

Baltic MacroScope July 2005

Estonian economy

(Written by Ruta Eier, SEB Eesti Ühispank)

Main indicators

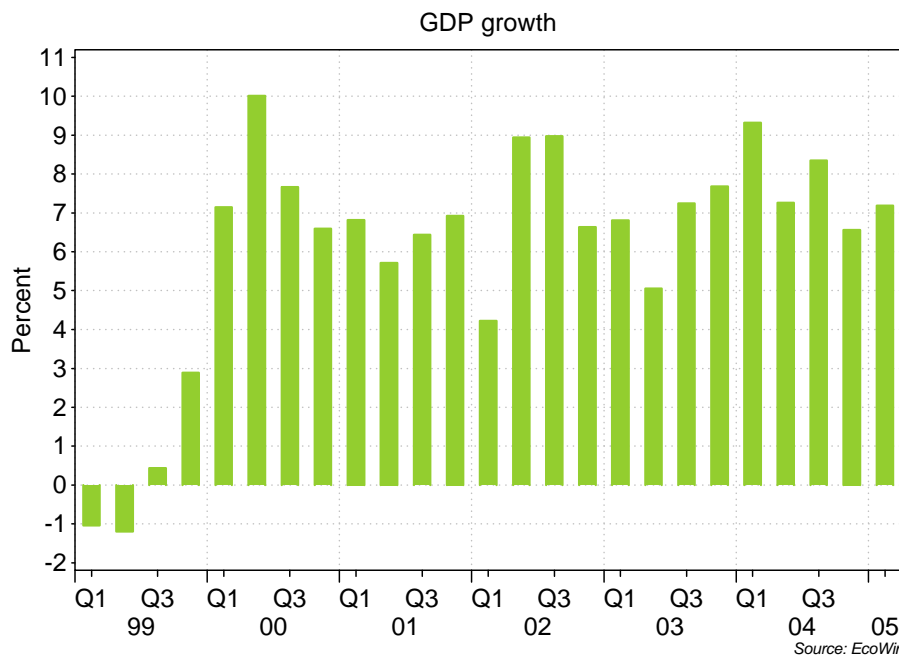
	1999	2000	2001	2002	2003	2004	2005E	2006E
GDP real growth	0.3%	7.9%	6.5%	7.2%	6.7%	7.8%	6.4%	6.4%
Export growth	-0.6%	53.9%	7.3%	-1.5%	9.7%	18.8%	14.1%	11.0%
Import growth	-8.7%	43.2%	4.0%	5.8%	12.9%	17.5%	10.3%	9.6%
Foreign trade balance, % of GDP	-18.8%	-19.7%	-16.5%	-19.2%	-21.3%	-22.0%	-20.0%	-19.2%
Retail sales growth	5.8%	10.5%	13.8%	14.3%	9.9%	13.0%	11.5%	10%
CPI growth	3.3%	4.0%	5.8%	3.6%	1.3%	3.0%	3.7%	2.5%
Unemployment rate	12.2%	13.6%	12.6%	10.3%	10.0%	9.7%	9.2%	8.9%
Public budget balance as % of GDP	-4.3%	-0.9%	0.6%	1.1%	2.6%	1.6%	0%	0%
Current account balance as % of GDP	-4.4%	-5.5%	-5.6%	-10.2%	-12.1%	-12.7%	-9.5%	-9%
Foreign direct investment inflow, mio EEK	4448	6644	9430	4800	12866	13111	38471	15126
FDI/CAD coverage	123%	130%	160%	40%	84%	73%	257%	97%
3m interest rate, end of period	5.1%	6.1%	4.0%	3.5%	2.6%	2.4%	2.4%	2.4%
Long-term interest rate, EEK loans	8.6%	8.9%	10.1%	6.6%	5.1%	5.4%	5.4%	5.4%

The heat is turned on

Economic growth rates continue upsurge

In the beginning of year 2005, the economy kept on growing at rapid pace. GDP increased 7.2% yoy in 1Q05, being less than in 1Q04 (9.3%) but more than in 4Q04 (%).

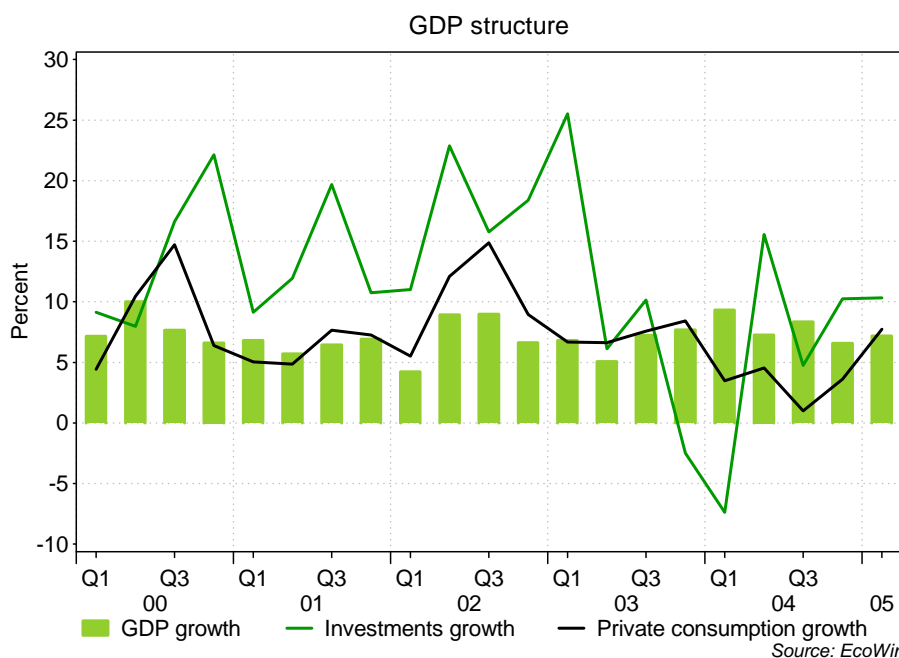
Statistical Office has revised once again the whole series of GDP data for period 1993-2004, in result of what last year's GDP growth reached 7.8% (previously 6.2%) and 1Q04 GDP increased even 9.3% yoy, being highest quarterly growth rate last year. The revisions were brought about by methodological changes in FISIM (financial intermediation services indirectly measured) calculation. As economic developments in 2004 were very broadly affected by the activity of financial institutions, these revisions were quite noticeable in GDP figures last year. Hereby, as we don't foresee any major changes in the activity of financial institutions and monetary environment to back up them, we believe it would be no surprise if 2005 GDP growth exceeded our forecast we've had so far.



...while the structure of growth is improving

The growth structure of GDP improved in 1Q, being more driven by exports than earlier. The goods' exports rapid growth was the main reason behind the acceleration of GDP growth in 1Q05. At the same time, domestic demand remained vigorous as well, both consumption and investments.

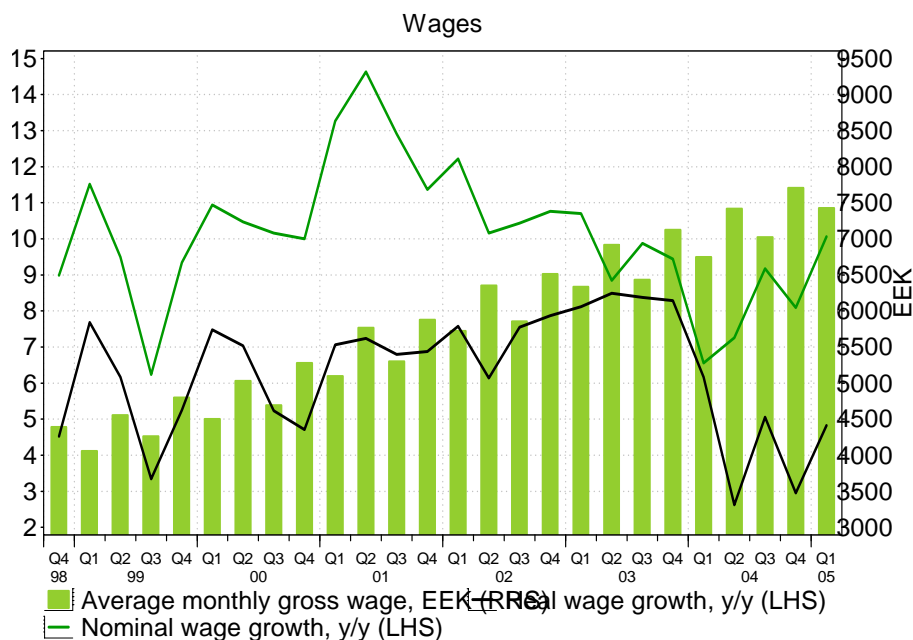
Companies' fixed investments increased 10% yoy, being not much brought about by investments into real estate, but apparently more by investments into production. Also these developments are healthy concerning the prospects of the future current account development and economic growth.



Consumption seen strong in 2005

The revised data for consumption in 2004 indicated that the growth rates were surprisingly low compared to the overall GDP growth rate and to consumption in previous years. In 1Q05, private consumption speeded up. We expect hefty consumption in 2005, on the back of rising real wages, rising disposable income as a result of income tax cut, falling unemployment rate, low interest rates and rising property prices. As an one-off effect, we expect

to see temporarily higher growth rates in consumption in 2Q as a result of massive money inflow from the buyout of minority shareholders of Hansabank.

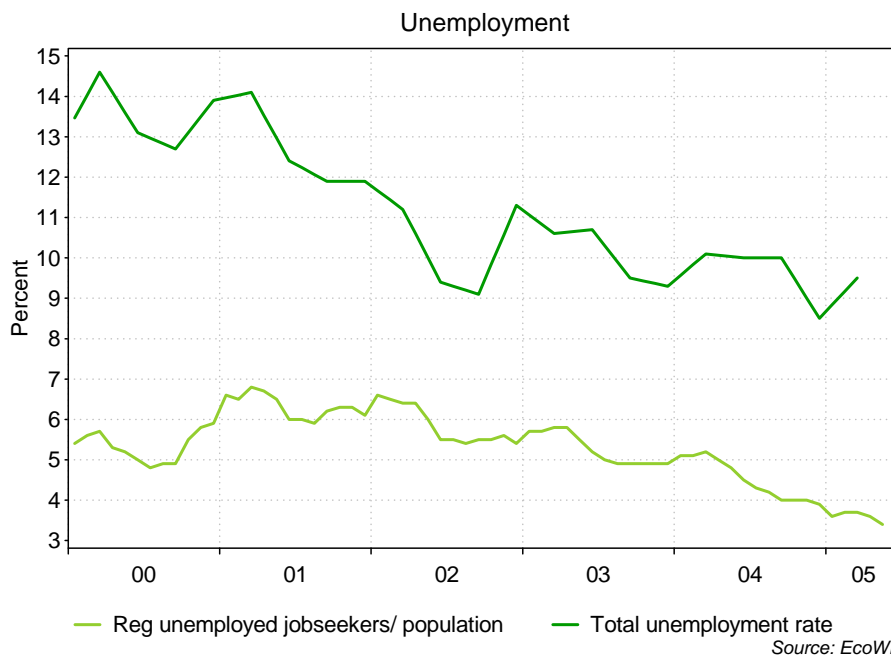


Source: EcoWin

Unemployment decreasing at more rapid pace than expected

We can say the intense economic growth is having its positive impact on unemployment and we expect the unemployment rate to decrease this year more rapidly than we thought earlier. The official unemployment figures reveal a sharp decline in unemployment rate in 2Q. For instance, in May, the registered unemployment decreased 17% yoy and the registered unemployment rate fell to 3.4% (4.8% a year ago). Hence, when in 1Q05 the total unemployment rate was 9.5%, we expect it to decrease further in 2Q and reach 9.2% as an average for 2005. On a more negative note, the share of long-term unemployment has not decreased in 1Q.

