% went into manufacturing[24]. The share of reinvested earnings decreased to 15.7% of FDI (41% in 1H 2006) driven by the withdrawal of almost all earnings in the 2nd quarter. This is not to be taken as an ebbing of confidence, e.g. in the 2nd quarter of 2005 along with booming optimism, funds were withdrawn 20% above the profits made.

The structure of FDI, however, shows that in financing its CAD the economy is too dependent on the banking sector, i.e. adding direct borrowing and investment into their capital bank flows account for close to 80% of CAD financing. An abrupt rise in the cost of funding and following drop in the volume of foreign inflows is the key risk to the soft landing scenario as it would swiftly contract domestic demand leaving small if any room for a manoeuvre.

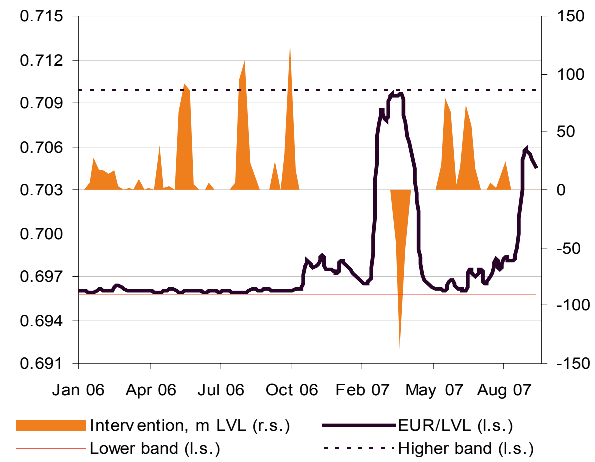
The funding cost has become higher due to both rising risk aversion globally and investors becoming increasingly sensitive the negative macro data flow on Latvia. As we wrote in our May report, the data will get worse before it gets better. It got worse and over the summer we saw only negative news coming out as the economy continued to move along the overheating path driven by inertia. Our analysis shows that the economy has turned towards slowdown and the macro data flow is to become more balanced and supported by positive news.

The risk of further rising funding cost, however, remains. Yet we do not see the risk of such cost become prohibitive for a soft landing. An important stabilizing factor here is the structure of bank ownership, i.e. largest banks are typically foreign owned and will have access to funding via parent banks. Parent banks themselves are not expected to cut funding dramatically as it would be purely value destroying for their previous investment and obtained market shares. Locally owned banks, however, may fair worse in this market situation as their financing costs will be higher.

4. Monetary Policy and Interest Rates

Monetary tightening continues. The Bank of Latvia is keeping a tight lid on liquidity with the aim of slowing credit growth. This has spilt over into high interest rates as banks aim to meet their required reserve requirements[25]. The lats' interbank interest rate spreads have therefore risen to about 8pp vis-à-vis those of the euro. Temporary one-off effects such as privatisation of Lattelecom, have added to the high interest rates[26]. The situation may ease later in the year as the government leaks liquidity into the market by running down the accumulated 2.5% budget surplus towards the approved 0.4% of GDP. Rising interbank rates for the lats have spilt over into deposit rates that hiked to 9-10% in late October from about 7% in September.

EUR/LVL Spot Rate and LaB Interventions



Source: LaB, Reuters

23 Hansen and Vanags [2007] estimate wage growth in Latvia as having a full effect on PPI within about 15 months. The current excessive wage growth will hence damage competitiveness long into 2008.

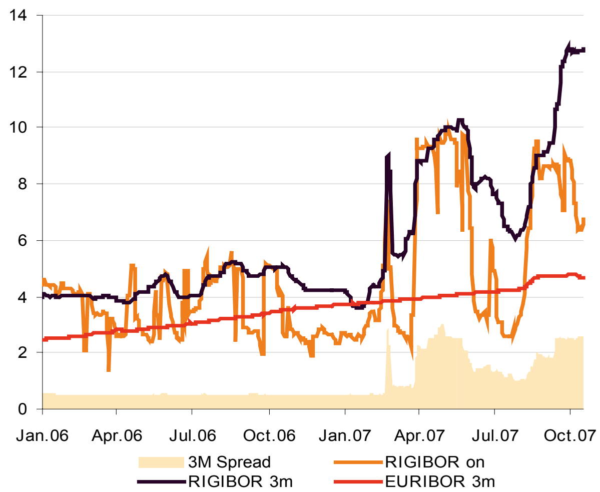
24 Of course, it is not necessarily bad as banks are lending to the manufacturing sector.

25 Even if a bank borrows and lends in the euro currency, it is obliged to hold 8% of its borrowing in the lats currency at the central bank. Given that the lats are in short supply, interest rates soar thereby making lending more expensive and slowing credit growth.

26 The *Lattelecom* privatisation is likely to come through within the next three months, and since part of the deal is to be made in the lats, these resources are being accumulated, which is one of the reasons why the lats' 3M rates are above overnight rates.

The exchange rate situation has remained stable. As explained at length in the May issue of The Baltic Outlook, speculative attacks are by and large impossible due to the shallowness of financial markets; devaluation is not a sober policy option. Medium to long term exchange rate stability will of course depend on macro stability. Therefore the current policy priority should be to rebalance the economy towards faster export led growth.

Interbank Interest Rates, %



Source: LaB, Reuters

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Lithuania

1. Recent Economic Developments

Lithuania's latest economy indicators were above our expectations, the labour market is tightening fast and inflationary pressures are accelerating. According to revised statistics the Lithuanian economy grew by 7.7% in 2006 and according preliminary data by 9.1% in the first three quarters of 2007. Preliminary GDP growth in 3Q 2007 surprised us with stronger than expected growth reaching 10.8%, the highest annual growth rate for almost four years. In 3Q the increase in gross value was conditioned by construction, wholesale and retail trade, transport, storage and communication, real estate, as well as manufacturing and agricultural activities. Value added created by agriculture reached the level of 2005 (in 3Q 2006, a 22.8% decrease in value added was recorded).

In the 1H of this year household consumption (14.2%) and gross fixed capital formation (20%, stipulated by very rapid developments in construction) continued to demonstrate a vigorous growth trend. Despite the increase in interest rates, consumer expenditure continued to be driven by an annual 22.4% rise in real net wages (1H), a 64.2% increase in borrowing, and lower unemployment rate (in 2Q it contracted to 4.1% from 5.6% in 2006). The real growth in exports of goods and services was 3.3%, while imports went up by 12.7%. Government sector expenditure grew at a slower pace (5%).

As a result of strong consumption, retail sales soared (19.5% yoy in the first three quarters). The industrial sales grew by 3.4% yoy while, excluding petroleum products, industrial sales continuously attained a healthy growth of 13.2% yoy over the reported period.

Strong domestic demand stimulates imports and, as a consequence, the current account deficit widened, induced by higher foreign trade deficit. According to preliminary data, during the first eight months of this year Lithuania's current account deficit reached 13% of eight month's GDP.

Consumer price inflation accelerated to 7.1% yoy in September with rapid price growth in primary goods and services: food (12.7% yoy), housing, water, electricity, gas and other fuel commodity group (12.5%, esp. rent). This price growth mostly affects families with low incomes. The average annual inflation for the last 12-month period was 4.8%. Similar developments could also be seen in other price indices: in 2007 September PPI reached 8.1% yoy and construction prices rose by 14.6%.

