Swedbank

The Baltic Outlook: Update

Macro Outlook, The Baltic Region, July 2009

Estonia

Further cuts needed for keeping budget deficit below 3% of GDP

Latvia

2009 budget spending cuts approved, but deeper restructuring is required

Lithuania

Adjustments in the private sector have been fast, the public sector lags despite efforts

Introduction

	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %							
Estonia	7.5	9.2	10.4	6.3	-3.6	-13.5	-2.0
Latvia	8.7	10.6	12.2	10.0	-4.6	-17.0	-3.0
Lithuania	7.4	7.8	7.8	8.9	3.0	-16.0	-3.0
Average consumer price growth, %							
Estonia	3.1	4.1	5.1	6.6	10.4	-0.5	-0.3
Latvia	6.2	6.7	6.5	10.1	15.4	3.0	-4.0
Lithuania	1.2	2.7	3.7	5.7	10.9	5.0	2.0
Current and capital account balance, % of GDP							
Estonia	-10.6	-9.3	-14.9	-17.2	-8.4	3.5	5.5
Latvia	-11.8	-11.2	-21.3	-20.6	-9.8	4.0	5.0
Lithuania	-6.4	-5.8	-9.5	-12.8	-9.7	2.0	1.5

There have been relatively little changes in the global economic forecast since our previous Baltic Outlook released at the end of April, especially if compared with the previous half-year's turmoil. Still, the expectations have become somewhat more pessimistic particularly concerning consumers in the developed world, albeit financial markets have improved and the prices of some commodities have grown (incl. oil). We have also seen worse than expected results of the 1st quarter all over the world, including in the three Baltic countries.

All this has been the basis for revising our GDP forecast for 2009 downwards, but the biggest reason is the local economic policy. The decision-making has been delayed mostly due to EU parliamentary and local elections, as the governments have to make difficult choices and substantially cut their spending. The cost-cutting in the public sector and tax increases will have a detrimental effect on domestic demand, which is expected to suffer from increased unemployment and lower incomes.

We acknowledge the governments' steps, and hope the subsequent decisions will be made more timely and with less hesitation. The need for further adjustment in public sector spending is high and this should be accompanied with structural reforms. Although the governments have to look on the budget position, they should not forget the need to promote long-term economic development as well.

The adjustments in the private sector have been faster and deeper than we expected. This along with stabilisation of production in major export countries has brought improvement in confidence and signs of stabilisation in exports and industrial production. But the recovery process will be slow and annual growth rates are many months ahead.

The unbalanced growth of 2005-2008 is the reason for the depth of the current crisis in the three Baltic countries. However, most of the imbalances have now improved: the current accounts are in surpluses, excessive inflation has been substituted with deflation (incl. wages, real estate, etc.), and the deleveraging process has started. We are of the opinion that although the three countries are among those suffering the most during the crisis, they can recover from it being much stronger and having good growth prospects. But this requires a lot of work both in the private and public sectors. Structural changes should continue and the governments should concentrate on building up an effective public sector and good economic policies.