In 1Q05, employment turned into increase again (0.9% yoy) after two quarters decline, driven by higher employment of part-time workers. By economic sectors, employment increase was mostly influenced by electricity production, hotels and restaurants, transport, storage and communications, real estate and health care sectors. Thus, it was primarily the services sector which expanded in terms of employment. Could that mean better prospects for services exports in near future? Possibly.



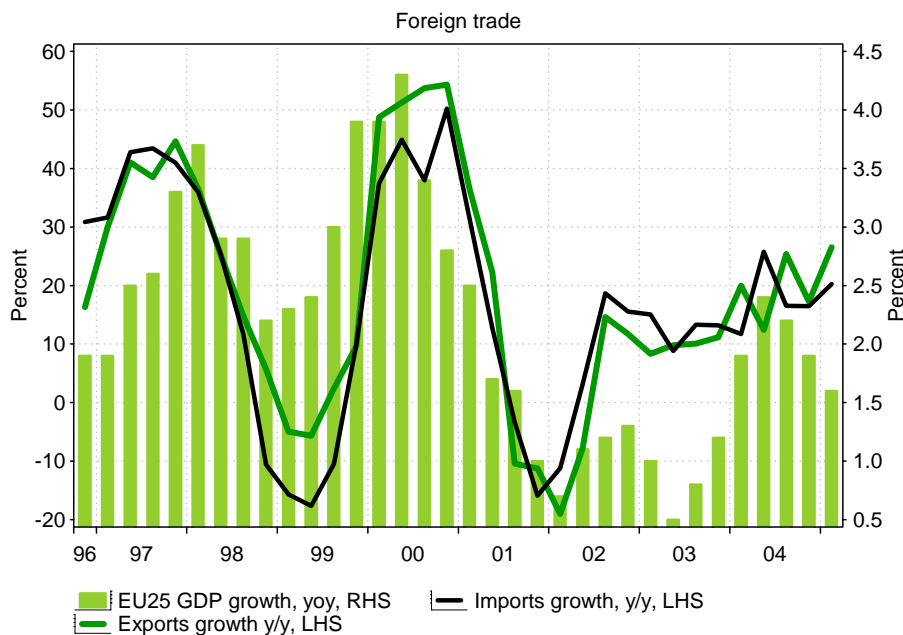
Global developments might imply the possibility of slowdown

There is no doubt recent economic growth in Estonia have been supported by favourable external demand, resulting from healthy global economic growth rates and to some extent, also helped by the EU-accession impacts. As of 1Q05, the indicators show a slowdown in global arena, which is expected to deepen even further.

GDP growth in euro zone will likely be disappointing again in this year. In 1Q, GDP growth rate decelerated and did also do so in Sweden and Finland, which are Estonian main export partners. The growth rates stalled in the autumn last year and pessimism among the consumers and enterprises prevent it to regain itself soon. The leading indicators point to deepening weakness in economy. The growth disappointments in euro zone may lead to interest rate cut after the summer, which, in turn, means the additional fuel to the Estonian GDP growth rates. Recent strengthening of US dollar has been beneficial for euro zone exports. Nevertheless, the underlying imbalances and twin deficit in USA are still there and are not going to decrease, which prevents dollar from further strengthening. The possibility of declining dollar would cut off also main engine of GDP growth in euro zone – exports.

But the EU-accession effects, low interest rates and strong domestic demand and international competitiveness have their offsetting effects

The potential slowdown in Euro zone implies without no doubt to the possibility that also Estonian economy growth rates would decelerate. Nevertheless, the experience from the history shows it doesn't necessary have to happen. Estonia has survived global economic slowdown hardly noticing it a couple of years ago, because of strong domestic demand and even without a drop in exports. Hefty domestic demand is still in place currently, being also supported by low interest rates and the EU-accession impacts. Firm international cost-based competitiveness might even prevent from serious exports slowdown.



Source: EcoWin

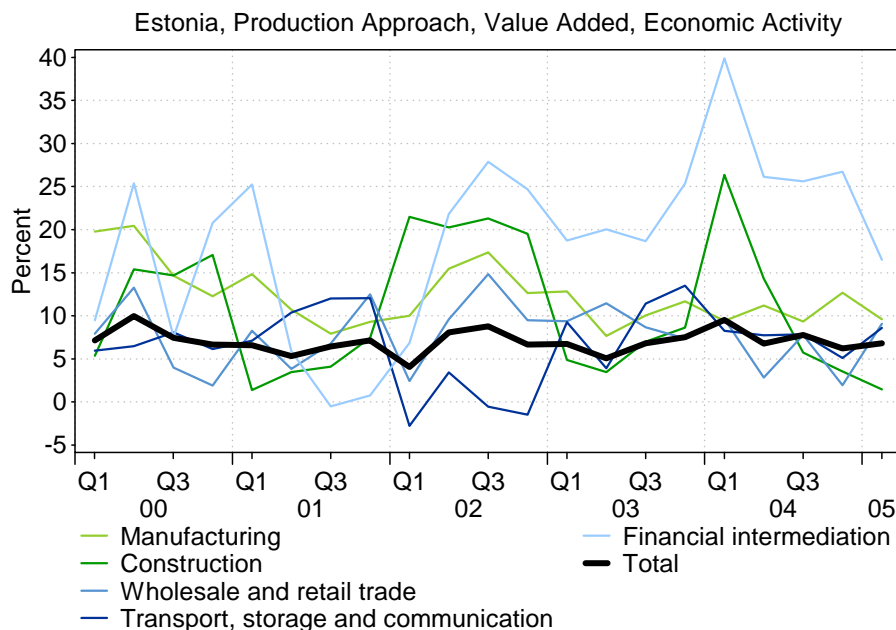
Export buoyancy is expected to carry on

We expected export buoyancy this year, based on good prospects of economic growth in main export markets Sweden and Finland and growing capability to use new export opportunities in the EU. The data for the first months of 2005 justify these expectations and the actual growth rates have even outperformed the expectations. Exports have increased 29% yoy with the first 4 months, accelerating from 19% the average growth rate in 2004. Imports growth rate has decelerated compared to the average of last year, to 12% from 18% in 2004. Of course, one couldn't forget the impact of extraordinary April last year, when imports surged in anticipation of the EU accession dramatically and brought along a 7% yoy drop in imports in April this year. Nevertheless, the implication from the data so far is that exports is very strong and stable and the relation of forces between exports and imports have turned around in a favourable direction. This is bringing about positive implications for balance of payments, as reducing its major underlying sources of deficit. Despite slightly worse outlook for Sweden and Finland economies and global slowdown, we expect export buoyancy to continue.

Economic growth continued to be very wide-spread

On production side, the main drivers of GDP growth in 1Q05 were manufacturing (9.6% yoy), whole- and retail sales (9.1%), and transport, storage and communications (8.6%). The most rapidly growing sector was still financial intermediation (16.5%). The primary sector seems to have suffered from a deep contraction, including agriculture, forestry and fishery.

The prospects for continuation of vivid economic expansion are good. Industry has been strong supporter of GDP growth and there are no signs of any potential weakening there. Also exports further expansion prospects are good, which is also lending support to industrial production.



External imbalances on the way of improvement

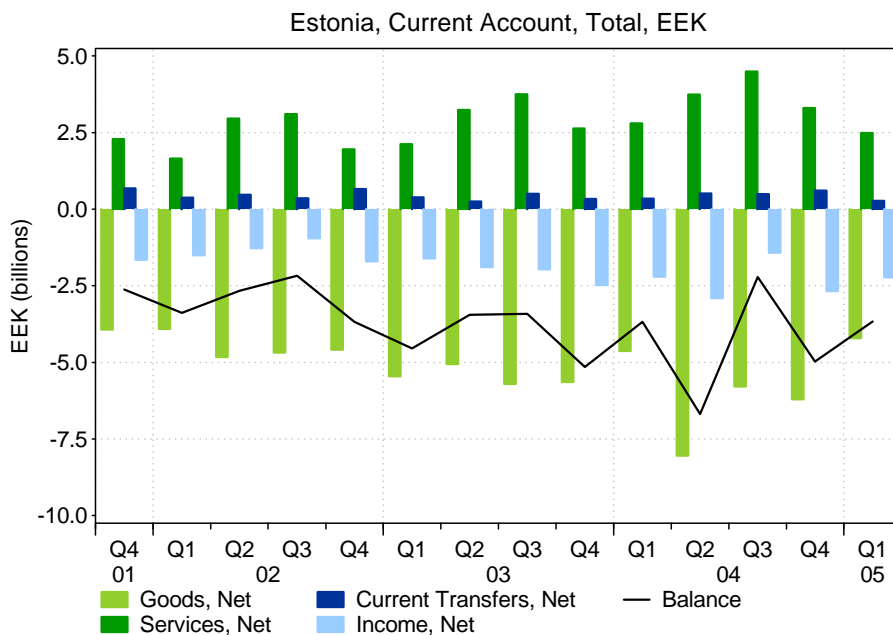
As already indicated by GDP data, the balance of payments data confirm that the trend toward the reduction of external imbalances has begun, as it was expected to. Primarily this was reflected in the improvement of trade balance, which brought down the current account deficit in 1Q.

Current account deficit amounted to 3.5 bn EEK in 1Q (-2.5% yoy and -43% qoq), constituting about 9.7% of GDP. Data for 2004 were revised somewhat, resulting in bigger current account deficit in last year than previously (17.3% of GDP in 4Q and 12.9% as an average of the year).

As a result of vigorous exports it was mainly trade balance responsible for current account deficit reduction. Exports grew 27% yoy, imports at the same time 20% yoy. Simultaneously, services balance performance was quite disappointing. The surplus of services balance decreased as a consequence of 9% yoy services exports growth and 24% yoy imports growth.

Strong income outflows continued to weigh on current account deficit. On the other hand, the inflowing incomes were far larger than usual for the first quarter. Nevertheless, this was not enough to prevent the deficit of income balance from growing.