2. Highlights of the Forecast

The latest data confirmed our insights about the upside risks on GDP growth. The demand-driven GDP growth appears to be stronger than previously expected, and we see Lithuania still moving up to the top of economic cycle. We revised our earlier forecasts to 9.2% in 2007 (instead of 8%) and to 7.5% in 2008 (former 7%). We expect Lithuanian economic growth will slightly slow next year, but it will be continuously driven by strong household consumption, and growth in both investments and government spending. However we do not rule out a possibility of an even higher cyclical increase of growth rates in the next 1-3 years, considering the current positive attitude among businesses and

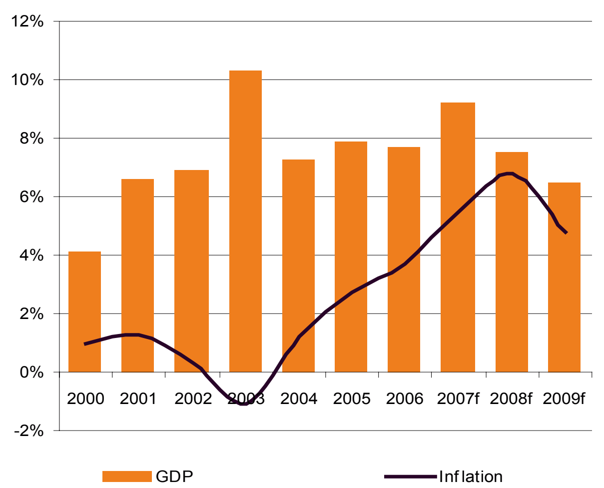
	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.9	10.3	7.3	7.9	7.7	9.2	7.5	6.5
GDP, mln euros	15,052	16,452	18,126	20,673	23,721	28,183	33,115	37,383
GDP per capita, euros	4,329	4,763	5,276	6,055	6,989	8,341	9,840	11,147
Growth of industrial sales, %	3.1	16.1	10.8	7.1	7.3	6.0	7.0	6.5
Growth of GDP deflator, %	0.1	-0.9	2.7	5.7	6.6	8.8	9.3	6.0
Growth of consumer prices, %	0.3	-1.1	1.2	2.7	3.7	5.5	6.8	4.8
Growth of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8	5.6	6.8	4.8
Growth of producer prices, %	-2.8	-0.5	6.0	11.5	7.4	5.8	7.1	5.3
Harmonized unemployment level, %	13.5	12.4	11.4	8.3	5.6	4.5	4.6	4.7
Growth of real net wage, %	3.8	9.3	4.9	6.8	14.9	15.0	10.5	6.7
Growth of exports of goods and services, %	13.4	6.2	12.0	27.0	17.9	13.0	15.0	14.0
Growth of imports of goods and services, %	13.1	6.9	14.2	26.1	23.1	19.0	15.0	12.6
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.4	-13.5	-13.2	-12.5
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-14.0	-13.5	-12.5
Current and capital account, % of GDP	-4.7	-6.4	-6.4	-5.9	-9.6	-12.8	-12.2	-11.3
FDI inflow, % of GDP	5.1	1.0	3.4	4.0	6.1	3.5	3.6	3.7
Foreign gross debt, % of GDP	39.5	40.5	42.4	51.2	60.9	66.0	67.6	68.7
General government budget position, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.6	-0.5	-0.5	0.0
General government debt, % of GDP	22.2	21.2	19.4	18.6	18.2	18.0	17.7	17.3

consumers, and the lack of policies aimed to limit the risks of overheating.

Recent developments observed in the labour market with strong salary growth and continuously growing demand for employees supported our predictions of a rise in wages. We slightly increased the projected growth of nominal wages because of higher inflation forecast, while the predicted real growth was left unchanged at 15% this year and 10.5% next year. For this year we also forecast a lower than previously anticipated unemployment rate (4.5% instead 5%), which may remain almost unchanged (4.6%) in 2008 due to a structural mismatch between labour supply and demand. Due to strong domestic demand, which is expected to boost imports further, we forecast the current account deficit to be about 14% of GDP this year and 13.5% next year. This rate is unlikely to decrease soon.

During 2007, inflationary pressures from both internal and external factors appeared to be stronger than previously expected. Also, the new heating season with higher central heating prices (depending on region ~15–20%) will push the prices even further, and inflation is expected to grow on average by 5.5% this year (instead of former 4.5%). In the next year prices should increase by 6.8% (instead of 4.5%) due to higher costs of labour, gas and electricity as well as higher excise duties for cigarettes and fuel.

Economic Growth and Inflation

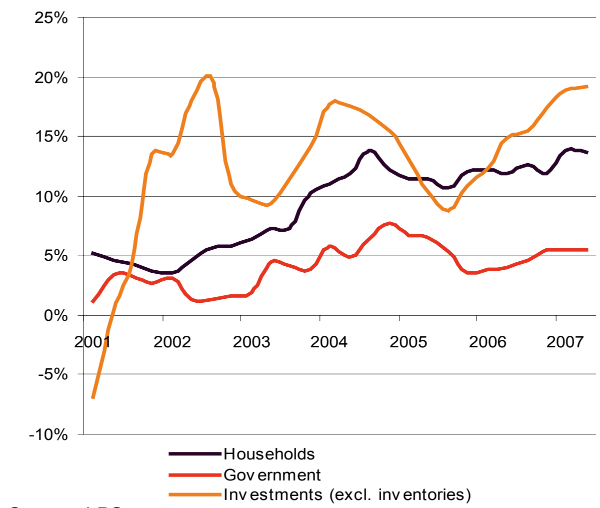


Source: LDS, HBM forecast

3. Economic Growth

The outlook for growth in 2007 and 2008 remains favourable. GDP growth is projected to gradually slow down but will remain robust. We expect the Lithuanian economy to grow by 9.2% this year and 7.5% next year. The main driving force will remain the same: strong domestic investments and household consumption. The latter will be fuelled by traditional factors: growing income and borrowing (although at slower pace), higher employment as well as transfers from emigrants. EU support and fiscal spending (especially in the year of Parliamentary elections) will also have a significant role to play in economic growth.

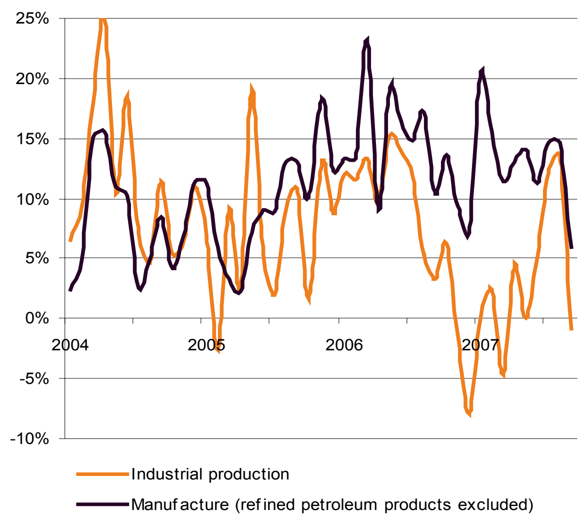
Domestic Demand (12 month rolling real growth)



Source: LDS

In the second half of this year a recovery in exports should also add more impetus to the growth of the economy. As we expected, Lithuanian industrial sales started to recover in July, when 12.2% yoy growth was recorded (3.4% in the first three quarters). The reason was lower comparable basis starting in the second half of last year related to the results of the biggest exporter "Mazeikiu Nafta"[1].

