

Baltic MacroScope

January 2005

Latvian economy

(Written by Andris Vilks, Latvijas Unibanka)



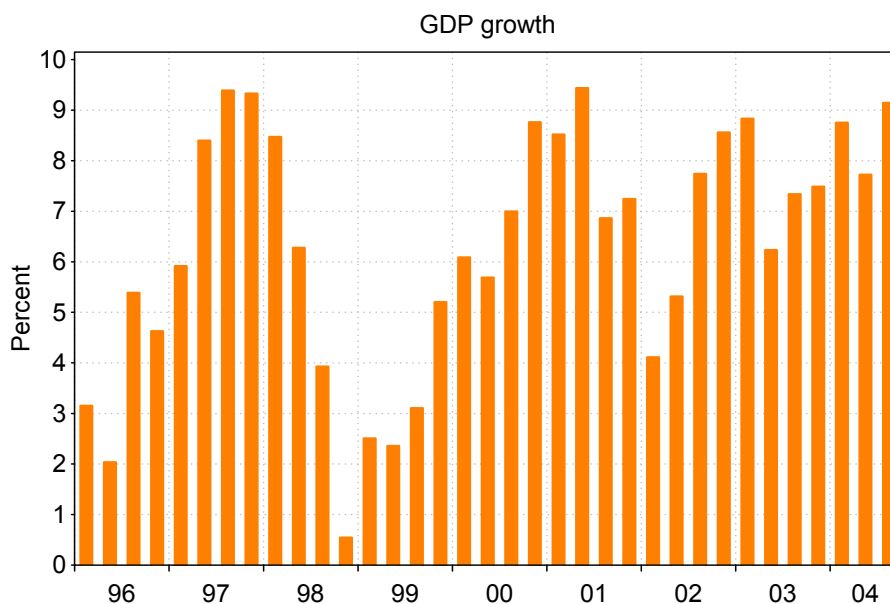
MAIN INDICATORS

	1999	2000	2001	2002	2003	2004E	2005E	2006E
GDP real growth, %	3.3	6.9	8.0	6.4	7.5	8.2	7.2	7.0
Export growth (goods), %	-5.1	12.2	11.1	12.1	17.2	26.0	23.0	20.0
Import growth (goods), %	-8.3	12.2	13.8	13.4	19.7	25.0	21.0	17.0
Foreign trade balance, % of GDP	-16.9	-17.1	-18.3	-19.1	-21.2	-22.3	-23.9	-24.5
Retail sales growth, %	6.0	17.5	2.7	12.4	13.6	12.5	10.2	9.8
Total loan portfolio as % of GDP	20.1	23.2	31.7	37.3	47.5	60.5	73.0	85.0
CPI growth, %	2.4	2.6	2.5	1.9	2.9	6.2	5.4	3.5
Unemployment rate, %	9.7	8.4	7.8	8.9	8.6	8.5	8.2	7.8
Unemployment rate (ILO), jobseekers rate, %	14.3	14.4	13.1	12.0	10.6	10.2	9.8	9.5
Public budget fiscal balance as % of GDP	-3.7	-2.6	-2.0	-2.3	-1.6	-1.5	-1.7	-1.5
Current account balance as % of GDP	-9.0	-4.6	-7.6	-6.7	-8.2	-11.8	-10.2	-9.5
Foreign direct investment inflow (mn LVL)	203	250	83	157	172	360	380	400
FDI/CAD coverage, %	53.4	115.2	21.1	41.2	33.1	42.0	45.0	47.0
Interest rate, long term national currency loans (annual average)	13.2	10.3	10.4	8.5	7.5	9.0	6.8	6.0
State debt as % of GDP	12.1	12.2	13.7	13.4	13.4	13.5	14.4	14.2

Economic upswing amazes

GDP growth in the 3rd quarter beats all expectations

In the **3rd quarter** gross domestic product was planned to grow by roughly 7%, the real increase, though, reached **9.1%**! This is positive news but at the same time setting forth intensive debates about a potential overheating of economy. As economic growth has again accelerated, in the **9 months GDP** rose by **8.5%** (8.2% in the first half of the year).