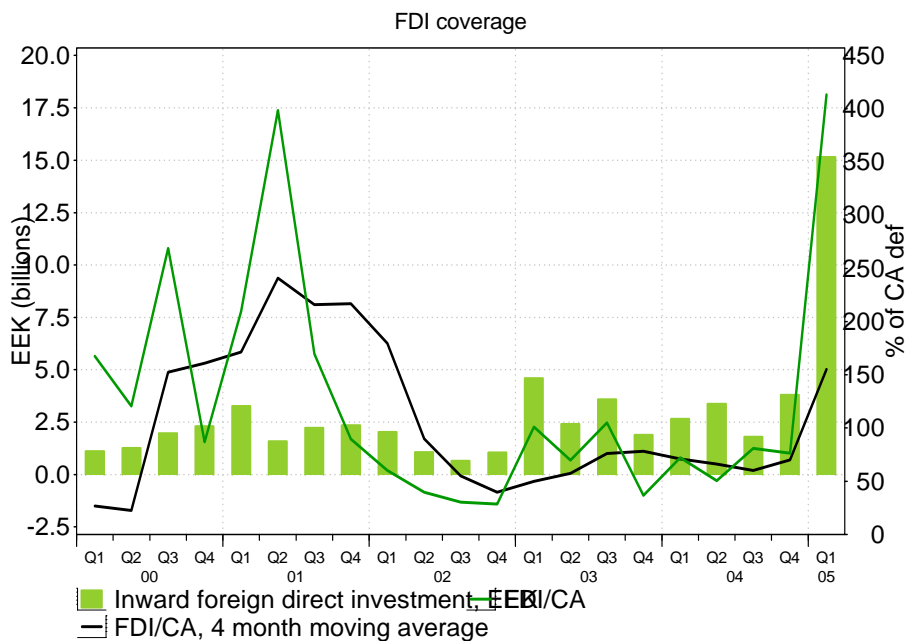
The main implication from the data is that while trade is vigorously improving, the other factors continue to swell the current account deficit. However, better than expected performance by exports adds ground to expectations of current account deficit reduction this year. We lowered our forecast for current account deficit for this year, as 1Q data showed quicker changes than expected.



Source: EcoWin

Extraordinary FDI flows improve the financing of current account deficit

FDI inflow in 1Q exceeded 13.8 bn EEK, which is more than the inflow for the whole year 2004 (which was a strong year in terms of FDI, reaching all-time high in history). The reason lied in the buyout of Hansabank shares by its core investor, in result of what some portfolio investments were turned into direct investments. Hence, no need to mention that 1Q FDI inflow was breaking all earlier records, exceeding about 4 times the amount of the current account deficit. However, 2Q will yet post another record, when even stronger inflow is expected because this was the time when the majority of money from Hansabank shares was being transferred from portfolio investments into direct investment.



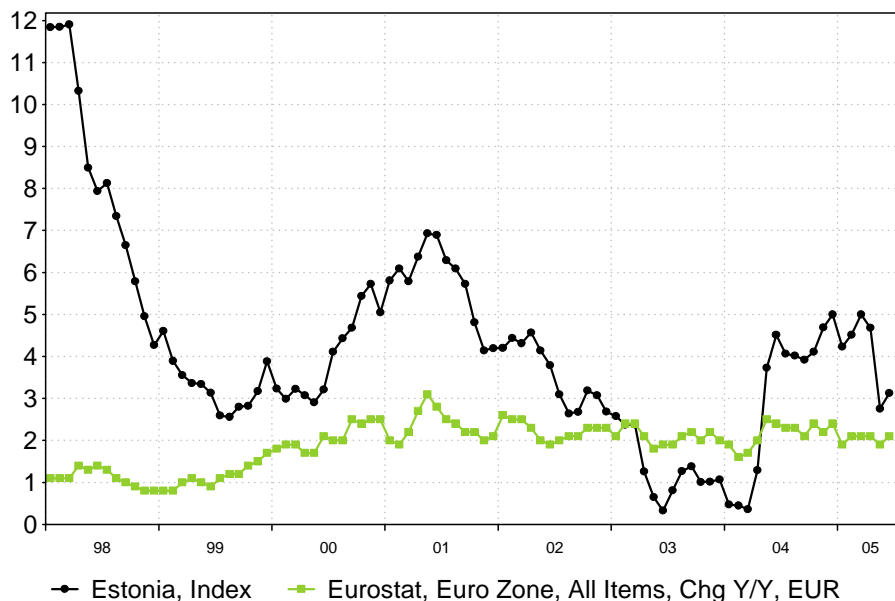
Source: EcoWin

Inflation so far driven more by supply-side

Inflation has followed the pattern it was expected to – the pre-accession base effects have faded away in May and the other underlying inflationary forces remained. So far, the inflation has been mainly supply-side. With the first five months of the year, all the expected administrative price increases have already taken place. So these factors will not be in place in coming months anymore. But the inflationary sources from external environment have not

subsided. The primary factors here are global oil prices. In addition to administrative price increases, recently the CPI increases have been very much driven by oil price skyrocketing and dollar strengthening. In June, CPI increased 0.7% mom, because of rapid fuel price increase and higher food prices.

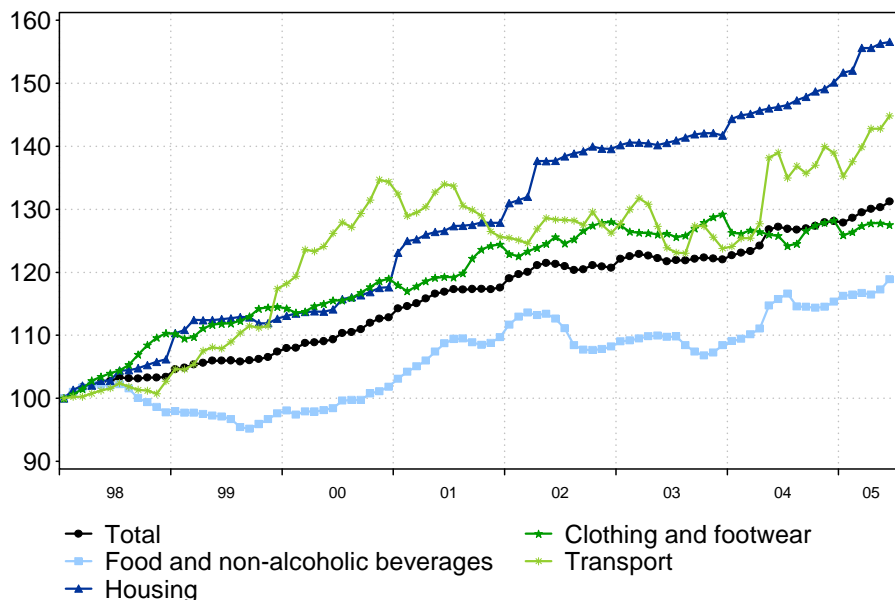
CPI y/y in Eurozone and Estonia



Source: EcoWin

As of 1H05, the average of last 12 month CPI inflation reached 4.2% and 6 months inflation 4% yoy. As a result of fade-away of base effect in the second half of the year, it will decrease somewhat for the end of the year. However, as a result of higher oil prices increase than earlier thought, we raise somewhat our inflation forecast for 2005, to 3.7%. As for coming years, the energy prices will still be issue, one component being the gas prices, which will increase quite considerably in next 3 years.

CPI components, Jan 1998=100



Source: EcoWin

...but vigorous domestic demand might add also demand-driven pressure

As a result of huge amount of additional money supply in economy, domestic demand will rise in the second quarter. In theory, that fact would add to inflationary pressures. But as the boost to consumption should be much of temporary nature, the prices might not respond significantly.

*Expansionary fiscal
policy is still a threat to
economic stability*

The government with its expansionary fiscal policy will just add to demand-side inflationary pressures. However, it seems to realize the threat of rising inflation as a result of high oil prices, reflected by its decision to abandon a plan of raising excise taxes for tobacco and fuel again next year to cover its budget revenue shortages. As a consequence of larger social responsibilities the government has taken, it has now trouble to find a proper financing to these costs. According to present plan, the shortage will be covered by state assets sell. This is short term solution and will postpone the problems only shortly. This game can be named as the bet on larger than expected economic growth rates which might rescue from the looming budget deficit trap. Should economic growth rates disappoint and further social costs be taken we may not see fiscal surpluses in coming years anymore.

Latvian economy

(Written by Andris Vilks, SEB Unibanka)

Main indicators

	1999	2000	2001	2002	2003	2004	2005E	2006E	2007E
GDP real growth, %	3.3	6.9	8.0	6.4	7.5	8.5	7.5	7.0	6.8
Export growth (goods), %	-5.1	12.2	11.1	12.1	17.2	28.1	30.0	25.0	23.0
Import growth (goods), %	-8.3	12.2	13.8	13.4	19.7	25.2	23.0	18.0	16.0
Foreign trade balance, % of GDP	-16.9	-17.1	-19.7	-20.9	-22.8	-22.1	-21.8	-20.2	-19.5
Retail sales growth, %	6.0	17.5	2.7	12.4	13.6	12.5	15.0	11.0	10.0
Industrial output growth, % of GDP	-8.8	3.2	6.9	5.8	6.5	6.0	5.5	7.0	7.0
Total loan portfolio as % of GDP	20.1	23.2	31.7	37.3	47.5	59.5	73.3	85.0	90.7
CPI growth, annual average %	2.4	2.6	2.5	1.9	2.9	6.2	5.9	4.5	3.7
Unemployment rate (ILO), %	14.3	14.4	13.1	12.0	10.6	10.4	9.3	8.7	8.2
Public budget fiscal balance as % of GDP	-3.7	-2.6	-2.0	-2.3	-1.6	-1.1	-1.4	-1.2	-1.2
Current account balance as % of GDP	-9.0	-4.6	-7.6	-6.7	-8.2	-12.3	-10.8	-9.5	-8.5
Foreign direct investment inflow (mn LVL)	203	250	83	157	172	350	370	380	400
FDI/CAD coverage, %	53.4	115.2	21.1	41.2	33.1	38.5	40.4	41.3	42.6
Interest rate, long term national currency loans (annual average)	13.2	10.3	10.4	8.5	7.5	9.2	8.0	7.0	6.5
3m interest rate, end of the period	6.5	5.5	6.7	3.8	4.2	4.4	2.6	2.7	2.7
State debt as % of GDP	12.1	12.2	13.7	13.4	13.4	13.2	11.6	12.1	11.5

Key trends in economic development

*Dynamic development
with problems looming
behind*

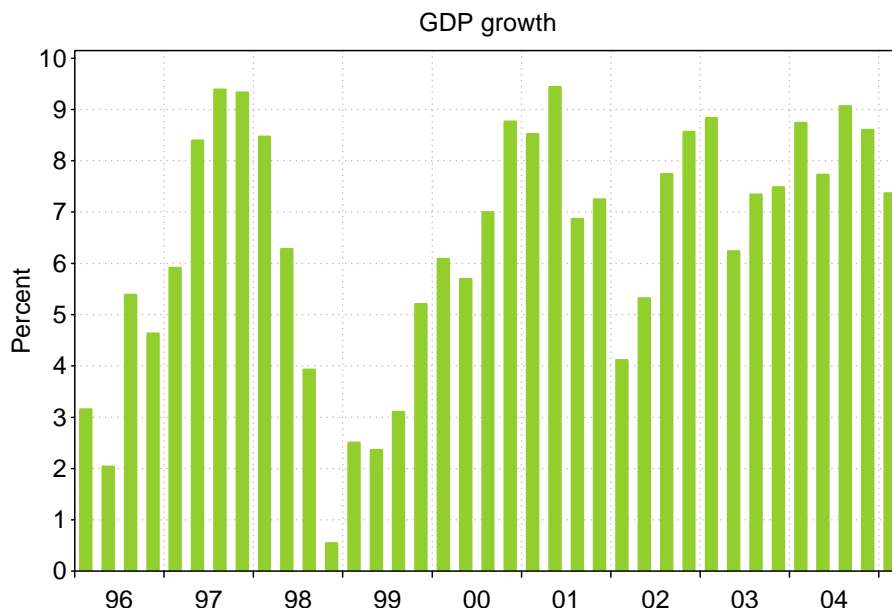
In the first quarter and the following spring months economy of Latvia was on a fast, dynamic upward direction, largely coinciding with the forecast. GDP growth is the highest in the EU, propelled by both internal and external demand. Soaring exports, which gradually curtails the predominance of imports over exports is a surprising feature in foreign trade. Current account deficit of the balance of payments remains high but the large inflowing foreign direct investment stock is a pleasing fact. The fiscal situation is good; the traditional surplus, which is posted to the budget in the first half of the year, is even larger than before.