Maris Lauri

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Estonia

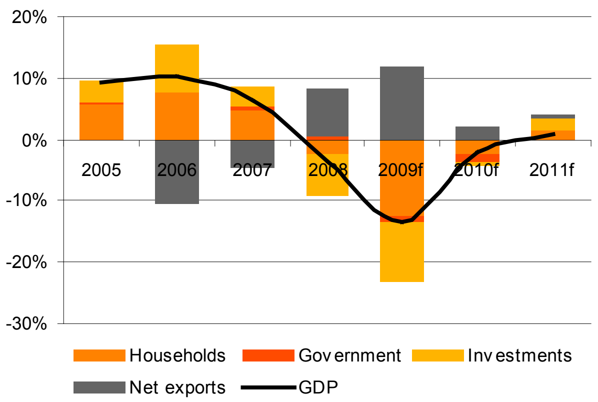
	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	7.5	9.2	10.4	6.3	-3.6	-13.5	-2.0
GDP, EURm	9,651	11,091	13,104	15,270	15,860	13,500	13,500
GDP per capita, th kroons	111.9	128.9	152.6	178.1	185.1	160.0	155.0
euros	7,153	8,239	9,754	11,381	11,830	10,200	10,100
Growth of industrial production, %	10.5	10.9	10.0	6.8	-6.2	-20.0	4.0
Growth of GDP deflator, %	3.3	5.3	7.0	9.6	7.8	-1.5	0.0
Growth of consumer prices, %	3.1	4.1	5.1	6.6	10.4	-0.5	-0.3
Growth of harmonised consumer price index, %	3.0	4.1	4.5	6.7	10.6	-0.3	-0.1
Growth of producer prices, %	2.9	2.1	4.5	8.3	7.2	-2.0	1.0
Harmonised unemployment rate (average), %	9.6	7.9	5.9	4.7	5.5	12.5	13.0
Real growth of average monthly gross wage, %	5.1	6.1	10.5	13.0	3.1	-7.0	-3.5
Growth of exports of goods and services, %	17.3	26.9	17.7	7.0	6.9	-18.0	2.5
Growth of imports of goods and services, %	16.2	25.0	25.6	8.0	-2.7	-25.0	0.0
Balance of goods and services, % of GDP	-7.0	-6.4	-12.2	-12.0	-4.3	2.5	4.0
Balance of current and capital account, % of GDP	-10.6	-9.3	-14.9	-17.2	-8.4	3.5	5.5
Inflow of FDI, % of GDP	8.0	20.8	10.9	13.1	8.4	3.5	5.5
Foreign gross debt, % of GDP	77.3	87.2	98.5	113.6	120.0	120.0	119.0
General government budget position, % of GDP	1.7	1.5	3.3	2.7	-3.0	-4.5*	-4.5*
General government debt, % of GDP	5.0	4.4	4.0	3.0	2.6	4.0	6.0

* if the government will not make additional budget adjustments; but we are of the opinion that some adjustments will be made

We expect the Estonian economy to contract by 13-15% this year and 1-3% next. Consumer prices are expected to fall slightly, while the decline in producer prices will be substantially deeper than for consumers in 2009. The external balances are expected to continue to improve: we forecast the current and capital account to be in surplus by 3-5% of GDP and foreign gross debt to decline as the deleveraging process deepens. The public sector deficit will be close to 3% of GDP, but its size will depend on how successful the government is in handling public sector spending.

We lowered our real GDP expectation most of all because of domestic demand, which we forecast to drop by over 20% this year and ca 4% next year. The contribution of net exports will remain positive despite falling trade volumes and this year it might reach 12% and next year 1-2%. Although investments are expected to fall the most (ca 25-30%), the biggest negative contribution is expected from households, whose spending declines by 19-21% this year and 3-5% in 2010. Government consumption will drop by 5.5-8.5% in 2009-2010.

GDP Growth Components



Source: ESA, Swedbank estimates and forecast

The improvement in the economy will start with exports, which follows the pattern of Estonia's main exports markets, i.e. Sweden, Germany and Finland, where we can currently see stabilisation and slight improvement. Hence we expect stabilisation of exports in the 2nd half of 2009, but at a substantially lower level than in the previous year. The next year might bring growth, albeit it will be slow at first. For sustainable export growth new investments are required but they are expected at best in the 2nd half of 2010.

Household spending is affected by growing unemployment, declining incomes and higher saving propensity. We forecast that unemployment will exceed 13% this year and in some months of 2010 it may reach 15%. The unemployment rate is also affected by a declining activity rate as in the course of the crisis increasingly more people will become discouraged. The number of employed persons will fall to the level of 2001-2002 (i.e. below 590 thousand) at the peak of the crisis. Incomes are also affected by wage and working hours' cuts. Wage cuts have been very extensive in the private sector but so far relatively modest in the public sector, where we forecast a correction in the 2nd half of 2009 and in 2010. We forecast that this year's wage bill will be ca 16-20% lower than in 2008 and an additional decline in 2010 will amount to 6-7%. That means a ca 7-8% and ca 4%, respectively, decline in the gross average monthly wage. Taking into account higher unemployment insurance payments, changes in sickness payments and temporary abolition of payments into the 2nd pension pillar, the net wages are expected to fall to the level of 2007 (i.e. close to EEK 9000 or EUR 575).