Source: EcoWin

Latvia will get out of the status – the poorest member state of the EU

Economic growth remains the highest in the EU, although it is not surprising. According to official statistics Latvia is the poorest member state of the European Union. It is true though – in recent years its growth rate has been so fast that in 2004-2005 Latvia, most likely, might break away from the last

place in the Union. Notwithstanding the impressive share of shadow economy in the country, accession to the EU seems to gradually reduce its influence and the companies start to legalize, thus brightening up official statistics and presenting a more realistic picture of the country's development.

Domestic demand remains the driving force of the growth

In the 3rd quarter economic growth in Latvia was determined sooner by local than by external demand. But demand grew in the services sector and not industry. **Services, with a share of above 72%** moved up by **10.2%** but in the 9 months – up by 8.8%. The largest increase was observed in the hotel and restaurant businesses (19%), in transportation and communications (17%), which must be viewed as a pleasant surprise, in trade and commercial services (10%), financial services (8%). Growth in the building industry keeps above 10%.

Contradictory development in manufacturing

According to monthly data lower growth was fixed in the **manufacturing industry – up solely by 5%**. This trend is rather depressing, because manufacturing industry holds a meagre **14% share in economy**, which is not enough. Although many branches of industry show a far larger than average growth, the total figure in the last months was hitched down by 3 staple industries – textile industry, metal working and partly also woodworking. Albeit, on the other hand, growth in exports has kept above 20% all the year round and we have not heard anything about depletion of the old commodity stock. As already expected a slight increase was observed also in agriculture. As is known, sizeable EU support funds have begun to flow into the agricultural sector and are deemed to spark off considerable growth. We can say that in the 3rd quarter growth was seen in practically all spheres of economy, retaining its upward trend as of the beginning of the year.

2/3 of GDP were generated in the Riga Region, the gap is widening between the capital and the rural areas

Alongside the high GDP growth there is no wonder that other economic indicators, too, have moved up. It explains also the highest inflation in our country, the crediting boom, growth of the purchase power, activation in the real estate market and attraction of foreign investments. Unfortunately, we do not know, yet, distribution of gross domestic product by regions, but it is quite certain that Riga and the Riga region get the lion's share. It must be mentioned that several larger towns and rural areas enter the scene more and more actively. At the same time the rift between Riga and rural districts is widening and European money alone is not the saviour.

Growth rate in 2004 will exceed 8% and more than 7% in 2005

As statistical data about the results of the 10 -11 months are already known, we can say that economic upswing in the 4th quarter will not be the smallest. The trend is similar to that one observed in the 3rd quarter. Namely, better results are expected in the services and the construction sectors, slightly lower in the industrial sector. The growth is expected to range between 7.5-8%, but **year 2004 growth could finish at 8.2-8.3%**. Most likely, the increase could rather exceed the given forecast. Considering the dynamic development, which is expected to run on also next year, we foresee a **7-7.5% rise in GDP in 2005**. Although louder and louder talks are heard about overheating of economy in the result of the unexpectedly fast development, greater attention should be paid not so much to these growth rates but more to their basis. And should we furiously battle Latvia's efforts to reach average wealth of Europe in 15-20 years rather than in the predicted 20-30 years?