Latvia has finally joined the Exchange Rate Mechanism II, retaining a faint hope to adopt the euro in the planned early 2008. Adoption of the euro may likely be delayed due to the unexpectedly high inflation. It has caused anxiety amongst the public; therefore the government is working on a strategy to rain in inflation.

GDP grows in accordance with the forecast

*In the forefront dominance
of services*

Against the 1st quarter of 2004 gross domestic product in the 1st quarter of the current year grew by 7.4%, that fully meets the forecast of experts. The growth rate of economy is stable and fast. The Baltic countries did not relinquish their leader positions in the growth of GDP. Domestic demand for goods and services topped external demand, although, judged by commodity exports data, it was considerable.

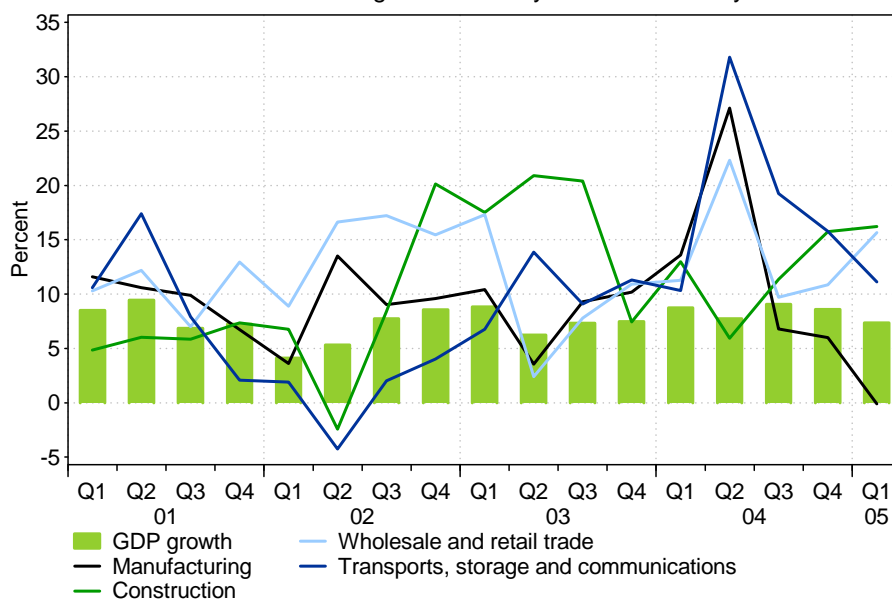


Source: EcoWin

Driving forces remain the same – retail trade, transport and communications, construction

The 11% growth in the transportation and communications sector was the most positive surprise. The biggest share in the growth was contributed by road and rail transport as well as by telecommunications business. Growth in the building and construction industry reached the forecast level (16%). The industry enjoys tremendous demand, facilitated by the fast-growing demand for a wider and better living space as well as for a larger space for industrial and commercial buildings and objects of infrastructure. Building companies can hardly cope with orders and the situation in the building and construction industry is becoming more and more complicated due to the increasing outflow of workforce from the country. Workers from Latvia are in high demand in the EU states. Owing to the lasting high consumption, domestic trade was up by 16%. A slightly larger growth was expected in the hotel and restaurant business and in financial services, where it fluctuated around 5-7%. In our daily life these industries seem to develop faster than what we see in statistics.

Value added growth rates by economic activity



Source: EcoWin

Temporary slowdown in manufacturing

Better results were expected also in the manufacturing industry. In fact, the industry's poor achievements hitched down the total GDP. But for the slowdown in industry (-0.1%), GDP would have increased by 7.6-7.7%. Results in the industrial sector were detrimentally affected by a downtrend in the key industries – woodworking, food industry, and metalworking. At times, considering the commodity exports boom, production figures give a false impression in most industries. The share of industry in the country's economic structure remains unsatisfactory, accounting for roughly 14% only, which, considering the large volumes of commodity imports in Latvia leaves a lasting negative impact on current account deficit. Currently though with the back up of foreign and local investors and EU funds, various production units have started operations or are in a design stage, which are projected for both domestic and external markets. And, as before, shortage of workforce may again become a stumbling stone on the road to development, which in industry is even more acute than in construction. Although the situation in the industry was not particularly pleasing at the beginning of the year, the pace of production will, most likely, speed up driven by increased demand towards the end of the year. Downturn in agriculture and forestry is associated more with climatic factors than with any negative tendencies.

At least 7.5% growth expected in 2005

There is no sense to change the annual forecast for the time being, which is 7.5%. In the following quarters growth ratios are expected to be up 7-8% against last year. The services and the construction sectors are expected to grow faster than the industrial and the agricultural sectors. Growth rates by sectors should square, e.g. as it happened a year before.

Latvia joins the European Exchange Rate Mechanism II

In May Latvia joined the ERM II

Rather quietly and unexpectedly as of 2 May Latvia, Malta and Cyprus joined the Exchange Rate Mechanism II to get ready for the introduction of the euro in 2008. At last it has happened, because from the very beginning of the year Latvia paid little interest in this forthcoming event, whereas foreign experts became more and more worried. We could also understand our government's behaviour, as it was not a recommended step in the period of a particularly high inflation.

Latvia in compliance with all criteria but inflation

Now Latvia will be obliged to observe ERM II for minimum 2 years and the key reporting period will be the first half of 2007. At present Latvia has been fulfilling all Maastricht criteria, excepting one – inflation. The government is optimistic about the possibility to introduce the euro in 2008 and is ready to curb the consumption boom as well as fight for regulated prices. Many experts doubt, though, that Latvia could be able to introduce the euro in the given period. Well, all are of one mind that Latvia has finally taken the step and thus has put an end to speculations.

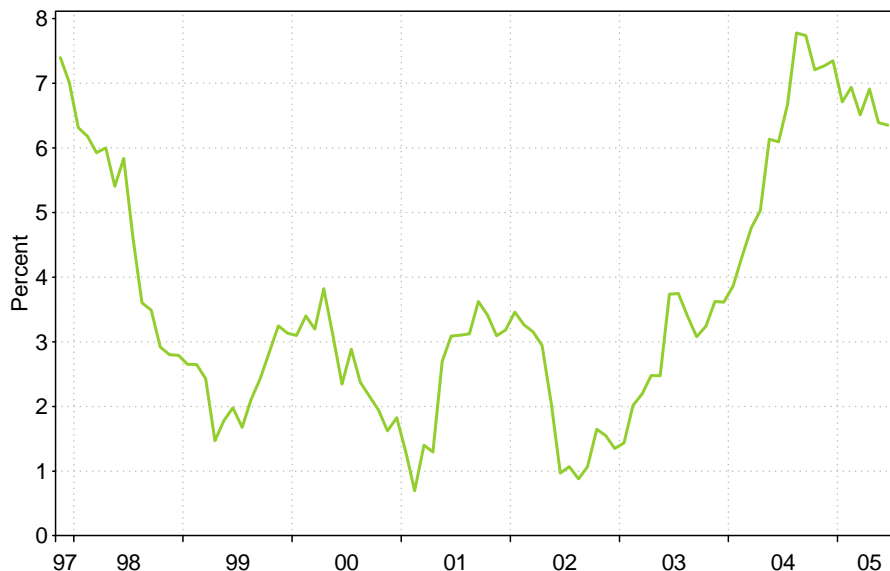
Inflation takes Latvia further away from the adoption of the euro

Annual average inflation in five months – 7%!

In the first five months of the year consumer prices have already risen by 3.9% and there is little hope that the pace of growth will abate. Therefore with each next month Latvia is moving further and further away from its goal to introduce the euro in January 2008. The fast rising food prices pushed inflation up to 0.7% in May. Had May not surprised us with lower fuel prices, inflation would have been even higher. In total in the 12 months consumer

prices climbed by 6.3%. Average annual inflation has reached unprecedented heights, namely, 7.1%. Over the year health care and transport service prices moved up by 11%, prices payable for restaurant and hotel services and food rose by 10%, education costs were up by 8%. Communications were 4% cheaper, footwear and wearing apparel also saw a slight cut-down in prices.

Latvia, CPI growth



Source: EcoWin

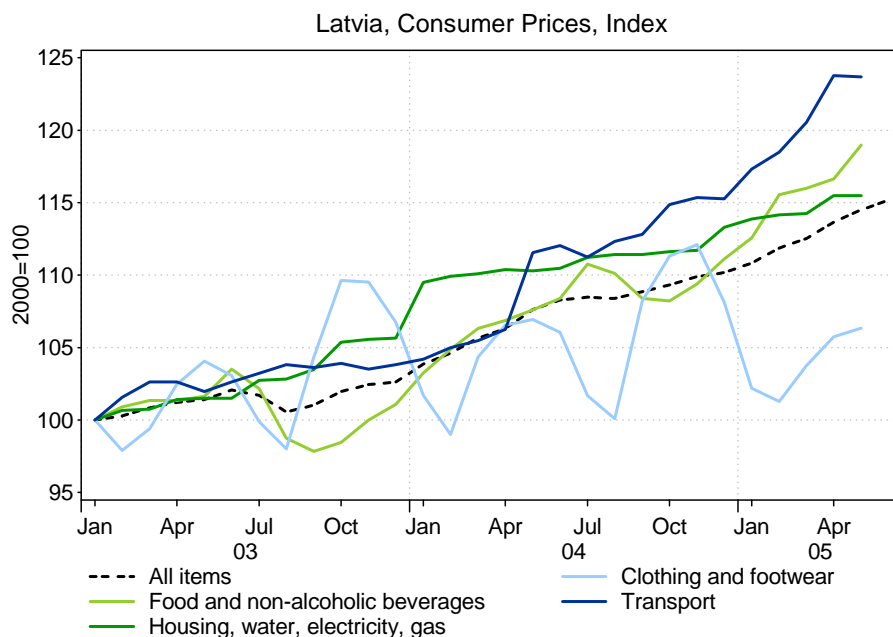
Social tension is rising, the government plans to curb inflation

The population is in rage with the soaring prices, employers are being pressed about increase of wages, while domestic and foreign experts stress that the prices are too high. The government is about to do something to repair the situation but has not yet taken any concrete measures. The government proposed lowering the value added tax on food from 18% to 5%, cutting the budgetary expenses, freezing the regulated tariffs and managing the consumption through putting limits to mortgage lending.