The poor employment and income outlook has already increased households' precautionary savings and we expect this process to continue. We expect that in 2010 unemployment insurance payments will decline as more and more unemployed persons will be not eligible to get them (it is paid up to 1 year). Hence, the incomes of many households will fall to extremely low levels, which induces households to use their savings. The worsening financial situation of households will encourage labour outflow in 2010 and beyond, and the improving situation in the EU economies will make it possible. This development is a strong long-term risk for the Estonian economy.

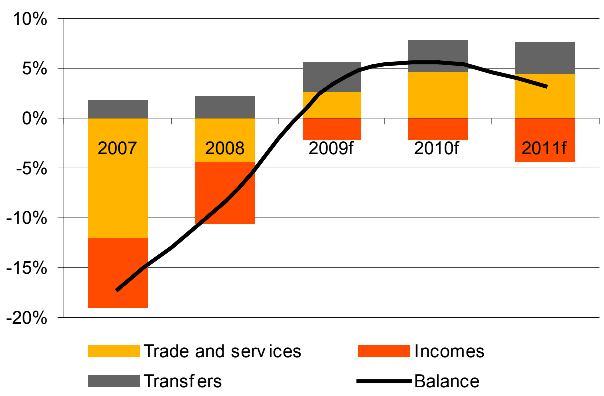
The government's policy has been to keep the budget deficit at a tolerable level, i.e. on a level which is possible to cover with reserves and loans taken in acceptable terms (e.g. with not too high interest rates). The Maastricht budget criterion (i.e. 3% of GDP) is a good target as besides being accepted as reasonable in an economic crisis it also has a complementary benefit in the form of allowing the EMU entry rules to be fulfilled. The clear perspective of euro adoption would lower several risks and make (foreign) investments cheaper and accessible, which would support faster recovery from the current crisis. But that of course is not the only requirement for the economic recovery. It is hard to fulfil the Maastricht budget criterion as forecasting GDP volumes in the unstable economic environment is extremely difficult. Hence, the safety margin should be taken into account in case the GDP volume is lower than expected. Consequently, the public sector's deficit should be below EEK 6bn, not below EEK 6.84bn as suggested in the MoF's spring forecast. We are still of the opinion that Estonia may enter the euro zone by 2011; however, the probability has declined due to political processes, making the budget adjustments a matter of complicated political bargaining.

Those intentions have already forced the government to make two supplementary budgets this year, but the third is required as according to our estimates adjustments in the amount of at least EEK 2bn are still needed. The good point is that the MoF admits the need for further adjustments (EEK 1-1.5bn). Our expectations differ from the MoF's due to less optimistic tax revenue expectations, particularly from consumption taxes. We are sceptical about the non-tax revenues, and we see that it is probable that cuts bigger than EEK 2bn may be needed.

Companies' inventory cutting will continue at least in the 2nd and 3rd quarters, and we do not expect real estate investments to grow in 2009-10. After exports recover we expect growth in corporate investments in production capacities, but their level is dependent on the availability of financing, which as of now is poor. Public sector investments from own sources will be very low for several years. However, investments related to EU (partial) funding will grow substantially as the available funds are larger than in previous years, the access made easier and fallen prices make investing cheaper. Hence we forecast strong growth in engineering, particularly in infrastructure construction (road building, environment investments, etc.).

The increase of consumption taxes will be distributed between consumers and sellers: the preliminary effect on consumers will be stronger, but retailers and companies will suffer later through the need to cut prices as consumptions slips. Hence, the CPI decline will continue, but in the 2nd half of 2009 it will be less and in the 1st half of 2010 deeper than we expected previously.

Current and Capital Account, % of GDP



Source: EP; Swedbank calculations and forecast

The weak domestic demand, which suffers not only from the global economic developments, but also from budget cuts and sharp adjustments in consumption and production, will mean that the decline of imports will be significantly deeper than exports and corporate profits low (incl. foreign investors' incomes). The increase of EU assistance (from different structural and other funds) will create a substantial flow of the current and capital transfers. Hence the current account will remain in surplus in 2009 and beyond. We will see the smaller outflow of foreign capital mostly due to losses, and through banks (as lending activity shrinks, borrowed funds will be returned to the mother banks).