Industrial Production growth, yoy



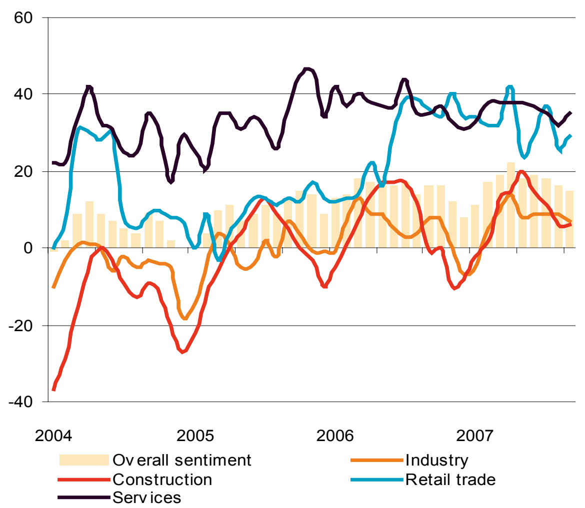
Source: LDS

1 In July 2006, the company reduced production due to the crude oil supply suspension from Russia as a result of the Druzhba pipeline damage. Further output decline followed in October after a fire in the refinery.

However In September, industrial sales decreased by 0.8% in yearly terms as at the end of this month Lithuania's, Mazeikiu Nafta, was shut down for a maintenance turnaround that will last for about a month and a half. Anticipating better results in sales of refined petroleum products in the last two months, we forecast industrial sales growth to be ~6% this year.

The economic sentiment indicators also give a picture of rather positive development in the economy, though the latest indicators have weakened slightly. The most significant drop was observed in consumer and industrial confidence. The latter fell mainly due to the shortage of qualified employees. The confidence indexes of trade and services both improved, driven by higher demand. However, the only improvement observed in comparison to the previous year was in the construction confidence index.

Confidence Indicators



Source: LDS

The economic risks are rising because of continuing emigration, an overstrained labour market, peaking inflation, the lack of reforms, and investments (to increase labour productivity). In this case high expenditures (of households, public sector, EU funds) may crank up the wage-inflation cycle, which would reduce the competitiveness of the country and slow the economy in the medium term.

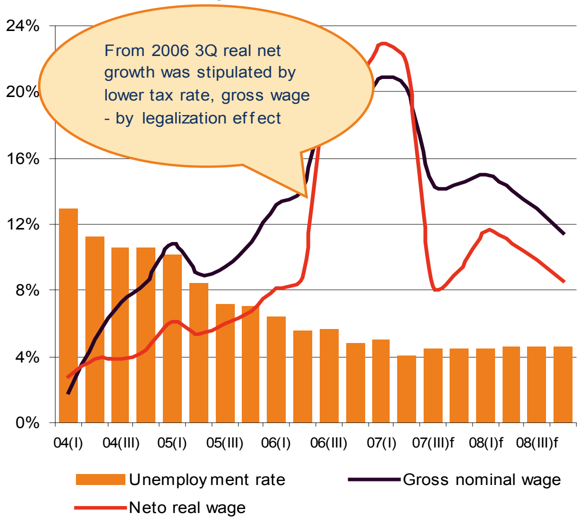
3.1. Domestic Demand

3.1.1. Household Consumption and Incomes

Household consumption remained very firm, on the back of continuously growing incomes, increasing employment, rapid expansion of bank credit and high consumer confidence. In the 1st half of the year household consumption grew by 14.2% and will remain one of the main drivers of economic growth in the future. We forecast that the growth of household spending will peak this year (increasing by no less than 12% in real terms) before a gradual slowdown in following years. Several reasons allow us to expect strong spending growth, although at a slower pace.

- High **pressure on wages** persists due to the lack of workers.
  - Wage growth **remained strong**: In the 1st half of this year the growth of average gross nominal wages soared by 20.6% yoy to LTL 1826 (EUR 529), while the growth of average net monthly wages stood at 27.9% yoy (LTL 1369). Increase in net wages exceeded the rise in gross wages due to the cut of personal income tax from 33% to 27% since the 2nd half of 2006. The real average wages rose by 22.4% yoy in the 1st half of the year. Nominal wage growth in the private sector accelerated to 22.7% yoy in 2Q, while the rise in the public sector was slightly slower (16.5%). This divergence supports our insights of continuing income legalization.
  - However, 2Q was the last quarter when such high annual growth could be observed due to lower comparable basis of last year. Therefore, starting 2H this year the wage **growth will be slower**. Although we slightly increased the nominal wages growth, higher inflation forecast left the earlier predicted real net wage growth unchanged: 15% for this year and a slowdown (10.5%) for next year. Hence **inflation** is a very important factor in household spending, which may hit demand quite significantly.
  - The strong **profits of Lithuania's companies** and wage demands still allow us to

Labour Market, annual growth rates

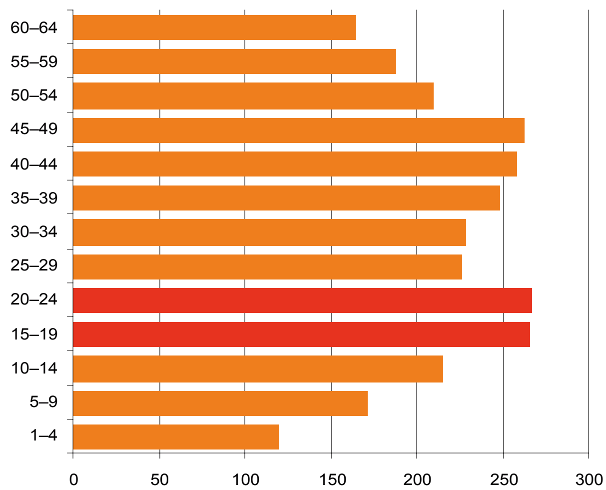


Sources: LDS. HBM forecast

expect rather strong wage growth. In 2Q the aggregate pre-tax earnings were 40.5% higher than a year before. In this period revenues rose by 21.8% and the average profitability, measured as a ratio of pretax profits to revenues, increased to 8.7% from 7.5% in the 2Q 2006 (the average in 2006 was 6.2%). However, strong profit growth is expected to ease in response to slightly weaker demand. Moreover, developments in the labour market are a headache for employers because of the increasing difficulty in hiring new workers, and growing production costs force companies to look for new opportunities and invest.

- The **Government policies** still working towards increased income prior to next year's Parliamentary election:
  - Starting 2H of this year the government aimed to improve the position of some household members who receive **social benefits**: raised maternity/paternity leave payments (to encourage births), added grants to pensioners with long working experience. Since next year's incomes from various state allowances are planned to be raised further: strong growth of pension payments and different allowances for families having children.
  - Expected **personal income tax** rate cut from 27% to 24% from 2008 will add about 3.3% on average to the net wages. The impact on statistics may be even stronger due to expected income legalization effect.
  - Starting next year the **minimum monthly salary** will be increased again by LTL 100 from the current LTL 700 to LTL 800. This will increase wages for low income families, although it may be another step for legalization.
  - **Wages in public sector** are continuously increasing. Wages will be increased for state officials and public sector employees as the government is planning to raise the official base for calculating public sector wages from LTL 442 to LTL 490 – in other words, the net monthly wage will increase by 10–10.5% on average. For instance, the net monthly wages of chief specialists will increase by LTL 140–235, and for the highest grade of public officials the wage will increase twice as much – by LTL 320–440.
- The **tightening situation remains in the labour market**.
  - Current data suggests that the situation in the labour market has not eased and trends point to the opposite case. In the 2Q 2007 Lithuania's unemployment rate **contracted more than expected** – to 4.1% and was 0.9 percentage points lower than a quarter before. The rate of unemployment was at its lowest level in the last decade (in 2001 it stood at 17.4%). The number of unemployed went down following economic developments and the creation of new jobs. In 2Q 2007 the number of employed grew by 2.8% yoy, while the number of unemployed reached 68.2 thousand (–23.1% yoy) and the number of long-term unemployed, i.e. those seeking a job for a year and longer, halved. Employment grew strongly among people of retirement age (11.6% yoy). The total labour force increased by 1.2% yoy. In 2Q 2007 Lithuania's unemployment rate was significantly below the average unemployment rate in the EU27 (6.9% s.a).
  - We **revised our unemployment rate** forecast from 5% to 4.5% this year, and it is expected to be at a similar level next year (~4.6%) as there is a lack of unemployed with suitable qualifications and economic development will slow slightly. Moreover, rapidly growing service and retail sectors point to a continuing strong demand for labour. Taking the demographic situation and age structure into account, we see a small possibility that the number of people of working age in Lithuania will increase in the coming years. This is a reflection of the relatively numerous generation of the late 1980s entering to the labour market. However, due to emigration this increase may not ease the shortage of labour supply.