Latvia has and for a few more years will have the highest level of inflation in the Baltic region. As long as Latvia will have the most robust economic growth in the region, a wish to catch up with average European prices, a soaring consumption boom, growing purchasing power, shadow-economy-created additional volume of cash, the wish of producers and merchants to savour the sugary fruit of the high demand, a conditional competition in many segments of economy and a passive government, inflation will be a few percentage points higher than in our neighbouring countries. Obviously, until the market is put in order - supply outbalancing demand, or until economic upswing begins to subside.

Weak chances for euro introduction in 2008

This year annual average inflation is roughly 6%; in 2006 it is expected to hover around 4.5%, in 2007 - roughly 3.7%. As it is well seen, it is much higher than the euro adoption criteria permit (about 2%). Latvia and the other new EU member states have deserved an obliging attitude on part of the Central Bank of Europe. It is obvious that the old criteria mustn't be applied to the new dynamic members of the EU. At the same time we are obliged to watch systematic violations of the criteria in the old EU states, in which the situation is worsening and worsening.

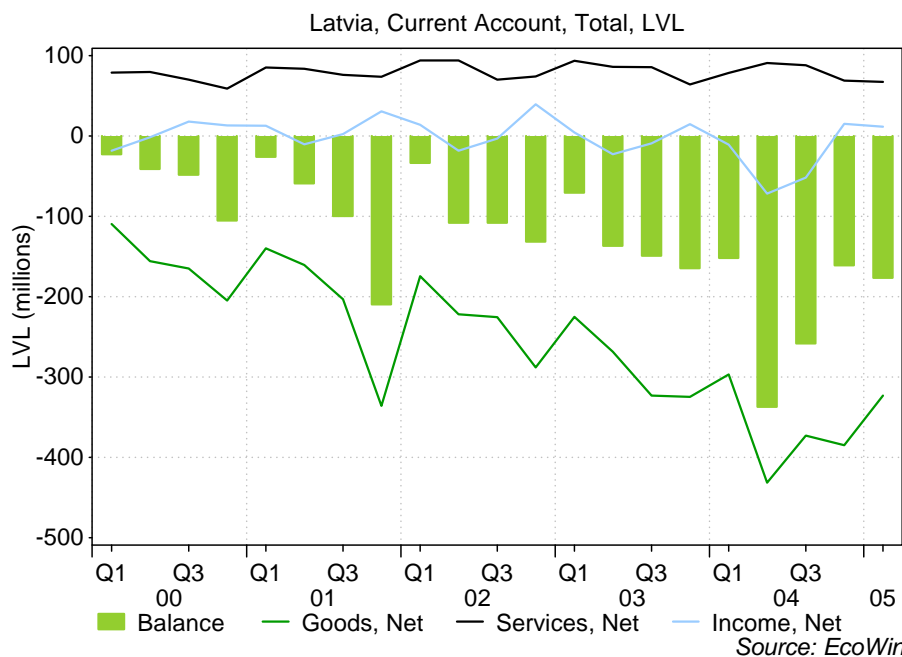


Source: EcoWin

Balance of payment is not improving

Balance of payments is unpromising

In the 1st quarter current account deficit of the balance of payments was slightly higher than forecasted. Namely, it reached LVL 198 million or 10.7% of gross domestic product. It exceeded last year's result by one per cent. The deficit was created by earlier reasons – a sizeable prevalence of commodity imports over exports, decrease of the positive services balance and growth of the negative income balance. Although commodity imports are considerably larger than exports, shrinking of the negative foreign trade balance against GDP is a positive feature.



Source: EcoWin

Exports growth is high, but short (insufficient) to compensate imports

The trend that exports' growth by 5-10% exceeds the growth of imports will continue also in the near future. The fast economic development is a stimulus for the growth of imports as it increases consumption. Another promoter of imports is weakness of industry. In its turn exports is driven forward by competitiveness between Latvia made goods and multiform goods in different markets.

Positive but stagnating balance of services

The situation in the services balance, which though positive is likely to reduce, is unpromising. Latvia is more actively making use of outside services and reduces providing services to non-residents. This is a field of immense potential but much depends on interstate relations with Russia and the EU. Growth of the negative income balance was associated with non-resident income in Latvia, which was larger than Latvian resident income in foreign countries.

CAD will remain high in coming years

In the following quarters current account deficit will reach roughly LVL 220-250 million each quarter. Therefore annual deficit is expected to come to LVL 900-950 million or roughly 10.5-11% of GDP. This figure could reduce by 1-2% next year and the year after the next year.

Investment stock is on an upswing

The volume of foreign direct investments in Latvia grew substantially, which manifests growing investor interest in the most dynamic region of the EU. In 1Q05 foreign direct investment flow reached all-time highest volume in a quarter, namely, LVL 117 million. It covered 52% of the negative current account balance. Most of the investments were funded in real estate operations, followed by the transportation and communications industry and the power industry. Germany and Sweden remain leaders in investing in Latvia, each holding a share of 15%. Leading positions are held also by Denmark, the Netherlands, the USA, and Russia, whose investors were particularly active in the 1st quarter. Obviously, the flow of foreign direct investments in Latvia will be even larger than last year, which fixed all-time largest volume.

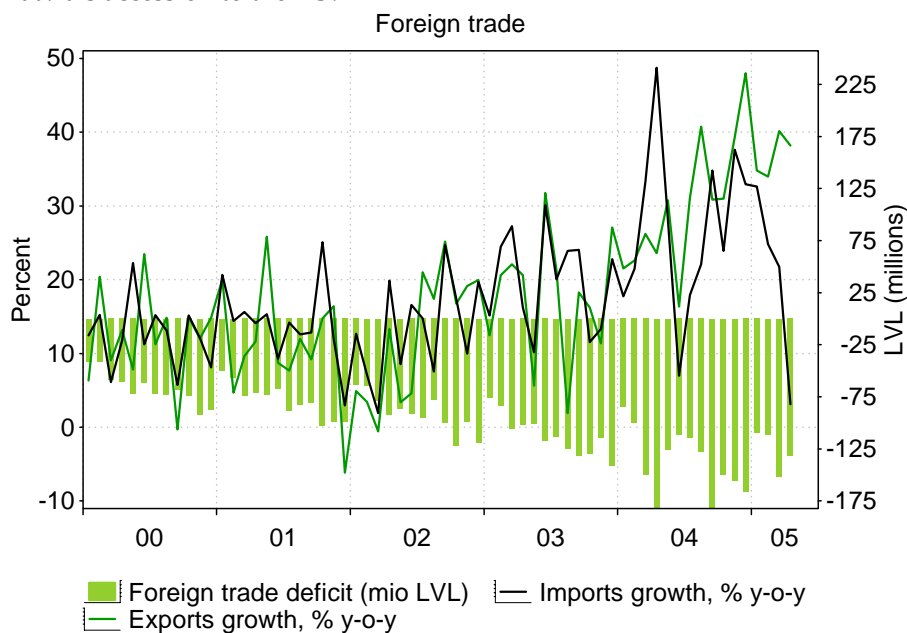
Current account deficit slightly better in 2005

Operative January and February data show that the situation has not changed significantly compared to 2004 in current account. The current account deficit exceeded the last year's level. The commodity balance remains markedly negative and the support from the services' sector becomes weaker. At the same time inflow of FDI was remarkable (more than LVL 50 million). We forecast 10.5% current account deficit this year and steady growth of foreign investments.

Foreign trade balance improves

Amazingly high exports growth

This year growth of exports has not fallen below 30%! And April was no exception, when exports was up by 38.1%. At the same time growth rates of imports are slowing down. In April imports grew by solely 3.1% but it was, most likely, associated with the crazy imports boom last April prior to Latvia's accession to the EU.



Source: EcoWin

Foreign trade balance improving

In total in the first 4 months commodity exports grew by 36.9%, whereas imports – by 18.6%. Although predominance of imports over exports is still very big, it is gradually diminishing. At the moment it closes at 58%, a year ago the difference was even 82%. Obviously average annual growth of exports will not fall below 30%, whereas that of imports will not exceed 25%. The negative commodity balance against GDP will, however, be above 20%.

The Baltics and the regional market is gaining importance and strength

Expansion of Latvian goods is making strides in Estonia, Lithuania, Poland, Russia and Sweden. Germany and Great Britain are gradually being ousted from their stable leader positions. In the nearest future the main export markets of Latvia will, most likely, be Estonia and Lithuania, followed by Poland, the Nordic countries and Russia. In the imports market the first three remains stable – Germany, Lithuania and Russia, expected to remain such also in the future.

Predominance of timber and wood products in the exports structure kept shrinking, whereas exports of food products, metals and hardware – growing.

Hike of real wages

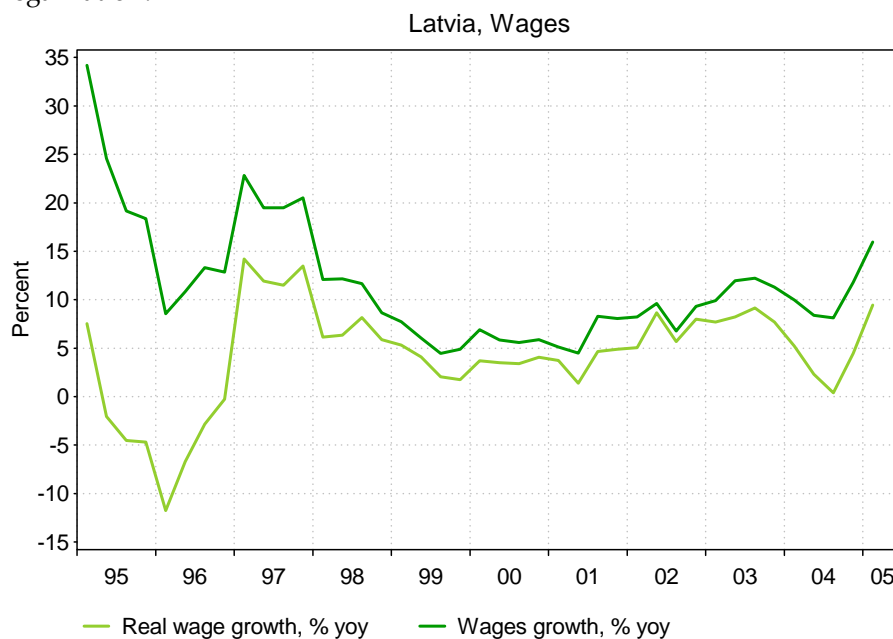
Labour market forces employers to raise wages

After a very pessimistic situation in the middle of last year, when inflation capitially axed increase of real wages, in the 1st quarter of the current year growth of real wages reached 10.3%! Gross wages grew even faster, namely, 16.4%, net wages were up by 17%. Wage increase was observed in both the state and the private sectors. It, most likely, was employer reaction to the

climbing inflation and efforts to hold the workforce in the company. Although unemployment in Latvia keeps at the level of 8-10%, in fact, year on year businesses or government institutions find it more and more difficult to recruit good workforce. Besides, up to 10% of the able-bodied population work in the EU States and this number keeps growing.