Inflation is expected to be slightly lower in 2005

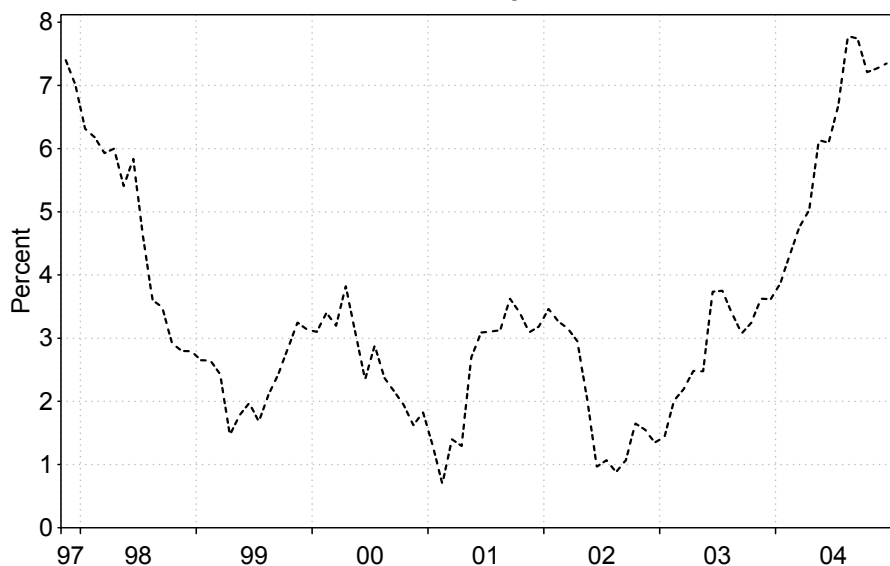
Last year inflation overran 6%

2004 was an exceptional year

A **0.3%** growth of consumer prices in December is regarded as a foreseeable level. Therefore in the last months of the year growth of inflation did not surprise us, since in September inflation was even lower than at the end of 2003. In total last year consumer prices rose by **7.3%**. In its turn, annual average inflation jumped from 2.9% in 2003 to **6.2%** in 2004.

Inflation has been the topic of debate for the whole last year. It must be stressed, though, that **the previous year was an exception** because Latvia's accession to the EU brought forth many inflation reinforcing factors. We felt also a speculative pressure and the so called psychological expectations of the inflation. In its result over the year's time the prices of health care and medicine grew by 14.3%, transportation services and fuel got up by 11%, hotel and public catering services, food products – by 10%. Administratively regulated prices grew by 5.4%. Of separate commodities and services the most substantial growth was fixed in the dairy product group, eggs, bread products, fuel, medicine and electric energy. Prices of the telecommunications tariffs, computer facilities, some household appliances decreased slightly. Looking at the situation from the structure of the consumption basket, we can see that the largest growth of this 7.3% rise was made by rise in the food prices (2.9%), transport (1.1%) and dwelling (1%).

Latvia, CPI growth



Source: EcoWin

Inflation will diminish slowly but it remains a major concern

In 2005 inflation is expected to drop substantially, because many of the factors, which affected the rise of prices in 2004, will be eliminated. Much will depend on the world's fuel prices and on the volume of imports brought into the country. A dramatic increase in the regulated prices is not expected either. The price-rise for many product and services groups will be determined by growth of the people's purchase power and by the government expenditure. Most likely, speculations with prices will go down. Competition ought to grow.

We have forecast average annual inflation to close at **5.4%**, it is more pessimistic than the official forecast given by the government – 4.3%. Although it is possible to reach a 4% inflation in 12 months, to push down average annual inflation to this level is an illusion.

Current account deficit is growing

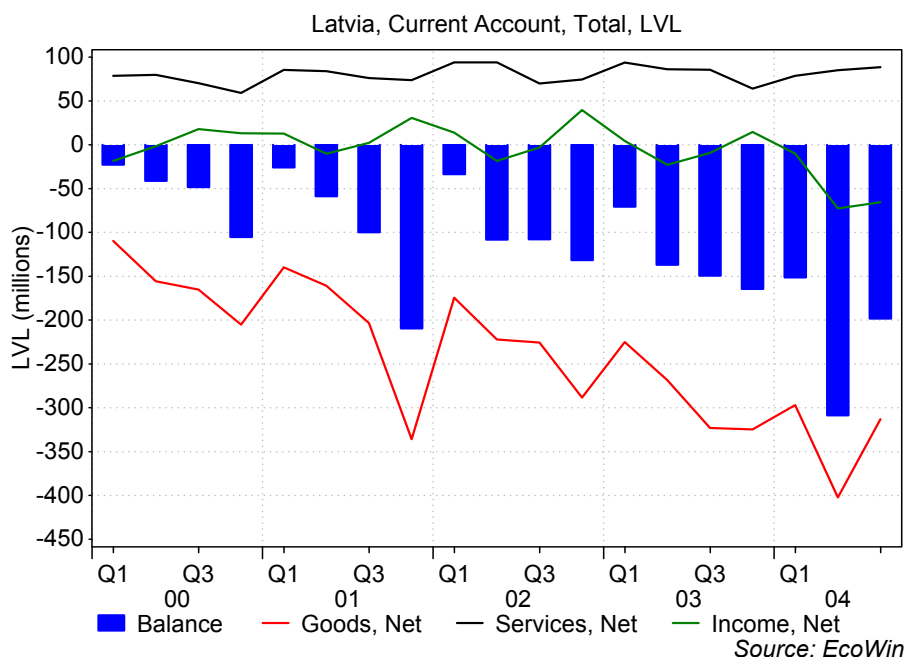
*Foreign trade balance keeps
overly negative ...*

*...and less support is drawn
from the positive services
balance*

Official 3rd quarter data, unfortunately, turned out even worse than the provisional figures of the period forecast. In the **9 months current account deficit reached 13.1% of GDP**, almost twice exceeding the deficit of the same period a year before. It is the price we pay for the fast development of the country and for the accession to the EU and NATO. We continuously are forced to import large volumes of industrial goods but the positive services balance is not so good as it was a couple of years ago. A considerably large deficit was created due to substantial growth of non-resident income from investments in Latvia.