Maris Lauri

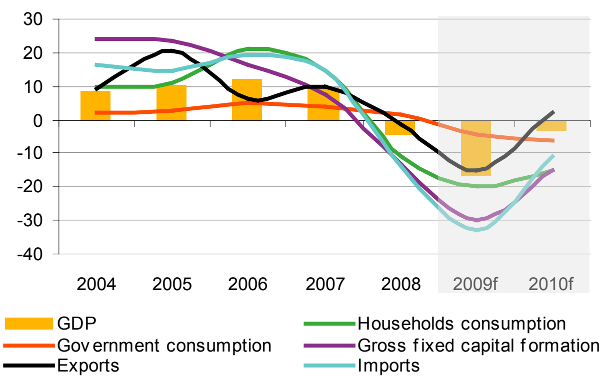
Latvia

	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	8.7	10.6	12.2	10.0	-4.6	-17.0	-3.0
GDP, mln euros	11,176	13,012	16,047	19,936	21,910	17,822	16,423
GDP per capita, euro	4,846	5,671	7,034	8,779	9,690	7,931	7,358
Growth of GDP deflator, %	7.0	10.2	9.9	20.3	15.2	-2.0	-5.0
Growth of consumer prices, %	6.2	6.7	6.5	10.1	15.4	3.0	-4.0
Growth of harmonised consumer price index, %	6.2	6.9	6.6	10.1	15.3	3.0	-4.0
Growth of producer prices, %	8.6	7.8	10.3	16.1	11.5	-5.0	na
Harmonised unemployment level, %	10.4	8.9	6.8	6.0	7.4	17.0	20.0
Real growth of average net monthly wage, %	2.4	9.7	15.6	19.9	6.1	-17.5	-5.0
Growth of exports of goods and services, %	21.4	31.4	15.3	24.1	10.4	-19.0	1.0
Growth of imports of goods and services, %	27.0	27.4	31.3	23.5	-3.3	-33.0	-9.0
Balance of goods and services, % of GDP	-15.8	-15.2	-22.2	-20.6	-13.0	-3.5	1.0
Current account balance, % of GDP	-12.8	-12.5	-22.5	-22.5	-12.6	2.0	3.0
Current and capital account balance, % of GDP	-11.8	-11.2	-21.3	-20.6	-9.8	4.0	5.0
Net FDI, % of GDP	3.8	3.6	7.5	6.7	3.3	1.0	3.0
Foreign gross debt, % of GDP	93.3	99.4	114.0	127.6	128.2	156.0	167.0
General government budget, % of GDP (ESA)	-1.0	-0.4	-0.2	0.1	-3.3	-9.0	-8.0
General government debt, % of GDP	14.9	12.4	10.7	9.0	19.5	33.0	44.0

Economic adjustment in the Latvian economy is proceeding quickly. The rapid decline in the trade deficit led to a current account surplus as of early 2009, and it has risen since then. The deflation scenario is working as the labour market is flexible, and the private sector is adjusting to the worsening economic outlook. The weakest link has become public finances, as significant government expenditure cuts were postponed due to local government elections on June 6th.

We forecast ca 17% GDP fall in 2009 (-15% before). The somewhat deeper than expected contraction in the 1Q (-18% yoy) was predominately driven by a decrease in inventories, while private consumption and investments (excl. inventories) declined less than we expected. Although we had forecast the de-stoking, the adjustment was extremely rapid. It is expected to continue throughout 2009 albeit at a much slower pace. As previously, we expect the economy to reach its deepest point in mid-2010.