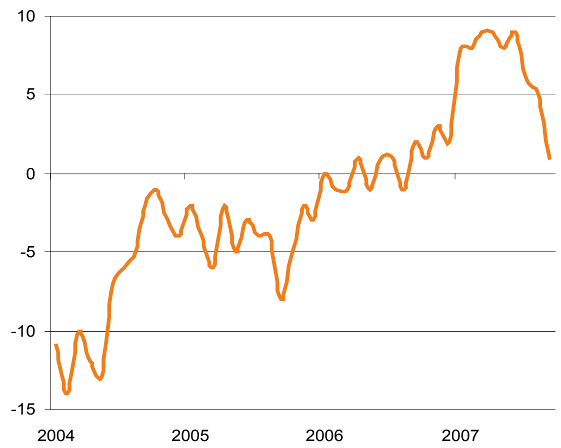
Population by age in the beginning of 2007 (th)



Source: LDS

- The **consumer confidence** returned to its 2006 year average. Lower consumer optimism compared with other months (–4) of this year was related to country's economic perspectives, especially development in unemployment over the coming years, and decreased expectations of household financial improvement.

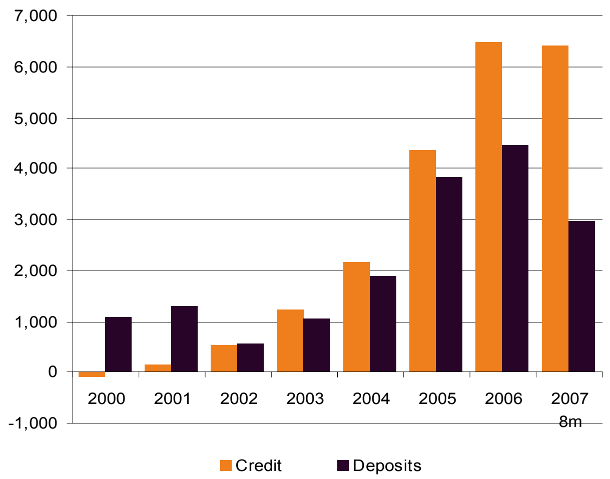
Consumer Confidence Indicator



Source: LDS

- Strong **credit growth** for households continues, strongly outpacing the increase in deposits. In the end of September the annual growth rate of lending slowed to 63.3% from 77% at the same time the year before. Although recently interest rates grew gradually, a lot of households still have the potential to borrow.

Household Finances (transactions), LTL m



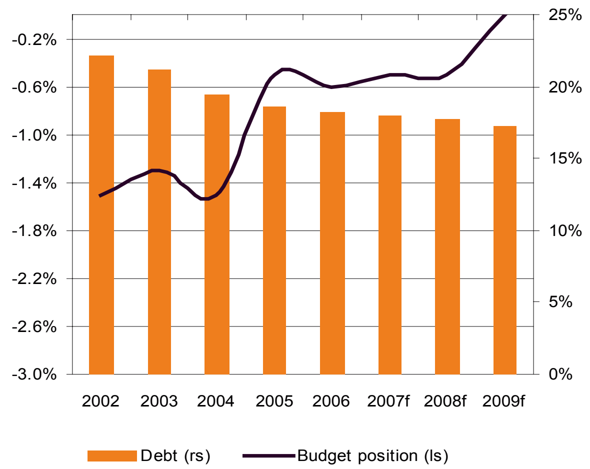
Source: LiB

Strong household consumption growth will remain beneficial to all domestic demand-driven industries and importers. For instance, retail sales, which are a good indicator of household spending, increased by 19.5% (in real terms) in the three quarters of this year. However, in the medium-term (3–5 years) consumption growth should be closer to the growth of GDP.

3.1.2. Government Spending and Policy

The Lithuanian national budget continues to benefit from exceptionally good revenue collection. The central government sector recorded a 0.3% deficit of our expected annual GDP over the first eight months of 2007. In the first three quarters the present collection of the state budget (excluding EU funds) is excellent with preliminary revenues being 16.2% higher than in the same period last year. The collection of VAT (28% yoy) and excise duties (18% yoy) was exceptionally strong fuelled by increasing consumption and price acceleration. Assuming that the budget revenue collection will continue to be good, we forecast that the general government deficit will remain rather stable this and next year (0.5% of GDP) on the back of strong revenue growth as well as of improved tax collection.

General Government Finances, % of GDP



Source: Lithuanian MoF, HBM calculation

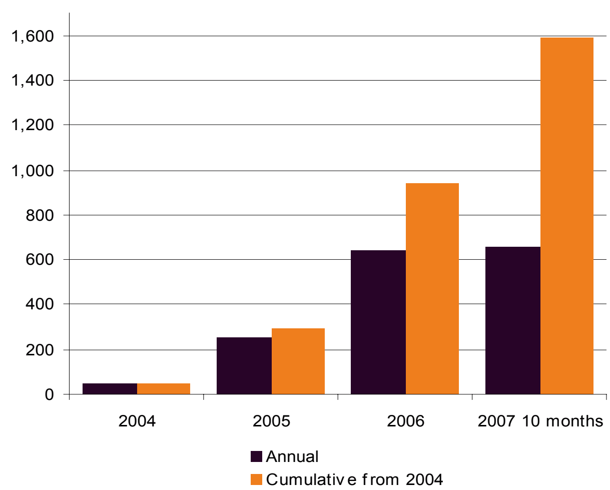
Lithuania's government has approved the draft national budget for 2008, which still has to be ratified by Parliament. The revenues of Lithuania's national budget, including the European Union (EU) support, should reach some LTL 29bn (EUR 8.4bn) in 2008, growing by 31.4% compared with the revenue figure projected for full 2007. A rise in revenues on income tax, which would be cut to 24% from January (one-third or a quarter of this growth is expected from income legalization effect), as well as higher revenues on value-added tax, tobacco and fuel excise taxes are anticipated. This will be again a record-breaking budget with the EU support soaring by more than 70%, exceeding LTL 5bn. Expenditures should increase by 28% yoy to LTL 30.2bn (EUR 8.6bn) leaving a deficit of LTL 1.08bn or 0.9% of our projected next year's GDP. The Government offers the following main changes together with the 2008 budget project:

- The **personal income tax** rate cut from 27% to 24% from the 1st of January 2008. The budget will lose ~LTL 560m, but wage growth and income legislation will cover this cap well. From 1st of July 2008 the **minimum monthly salary** will be increased by LTL 100 from the current LTL 700 to LTL 800.
- A rise in the wages of **state officials and public sector employees**. Wages of civil servants and politicians will be calculated using LTL 490 as the official base instead of LTL 442. Salaries in the budget institutions will be raised as well. The overall amount to be paid from the state budget as the wages of state officials and public sector employees would increase by more than LTL 1bn in 2008.
- Social allowances for **pensioners and children** will be raised. For example, the basic pension rate will be increased by 18.8% from LTL 266 to LTL 316 (EUR 92) and an individual's insured income[2] by 15.5% from LTL 1356 to LTL 1566 (EUR 454).
- **Excise duties for cigarettes** will be raised by 30% from the current LTL 98 for 1000 units to LTL 129 from the 1st March next year. It will push the retail price of the most popular price category of cigarettes upwards by some 0.73 litas (EUR 0.21) or 17% from current LTL 4.28 to LTL 5.01 (EUR 1.45) per pack. In 2010, to comply with EU regulations, the excise tax on cigarettes in Lithuania must be approximately twice as high as now and reach a retail price of 7–8 litas per pack. To achieve the minimum EU rate and avoid any sharp surge in the prices of cigarettes, the excise duty should be raised gradually each year until 2010.
- **Excise duties for fuel** will be raised by approximately 12.5%. Draft amendments to the Law on Excise Taxes stipulate that the rates of excise tax levied on diesel fuel and kerosene will rise by LTL 123, to LTL 1125 per ton, while the petrol excise tax rate will grow by LTL 166, to LTL 1484 per ton. **In this case the average retail price for petro**l will increase by LTL 0.15, for diesel – by LTL 0.12. Excise duties will be boosted to the minimum rates prescribed in the EU Treaty for 2008. The next increase in excise duty rates of fuel has been projected for 2011. The raise of excise duties for both cigarettes and fuel will add some LTL 177m to the budget.
- A **temporary social tax** will be abolished starting next year – the budget will lose ~LTL 350m. The tax was introduced in 2006 to cover the loss of budget revenues from the personal income tax cut from 33% to 27%.

Obviously Lithuania's Government continues its expansive fiscal policy, which supports the currently strong economic growth and inflation. It is not surprising, considering that general elections will be held in October of next year, that the government is struggling to balance the need to satisfy the electorate and criticism from experts and opponents, as there is a minority Government in Lithuania. Following the Convergence program, the government is planning to have a budget deficit for 2007 and 2008, but the 2009 budget is planned to be in balance.

One of the important factors for economic growth is the absorption of the EU structural funds and other financial assistance. 51% of the total, or LTL 1.6bn (EUR 460m), of the EU's Structural Funds had been spent by October this year from 2004. For the period 2004-2006 almost LTL 3.1bn was granted to Lithuania. Rules for the use of EU assistance stipulate that funds have to be spent within two years of the signing of a contract. Consequently, the deadline for signing contracts is 31st December 2006, so the funds from 2004–2006 budget periods will be available for distribution up to the end of 2008. In the period 2007–2013 Lithuania is scheduled to receive more than LTL 23bn (EUR 6.7bn) in EU assistance. This is equivalent to an additional annual state budget. It is estimated that the largest part of funds (46%) will be allocated to the Operational programme for Economic Growth. 10% will be allocated to scientific research and technological development of competitiveness and growth of economy. EU funds will result in improvements in public infrastructure and higher production capacities.

Absorption of EU Structural Funds, LTL m



Source: Lithuanian MoF

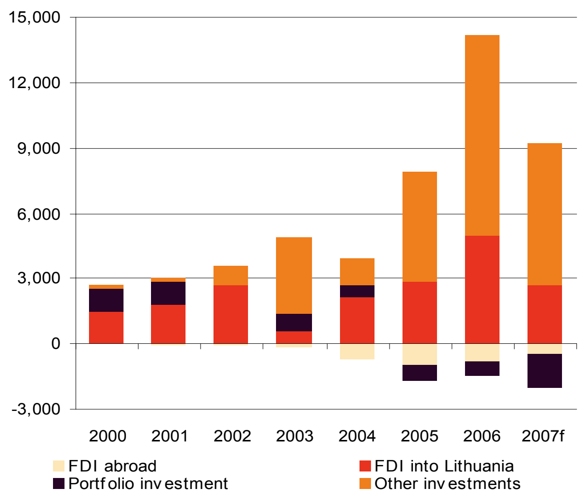
2 **Insured income** means all the income of a person on which compulsory state social insurance contributions were paid or had to be paid as well as sickness and maternity (paternity) benefits, benefits for illness resulting from an occupational accident or occupational illness, and also unemployment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

3.1.3. Investments

In the 1H of this year the gross fixed capital formation growth was vigorous at 20% yoy, mostly stipulated by domestic investments. However, the sad story is the lack of foreign direct investment inflow. The majority of foreign capital is coming in the form of banking loans (81% of total financial account in the first eight months).

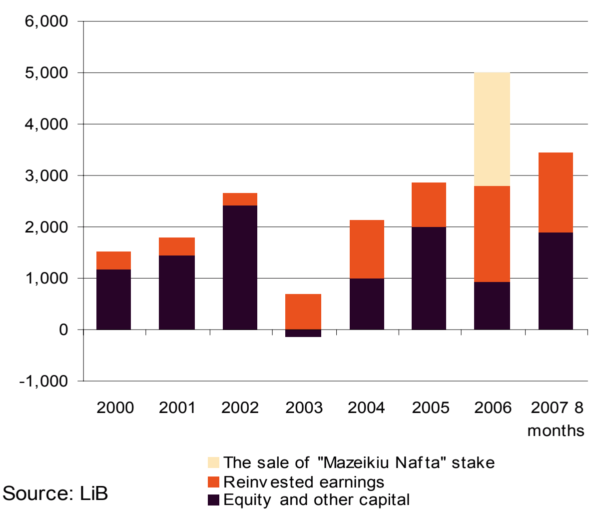
FDI inflow in nominal terms increased by 67.6% over the first eight months of this year and reached 5.6% of GDP for the same period. That is not a pleasing fact taking into account that the flow in the first quarter was mostly related to Poland's PKN Orlen investment in buying out minority shareholders in Mazeikiu Nafta and a large share belongs to reinvested earnings (45% of total FDI), not to green field investment. Looking ahead we forecast the FDI inflow ratio to GDP will return to its 2004-2005 level, reaching ~3.5%.

Financial Account, LTL m



Source: LiB

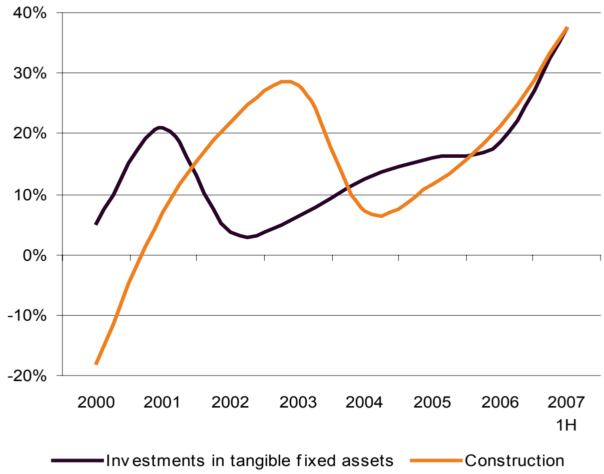
FDI inflow to Lithuania by componets, LTL m



Source: LiB

The investment in tangible fixed assets grew by 37.5% yoy in real terms over the 1H 2007 and continued to be attracted by domestic-demand oriented spheres. This tendency is expected to continue in the coming years. In 2Q 2007 a rapid growth in investments was registered in public administration (70%), transport and storage (67%), construction (46%), education (40%), and real estate (34%). A positive development was observed in manufacturing, where the growth of investments rebounded (35% yoy) and might have a positive effect on export growth in the medium term.

Real Growth of Investments and Construction



Source: LDS

The Lithuanian construction sector continues to grow fast and the number of complete new dwellings increased by 51.2% in the 1H of this year. In this period construction enterprises own-account work (99% within the territory of Lithuania) grew by 37.5%. The major part was recorded in new construction (55% in total); reconstruction took 22% and repairs – 20%. However, looking further we anticipate a slowdown in the construction sector due to the shortage of workers and weaker demand due to high prices.