In the 3rd quarter current account deficit was LVL 233 million (12.2% of GDP). Obviously also in the 4th quarter current account deficit will be sizeable, yet it is expected to be smaller than in the 3rd quarter.

It is clear now that we will have to revise our forecast for both – year 2004 and year 2005. In 2004 current account deficit will reach LVL 850-880 million or **11.5-12% of GDP**. In **2005** our forecast is revised from 9-9.5% to **9.5-10.5%**. Numerically it will finish above LVL 800 million.



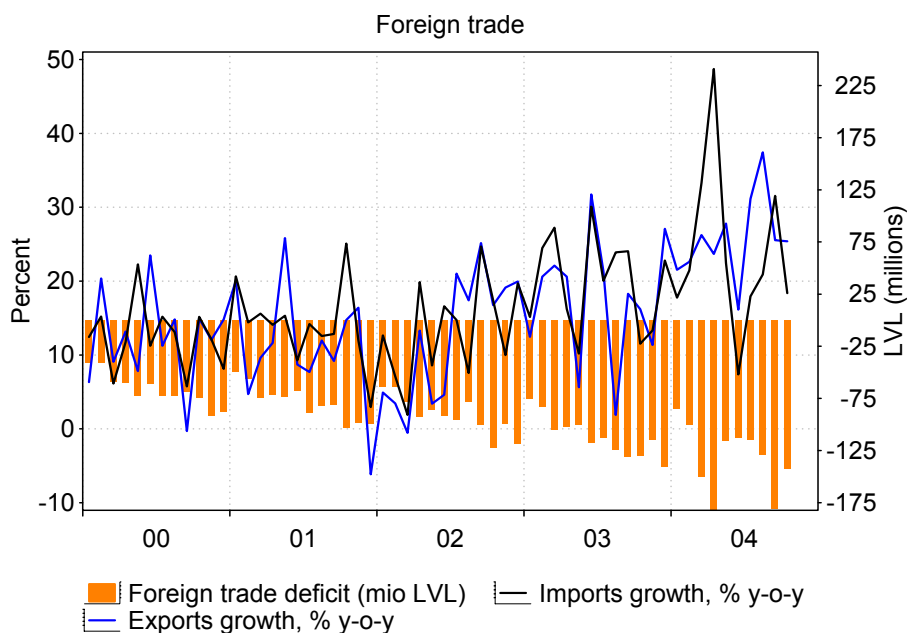
*Record high inflow of FDI in
2004, even more expected in
the coming years*

In return inflow of foreign direct investments has been unprecedentedly liberal. In the 10 months of the year foreign direct investment stock reached **LVL 310 million**. It is almost as much as in the two preceding years taken together! We think that the total volume of foreign direct investments in 2004 will be roughly **LVL 340-360 million**, in 2005 – about **LVL 350-400 million**. The final figure, most likely, will be even larger. Unfortunately, at the moment foreign direct investment stock covers solely about one third of the current account deficit.

Foreign trade is booming

Flexibility, low costs, competitive prices and quality, the euro rate stimulate exports

Build-up of **exports** has kept over 25% for a longer period, thereby proving that accession to the EU has ensured more favourable preconditions for exports of industrial goods from Latvia. Small and medium size companies of Latvia are sufficiently active in search for new sales markets, because we can find only a few large industrial enterprises in the country. In total in the **10 months it has grown by 26.2%**. Obviously, a similar increase is expected for the whole 2004. The growth is considerably more substantial than the 17-20% upswing forecast at the beginning and in the middle of the year. Although the key commodity group remains timber (32%), its share and growth rate in the exports structure continued to slow down. Exports of machinery and mechanisms, electric equipment, metals, chemical goods, rubber and plastic materials, agricultural and food products as well as mineral products saw the highest growth rates. Growth was fixed in practically all commodity groups. 75% of the exports go to the EU States although its share is slowly shrinking due to larger volumes of exports to other countries. The share of exports to the CIS countries has grown by 13%. The main exports markets though are Great Britain, Germany, Sweden and the Baltic countries. This year exports to Estonia, Lithuania, Sweden, Russia, Great Britain, Norway, Finland, and the USA are gaining ground. Exports to Byelorussia, Poland, Switzerland, Iceland, Kazakhstan and Uzbekistan have doubled.