Still the lowest- paid workforce in the EU

In the 1st quarter average gross wage in Latvia constituted LVL 227 (EUR 324). It remains the lowest remuneration for one's work not only in the Baltic countries but also in the EU. An average gross wage in Lithuania was EUR 368, in Estonia - EUR 475. As the standard of living in the Baltic countries does not differ much, and the consumption boom in Latvia is not subsiding, we can only guess what is the size of real wages in the country. Or would the jump in real wages in the 1st quarter mark the beginning of income legalization?



Unemployment shrinks, employment level grows

Booming economy gives more job opportunities

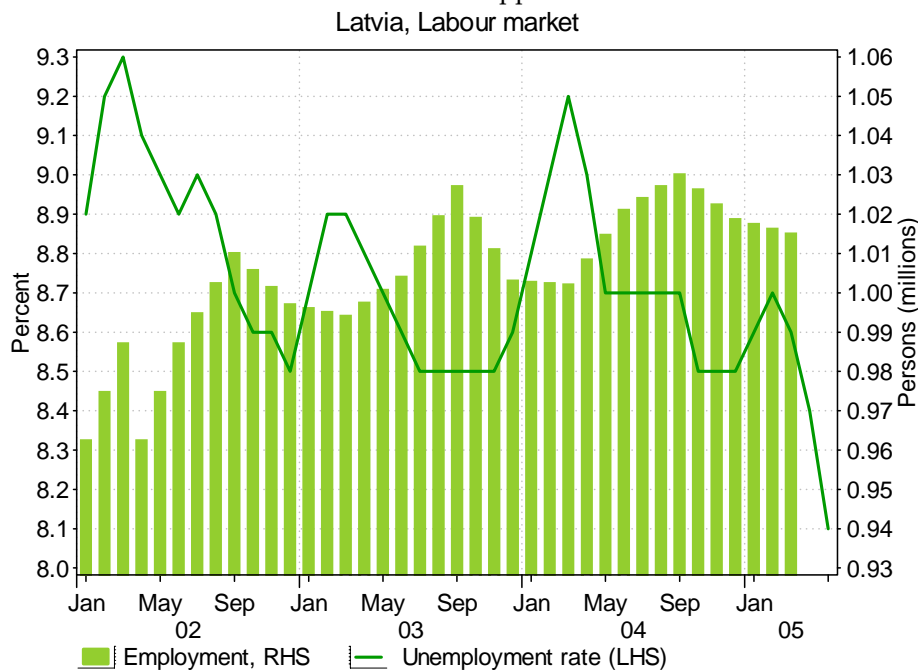
In spring the situation in the labour market was gradually improving. The officially registered number of the unemployed decreased. Apart from that workforce inquiry polls showed that the number of job seekers had also contracted. The number of the employed has grown reaching 56% of the population aged 15 to 74 years. Over the last 3 years the number of the employed has grown by 7%, although the total number of the population has shrunk by 0.5%. In total 62.2% of the total population are economically active people.

Unemployment figures drop to all time low

At the end of May officially registered unemployment stood at 8.1%, which is the lowest level in recent years. The situation substantially improved in the last few months, when the number of the unemployed was a few thousand people lesser than a year before. E.g., at the end of May a year ago unemployment was 8.7%. In the 1st quarter of the year the ratio of job seekers fell to 9.9% of the economically active population. A year earlier it was considerably higher, namely, 11.5%.

*Labour force poses problems
for the fast-developing country*

Although unemployment is gradually abating unemployment-related structural problems remain; the level of unemployment is low, newspapers keep publishing all kinds of job offers. In more active regions we feel a strong demand for a professionally qualified workforce. In the largest part of rural areas the level of unemployment is high, determined by the weak business environment, passivity of the people and inability or disinclination to change his/her life. Besides, the more active members of society look for jobs in Riga, other more active towns or look for new opportunities outside Latvia.



Lithuanian economy

(Written by Alge Budryte and Vilija Tauraitė, SEB Vilnius Bankas)

Main indicators

	1999	2000	2001	2002	2003	2004	2005E	2006E	2007E
GDP real growth, %	-1.7	3.9	6.4	6.8	9.7	6.7	6.8	6.5	6.2
Export growth*, %	-14.9	28.9	20.6	11.7	11.2	21.4	22.6	16.4	15.7
Import growth*, %	-13.7	12.8	16.1	13.4	7.1	16.8	16.3	13.0	12.5
Foreign trade balance, % of GDP	-17.3	-14.7	-14.7	-16.2	-14.6	-13.8	-12.4	-11.4	-10.3
Retail sales growth, %	n/a	12.9	7.2	12.4	14.3	9.3	10.0	9.5	8.5
Total loan portfolio, % of GDP	12.8	12.1	14.3	15.6	21.5	27.3	32.6	37.4	43.1
CPI growth (y-o-y), %	0.3	1.4	2.0	-1.0	-1.3	2.9	2.8	2.5	3.0
Unemployment rate (ILO)**, %	15.9	16.9	17.9	13.0	11.6	10.7	9.6	8.4	7.5
Public sector balance (ESA'95), % of GDP	-5.6	-2.5	-2.0	-1.5	-1.9	-2.5	-2.5	-2.0	-2.0
Current account balance, % of GDP	-11.0	-5.9	-4.7	-5.2	-6.9	-7.2	-8.5	-7.8	-7.5
FDI inflow, % of GDP	4.5	3.3	3.7	5.2	1.0	3.5	4.5	5.1	4.9
FDI/CAD coverage, %	40.7	56.1	77.7	99.8	14.3	48.4	55.0	65.0	65.0
3m interest rate, end of period	18.8	8.7	5.3	3.5	2.7	2.6	2.4	2.7	2.9
Average interest rate, loans in litas, %	13.0	11.0	8.1	6.1	5.1	5.6	5.5	6.0	6.0

* Based on special trade system, excluding services

** Last quarter of a year

Political arena is clouded over

Debates on tax reform brought up resignation of finance minister

Recently Lithuania has faced a tirade of political scandals triggered by debates on tax reform. After long deliberation, the governing coalition has finally managed to find a final solution on tax changes, though this was not costless. Unwilling to take a huge responsibility for the so-called solidarity tax, which was initially supposed to be levied on corporate turnover (see previous issue of Baltic MacroScope), the finance minister A. Butkevičius decided to resign. Indeed, the probability for such a tax to be pronounced as contradicting the EU legislation would be more than 50%. Thus, the minister's choice to leave the government is quite understandable. The new minister of finance is Z. Balčytis who led the ministry of transportation before his new appointment.

Benefits of recent tax changes will be reaped no earlier than in two years

It is worth pointing out that the package of tax changes finally saw the light on June 7, 2005. Instead of introducing the solidarity tax, the Seimas agreed to impose the so-called social tax, which means that the companies will have to pay an additional 4% tax on profits in 2006 and an additional 3% tax on profits in 2007. Starting from 2008, the current profit tax rate of 15% will apply without any additional payments. Furthermore, a new tax on residential property used for commercial purposes will be introduced starting from 2006. Both the social tax and the real estate tax are intended to compensate (at least to a certain extent) a loss in budget revenues, which is likely because of the core of tax changes – a cut in the personal income tax. The Parliament approved a decrease in the general rate of personal income tax from the current 33% down to 27% starting from July 2006 and then down to 24% starting from 2008. Despite all the drawbacks, cutting the tax burden of personal income in particular makes the tax reform worthwhile doing. Taking into account the above-mentioned compensating measures, most of reform's benefits will surface no earlier than in 2008.

Quick and easy popularity of V. Uspaskich was followed by political downfall

The resignation of Mr. Butkevičius was only the "first robin". In the second half of June 2005, the government lost another member – the minister of

Future of the Labor Party is ambiguous

economy V. Uspaskich. The latter story was very different from that of A. Butkevičius. The ex-minister of economy was accused of violating the principle of separation of public-private interests. Despite President's concerns expressed publicly, V. Uspaskich waited for the verdict of Parliament's Chief Official Ethics Commission to leave his position. It is worth pointing out that Mr. Uspaskich also gave up his seat in the Parliament. This is already the second time in Lithuania when quick and easy popularity ends in political overthrow – one can recall the case of ex-President Rolandas Paksas.

Opposition cannot escape bad luck

After Mr. Uspaskich's withdrawal, the outlook for the Labor Party looks gloomy. A certain share of Labor Party's members will definitely join the Social Democrats or other partners of the governing coalition, whereas others may still like to be led by V. Uspaskich. Some analysts interpret Uspaskich's resignation as even being beneficial to him – leading one of the ruling coalition's parties V. Uspaskich can continue lobbying in favor of his own interests and at the same time bear no political responsibility. To a certain extent, such an opinion is justified by the fact that Uspaskich's replacement in the economy minister's position is his party member K. Daukšys.

The opposition also lives through some difficult times. For instance, the Liberal and Centre Union is currently troubled by its leader A. Zuokas, who is suspected in corruption with one of the largest Lithuanian enterprise groups Rubicon. The President of the country has clearly prompted Mr. Zuokas to resign from the position of not only the leader of the Party but also of the mayor of Vilnius.

The official leader of the opposition – Homeland Union – appears to comprehend its responsibility and tries to fulfil it within its ability framework. Unfortunately, the party badly needs a prominent economist. The Conservatives seek to make up for it in other spheres, e.g. foreign policy (in particular in relations with Russia), promotion of knowledge economics, family values, etc. The average statistical voter is, however, too pragmatic to get interested in geopolitical nuances or cluster terminology.