As expected, the activity in the residential real estate market has stabilized. Since the beginning of the year prices of dwellings have increased by 10–20% (especially for apartments of old construction in the so-called "sleeping" districts further away from the centre), however, the price growth stopped in the summer. Looking ahead, stabilization of dwelling prices and a longer realization period is expected. Moreover, a surplus of supply in the residential real estate market seems unlikely due to growing construction costs (14.6% yoy in September), the lack of labour force and the tightening lending policy. While the activity of buyers, especially in the primary new construction market, remains rather high as growing household incomes partly compensate for increased mortgage interest rates, apartments are becoming too expensive for most households. Therefore, the increase in dwelling prices is not expected to be more than in the range of 5-10% in the coming year.

Lithuanian businesses are accelerating their investment abroad, especially into neighbouring countries. In the first eight months Lithuanian direct investment abroad accounted for 1% of GDP and this was 24% less than in the same period of the previous year. The majority of Lithuanian FDI goes into the wholesale and retail trade (23% of total), manufacturing (22%), real estate and other business activities (21%), mainly to Latvia (30% of total) and other neighbouring countries. Looking ahead, investment abroad is expected to show slight growth. On one hand, the fact that enterprises have outgrown the domestic market and are profiting elsewhere is a positive sign, but on the other hand Lithuania still needs to attract a lot of investment into the country.

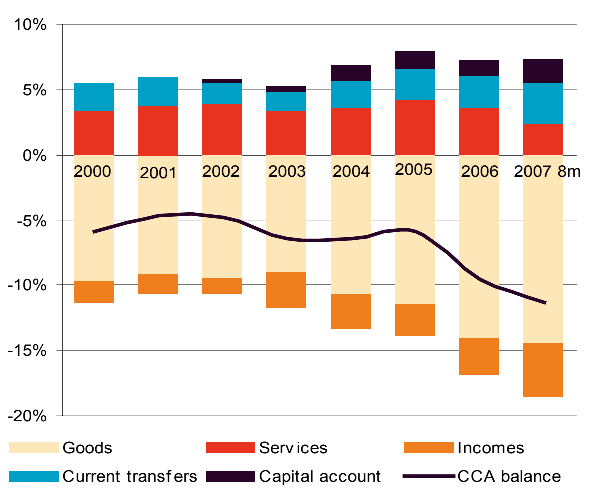
Looking ahead we expect a further increase in investment in Lithuania supported by the positive expectations of households and companies. Companies not only have to reorganise and expand production due to strong demand, but also invest in technologies to increase productivity as the labour force becomes more and more expensive. Besides, investments are also supported by the favourable monetary conditions, strong companies' financial situation, state investments and the EU funding.

3.2. External Demand and Balance of Payments

Strong growth in domestic demand, as well as consumer and business optimism, stimulated the demand for imports and deepened the current account deficit. An apparent tendency of increasing deficit has been observed since 2005, and in the first eight months of 2007 it reached 13% of this period GDP (10.8% in 2006). The trade in goods deficit (14.5% GDP) remained the main cause of CAD, however, the widening also occurred due to higher income deficit, which increased by 27% yoy and declining surplus of services by 25.8% yoy.

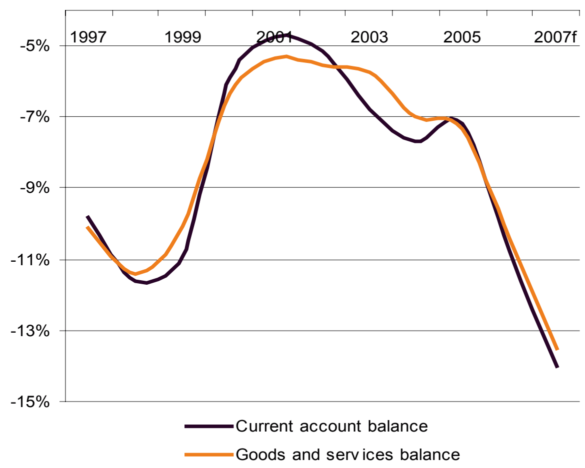
We have not changed our current account forecasts since our last Baltic Outlook in July. CAD should total approximately 14% of GDP this year and slightly narrow to 13.5% next year. A small contraction is projected because of the anticipated slower increase in domestic demand and better export results from the biggest Lithuanian exporter "Mazeikiu Nafta".

Current and Capital Account (CCA), % of GDP



Source: LiB, HBM calculations

Current Account and Goods and Services Balance, % of GDP

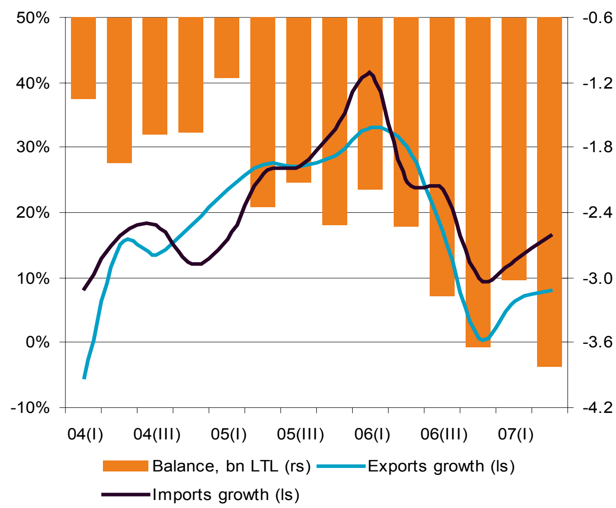


Source: LiB, HBM calculations

3.2.1. Foreign trade

1H 2007 showed decreasing growth rates in foreign trade of goods. Although the growth of imports

Trade of goods

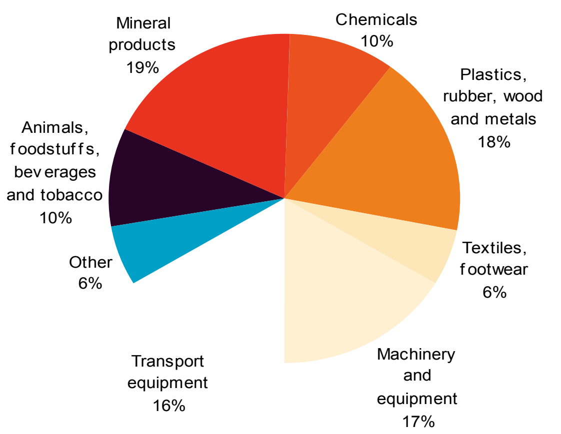


Source: LiB, HBM calculations

decreased to 14.6% yoy (33% yoy in 1H 2006), the rates were still double-digit, driven by the booming domestic demand. Preliminary data of July and August did not point to any significant changes. On the other hand, the growth of exports experienced a slump, especially in the beginning of the year. These two trends determined a widening trade of goods deficit, LTL 3.4bn (EUR 1bn) in 1H 2007, i.e. 45.3% higher than a year ago.

