Baltic MacroScope April 2005

Estonian economy

(Written by Ruta Eier, SEB Eesti Ühispank)

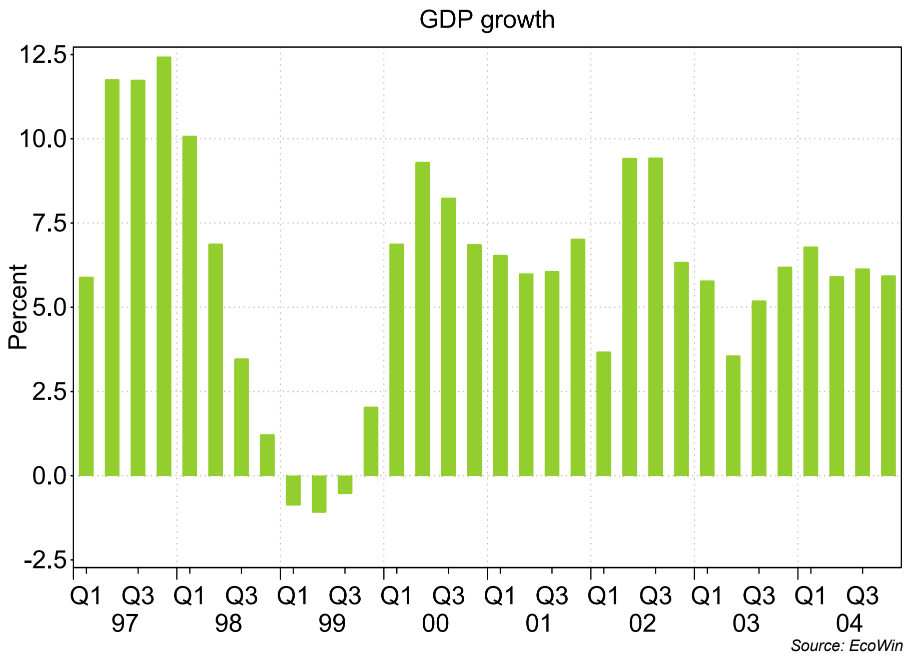
Main indicators

	1999	2000	2001	2002	2003	2004E	2005E	2006E
GDP real growth	-0.1%	7.8%	6.4%	7.2%	5.1%	6.2%	6.2%	6.4%
Export growth	0.5%	52.2%	7.4%	-1.5%	9.8%	17.5%	12.9%	11.0%
Import growth	-8.6%	43.1%	4.0%	5.9%	12.9%	18%	11%	10%
Foreign trade balance, % of GDP	-18.4%	-19.8%	-16.5%	-19.2%	-21.6%	-22.9%	-22.0%	-21.3%
Retail sales growth	5.8%	10.5%	13.8%	14.3%	9.9%	13.0%	11.5%	10%
Total loan portfolio as % of GDP	33%	37%	39%	43%	55%	67%	77%	81%
CPI growth	3.3%	4.0%	5.8%	3.6%	1.3%	3.0%	3.5%	2.7%
Unemployment rate	12.2%	13.6%	12.6%	10.3%	10.0%	9.7%	9.6%	9.4%
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%	-13.2%	-12.7%	-11.0%	-10%
Foreign direct investment inflow	4,448	6,644	9,430	4,800	12,471	11,613	38,471	15,126
FDI/CAD coverage	123%	130%	160%	40%	75%	66%	226%	88%
3m interest rate, end of period	5.1%	6.1%	4.0%	3.5%	2.6%	2.4%	2.4%	2.7%
Long-term interest rate, EEK loans	8.6%	8.9%	10.1%	6.6%	5.1%	5.4%	5.6%	6.1%

Prosperous year 2004

Year 2004 as a milestone

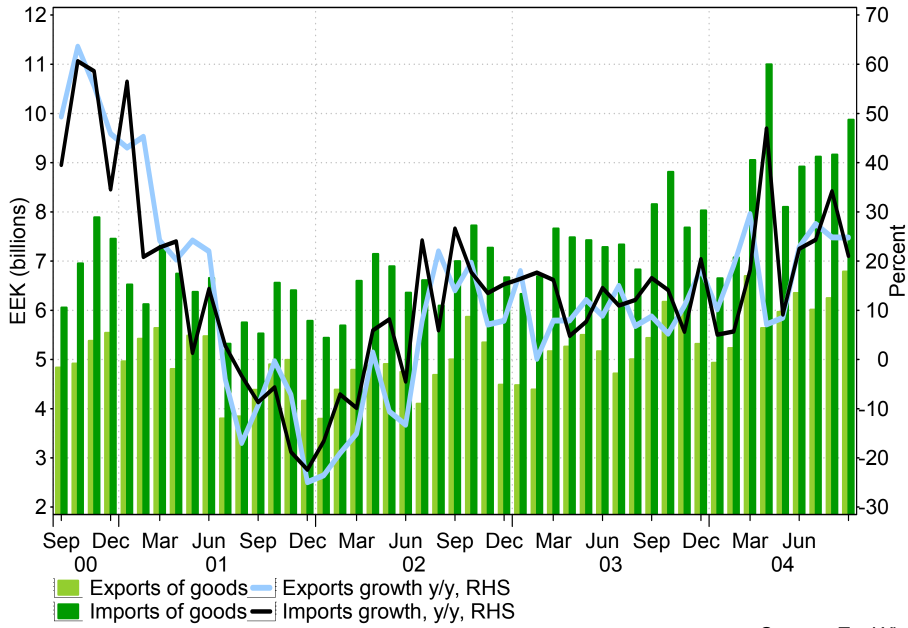
Year 2004 was expected with anxiety and excitement, with different expectations and fears related to the EU accession. Some expected no changes when the accession finally would take place, some waited for the new emerging opportunities. Indeed, much of the impact was discounted for some time already, e.g. concerning credibility and low interest rates. While the distance to assess the effects of the entry to the EU is apparently still too short, there can be a couple of impacts noticed already. Despite of statistical disturbances, we could say the effects for tourism and foreign trade were there for real, which contributed to higher GDP growth in 2004.



According to national income data, the value added in Estonian economy expanded 6.2% in 2004. While in earlier years Euro zone was surviving trouble times, it has been mainly domestic consumption and investments that have helped to maintain economic growth in recent years. Whatever the swings in domestic demand, in a small economy the latter can never become a credible substitution for exports. In 2004, there was slight revival of EU economies. Thus, there was increasing contribution from exports to GDP growth in Estonia and improving signs of capability to realise the export opportunities. The competitiveness of Estonian exports is persisting strong and the EU expansion effect still waiting to be caught; therefore we expect exports to continue solid growth in 2005. Exports will also be supported by good growth prospects of Estonian main export markets - Sweden and Finland (in 2005 GDP growth 3% in both is expected), which mean strong foreign demand.

Increasing contribution to GDP growth coming from exports…

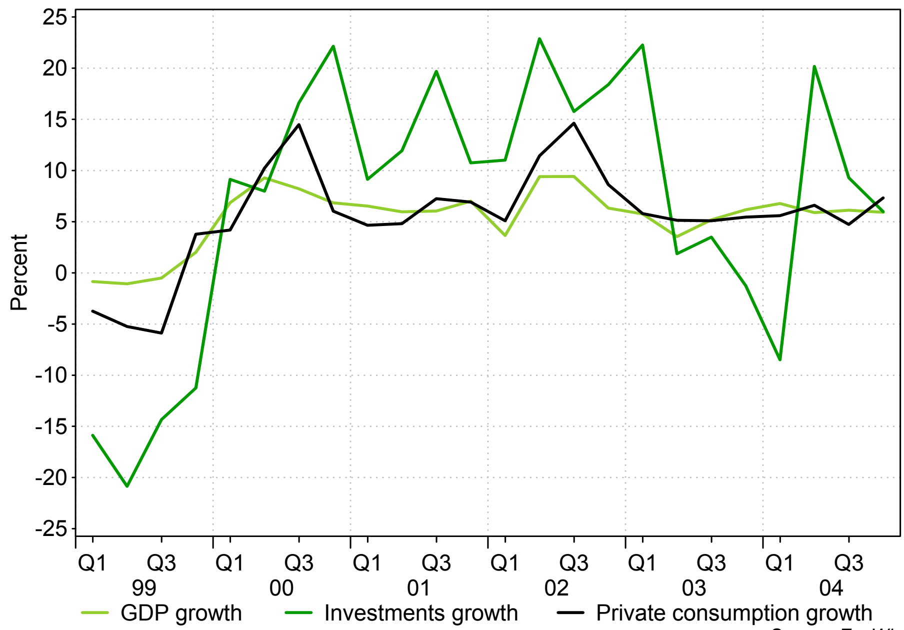
In 2004, export growth was a significant contributor to GDP expansion, being the most vivid in services exports. Export growth outpaced imports growth in both goods and services. Services exports increased 13.7% and their imports respectively 7.9%. In goods trade, the respective numbers were 17.5% and 15%.