Source: EcoWin

Imports remains steadily high due to high demand and comparably weak industrial sector

In October growth of **imports** was slightly smaller than in September. Annual growth stood at 18.3%, whereas the **10 months increase reached 24.9%**. This level, however, remains high, exceeding exports by 75%. But what can we wish, given the national economy is up by 8-9% only, consumption remains steadily high but the share of industry in the economic structure of the country keeps low. Imports, too, has seen upswing in all commodity groups, particularly in the imports of timber, vehicles and metals. Imports from the EU constituted 75%, that from the CIS countries – 13%. The main trade partners of Latvia are – Germany, Lithuania, Russia, Estonia. This year imports from Byelorussia, Estonia, Lithuania, the Netherlands, Ukraine,

Poland and Sweden grew particularly fast.

Most likely substantial changes are not expected also in **2005** and both exports as well as imports could grow by **20-22%**. And, unfortunately, foreign trade balance keeps worsening.

Pegging rate of Latvian lat to Euro – a stimulus for the development of industry

Latvia pegged LVL to euro at a particularly high rate.

According to earlier announcements on 30 December the *Bank of Latvia* pegged the lat from the SDR basket to the euro. It was pegged to euro at a particularly high euro rate, namely, **1 EUR = 0.7028 LVL**. Let us remember that in 2004 the average euro rate against the lat was roughly 0.67, but in 2000-2001 – only 0.56. Just like earlier the *Bank of Latvia* will unilaterally guarantee lat/euro exchange rate differences at about ± 1 per cent from the central or the pegging rate. In the coming months Latvia is preparing to join the mandatory Currency exchange rate mechanism II, which will be in force for two years on, at least. Latvia will not sheer from its target to introduce euro as a means of settlement as of January 2008.

People find fewer euros in their pockets. Statistical indicators in euros are down

As the **lat has been pegged to the euro at the all time highest EUR/LAT rate** it raised and continues to raise many queries in the public. Consequently imported goods will become more expensive, because most of them come from the euro zone but the fast growing economy will not be able to damp growth of imports. On the conversion we shall find fewer euros in our purses than a couple of years ago. Travelling around Europe has also become more expensive. Therefore at a social level it seems to be a bad bargain. Yet, lat rates will gradually approximate euro rates and at the end of the year the difference is expected to be **roughly 1%**. Wherewith the rates in lats and euros will be practically the same. In turn the expected growth of the dollar rate in the 2nd half of the year will give dollar users to understand, whether it is not better to minify the risk and change over to euro/lat. The crediting boom will subdue minimally.

We will be able to assess the situation realistically only a couple of years later. Very often short-term losses become long-term gains. Most essential is the fact that currency exchange risk is eliminated, because year on year the role of the euro in our life is only going to grow.

The winner from the repegging should be the manufacturing sector and exporters

The main winner from the high rate will be Latvian manufacturing industries, exporters to the EU States. These countries pay for the goods in euros or euro-pegged currencies. Compared with the situation a few years ago it is a good pay. It will spur our manufacturing industry on to faster development for at the present moment its share in economy does not exceed 14 per cent, being one of the lowest in the EU. Even in our neighbouring countries - Lithuania and Estonia manufacturing industry accounts for a share of 18 per cent in economy. At this pegging rate trading in the dollar zone will be less profitable (CIS, Asia, USA), given the companies use raw materials purchased for lats and euros in the manufacturing of their products. The companies, purchasing raw materials for their business in the dollar zone but selling their output for euros, should, definitely, prosper.