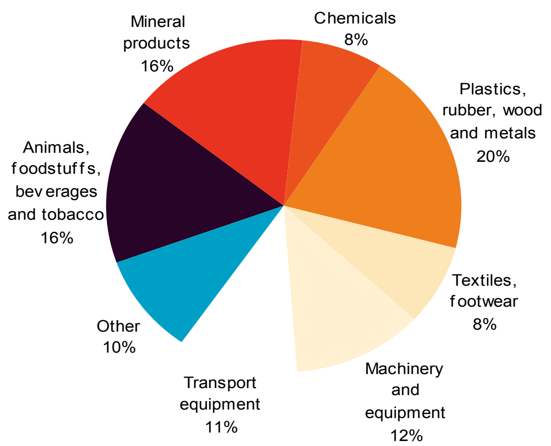
The main reason for the weak export growth was the reduction in exports of mineral products. The oil refinery "Mazeikiu Nafta" had to reduce production as the crude oil supply from Russia was cut off due to the damage of Druzba pipeline in July 2006, and the company had to start importing crude oil by sea. Another disruption in oil production occurred in Oct2006 after a fire in the refinery. During the first eight months of 2007, exports of mineral products declined by 36.7% compared to the same period of 2006. Acceleration in mineral product exports has only recently been observed. Preliminary export data of July and August supports our earlier expectations of the recovery in the light of last year slump.

Lithuanian Import Structure, Jan-Aug 2007



Source: LDS. HBM calculations

Lithuanian Export Structure, Jan-Aug 2007



Source: LDS, HBM calculations

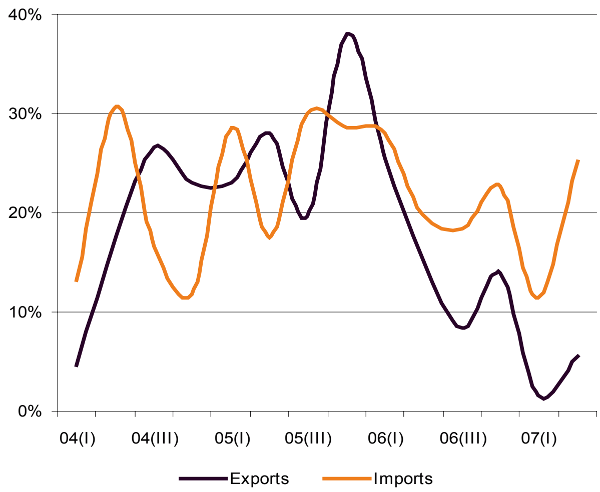
Mineral products, which accounted for 16% of total exports in Jan-Aug 2007, are the main foreign trade commodity, so its fall substantially reduced the total export growth (10.6% yoy over the analysed period). Excluding mineral products, the growth remained vigorous and increased by 28.8% yoy over the first eight months of the year. Other traditional key export commodities, such as machinery and electrical appliances (12% of total exports) and transport equipment (11% of exports), maintained a stable growth over the first eight months of 2007, 12.7% and 25.2% yoy respectively. The exports of plastics and rubber, and also food products, soared well above average. The latter may be explained both by rising demand for Lithuanian food products in the foreign markets, and the expansion of Lithuanian retail companies into neighbouring markets as it creates additional export possibilities for smaller Lithuanian producers.

The growth of imports over the first eight months of 2007 was 17%. The same three commodities which dominated exports; mineral products, machinery and electrical appliances, and transport equipment, also dominate in the import structure (19%, 17% and 16% of total imports over the eight months respectively). The fall in the amount of imported mineral products was significant due to the disruption in oil imports by the pipeline from Russia and a need to find new suppliers. Consequently, the imports of mineral products deceased by 18.7% over the first eight months of 2007, comparing to the same period a year ago. Total imports excluding mineral products expanded by robust 26.9% yoy. A significant contributor of the import growth was transport equipment, 46% higher than a year before. Above average growth was also observed in the import of chemicals and metals, 39.2% and 37.6% yoy respectively.

3.2.2. Trade in services

Over the first eight months of 2007, export of services rose by 7.1%, witch is significantly lower than the growth rate in last year (15.8%). The growth in service imports was more than three times higher than that of exports (22.1%), hence the surplus of service balance narrowed to 2.4% of GDP (3.6% of GDP in 2006).

Trade in Services, Annual Growth

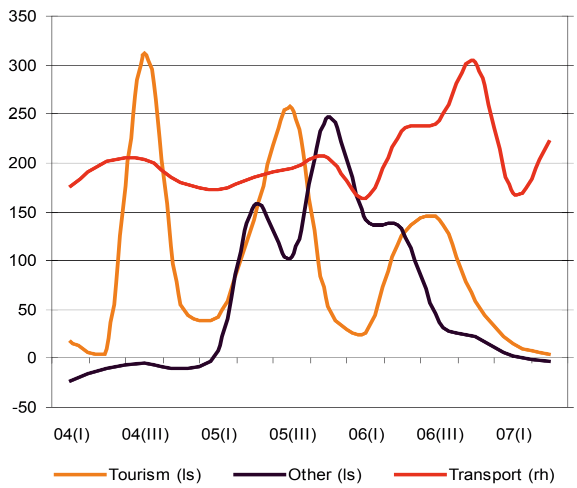


Source: LiB

The surplus of trade in services emerges mainly because of positive transport service balance, which comprises 98.2% of the total surplus. The trend in the service trade surplus in 1H 2007 was negative (–29.7% yoy). The transport services decreased only marginally (1.2% yoy), and the biggest part of decline arose from a fall in the travel service surplus. Increasing household income and strengthening business relationships led to more Lithuanians travelling abroad. We anticipate that rising household purchasing power will encourage travelling abroad, and this tendency will further outpace the attraction of foreign tourists to Lithuania. Moreover, the transport service exports will remain strong and continue to drive the surplus in service trade.

We expect the growth of goods and services exports to lag further behind the growth of imports over the next couple of years. The growth of Lithuanian goods and services exports should slow to ~13%

Services Balance, LTL m



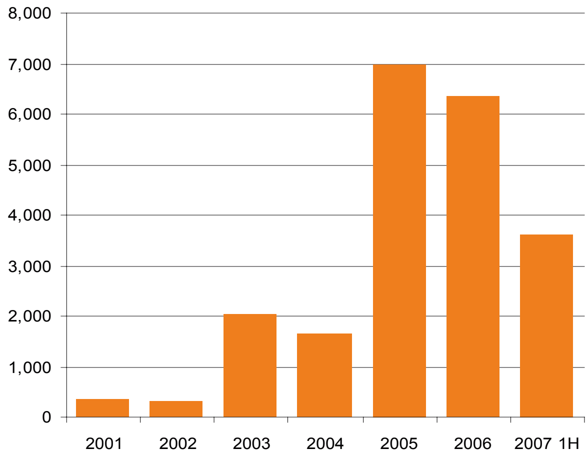
Source: LiB

this year from 17.9% last year, driven by higher production costs, in particular rising wages, and an increasing risk of deteriorating competitiveness of local companies. The growth of goods and services imports is forecasted to remain strong (~19%) because of booming household consumption and buoyant investment activity. These trends will cause a further widening of the current account deficit, which should reach ~14% of GDP this year (10.8% in 2006).

3.2.3. Inflow of foreign capital

Widening CAD shows increasing Lithuanian dependence on foreign capital inflow. The majority of foreign capital inflows took the form of loans, especially to the banking sector. The role of FDI as a source of CAD financing remained moderate, while the loans to the banking sector, mostly obtained from Scandinavian parent banks, covered 81% of the CAD (10.5% GDP) over eight months this year. The tendency of significantly higher foreign loans to Lithuanian commercial banks than FDI inflows is expected to continue in the coming years.