Source: EcoWin

…but it's still not enough to counteract external imbalances

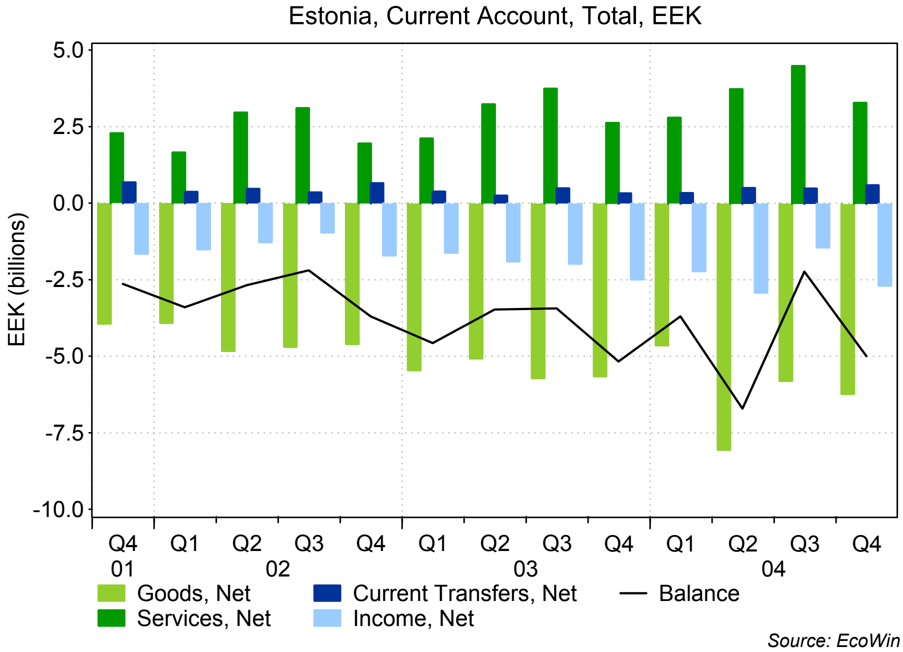
Even though export was doing well, the large external imbalances persisted in the economy, being too wide to decrease rapidly. Both investment and consumption demand were responsible for stretching the trade balance wider. An acceleration of both private consumption and investments compared to previous year drove up domestic demand by 6.6%.



Source: EcoWin

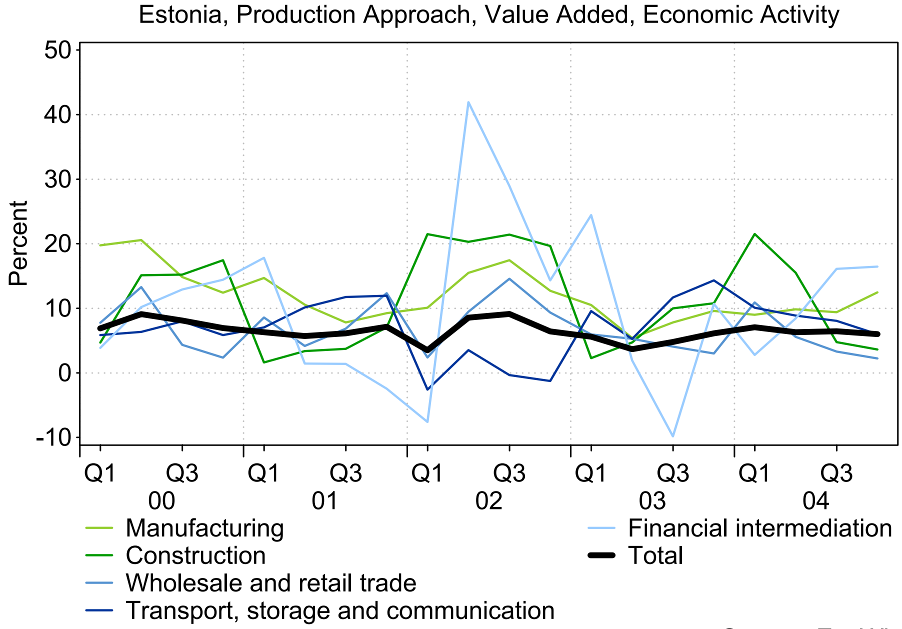
In current account only slight improvement in 2004

A boost to net exports of services was also the main component giving a relief to the current account deficit in 2004. The rest of the picture about external imbalances remained largely unchanged compared to 2003. Trade deficit amounted to -17.7% of GDP, income balance to -6.6% of GDP and services balance to +10.3% of GDP. The overall current account deficit reached -12.6% of GDP, which was a touch smaller than in 2003, because of positive contribution of services.



Broad-based economic growth brought gains for many

GDP growth in 2004 was very broad-based, being indicated both by expenditure and production approach of GDP composition. Of course, that's a welcomed development which is characteristic to economy at its full growth steam of cycle. The main pillars of economy – manufacturing, whole and retail sales, construction, transportation, storage and communication – all their performance in 2004 was remarkable. Favourable financing conditions contributed naturally to prosperity of financial sector and real estate sector. Also hotels and restaurants had a very good year, helped by increased tourist flows. The contracting sectors were fishing, forestry and mining, all with less than 2% share in GDP composition.

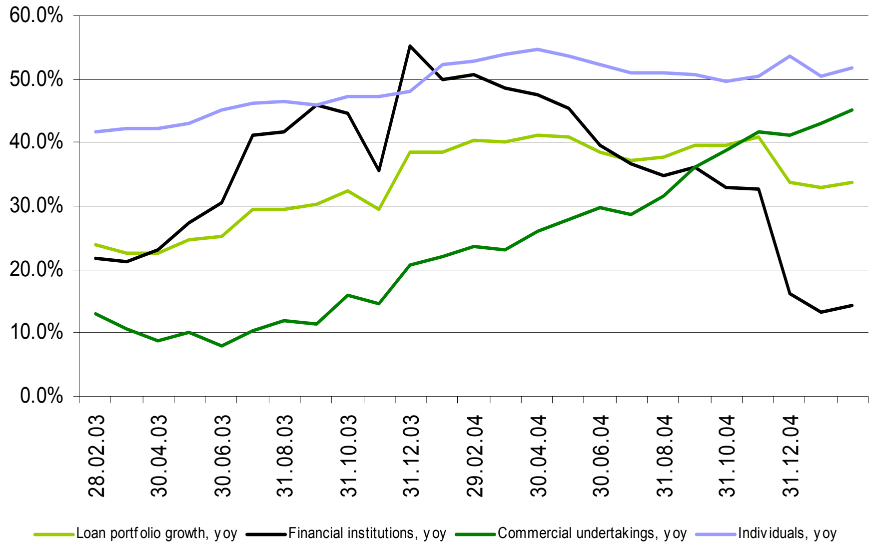


Source: EcoWin

An additional dose was given by loans, revealing high optimism about the future

An additional dose to different sectors developments was given by aggressive lending supply and decreasing interest rates. Interest rates in Euro zone have persisted stubbornly low since mid-2003 and a harsh competition in the banking market has dramatically decreased the interest margins in lending, which altogether have led to powerful lending increase in last years. Private individuals' loans have been increasing at an accelerating pace for several years already and reached more than 50% growth rate in 2004. We think, in terms of growth rates of loans to private individuals, we should have seen the peak already and lending growth rates should begin to decelerate. However, the lending growth will remain very buoyant in near years, too. The same tendencies apply for enterprises, loan portfolio increased by nearly 40% in 2004. Such a high lending activity among both consumers and enterprises indicate their optimism about the future. That's also what the confidence indicators confirm.

Loan portfolio growth, yoy



Self-fulfilling expectations in real estate market

Housing loans boom among consumers had direct implications for real estate market. Real estate price appreciation has been fast, e.g. 2-room flat prices increased more than 20% yoy in 2004, which was even faster than in 2003. Real estate prices were driven by huge demand and limited supply, the main drivers being buyers already on the second round, i.e. having taken out profits from existing real estate objects. Thus, this is looking like an emerging self-fulfilling bubble where real estate price increase itself is the driving force of further price increase and generates additional demand through increased wealth. Incomes growth rate only is not sufficient enough to fuel the real estate market boom. There is certainly more potential to increase lending amounts, even though Estonia is among most indebted countries in CEEC in terms of private sector debt. Taking into account that currently the debt burden is very concentrated among top-salary receivers, the potential lies mainly, but is not limited to, middle-income groups.

Another real estate price driver was the increasing construction costs. During 2004, construction prices were shooting sharply after a couple of years' snooze, reaching about 9% yoy appreciation at the end of year. The labour shortage has pushed up the construction workers wages and the price of land appreciates rapidly. The evidence for rapid wage increase in construction is found when compared it to the average wage developments. Wages in construction have outpaced the average wage of Estonia, being 110% of average wage in 2Q04 compared to 82% in the beginning of 2000.

Further lending activity together with increased costs in construction will be the driving forces of real estate price appreciation also in 2005.

Prospects for 2005 still good

Well…but what next?

Even if 2004 GDP growth surpassed expectations, we think that was not a peak yet and the show will go on. Continuation of such growth rates would stop if foreign investors would squeeze external financing. That would happen in case of sudden change in perception of risks and confidence drop. That in turn would happen if for example euro adoption would delay.