Speaking about inflation we must admit that it will be significant, because it will be pulled up by the high rate and imports will continue to be steadily bulky. Most of the industrial goods will come from the euro zone. They will, definitely, be expensive. It must be mentioned though that dollar-

denominated energy resources and raw materials ought to depreciate. Since most of the commodities come from the euro zone this rate, in a short term, is inflation magnifying phenomenon. Inflation and current account deficit will be driven up by the acquisition of the EU funds and by the necessity to import EU-manufactured equipment.

Are there signs or a threat of overheating in economy?

Booming crediting and real estate market, huge current account deficit call for more explanations

Although louder and louder talks are heard about overheating of economy in the result of the unexpectedly fast development, greater attention should be paid not so much to these growth rates but more to their basis. And should we furiously battle Latvia's efforts to reach average wealth of Europe in 15-20 years rather than in the predicted 20-30 years (or even 70)? Subject to faster convergence we will always face high growth rates everywhere. Is that a threat? May be yes, may be not.

Regarding signs of a nascent overheating of economy in Latvia we can conclude that the fast economic growth, high inflation, very rapid credit expansion, worsening of foreign trade balance and current account, booming real estate market and construction, increasing inflow of foreign money in deposits and real estate, comparably high fiscal deficit – all that in total is a real threat to joining the Euro zone. Actually there is just one real threat – inflation. This, most likely, is the only phenomenon, which Latvia would not be able to eliminate in 2005-2006.

Since 2002 the loan portfolio of commercial banks has doubled

Although **annual lending growth** in 2004 would be close to **50%** and increase in mortgage loans might reach even 80%, their basis is very low. For example, **household loans** constitute just some **20% of GDP** more than twice less than in the EU on average. And **less than 10% of households** have mortgage loans.

Real estate is booming and that is true. The annual price growth for apartments in multi story apartment houses reached 20-30% last year, land prices near Riga have even doubled, tripled since 2002. But at the same time the average living space per capita is just 22 m² in Riga. The new projects are coming but slowly and many of them are still too costly for the majority of the potential customers. We hope that market will recognize the early warnings of overheating and will react properly.

Estonian economy

(Written by Ruta Eier, 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%	6.1%	6.2%	6.4%
Export growth	0.5%	52.2%	7.4%	-1.5%	9.8%	23%	9.4%	12.3%
Import growth	-8.6%	43.1%	4.0%	5.9%	12.9%	19.0%	8.3%	10.0%
Foreign trade balance, % of GDP	-18.4%	-19.8%	-16.5%	-19.2%	-21.6%	-21.6%	-20.7%	-19.4%
Retail sales growth	5.8%	10.5%	13.8%	14.3%	9.9%	12.4%	11.5%	10.0%
Total loan portfolio as % of GDP	32.7%	36.9%	39.0%	42.8%	55.0%	66.9%	77.3%	81.1%
CPI growth	3.3%	4.0%	5.8%	3.6%	1.3%	3.0%	3.2%	2.9%
Unemployment rate	12.2%	13.6%	12.6%	10.3%	10.0%	10.0%	9.7%	9.6%
Public budget balance as % of GDP	-4.3%	-0.9%	0.6%	1.1%	2.6%	0.3%	0.3%	0.0%
Public debt, % of GDP	6.5%	5.0%	4.7%	5.7%	5.8%	5.0%	4.7%	4.60%
Current account balance as % of GDP	-4.4%	-5.5%	-5.6%	-11.3%	-13.2%	-13.4%	-12.2%	-11.1%
Foreign direct investment inflow	4,448.0	6,644.4	9,429.7	4,800.3	12,470.9	11500	10000	10000
FDI/CAD coverage	123%	130%	160%	36%	75%	60%	54%	54%
3m interest rate, end of period	5.10%	6.10%	4.00%	3.50%	2.60%	2.40%	2.90%	3.90%
Long-term interest rate, EEK loans	8.56%	8.86%	10.14%	6.56%	5.13%	5.39%	5.60%	6.45%