Real Growth of GDP by expenditure, % yoy



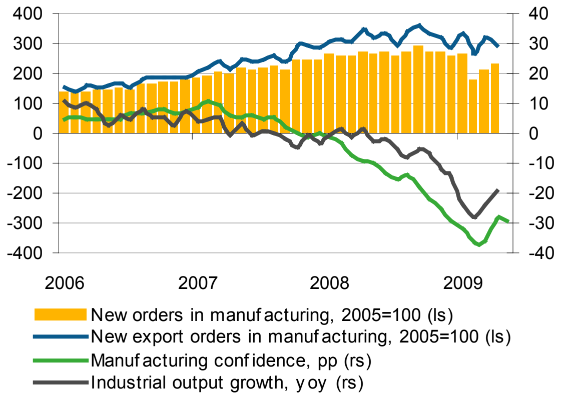
Source: CSBL; Swedbank calculations and forecast

Our GDP forecast was also lowered due to harsher government spending reduction in the 2H 09 and sharper spill-overs. The supplementary budget was approved on June 16th and the amendments came into effect on 1st July. It is planned that central government expenditures in 2009 will be 8% lower than in 2008, while revenues will decline by 14%. We believe that the fall in government revenues is likely to reach 20%. In such a case the general government deficit will reach ca 9% of GDP (of which municipalities' deficit is ca 2% of GDP). Sizeable expenditure cuts in the 2H 09 will hit the companies that are mostly oriented towards government orders particularly hard (e.g. in the IT sector that has not been directly hurt so far).

The modest decline in private consumption in the 1Q can partly be attributed to the fact that households proactively cut their consumption in 2008, i.e. before reduction in their real incomes. The 2Q was also relatively good but we expect a large decline in consumption in the 2H 09 with another unemployment wave and sharper wage cuts (e.g. ca 20% in the public sector) triggered by government spending cuts. After temporary improvement in consumer confidence in March-May it retreated in June to early 2009 levels. As private consumption contraction is now skewed to the end of 2009 and expected to bottom out in the 2H 2010, a larger fall is anticipated in 2010 (15% vs. 12% before) due to the base effect.

Investments excluding inventories performed better in the 1Q 09 than we had expected, but as the data are usually substantially revised, we are not changing our -30% forecast for 2009 so far. The deepest point is forecast in mid-2010 levelling out afterwards due to export needs. On the negative side are non-existing residential real estate investments, as well as the planned decrease in capital expenditures by the government. Postponement of the government decisions raises uncertainty and lowers investor confidence. On the positive side, there are several large investment projects announced in the wood processing sector and pharmaceuticals in 2009.

Industry Indicators, s.a.



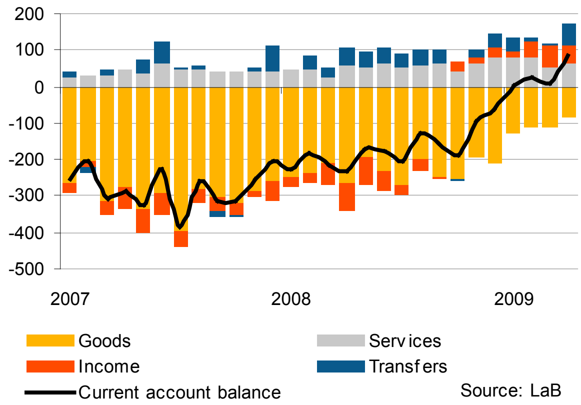
Source: Reuters EcoWin, CSBL

After a swift real exports contraction in the 1Q (due to a fall in global demand), we expect them to resume at the end of 2009. Industrial output stabilised in recent months; industry confidence rose in April and has evened out since then due to improving future production expectations. For instance, companies in the wood processing industry are already back to their quantities of last year albeit the prices have nearly halved. While other countries are not ready to sell at such low prices, in some industries Latvian producers are increasing their market shares. Although the export deflator decreased only by 2.7% qoq in the 1Q, producer price developments show further deflation, which is necessary to restore competitiveness. With the smaller fall in the export deflator, nominal exports are anticipated to decrease less than 20% in 2009. Global price developments and exchange rate movements suggest that the import deflator in 2009 will fall less than we have expected. The decline in nominal imports is thus anticipated to be smaller than in our previous forecast (i.e. less than 35%).

These foreign trade developments will result in swifter current account improvement. The current account was already in surplus of 1.1% of GDP in the 1Q. The trade deficit will continue to diminish rapidly albeit a bit more slowly than previously as imports' fall decelerates (e.g. due to higher exports and already significantly reduced inventories). As a result, the current account surplus is anticipated to reach ca 3% of GDP, supported by losses of FDI (which improve income account) and remain positive in 2010.