The short-term outlook remains reasonably sanguine, while the longer term risks are associated with the fate of the EU economies. As long as GDP growth gains convincingly strength in the EU, the interest rate will likely remain low and fuel economic growth rate in Estonia. GDP growth rate in Estonia might well surprise in 2005, increasingly supported by exports. Good exports prospects allow also domestic demand to continue growing at a full swing.

Both monetary and fiscal environment are expansionary – a threat for future?

In 2005, both monetary and fiscal environment are expansionary. Monetary environment remains largely unchanged, with low interest rates and aggressive lending policy by the banks. Fiscal policy becomes even more expansionary in 2006 as a result of recent government change.

The economic developments in near term will be influenced by massive inflow of money, among them FDI, EU funds, loans. Strong capital inflow still enables to finance external deficits and feed domestic money supply.

Increased money supply tends to increase inflation, which is promoted by loosening fiscal policy.

2Q05 was eventful for Estonian economy, with its consequences for a longer period. Estonia survived a government change and Estonian largest company on stock exchange, Hansabank, was bought out.

A turn to the left?

New government has

The government fell apart in April 2005. The prime minister’s party, the *been set up – more social-oriented fiscal policy will have negative implications for public budget*

newest party in Estonian political landscape, has dramatically lost support from 28% at the time of last elections to the level of barely crossing 5% threshold. Internal pressures got too strong to hold the coalition together.

The new coalition is more socially oriented than previous one. They have set quite an ambitious programme, trying simultaneously to lower taxes and raise social benefits, especially pensions. The rise in pensions will take 1.3 bn EEK. A compromise was made with income tax cuts pace – slowing it down to 1 percentage point per year, reaching 20% in four years. This compromise will save, however, 0.5 bn EEK, which is not enough to cover the shortage from pensions increase. Thus, meeting budget balance in 2006 will be tough. We believe there won't be brisk surpluses we have used to see in previous years anymore and the risks to fall in budget deficits have increased. Nevertheless, the probability of plunging into deficit will be weakened by high economic growth rate and inflation.

…which will not be the only problem, unfortunately.

New government has expressed the readiness to issue debt to finance potential deficits. We take this hint as with negative implications. Even if we don't believe the budget would fall in deficit in 2005, the timing for these experiments with fiscal policy is not particularly good because of potential implications for euro adoption. Not because of budget balance itself, as this is hardly becoming any problem in terms of meeting Maastricht criteria. The problem is that there will be an additional pressure to inflation from fiscal loosening, which is on the edge of Maastricht criteria already.

Thinking in the longer perspective, fiscal policy will have pressure to inflation also in mid-term perspective. This is stemming from the principles of fiscal policy which foresee an increase in indirect taxes, which are meant to compensate the tax revenues lost on account of direct taxes reduction.

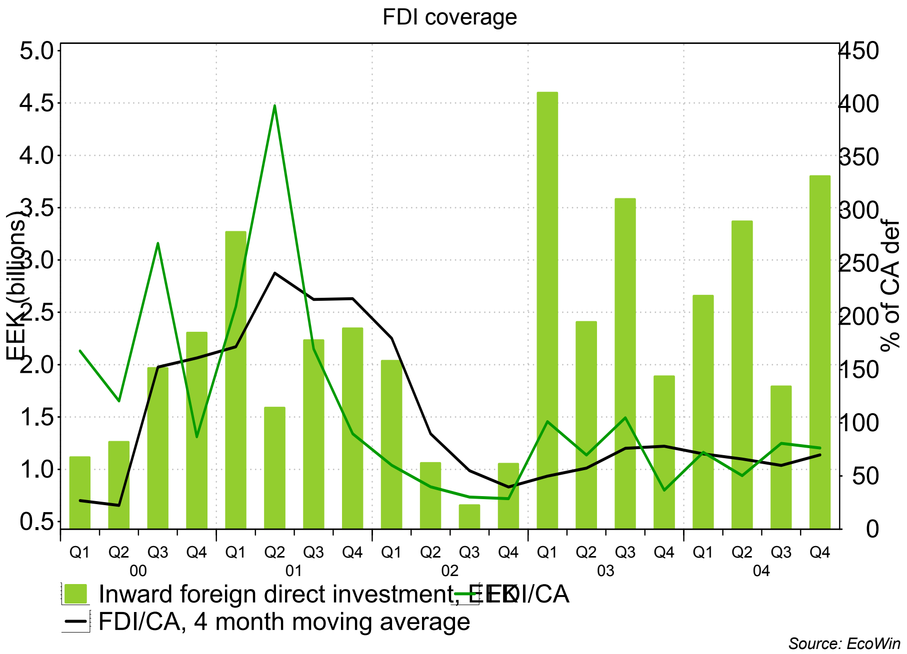
As fiscal policy has a crucial importance in economic policy in Estonia, the timing for expansionary policy is not appropriate, bearing in mind the struggle with external imbalances Estonian economy has.

Money flowing in is setting tone for 2005

A record inflow of FDI will be witnessed in 2Q05

The buyout of Hansabank by its Swedish core investor is one major source of extra liquidity in 2005. Tiny as Estonian economy is, every large transaction has its impact on economy. In 2Q05 a buyout offer to minority shareholders was made, worth 1.7 bn EUR. As a consequence, a record amount FDI will inflow in 2Q05, which means that in 2005, the current account deficit will be boldly covered after several years.

The other side of the coin is that the hopes for emerging signs of Estonian FDI incomes earned abroad which would improve the current account deficit, which we mentioned in the last MacroScope, have largely died with that. Profits from Hansabank investments into Latvia and Lithuania will be now accounted as inflowing and simultaneously outflowing funds in Estonian balance of payments current account balance.



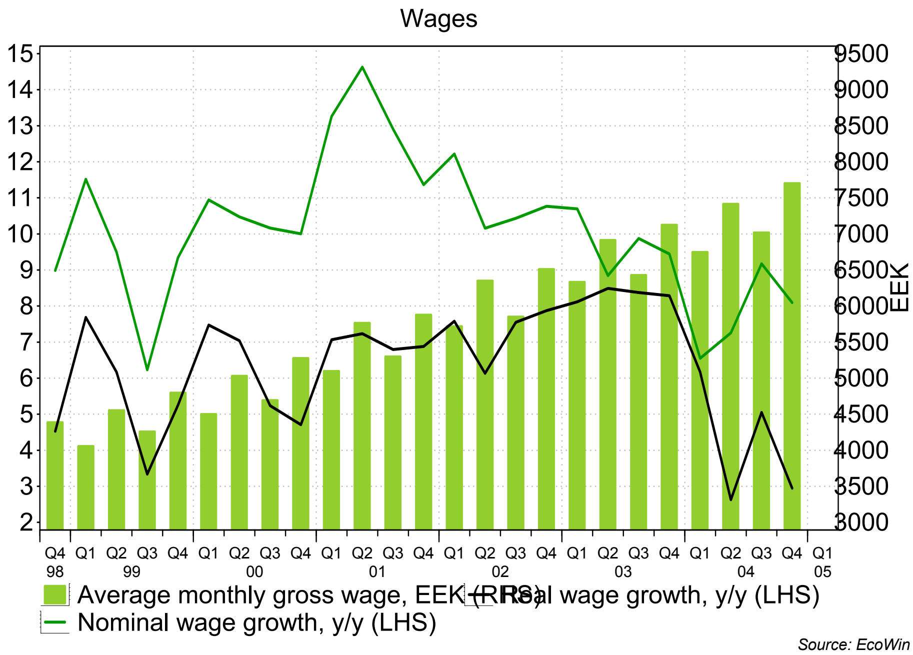
Source: EcoWin

Additional money will boost domestic demand

Hansabank shares selloff by private individuals will bring additional money into domestic demand. Local investors revenue amounted to 4 bn EEK. Some of this money is going to flow to other stocks and boost the local stock exchange, but it certainly will have also spill over effects for both private consumption and direct investments into entrepreneurship or real estate. Because of tax exemption, investments into entrepreneurship are likely to be especially attractive destination and would therefore experience an extra boost.