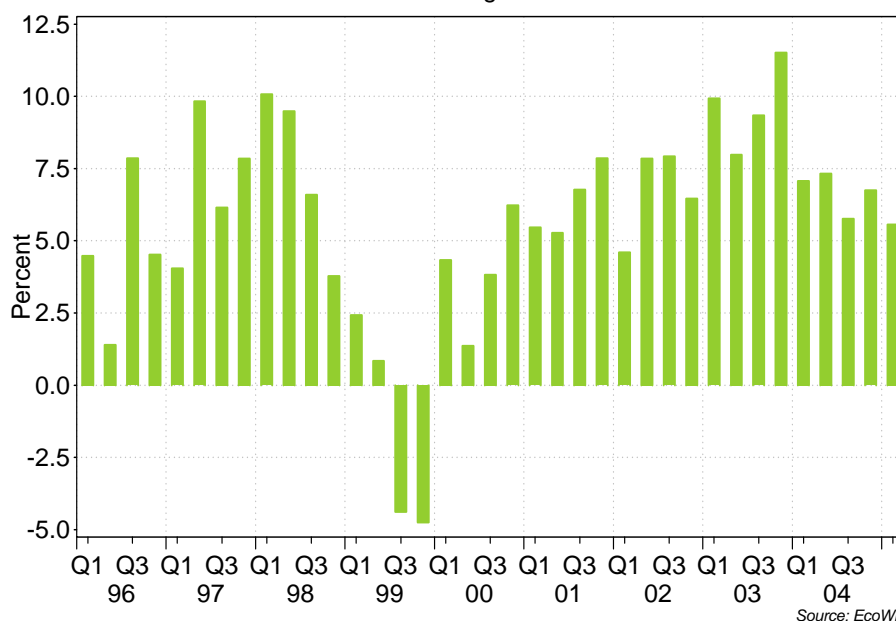
Economic growth and its outlook: does bad news outweigh good news?

GDP continues to slow down

Lithuania's economy has found itself trapped by some conflicting factors and may remain in such situation for some time. On the one hand, high international oil prices, labour emigration and thus rising wage costs, a painful lack of green-field investments are major current constraints for rapid economic growth. On the other hand, record-low interest rates stimulate borrowing and consumption; European Union's structural funds call for economic restructuring; and the service sector undergoes a boost after the country's accession to the EU.

According to revised data of Statistics Lithuania, in 1Q05, GDP at constant prices was by 5.7% higher than in the same period a year ago. This was the smallest increase since 1Q02.

GDP growth



Economic sectors with declining outputs are few in number

Domestic markets are still main drivers of growth but...

... this cannot last forever

Success story of Mažeikiai refinery can be temporarily interrupted

The sectors of mining and energy are facing hard times. Mainly due to shutdown of the first block of Ignalina Nuclear Power Plant, in January through March of 2005, compared to the same quarter a year ago, the value added by the sector of electricity, gas and water supply was by 5.8% lower. The value added by mining suffered an even more drastic slump of 12.7%. Because of continuing exhaustion of oil resources in Western Lithuania and unsuccessful attempts to discover new ones, Lithuanian mining companies are seriously considering relocating their business into other countries.

In 1Q05, compared to the respective quarter of 2004, the value added by fishing, if measured in constant prices, increased most impressively, i.e. 46.3% year-on-year (yoy). On the other hand, its contribution to the whole country's GDP growth was trivial, because fishing is the smallest economic activity in Lithuania. The value added by hotels and restaurants showed a yoy increase of 10.1%, real estate, renting and business activities – 9.1%, transport, storage and communications – 9.0% and financial intermediation – 8.8%. The growth rate of top favorites (in terms of growth rate) of last year – manufacturing and domestic trade – is pumping down. In 1Q05, the value added by the former was by 6.9% higher than a year ago, whereas the respective growth figure for domestic trade coincided with that for the whole economy and reached 6.8%.

Domestic markets cannot fuel economic growth forever. Medium- and long-term growth prospects of a small and open economy depend on its ability to take an efficient part in the international process of exchange of goods and services and to increase its exports more rapidly than its imports. Failure to do so would eventually result in the deteriorating financial stance and worsening expectations of businesses and households, and this in its turn would affect the general country's indicators of output and revenues.

Another challenge to Lithuania's economic development is to ensure a smooth transition of Mažeikiai oil refinery into the hands of a new strategic investor. In relative terms, the refinery does not produce a significant share of the country's GDP; however, if the company confronted any serious problems, this would hardly cause a physical shortage of fuels in the country,

but could easily bring about at least a temporal increase in the prices of oil products. This, of course, would be very sad news, especially having in mind the current situation in the global oil markets, trends of strengthening US dollar (i.e. the currency in which Lithuania pays for imported crude oil) as well as slowing economic growth.

Additional drivers of inflation pop in

Inflation is likely to gather momentum

In the coming years the inflation rate will be higher than before Lithuania's entry to the European Union. Although the EU accession did not cause a direct hike in prices, it speeded up the price convergence process. Unfortunately, the beginning of this process coincided with the drastic rise in the global oil prices, which is likely to continue for quite a long time and may instigate the price-wage spiral. Relatively tight Lithuania's dependence on oil and fuels as well as on state-administered prices (mainly related to energy resources such as electricity and gas) is quite high, and this is another disadvantageous factor.

Lithuania is relatively more energy-intensive

Lithuania is vulnerable to external energy shocks because of the following. First, the relative share of electricity, gas and other fuels accounts for 10% in the HICP basket, whereas the same indicator of the EU is only 5%. Second, excise duties on fuels in Lithuania are still considerably lesser than in the EU, thus not so well amortizing the increase in oil prices (excise duties are established as absolute rather than relative values, therefore they do not increase together with the price of raw oil).

Conditions in the labor market also lend a hand to inflationary pressure...

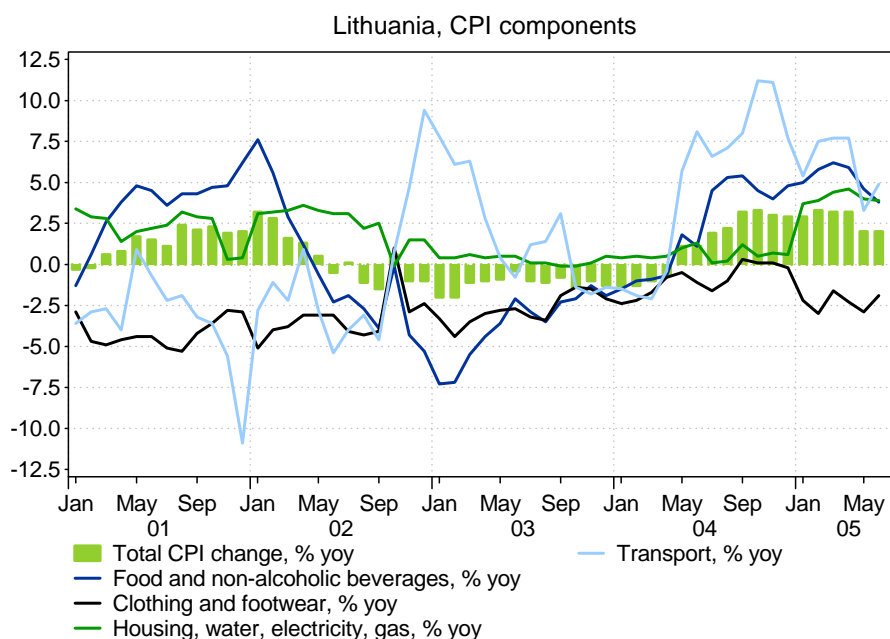
The intensifying struggle for re-distribution of national income between employers and employees, between the public sector and the private sector, among different economic sectors, etc. is another factor causing concerns. The recent strike of medical employees and their demand to increase salaries by as much as 50% during one year demonstrate the situation in the labor market, which can be defined as "the supply market". Under such circumstances, the trade unions do not have to do anything more but only to co-ordinate actions of hired workers, since the deficit of labor allows exerting pressure on the employers.

... and there are some more inflationary factors

Furthermore, the approved reduction of the personal income tax rate (see the first section) will increase disposable income, thus encouraging consumption. This, of course, may provide more room for businessmen to increase prices.

Last but not least, if the euro is introduced in 2007, the temporary effect of price rounding should also be taken into account. The extent of this effect should not be overestimated, however. We believe that the impact of price rounding on consumer prices in Lithuania will not be greater than that in the euro zone back in 2002, i.e. approximately 0.2 percentage points.

According to the latest data of Statistics Lithuania, in June 2005, compared with May, the prices of consumer goods and services went up by 0.1%. Annual inflation in June of this year (June 2005 as compared with June 2004) made up 2.0%. The sharpest increases over the year were recorded in the prices of health care (7.8%), transport (4.9%), utilities (3.9%), food products and non-alcoholic beverages (3.8%) and hotels and restaurants (2.9%).

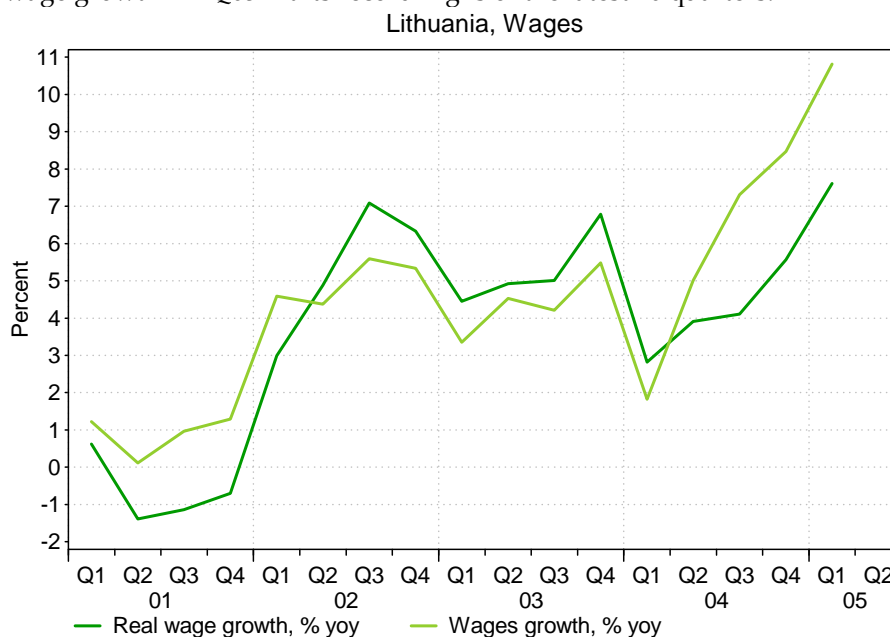


Source: EcoWin

Household income is on the upward sloping trend

Wage growth continues speeding up mainly due to ...

Despite stepping up inflation, the purchasing power of the population is not dipping. The trend that has emerged in 2004 – wages growth at an accelerating pace – was a characteristic of 1Q05, too. According to Statistics Lithuania, in 1Q05, the average monthly gross earnings (except individual enterprises) were by 10.8% higher than in the same period a year ago. For comparison, the same figure for the previous quarter was 8.5%. The pace of wage growth in 1Q05 hit its record highs of the latest 20 quarters.



Source: EcoWin

... shrinking labor force and its structural changes

Lately the growth rate of income from employment is being determined by the factor of labor supply rather than labor demand. The continuing and increasing process of emigration (last year approximately 42 persons left

Lithuania each day; in 2003 – 30 persons and in 2002 – only 19 persons), reduces the supply of labor force as well as affects its structure. The highest emigration is among the youth, i.e. the part of the labor force, which is the most attractive to employers. The youth is much more mobile than older people are. In 2004, the sharpest drop in the number of labor force was in the age group from 20 to 24 years, whereas positive changes were recorded only in the group from 45 years and above.