CPI monthly deflation has been slower than expected albeit somewhat accelerating. Growing fuel prices that we did not anticipate in our previous forecast push CPI up. The excise tax on alcohol increased on 1st July, which was only decided in June. As a result, average CPI inflation might be closer to 3% in 2009 (2% before). The negative output gap will continue to put downward pressure on prices in 2010 as well, but possible tax rises will have an opposite effect. There is still no final decision regarding tax changes in 2010 and we thus will not change our forecast.

Current Account, LVLm



Source: LaB

Speculative pressures due to uncertainty about the 2nd trench by the EC and IMF led the Bank of Latvia to withdraw lats. Due to this liquidity squeeze interbank interest rates increased with the RIGIBOR hitting 30% in June. Banks' necessity to fulfil lats reserve requirements moved the LVL/EUR exchange rate to its stronger side and the Bank of Latvia intervened by buying lats from 8th of June till the end of the month. Volatility in the financial market remains high and closely linked to reserve requirements. Credit stock continued to decline (by 3% since January). The worsening loan quality led to loan provisions reaching 4.5% of the credit portfolio in May. Banks are forced to increase their capital in expectations of further losses.

The key source of uncertainty is the government policy – the timing and quality of its decisions. Although the 2nd EC payment of EUR 1.2bn was agreed upon after the Latvian parliament approved the budget cuts, the structural adjustment is still delayed. It is unclear how the public sector will be reformed and what support for businesses will be. Poor communication and frequent changes result in a perception that the government is not doing its job (and does not have a clear action plan). It is extremely important to plan the 2010-2012 budget and structural reform implementation process in the nearest 3 months, as short-term government actions determine business and public confidence and longer-term developments. Revenues should be planned with particular caution as excessively optimistic forecasts (as in 2009) may put at risk attaining budget deficit targets[1]. Current delays in the decisions harm sustainable growth prospects several years ahead.

Lija Strašuna
Mārtiņš Kazāks

1 According to revised Memorandum of Understanding among EC and Latvia, general government budget deficit should be under 10% of GDP this year, 8.5% in 2010, 6% in 2011 and 3% in 2012.

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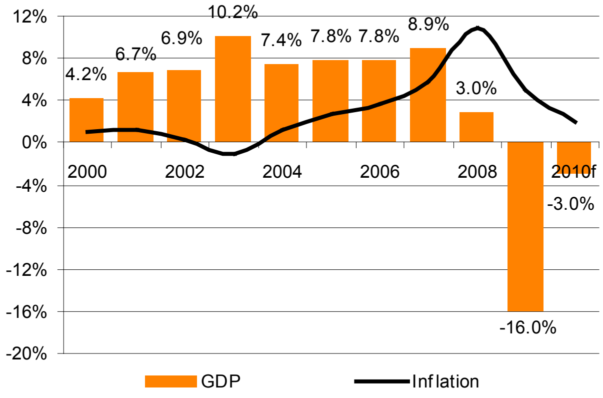
Lithuania