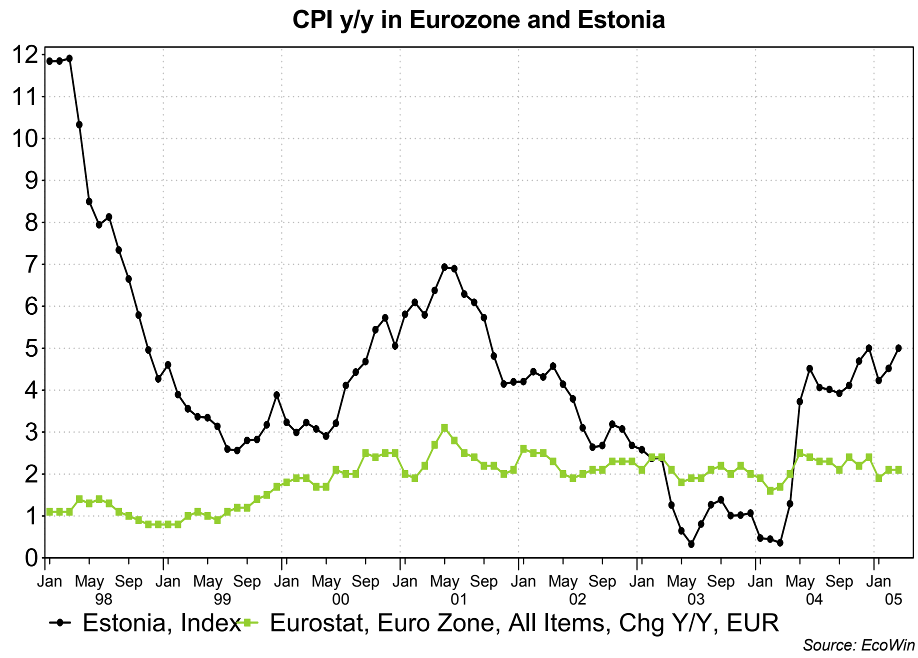
…which would be strong enough anyway

Apart from additional money, domestic demand would not forfeit its strength even without it. Private consumption will be supported by purchasing power increase in both lower- and higher income groups, propelled by income tax cut and tax-exempt minimum increase. Real wages growth should accelerate, hauled by productivity rise and agreements achieved by labour unions. The primary factor working on the opposite direction is prices increase, which tends to lower consumer confidence and might lower consumption demand. Oil price sharp appreciation is a clear potential factor here.



Inflation – more risks than before

In 2005, inflation will be driven by administrative prices, like electricity and municipal services prices, housing services, some excise tax increases, but also by global factors like oil price, which is the main risk factor for inflation in the second half of the year. On the other side, there are also inflation-mitigating factors continuously in place – strong euro, tight competition in retail and telecommunication market. Altogether, we expect inflation to remain in the range of 3.5%.



The prospects of labour market stable

While unemployment fell to 9.7%, the employment was practically unchanged in 2004. Employment increased in construction, manufacturing and financial intermediation, but decreased in agriculture and services sector, like real estate, hotels and restaurants and retail sales sectors. While the decrease in the number of unemployed persons is clearly good news, a negative aspect is still a huge amount of inactive persons, who are unmotivated to work or discouraged from labour market at all. There is lying a potential for economic growth.

Mainly in rural areas, wages are often too low to motivate looking for a job. On the other hand, the quality of labour is too low to pay more wages. Seems like a vicious circle. The time will bring higher wages to break out of this, but it won't happen in the nearest future.

The labour force question is becoming a crucial one for the economy. The quality of labour will determine the arrival of new high-tech FDIs into country, which is badly needed. Currently, FDI growth is mainly fed by reinvestments from current investors.

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Latvian economy

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Main indicators

	1999	2000	2001	2002	2003	2004	2005E	2006E
GDP real growth, %	3.3	6.9	8.0	6.4	7.5	8.5	7.5	7.0
Export growth (goods), %	-5.1	12.2	11.1	12.1	17.2	28.1	24.0	20.0
Import growth (goods), %	-8.3	12.2	13.8	13.4	19.7	25.2	20.0	17.0
Foreign trade balance, % of GDP	-16.9	-17.1	-19.7	-20.9	-22.8	-22.1	-23.2	-22.7
Retail sales growth, %	6.0	17.5	2.7	12.4	13.6	12.5	11.0	11.0
Total loan portfolio as % of GDP	20.1	23.2	31.7	37.3	47.5	60.2	73.0	84.0
CPI growth, %	2.4	2.6	2.5	1.9	2.9	6.2	5.7	4.0
Unemployment rate, %	9.7	8.4	7.8	8.9	8.6	8.5	8.3	8.0
Unemployment rate (ILO), jobseekers rate, %	14.3	14.4	13.1	12.0	10.6	10.3	10.0	9.7
Public budget fiscal balance as % of GDP	-3.7	-2.6	-2.0	-2.3	-1.6	-1.1	-1.4	-1.2
Current account balance as % of GDP	-9.0	-4.6	-7.6	-6.7	-8.2	-12.3	-10.5	-9.5
Foreign direct investment inflow (mn LVL)	203	250	83	157	172	350	370	380
FDI/CAD coverage, %	53.4	115.2	21.1	41.2	33.1	38.5	41.6	43.2
Interest rate, long term national currency loans (annual average)	13.2	10.3	10.4	8.5	7.5	9.2	6.8	6.0
State debt as % of GDP	12.1	12.2	13.7	13.4	13.4	13.2	14.1	14.7

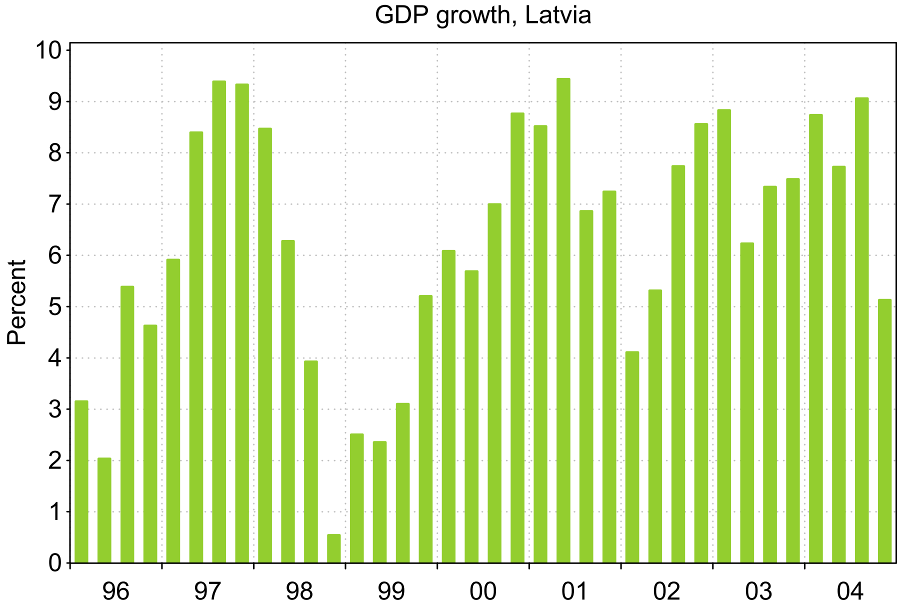
Gross domestic product reaches all time highest increase

Growth rate!

Continuously surprising

Economic growth of Latvia in the 4th quarter of 2000 continued uphill, reaching **8.6%**. The growth remains the highest in the countries of the EU. GDP grew by **8.5%** last year, which is the all time best result since Latvia regained independence in 1991. Since 2000 the Latvian economy has kept growing at an average rate of 7%.

However despite stable and strong growth Latvia is not likely to have shed the title of the poorest EU state. A significant part of its economic potential is hidden in the haze of the grey economy which is only partly reflected in statistics and tax returns.



Source: EcoWin

In the forefront dominance of services

Growth at the close of the year was again higher than could be expected and contributed to the achieving of the presentable last year's results. It must be noted that the growth is balanced and a smaller or a larger growth is observed in all industries. At the end of the year the key locomotives were services (transports and communications, hotels and restaurants, finances) and building industry. The growth was determined by an increased domestic demand. In the 4th quarter hotel and restaurant business grew by 17%, transports and communications, building industry – by 16%, financial services increased by 9%. Growth rates in industry fell slightly, the rise did not exceed 6%. The cheering results, obtained in commodity exports, however, are temporary. The agricultural sector saw a 3% increase but growth in the forestry sector, due to unfavourable weather conditions, was hardly noticeable.

7.5% growth of GDP is expected in 2005

Annual data on economic achievements are similar to the results obtained at the end of the year. The proportion of services in the GDP structure is almost 73%. The proportion of trade has moved up by 18.4%, transports and communications – by 15.4%, but the manufacturing industry holds 14% of the specific weight. The presentable last year's results show that we are on the right track and we may expect a growth of roughly **7.5%.** It will hardly be 8%, but it will not fall below 7% either. Are we mistaken to say that economy of Latvia has well adapted in the fertile soil of the EU? Most likely, yes.

It is obvious that economic activity is particularly high in the Riga region, which produces more than 2/3 of GDP, but from which, via various transportation arteries, it gradually moves over to other lower activity centres. Economic activity has particularly been gaining ground in Jelgava, Daugavpils, Liepaja, Valmiera. At the same time Ventspils is waiting for its lucky break (resumption of oil transit via the pipeline).