Foreign Loans to Lithuanian Commercial Banks, LTLm



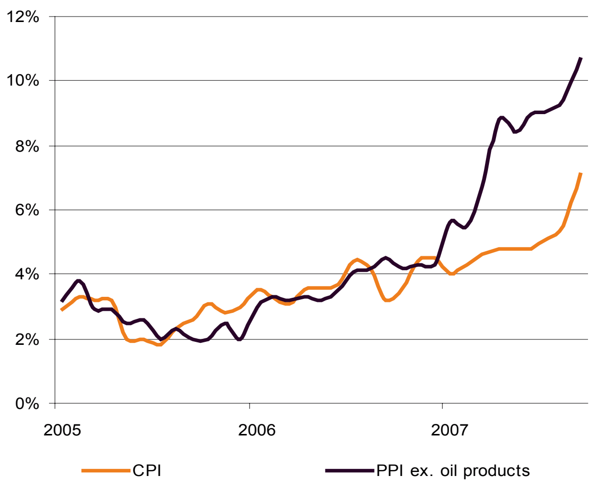
Source: LiB

4. Monetary Issues

4.1. Inflation

CPI inflation was rising throughout the year. The average annual 12-month inflation in September reached 4.8%, but the accelerating trend was marked: annual inflation jumped from 4% in January to 7.1% in September. Similar developments were recorded in other price indices: in September 2007 annual growth of PPI excl. oil products soared to 10.7% (5.6% in January), construction input prices gradually rose to 14.6% yoy (9.8% yoy in January) and the same tendency was observed in import and export prices as well, although less marked.

CPI and PPI ex. Oil Products, Annual Growth



Source: LDS

The main drivers of consumer price inflation remain the primary goods and services, namely food products and housing costs, which has a serious negative effect on low-income households' consumption. In September, these two price groups mounted up to annual growth of 12.7% and 12.5% respectively and account for 68% of total price increase. More expensive food products and growing wages (especially increases in minimal monthly salary) stimulate the rise in accommodation and catering service prices. The prices of education and health care are raised aiming to improve the financing to the public services and increase the wages in these sectors.

The main factors expected to drive inflation further involve:

- **Food prices**. The peak in global prices of food has already been described in General Assumptions. The surge in global food prices influences, and will further influence, Lithuanian inflation more significantly than, e.g. inflation in EU-15. The more evident impact is anticipated because of a higher share of food in the total consumer basket in Lithuania compared to the old EU member states.

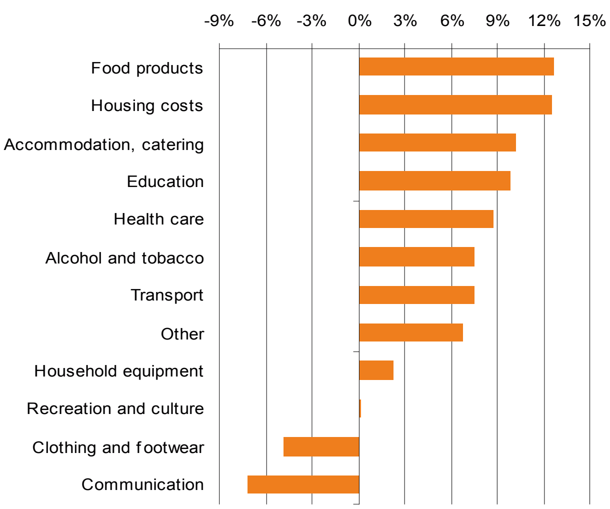
- **Administered prices**. The Russian company Gazprom, the only gas supplier to Lithuania, aims to raise the gas sale price for the country. Therefore, the gas prices have been increasing for the last three years, and the last significant increase is expected from the beginning of 2008. Growing gas prices have further impact on administered central heating and hot water supply prices, which directly affect CPI inflation, and producer prices, which later are most likely to be passed onto final consumers. The prices of electricity, regulated by the State Price and Energy Control Commission of the Republic of Lithuania, are expected to increase from 2008. Despite the direct effect on CPI, this rise will also have an indirect effect through producer prices. In general, the energy prices will remain among the most important contributors to total inflation over the coming years.

- **Tax harmonization** with EU directives. The Finance Ministry announced that the excise duties for petrol and diesel will be increased from January, and the excise duties for cigarettes from March 2008. The excise duties for petrol and diesel will be raised by about 12–13%, and the expected instantaneous effect on CPI inflation is approximately 0.1–0.2pp. The fuel price increase will consequently affect transport service prices and producer prices. Excise duties for cigarettes are expected to boost their prices by 17% and add about 0.2–0.3 pp to total inflation.

- **Rising wages**. Rapid growth of wages increases the purchasing power of households and hence fuel private consumption. Strong demand allows the producers to pass higher production costs to the consumers. However, we also see a worrying risk of wage-price spiral, which may push inflation to even higher levels in the short term.

- The government plans to continue increasing disposable income of households, including the personal income tax cut, minimum monthly salary raise and a growth in the wages of state officials and public sector employees. Consequently, the **government budget** is not expected to ease inflationary pressures in the near future, which is partly related to the forthcoming elections in 2008.

CPI Components, Annual Growth in September, 2007



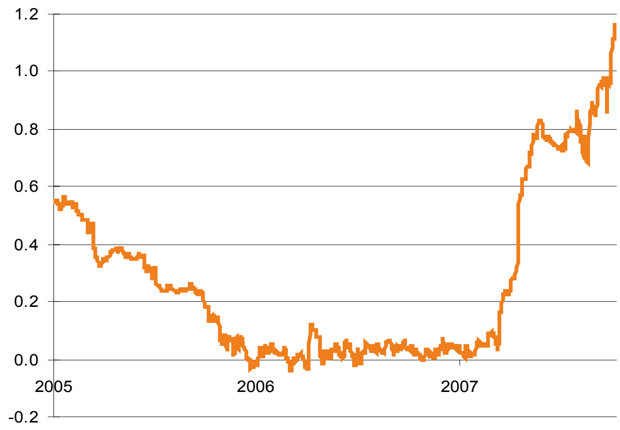
Source: LDS

Considering the current inflationary developments and above listed factors, we have significantly raised our inflation forecast to 5.5% and 6.8% for 2007–2008, easing to 4.8% in 2009. Naturally, the ongoing convergence process includes price levels, and the inflation will remain higher than the EU average. These convergence pressures demand good economic policy, which may keep inflation from picking up too much compared with the EU. However, Lithuania seems to be following the path of other two rapidly growing Baltic states, where inflation has heated up. As inflation is on the rise, the fulfilment of Maastricht inflation criterion is not projected in the coming years. The Lithuanian government has stated recently (September 2007) that the most favourable time for Lithuania to adopt the Euro would start from 2010. However, increasing price pressures in the economy, as well as relatively loose fiscal policy, has overshadowed official statements. We are sceptical about the chances of joining the euro earlier than 2013, although the latest inflation trends may point to even later date.

4.2. Monetary Policy and Interest Rates

In the beginning of 2007, Lithuanian interest rates closely traced those of the euro area interest rates. Following discussions about the risk of overheating and troubles in Latvia in early spring this year, the local interbank market reacted and widened the interest rate spread between litas and the euro. The spread between 6-month VILIBOR and same period EURIBOR diverged to 70–80 basis points. After a short stabilisation period (June–August), the spread widened further because of the liquidity crisis in global markets, which also affected the financial market of Lithuania. At the beginning of October, the spread between 6-month VILIBOR and EURIBOR exceeded 100 basis points and is expected to increase further because of continuing liquidity problems and the fears of overheating in the Baltic economies.

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



Source: Bloomberg, HBM calculations

Considering the rising risk of overheating, a spread increase between local and the euro area interbank rates and booming prices of real estate, the mortgage loan portfolio is anticipated to grow rapidly over the coming years albeit at a somewhat slower pace than recently. A slightly slower increase should also be observed in consumer credit and other loans. Higher interest rates and a weaker rise in the loan portfolio will help the economy to grow in a more balanced way.

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