	2004	2005	2006	2007	2008	2009f	2010f
Economic growth, %	7.4	7.8	7.8	8.9	3.0	-16.0	-3.0
GDP, mln euros	18,159	20,870	23,978	28,423	32,292	27,261	26,575
GDP per capita, euros	5,285	6,113	7,065	8,420	9,612	8,151	7,978
Growth of industrial sales, %	10.8	7.1	7.3	4.0	2.7	-20.0	-4.0
Growth of GDP deflator, %	2.5	6.6	6.5	8.8	10.3	0.5	0.5
Growth of consumer prices, %	1.2	2.7	3.7	5.7	10.9	5.0	2.0
Growth of harmonised consumer price index, %	1.2	2.7	3.8	5.8	11.1	5.0	2.0
Growth of producer prices, %	6.0	11.5	7.4	7.0	18.2	-13.0	3.0
Harmonised unemployment level, %	11.4	8.3	5.6	4.3	5.8	14.5	16.0
Growth of real net wage, %	4.9	6.8	14.9	17.7	11.2	-10.0	-5.0
Growth of exports of goods and services, %	12.0	27.0	17.9	9.2	25.4	-27.0	-2.0
Growth of imports of goods and services, %	14.2	26.1	23.1	15.9	18.3	-37.6	-1.3
Balance of goods and services, % of GDP	-7.0	-7.2	-10.3	-13.4	-10.5	-0.3	-0.6
Current account, % of GDP	-7.7	-7.1	-10.6	-14.6	-11.6	0.0	-0.5
Current and capital account, % of GDP	-6.4	-5.8	-9.5	-12.8	-9.7	2.0	1.5
FDI inflow, % of GDP	3.4	4.0	6.0	5.2	3.8	1.5	1.0
Foreign gross debt, % of GDP	42.4	50.7	60.2	72.3	71.4	76.7	76.0
General government budget position, % of GDP	-1.5	-0.5	-0.4	-1.2	-3.2	-7.0	-7.0
General government debt, % of GDP	19.4	18.4	18.0	17.0	15.6	-21.5	-22.0

We downgraded our GDP forecast to a ~16% fall instead of 13% for 2009, taking into account the sharper GDP contraction in the 1Q, according to the second statistics estimate, and the weaker than anticipated industrial sector performance. Domestic demand, consumption and investments in particular have so far been weakening more quickly than assumed previously and is expected to fall more substantially in 2009 with annual growth resuming at best in the 2H of 2010. The net export contribution to GDP, on the other hand, will be more positive than forecasted before: even though exports will remain weak, the drop in imports is expected to be larger. Weak credit growth due to global and domestic deleveraging and pessimism will be significant factors deepening and prolonging the economic downturn. We expect the annual GDP decline to be the deepest in the 2Q and 3Q of 2009. A slightly smaller contraction is forecasted starting in the 4Q this year as business and consumer confidence already showed some signs of stabilisation and more positive news is expected regarding the global economy at the end of 2009.

Economic Growth and Inflation



Source: LDS, Swedbank forecast

Despite the effects of the closure of the Ignalina nuclear power plant in 2010, the fall of domestic demand is expected to be smaller. Thus, economic contraction will be modest (-3%), slightly stimulated by the government's economic stimulus plan. We anticipate some stabilisation at the end of 2010, followed by a limited recovery in 2011. The economy will go through restructuring in the next few years and regain its competitiveness through significant cost (incl. wage) cuts and production adjustments. The target is euro adoption in 2012: the right fiscal policy would make it possible to fulfil the Maastricht budget criteria of 3% of GDP by then.

Household consumption is forecasted to show a sharp annual decline for the next few years due to wage cuts, a rise in unemployment and weak confidence. As people are afraid of losing jobs, they increase precautionary savings and try to reduce their debt level. Although while in recent months the first stabilisation signs in confidence were registered, another wave of pessimism is likely to come at the end of the year with substantial cuts in pensions, social benefits and wages for employees in the public sector as well as an expected surge in unemployment. We forecast household consumption to contract by ~18% in 2009 and ~5% in 2010.

Government consumption is expected to contract this and next year due to a huge shortfall in revenues and the government's intention to keep the budget deficit in the range of 6-7% of GDP. In our opinion, this fiscal target is possible, but

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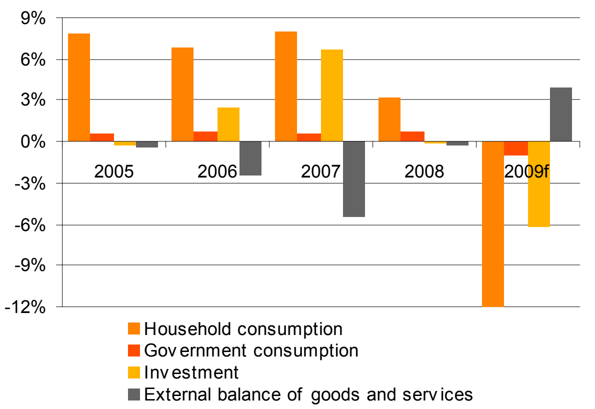
will be difficult to achieve. According to the draft of the second supplementary budget the central government's revenues will be reduced by EUR 0.58bn, while the expenditures – by a mere EUR 0.1bn compared with the first estimate in May. The central government's budget deficit is to be increased to EUR 1.3bn up from EUR 0.9bn and the net borrowing limit is to be raised to EUR 2.7bn.