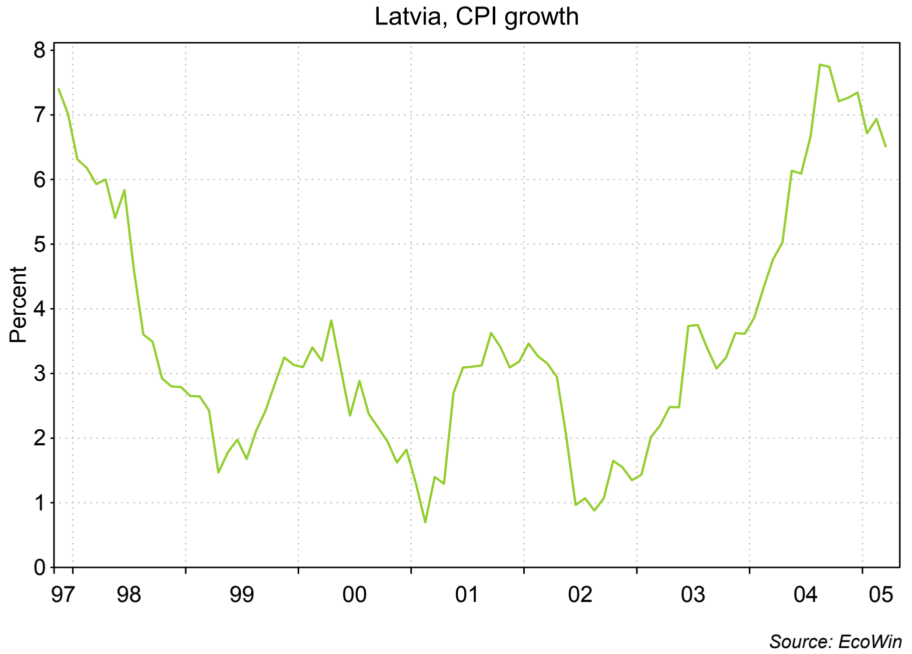
Talks about overheating of economy have abated, albeit the crediting boom keeps strong. Real estate prices are on an upward direction. Inflation, too, remains high but it is no wonder when we consider the high economic growth rates.

Inflation remains high in 2005

Inflation in the 1st quarter just seemingly lower

Consumer prices in the 1st quarter grew by **1.7%** since the end of the previous year, which is slightly less than a year ago (2.3%). This level of inflation seems quite acceptable compared to the beginning of previous year, but the reason behind it is the comparatively small growth of housing tariffs this year.

In March the CPI was up by 6.4% in the 12 months period while annual average inflation reached **6.8%.** In this respect Latvia keeps its leading position in the EU.



Fuel, transport costs, health care, food are provoking inflation

In 12 months transport costs increased by 14%, health care expenses and prices in public catering and accommodations by 10%, food, individual services and insurance by 9%. Only telecommunication tariffs decreased.

Inflation is likely to exceed the earlier forecasts

Inflation remains as a major headache for Latvia on its way to the EMU. The trend is especially alarming as it is likely to persist in the future. Economic boom and strong domestic demand supported by increasingly available loans pushes up consumption of goods and services. Another caus e is the unprecedented growth of fuel prices, expected hike of gas tariffs, food and health care expenses.

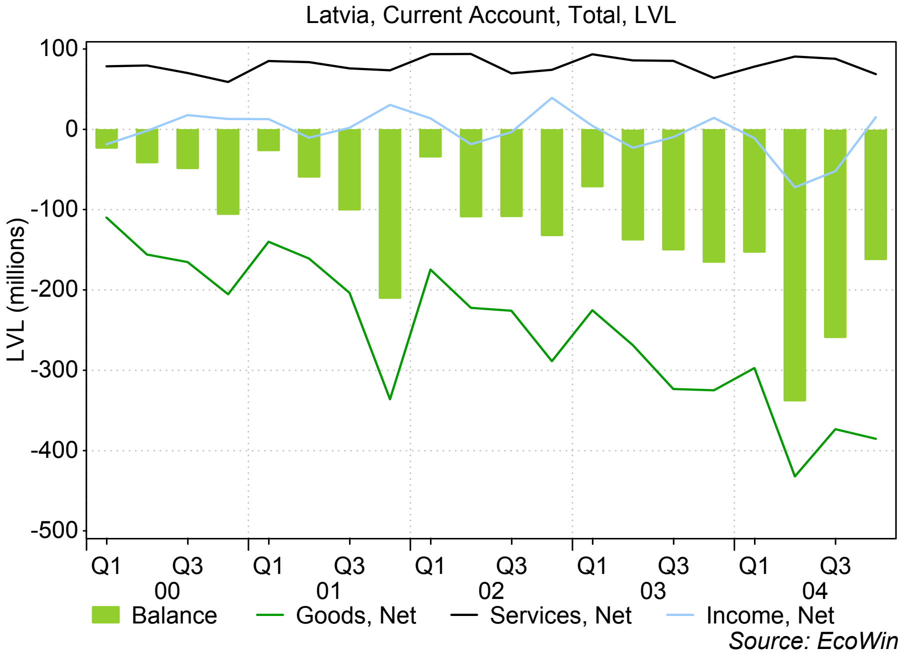
Therefore we have to raise the average inflation forecast for 2005 to 5.7% from earlier 5.4%. We foresee higher price hikes in the spring and summer months (fuel, gas, food, services).

The hope to meet inflation criteria for euro introduction is declining month by month. In this continuous economic upsurge it would be strange to expect inflation lowering to 3%.

Current account deficit all time high

Last year current account deficit reached the record level of 12.3%

The official data released by the *Bank of Latvia* on the balance of payments did not particularly differ from the preliminary figures; there was only a certain shift in the data of several quarters. A slightly larger current account deficit was in the middle of the year but smaller in the 4th quarter (7.7% of GDP). In total last year current account deficit of the balance of payments reached LVL 908 million or **12.3%,** all time highest indicator. Such is the price we pay for joining the EU, fast economic development, increasing consumption, low industrial potential and growth of the euro rate. The negative commodity balance keeps growing year on year, whereas the positive services balance, formerly serving as a substantial counterbalance, has now been on a standstill for the third year in succession (crude oil, Russia!). The negative income balance has grown considerably. In its turn the finance account has doubled.



EU membership is triggering the foreign direct inflow

Last year foreign direct investment stock in Latvia reached **LVL 350 million**, which must be regarded as a presentable achievement. Unfortunately, though, it covered now solely 39% of current account deficit. Residents of Latvia had invested LVL 59 million abroad, also a considerably larger amount than before. The accrued volume of foreign direct investments has reached **LVL 2318 million**. Investments have been evenly distributed amongst the leading branches of industry – commercial services and real estate operations, transport and communications; trade, manufacturing industry and finance industry. Germany's investments constituted 15%, followed by those coming from Sweden, Denmark, the Netherlands, Estonia, Finland, Russia, and USA.

Current account deficit slightly better in 2005

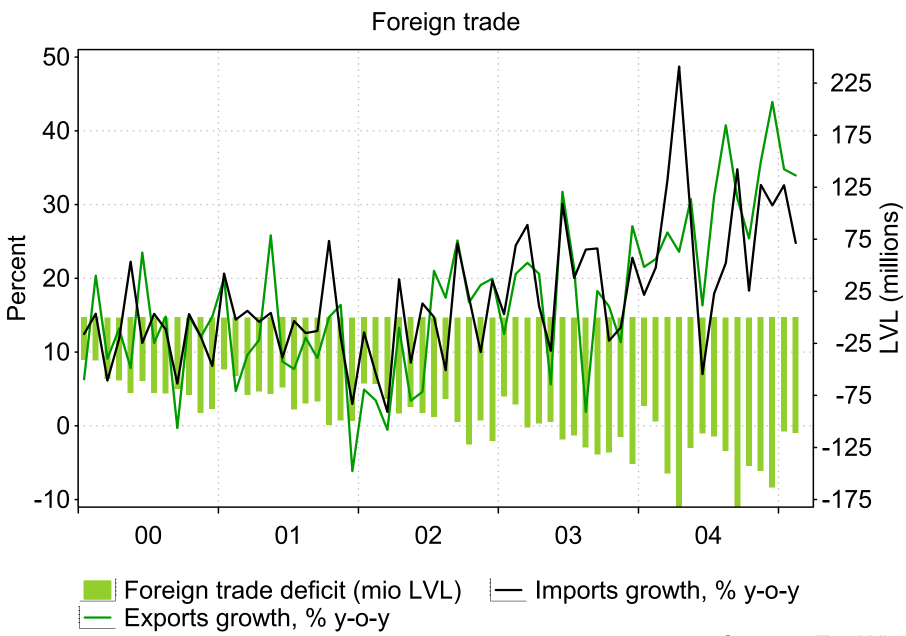
Operative January and February data show that the situation has not changed significantly compared to 2004 in current account. The current account deficit exceeded the last year's level. The commodity balance remains markedly negative and the support from the services' sector becomes weaker. At the same 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 flourishing

Unprecedentedly high activity in the foreign trade sector – a positive side of EU accession

The unprecedentedly high activity in the foreign trade sector can be viewed as a certain surprise. Considering the upswing of economy in recent years and growth of people's purchase power, a faster growth of imports could be expected but the unexpectedly fast growth of exports was a real knock-out. At the beginning of 2004 we felt a certain fear as to how our producers would feel in the EU and whether they would be able to force exports. On the one hand there was a lot of talks about the miserable state of the industrial potential, insufficient capacity of enterprises, out-dated equipment and workforce problems. At the same time we saw that in the recent years many companies had systematically raised their competitive edge, which many of them had reoriented themselves to manufacturing of other kind of products and trading off on new markets. Consequently, we could find more positive than negative features in our industry and after joining the EU Latvia's exports swelled sizeably.