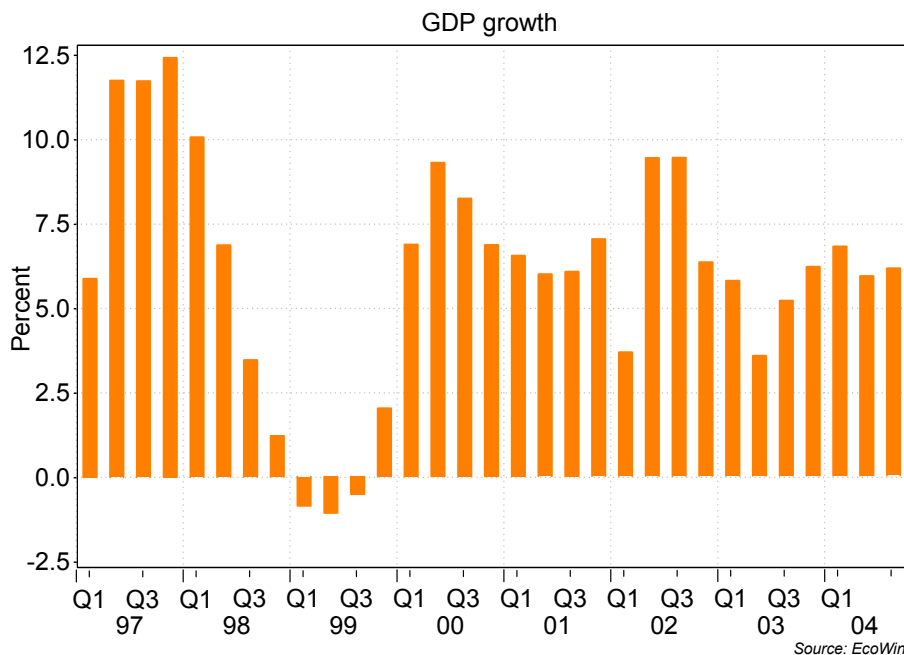
Economic imbalances no exception in global scope

All the three Baltic countries witnessed widening economic imbalances in 2004. Unprecedented imbalances in between the world's current account deficits (mainly US) and surpluses (Asia, and to a lesser extent, Europe) and real estate booms have been the keywords also for the world's economy in 2004. Low interest rate globally had its impact also on Baltic economies and fuelled the economic growth rates.

Better than expected growth in 2004

The outlook for Estonia's economic growth rate in 2004 improved with the dataflow in third quarter. Economy grew 6.1% in 3Q, which was faster than expected. The overall 2004 GDP growth rate will exceed that of predicted earlier and reach about 6.1%. More to that, the growth structure improved in 3Q, but largely this was brought by seasonal factors. However, we think growth drivers in 2005 in general will be more balanced. The ground for these hopes lies in relatively good growth prospects in the eurozone and investments already made, which should contribute both to goods and services export increase.