Wage growth will continue to be faster than in Europe

Although emigration is a very serious challenge to Lithuanian businessmen, the free movement of labor is a necessary pre-condition for pay convergence within the European Union to continue. Since average wages in Lithuania are still among the lowest in the EU, they are likely to increase at a more rapid rate than the region's average.

It is worth noting that huge flows of emigrants are not the only reason underlying the drop in the Lithuanian labor force. Another problem is the shrinking birth rate. For instance, in 2004 the number of newborns was 30 570, or 28 babies less than a year ago.

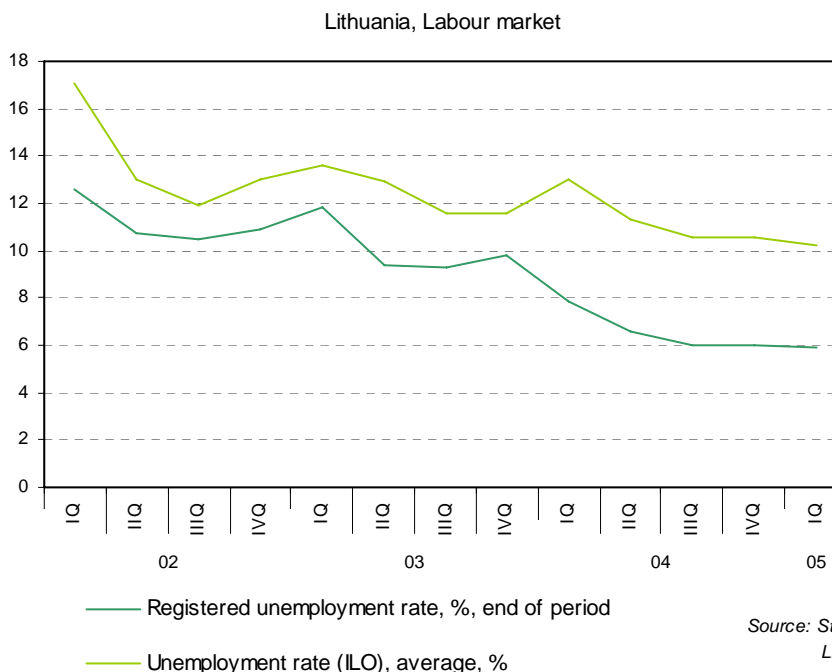
Alternative motivation instruments will rapidly increase in popularity

In order to improve employee satisfaction with the job, to prevent them from leaving the company or simply to increase their productivity, a pay rise is not enough. Such strategy is effective only in the short-term, because already a few months later the higher salary is taken as a matter of course. Having in mind the latter statement as well as the current situation in Lithuania's labor market, a rapid development of other (than wage) employee loyalty reinforcement instruments in the near future is out of question. Some years ago a possibility to become shareholders of a company, a traveling trip financed by the employer or an unexpected picnic together with one's co-workers appeared to be a big rarity. Today, on the contrary, an increasing number of Lithuanian companies start talking about the need for unique and effective incentives for employee stimulation. Many employees are already well familiar with such motivational instruments as skill-improving courses, life insurance savings plans, a possibility to acquire the company's products or services on preferential conditions, etc.

Unemployment keeps abating

The outlook for the labor market continues to be easily predictable: in the next few years the flow of emigration will continue (this is confirmed by results of the most recent sociologic polls) and the signs of structural unemployment will continue becoming more prominent. The shortage of labour force calls for structural changes in the industry (e.g. textiles) and other activities of the economy (road transport, construction). It is necessary to open ways for a wider immigration of labor from the East, although we have to admit that Lithuania is not as attractive as other EU member states in terms of employment terms.

Trends in the labour market are not surprising



The economy makes a turn towards external balance

Current account kept improving...

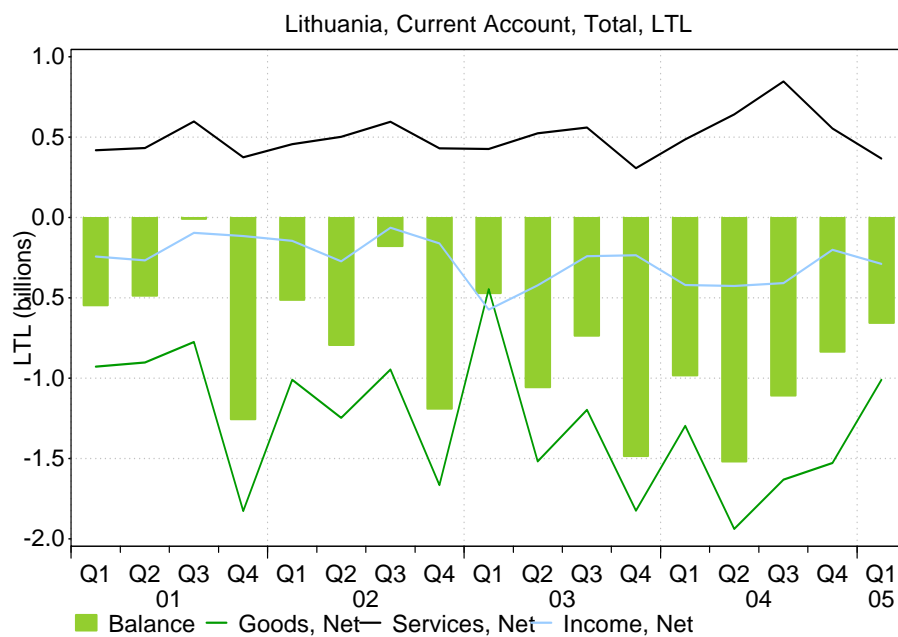
In 1Q05, the current account of Lithuania looked quite well. The current account deficit (CAD) shrank by 15.6% year-on-year (yoy) down to LTL 829 million and constituted only 5.6% of GDP. Thus, Lithuania still may enjoy having a twice-lower CAD to GDP ratio than other Baltic States and thus being closer to external balance.

... mainly due to booming exports and thus shrinking trade deficit

Quite unexpectedly, especially having in mind booming domestic demand, import growth lagged behind export growth. Thus, the CAD improvement was the result of a decrease in trade deficit by 17.4% (yoy) to LTL 1.1 billion. On the other hand, changes in the balance of income and the balance of services pulled the current account down. To a large extent, the deepening negative balance of income reflected dividend payments from growing stocks of foreign investments. A surplus of the services balance shrank mainly because imports of road and air services more significantly outweighed exports.

Most of CAD sustainability ratios look good

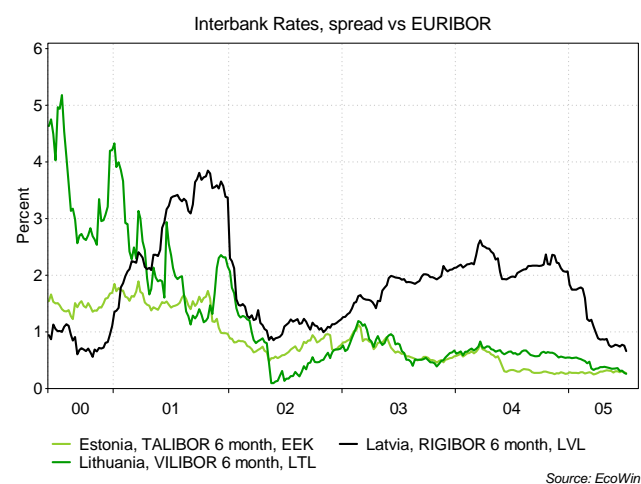
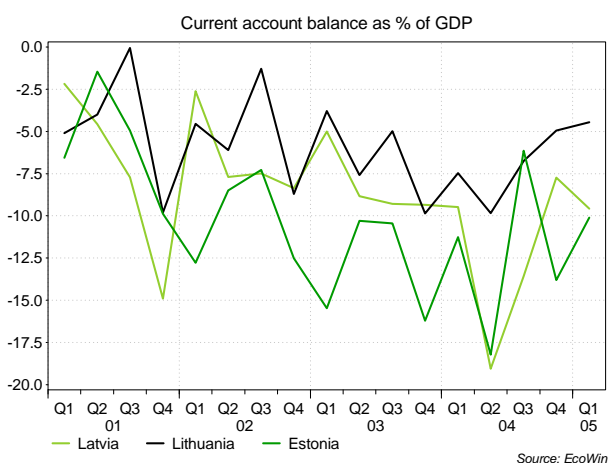
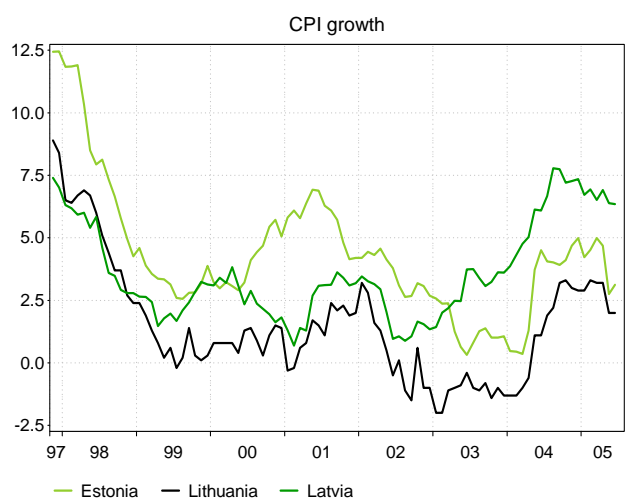
Nonetheless, the most important CAD sustainability ratios got better at the beginning of this year. The FDI to CAD ratio stood at a quite satisfactory level of 68.3%, whereas the ratio of FDI combined with current transfers to the government (EU structural support mostly) to CAD went up to as high as 102.1%. The official international reserves were worth slightly more than 3 months of imports and reflected sufficient resources for appropriate country's settlements. The ratio of CAD (as a percentage of GDP) to nominal GDP growth climbed to substantially over 2, thus offering strong grounds for CAD stabilization. The gross external debt expanded by 11.5%, nevertheless its ratio to the forecasted GDP stayed low at 41.2%.



What is the biggest immediate threat?

To sum up, at least now, the set of Lithuania's key economic indicators – GDP growth, inflation and CAD – is one of the best in Central and Eastern Europe. However, it is hardly time to plunge peacefully into a slumber. Inflation and wages continue to increase at an accelerating pace each quarter, thus hitting new record highs. Furthermore, it is not likely that these trends will stop in the near future. Taming inflation is partly possible by the means of fiscal or administrative measures, whereas trends in wage growth can only be affected by altering income taxes or by regulating the salaries of employees in the public sector. The recent increase in the minimum monthly wage (MMW) also has quite a strong impact on the general earnings statistics – according to official data, the share of those earning MMW amounts to 20% of the working population.

Baltic states in figures



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