Source: EcoWin

Exports grew in all directions

If in 2003 commodity exports increased by 17.2%, then last year it was up by 28.1% already. Besides, in the second half of the year the growth rate exceeded 30%. The major exports market continued to be the EU (77%), over the year export volumes increased by 24%. Last year was a turning point also in exports to other countries. Thus, exports to the CIS (occupying a share of

11.5% in the exports structure) grew by 50%, to the USA – by 40%, to countries of Asia – by 36%. Although Great Britain, Germany and Sweden remained the main exports partners, their share in the exports structure shrank. Exports to the Baltic countries, Russia, Poland grew considerably. The key export items were timber (31% of the total), metals and hardware, soft goods, equipment and mechanisms, and food. Exports of machine building products, metal goods, food products and chemicals increased sizeably. We expect a fast growth of exports also in the current year, which could reach roughly 22-26%.

Imports prevalence over exports still huge

A boost in imports occurred shortly before Latvia joined the EU, when trying to prevent the possible growth of prices, businesses intensively imported vehicles, machinery, metals and various raw materials. In total imports grew by 25.2% in 2004, against 19.7% in 2003. Unfortunately, expressed in figures, imports, beyond measure, exceed exports – last year the difference was 77%. In 2003 this prevalence was even higher – 81%. It explains the huge current account deficit of the balance of payments. In the imports structure the prevailing imports items remain machinery and mechanisms (20%), mineral products, vehicles, metals and chemical goods. Imports of mineral products evidenced the largest increase (61%), so did imports of metals and machine building products. Just like in the exports structure also in imports the largest share was taken by the countries of the EU (75%), but imports from the Baltic countries, the CIS and Poland fixed the fastest growth. Imports are expected to grow by 20-24% in the current year, which is only going to enlarge the negative trade balance. The trade balance is expected to stabilize and slowly improve in 2-3 years time at best. The bulky volume of imports most likely will not shrink, because the country is progressing rapidly and there are no grounds for a decline in economy.

Industrial indicators are poor while consumption is booming

Disappointing results in industry while exports of goods is booming?

January and February data about the output of industrial production were disappointing, as they did not differ much from last year's data and were partly even worse. It was the effect of the warm winter, which did not require large heating resources and the unfavourable weather conditions, which hampered timber cutting. The perfomance was heavily affected by a downturn in woodworking and a slight decrease in food industry. But those two are the largest industries. The remaining key industries saw a higher or lower growth. Good results were obtained in the manufacturing of vehicles, in furniture making and in the production of building materials as well as in the printing and publishing industry, radio engineering. Although the situation at the beginning of the year was unsatisfactory we still expect that growth in the industrial sector will improve. This forecast is supported by continuously excellent commodity exports figures.

Consumption beats all expectations!

The boom in retail trade has not subsided and its volume in January-February jumped 20% from the same period a year before! Sale of wearing apparel and footwear rocketed by 55%, while sale of household goods, building materials and white goods – by 33%. Sale of cars soared by 33% but fuel – by 38%. In the following months this record growth will, most likely, slow down but the growth figure may again exceed our forecast. Consumption is expedited by the fast economic development, growth of income and the more freely accessible loans.

In 2004 real wages grew by just 2.5%

Pay rise was eaten by high inflation

The unexpectedly large growth of consumer prices *finished*-up a large part of the rise of salaries, in its result the actual increase of wages and salaries was **2.5%.** The rise is the lowest in recent years. At the end of summer and in autumn months there were periods, when practically no raise of wages and salaries could be detected.

Last year gross wages grew by **9.6%,** but net wages – by 8.9%. In the 4th quarter average gross wage reached **LVL 230 (EUR 329)**, but average annual wage closed at LVL 211 (EUR 301). A drastic difference is seen between wages paid in Riga, Riga region, and rural areas. And the difference is only increasing. These figures do not give a true picture of the situation in the labour market, because a lot of businessmen assert that information concerning wages paid to their employees is confidential. It is best seen in the steadily high consumption indicators and average wage paid in the neighbouring countries. In the 4th quarter gross wages in Lithuania rose to EUR 380 but in Estonia it was EUR 492. But we know that living standard in the two countries is not 30-50% higher than in Latvia.

While the private sector dodges declaring real wages to the government institutions, strikes are brewing in the public sector. Demand for a radical and not only cosmetic increase of wages are well-founded and already last year the government set to get ready for wage increase for several categories of the employed.

Considering the fact that wages in Latvia are the lowest in the EU but entry in the common labour market opens up new opportunities for work in other countries, in the following years the government and businesses will have to use their brains if they wish to maintain a competitive workforce. We hope that the labour market will be put in order and the situation when promising business projects start to skid or are not even addressed, because of the shortage of workforce, will not occur.

Lithuanian economy

(Written by Alge Budryte and Vilija Tauraite, SEB Vilniaus Bankas)

Main indicators

	1999	2000	2001	2002	2003	2004	2005E	2006E
GDP real growth, %	-1.7	3.9	6.4	6.8	9.7	6.7	6.8	6.5
Export growth*, %	-14.9	28.9	20.6	11.7	11.2	21.0	14.0	11.0
Import growth*, %	-13.7	12.8	16.1	13.4	7.1	15.8	13.0	9.0
Foreign trade balance, % of GDP	-17.3	-14.7	-14.7	-16.2	-14.6	-13.5	-13.6	-13.3
Retail sales growth, %	n/a	12.9	7.2	12.4	14.3	9.3	10.0	10.0
Total loan portfolio, % of GDP	12.8	12.1	14.3	15.6	21.5	27.3	31.9	36.7
CPI growth (y-o-y), %	0.3	1.4	2.0	-1.0	-1.3	2.9	2.8	2.5
Unemployment rate (ILO), %	14.6	16.4	17.4	13.8	12.4	11.4	10.1	8.9
Public sector deficit (ESA'95), % of GDP	-5.6	-2.5	-2.0	-1.5	-1.9	-2.5	-2.5	-2.0
Current account balance, % of GDP	-11.0	-5.9	-4.7	-5.2	-6.9	-7.2	-8.5	-7.8
FDI inflow, % of GDP	4.5	3.3	3.7	5.2	1.0	3.5	4.5	5.1
FDI/CAD coverage, %	40.7	56.1	77.7	99.8	14.3	48.4	55.0	65.0
Interest rate, national currency loans, %	13.0	11.0	8.1	6.1	5.1	5.7	6.0	6.3

Euro introduction is being mapped

Euro adoption is considered to be a goal of primary importance

After becoming a member of the European Union, Lithuania is taking hard its next stage goal to enter the European Economic and Monetary Union as soon as possible. This intention is already making a major effect on the current decisions of economic policy.

In order to get well prepared for joining the euro zone, in mid-January the government of Lithuania approved a revised version of Convergence Program. The Program projects the country's fiscal deficit to remain at 2.5% of GDP in 2005, after that a decrease to 1.8% of GDP in 2006, and to 1.5% of GDP in 2007. Indeed, having in mind that the country is operating under a currency board and thus almost does not have any room to apply monetary policy tools, a restrictive stance of fiscal policy is crucial to ensure low interest rates and price stability. Furthermore, adherence to fiscal austerity provides a strong cushion against speculative attacks on the litas before its replacement.

In preparation for euro introduction, the Bank of Lithuania is not plunging into a slumber either. In early April, the Bank presented a draft Law on Euro Introduction for the public's verdict. Some of the most important provisions of the draft Law are the following. First, all commercial banks have to get ready to exchange litas for euro free of charge for a half-year after the official day of euro introduction. Next, shopping centers and services providers have to make sure that prices of their items for sale will be cited in both litas and euro before and 2 months after euro introduction. Finally, litas are envisaged to circulate together with euro for 15 days after the latter replaces the former.

Although the final Law on Euro introduction may be very different, the existence of its draft today as well as the fact that Lithuania's early entry to the euro zone has become a part of its official policy leaves almost no doubts that the euro will arrive on January 1, 2007. Now only economic shocks can put a spoke in euro's wheel.

Tax reform is approaching the end of a tunnel

The goal to keep fighting fiscal deficit explains why the government is shilly-shallying over tax reform. Although a majority of politicians agrees that inadequately high taxation of labor income is one of the largest drawbacks of the current tax system, the ruling coalition thinks that the only way to reduce this type of tax burden and, at the same time, to meet its fiscal targets is to introduce new taxes or to increase the old ones.

Planned reduction in personal income tax is to be followed by compensating measures

On April 1, 2005, the four ruling parties of Lithuania (Social Democrats, Social Liberals, Labour Party and Union of Peasants' and New Democratic Parties) finally signed an agreement, which envisages to cut the personal income tax rate from the current 33% to 27% on July 1, 2006 and then down to 24% by January 1, 2008. On the other hand, the government proposes to impose a new real estate tax on residential property used for commercial purposes starting from 2006. Furthermore, the ruling coalition talks about a so-called solidarity tax for companies. The solidarity tax can be thought of as a simple prolongation of the current road tax, which is going to be abolished since the middle of this year.