In an attempt to overcome the deepening economic crisis and fill a widening gap in public finances, the Government yet again proposed a package of measures, which includes increasing the value-added tax from 19% to 21%, raising social insurance contributions, and cutting public sector wages, pensions and maternity benefits. The document also calls for submitting plans for substantial structural reforms aimed at reducing the deficit in 2010 (by ~EUR 1.1bn) by the 1st of September.

As forecasted, investments (excl. inventories) took a deep plunge in the first quarter of this year, while companies continued to reduce their inventories. Investments from own and borrowed sources are virtually non-existent, while the main source of investment will come from EU funds. We continue to expect a slight pick-up in investment in the export-oriented sectors next year contingent upon the signs of revival in economic activity in our main export partners. Virtually no significant help for investments is likely to come from the real estate sector in 2009-2010 – oversupply remains high, which, given the labour market and credit market developments, is likely to be reduced only after a few years.

Contributions to GDP Growth



Sources: LDS, Swedbank calculation

We expect the current account to be approximately in balance this year and next. Due to a sharp economic downturn, the improvement in the external imbalances has been swifter than anticipated – during the 4Q of last year CAD narrowed to -3.8% of GDP, while in the 1Q of 2009 a small surplus of 0.4% of GDP was registered. Two main factors, which contributed to the change, were a rapid decline of the trade deficit and a fall of the income account deficit due to a decline of reinvested profits from FDI. We expect that the improvement in the merchandise trade deficit will be significant throughout the year – even though the freefall in exports and imports has ended, no substantial pick-up in domestic demand, and hence in imports, is expected. While consistently showing a surplus, the services account will remain one noteworthy factor pulling the current account balance to the negative side, as the demand for transport services continues to decline. Although the currency depreciation in the CIS region as well as Poland has ended, competitiveness compared to these countries remains weak; given the economic downturn in these countries as well, no pick-up in exports to the region is likely. Thus, economic recovery in the near term is dependent on the revival of exports to the EU and other markets.

As anticipated, consumer price inflation is quickly easing. After the initial jump at the beginning of the year monthly inflation was only marginal and monthly deflation was registered starting in April. The retail sector, accommodation, restaurants – all these sectors registered a fall in prices in the last few months. Labour market developments mean that household purchasing power will continue to weaken, which will continue to push the prices of goods and services downwards. Authorities also indicated that administratively regulated prices are to be lowered this year, namely electricity – by ~11%, and gas – by 17% starting July 1st, which is likely to have a composite ~-0.45 pp effect on annual inflation. Even though the fall in prices appears to be unrelenting, the CPI this year is positively influenced by a rise in oil prices in global markets. However, the firms for which fuel is a salient expense item, have a limited ability to pass on the price increase to consumers; the same limited effect is anticipated from the planned increases of the VAT rate from 19% to 21%. Hence, we retained our forecast that average annual inflation would ease to 5% this year and further slip to ~2% next year. Even if current developments in energy prices, especially gas, persist, a rise in electricity prices and second-round effects following the Ignalina NPP shutdown may be significant next year.

The slowdown in the credit growth has become swifter after the first months of the year and will be even more apparent in the next quarters. Money market rates experienced ad hoc jumps in the last months, which is likely to occur again until uncertainty and tension in the economy ease.

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Please see important disclosures on last page

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Abbreviations:

CB– central bank

CEE – Central and Eastern Europe

CPI- consumer price index

CSBL - Central Statistical Bureau of Latvia

EC - European Commission

ECB - European Central Bank

EKI - Estonian Institute of Economic Research

EP – Eesti Pank (central bank)

ESA– Estonian Statistical Office

EU – European Union

HICP – harmonized index of consumer prices

IMF - International Monetary Fund

LaB – Latvijas 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