In our opinion, cutting the personal income tax is crucial for Lithuania to stay competitive and to sustain its rapid economic development. However, if this tax reduction is followed by introduction of new taxes or increase of the old ones, all positive effects of this decision can melt into thin air.

Economic growth matches expectations

Economic growth forecasts turned to be precise

Lithuania's economy started to put its spurt on in 2000, achieving a peak of growth in 2003. Last year, however, the country's economic situation became more complicated due to a multitude of controversial factors. According to preliminary data released by Statistics Lithuania, in 2004 Lithuania's real GDP went up by 6.7% year-over-year (y-o-y), i.e. by 3 percentage points less than in 2003. Nonetheless, the result was not unexpected, as it came only by 0.1 percentage point lower than SEB Vilniaus Bankas' forecast of 6.8%.

Manufacturing, trade and transport are doing best

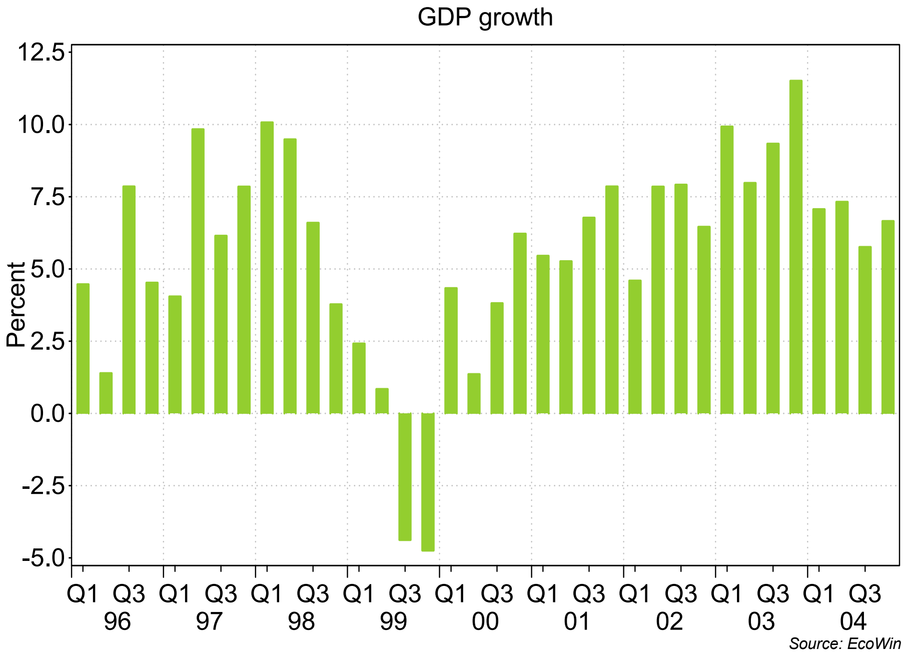
Like in 2003, in 2004 the value-added by economic sectors, which are mainly focusing on domestic markets, grew most vigorously. Nevertheless, the economic activity of manufacturing industry, which sells the lion's share of its output abroad, was very successful as well. Booming activity of Mažeikių nafta has also contributed to strong performance of the latter sector. According to revised data from Statistics Lithuania, the value-added by manufacturing industry (+11.4%), retail and wholesale trade (+10.4%), transport, storage and communications (+7.8) and hotels and restaurants (+7.0%) increased more than the whole economy on average.

Agriculture, mining industry and public activities Impede the growth

Traditionally, public activities were impeding overall growth of the economy as public administration and defence demonstrated an increase of 4.4%, education – 4.8%, healthcare – 1.7% only. Last year was also a failure for agriculture and mining industry, where value added at constant prices dropped by 0.1% and 8.3%, respectively. The decline of the mentioned sectors is proved not only by lower value added but also by slump in natural indicators, i.e. in the purchase of agricultural products and extraction of crude oil. This year, agricultural sector might somewhat recover while mining industry will subside further most likely.

Domestic demand is the main driver of economic expansion

Last year, the development of the country was complicated by external factors (global oil and metal prices, sluggish EU market, etc.) mainly. Meanwhile, in both 2003 and 2004 Lithuania's GDP growth was driven by credit growth and domestic demand boom to a large extent. Unfortunately, sooner or later the credit boom will end and cause major changes in the structure of private consumption and business investments. The surfacing lack of labour force in many market segments is another challenge. Without the positive effect of EU structural funds, the country's real GDP growth rate in 2005 would probably be less than 6%. Nevertheless, taking this additional stimulus into account, SEB Vilniaus bankas expects the real GDP to show a y-o-y increase of 6.8%. In 2006 GDP growth is forecasted to slow down to 6.5% y-o-y.



Emergent inflation swings on a scale of balanced factors

Inflation becomes common , but staying moderate

After a pause of two years, in 2004 the price level bid farewell to deflation and showed inflationary trends; so does the year 2005. In March 2005, the year-on-year CPI inflation made up 3.2%. Inflation was primarily caused by the increase in prices of food products and non-alcoholic beverages (by 6.7% year-on-year), transport (by 7.7%) and healthcare services (by 10.2%). The increase in the CPI was partly compensated by decreasing prices of culture and recreation showing a year-on-year decline of 2.3%, furnishings, household equipment and routine maintenance (-3.1%) and communication services and goods (-2.0%).

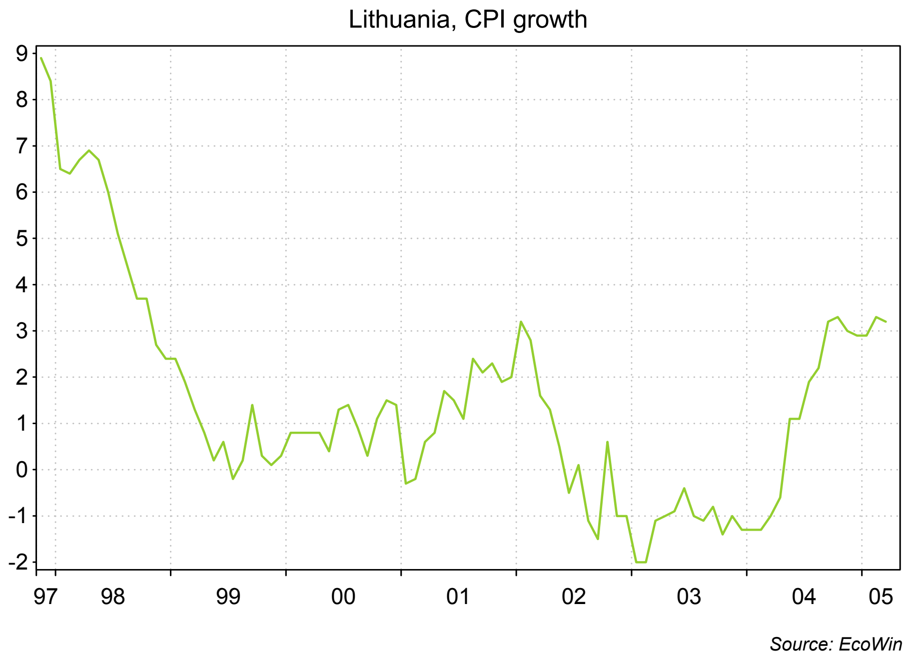
Pro- and anti-inflationary factors are balanced

Further in 2005, such varying changes in the prices of individual components of the representative consumer basket of goods and services is not likely.

Recently the environment of consumer price formation has stabilised; both pro-inflationary and anti-inflationary factors are in place. On the one hand, the prices of electricity and gas were increased at the beginning of 2005; civil liability insurance fees paid by owners of cars are going to be increased; tension in the labour market "press" employers to improve employee motivation systems, etc. On the other hand, many pro-inflationary factors associated to an entry to the EU (e.g. imports from the third countries going up in price, changes in certain indirect taxes) are ineffective this year.

Inflation poses a major risk for timely euro adoption

Recently, some turbulence around inflation as major risk for euro introduction occurred. One should admit that the fears are well grounded. In March 2005, average annual increase in CPI made up 2.3% and approached a dangerous bound since in 2004 the Maastricht reference rate stood at 2.2%. Assuming that up to the mid-2006 month-on-month inflations follow the track of respective months in 2004 and 2005, the annual average inflation in Lithuania at the assessment period may reach up to 3%. If the CPI in the three lowest inflation countries does not rise accordingly, a serious threat of missing euro introduction on January 1, 2007 will emerge. As other Maastricht criteria are easily met in Lithuania, inflation poses the only risk of preventing from euro adoption according to the planned timetable. However, Lithuania still may enjoy a better situation in terms of inflation relative to other countries that look forward to membership in the EMU.



Concerns about current account fade away

CAD much lower than anticipated

Lately, the aggravated concerns on CAD faded away after Bank of Lithuania published data of balance of payments for 2004 with revised statistics for previous quarters. Last year, the current account deficit (CAD) amounted to LTL 4.44 billion or 7.2% of GDP. Compared to 2003, CAD rose by LTL 587.5 million, i.e. 15.2%; however, its ratio to GDP was only by 0.3 percentage points higher than in 2003. Furthermore, last year the Lithuanian CAD to GDP indicator was almost twice as low as it was in Latvia and Estonia.

Trade deficit was the only part of current account that deteriorated

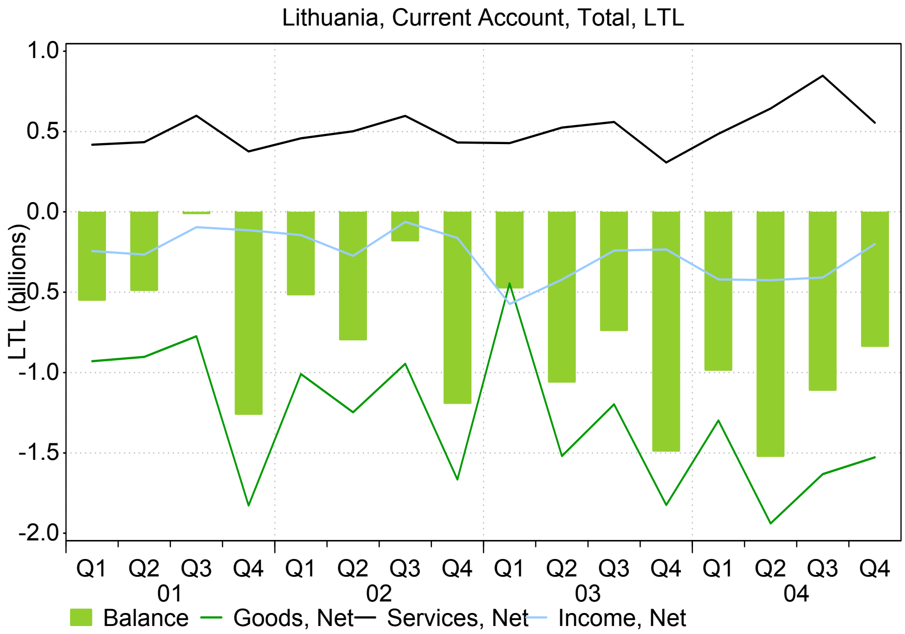
The said relief was brought by particularly good shape of the current account in the fourth quarter when CAD comprised 4.9% of GDP only. In overall 2004, the widening of the current account deficit was mostly determined by the increased foreign trade deficit, while the main factor reducing it was a higher positive surplus in the balance of services. Fast economic development of the country, increasing income and favourable borrowing terms fuelled domestic demand, which increased imports of consumption goods and worsened the foreign trade deficit. Other sub-accounts, that is, income deficit and surplus of current transfers also made a positive effect on CAD due to higher employment and investment income from abroad and structural support from the EU.

Both static indicators and dynamic models prove the current account

Both static and dynamic factors prove CAD sustainability

sustainability in Lithuania. In 2004, Lithuanian CAD coverage by FDI remained on a quite low level of 48.4%. However, CAD financed from other sources than FDI and non-repayable capital transfers to the Government (mostly the assistance from the EU funds) made up only slightly more than 2% of GDP. The ratio of CAD (as % of GDP) to nominal GDP growth comprised 1.42 and created grounds for possible CAD stabilization. The indicator of official international reserves in terms of import months stood at a comfortable level of 3.2 months. Thus, one might see that Lithuanian CAD is not financed from "dangerous" sources like short-term debt and consequently does not threat with problems in country settlements.

In an extra-fresh paper on Lithuanian CAD, IMF staff applies the dynamic model of intertemporal approach involving factor of rational expectations to the current account. This survey also confirms that CAD is sustainable since it might be explained by positive expectations and consumption-smoothing theory.



Source: EcoWin

Problem of labour force shortage is sharpening

Emigration of labour force turns to a shortage problem…

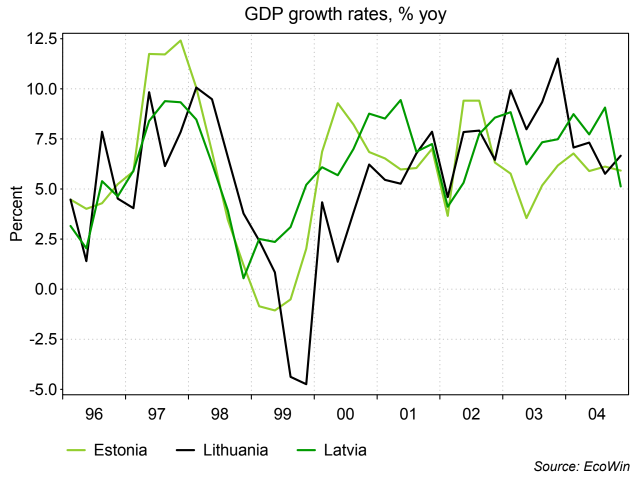
Lithuania's labour market continues to feel an increasing pressure, caused by labour force emigration to Western Europe and the USA. Nevertheless, so far it would be wrong to make a straightforward conclusion that the physical shortage of labour force hinders fulfilment of business orders. Companies refuse to accept new orders for the reason of being short of human resources very seldom. Usually there is a possibility to persuade the employees to work overtime or to attract competitor's labour force. The consequences of shrinking labour supply are somewhat different, i.e. deficit of human resources increases their price and thus general production costs. In turn, this weakens competitiveness of Lithuanian companies as well as their ability to win new orders. Due to a different production cost structure, the increase in wages and salaries has a different impact on different economic sectors, but none of them is likely to shake off it fully.

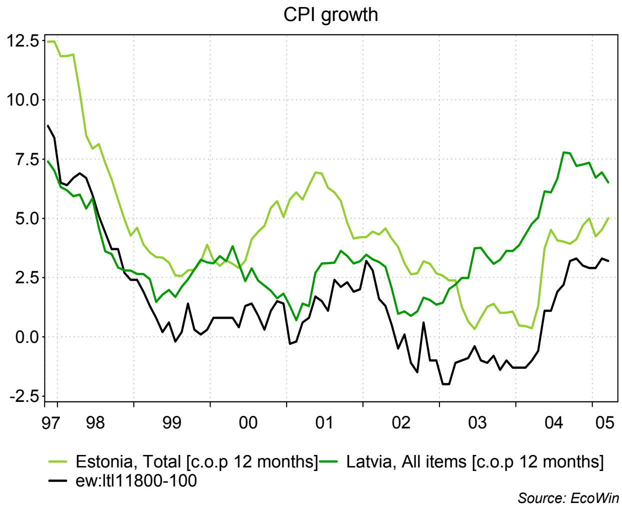
…but formally it reduces unemployment as well.

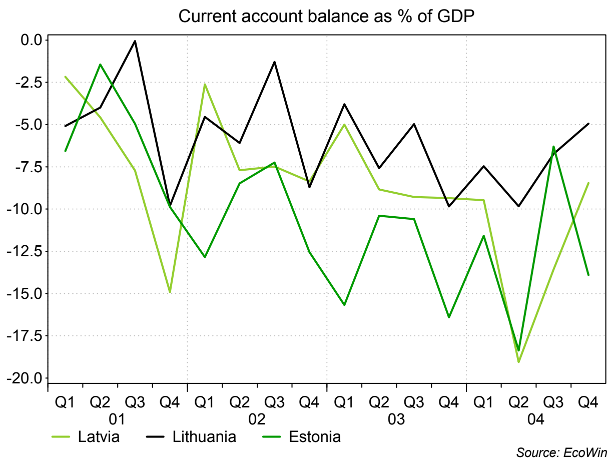
On the other hand, labour emigration formally reduces the level of unemployment measured on the basis of both the number of the registered unemployed and labour force surveys. According to Lithuanian Labour Exchange, at the end of March 2005 the level of so-called registered unemployment in Lithuania was only 5.9%. According to labour force survey data, average unemployment rate constituted 11.4% in 2004, and was by 1 percentage point lower than in 2003.

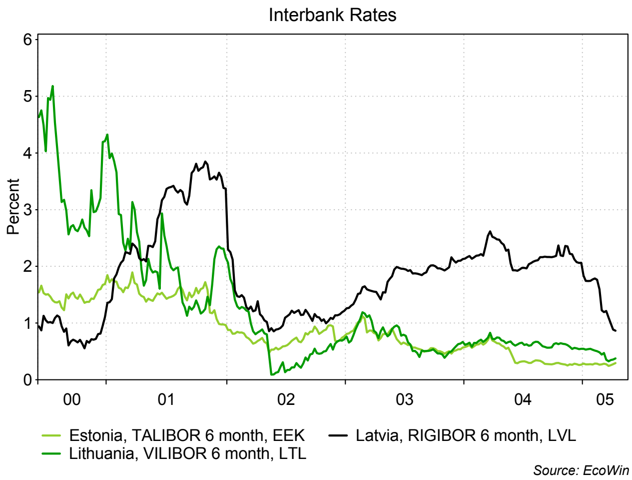
At present, there are few, if any at all, reasons that could prevent Lithuanians from looking for better-paid jobs abroad. Furthermore, in both 2005 and 2006 Lithuania's GDP growth is likely to exceed its potential level, which means that more and more of presently unemployed people will be involved into the process of producing goods and services. Based on those two assumptions, the unemployment rate (measured according to ILO methodology) is forecasted to follow a further decline.

Baltic states in figures









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