GDP growth may reach 6.1% in 2004

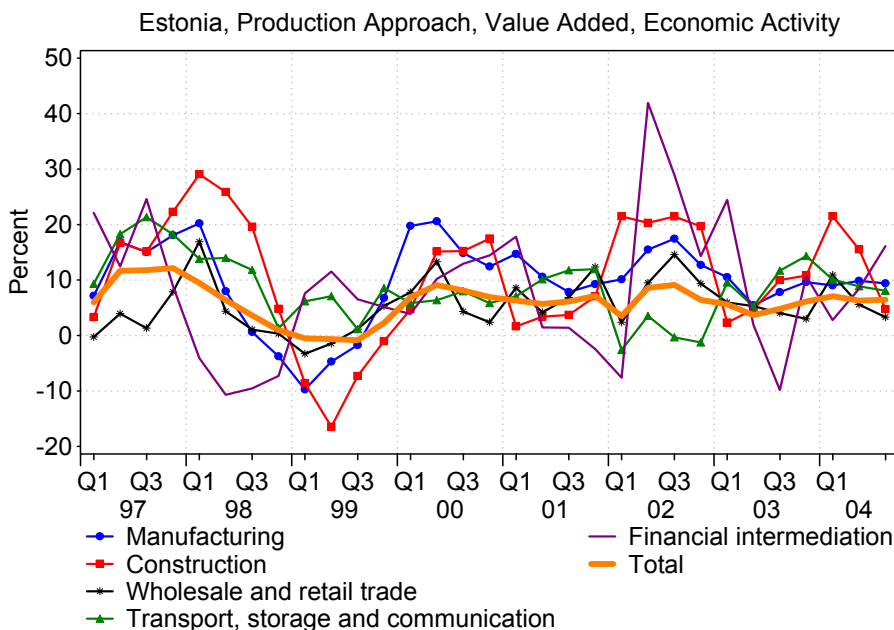


Powerful boost from monetary conditions

What are currently the driving forces of the economy? Current monetary environment is certainly having a crucial influence here, adding power to domestic demand. Sluggish growth in the eurozone has prevented interest rate hikes in this region, which is determining the monetary conditions in Estonia. Low interest rates have boosted investments, which has lent a helping hand to construction sector, real estate, and financial intermediation and even retail sector through investments into residential spaces. The third quarter was not an exception in this respect. Although there was some temporary correction downwards in construction sector growth, the fundamental driving forces for the economy remained the same. Mounting investments made in recent years in infrastructure and transportation have started to pay off in export of services. Increasing wages, but also to some extent loan growth provides support to solid consumption growth.

Main driving sectors manufacturing, transportation and real estate sector

The main contributing sectors to GDP growth in 3Q were manufacturing (9.4%yoy) and logistics, storage and communication (8.1%yoy), the latter being related to the increase of the net export of services. The real estate activity remained very strong and low interest rate fuelled the profits from real estate, which led to high growth of value added in real estate sector (6.9%yoy). Related to activity in real estate market, loan growth continued to be very high and value added in financial sector increased by 16%yoy.



Growth structure improved

GDP growth in 3Q was not so dominantly related to domestic demand as before. Domestic demand amounted to 104.1% of GDP vs 108.7% in 2Q04. Nevertheless, both consumption and investments kept on growing at a solid pace. Private consumption growth adjusted to 4.7% yoy in 3Q from 6.6% in 2Q, both quarters' growth rates being temporary deviations from its trend because of consumption spike in the eve of accession into the EU. Investment growth was rather strong despite slowdown in construction sector.

Industrial production growth rates slow down

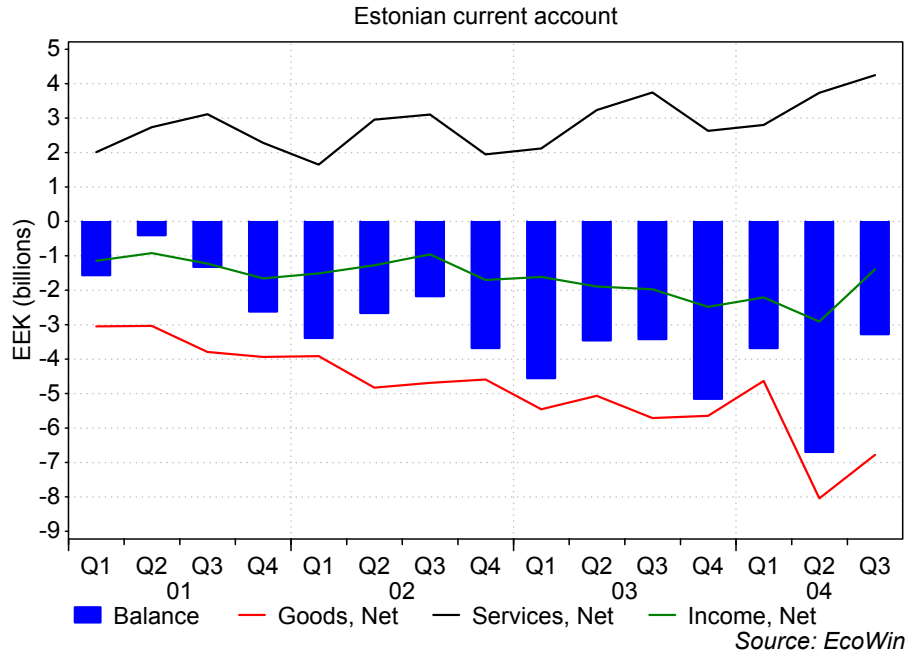
On the background of robust domestic demand growth, quite encouraging is the **industrial growth** rate, which persists strong and well above total GDP growth. In the final months of 2004 industrial production growth slowed down somewhat. Industrial confidence index implies decreased future orders from abroad. Most manufacturing branches are doing fine, but textile production and fish processing are in trouble. For some quarters already, fishing industry faces difficulties; also manufacturing of clothes, leather processing and metal processing remained below the level of last year. In November, machinery production growth turned into negative territory. One of the forces pulling industrial production growth rates down may have been the reduction of food processing industry production recently, being the biggest industry in Estonia. Food processing sector exports to its main markets Russia and Latvia have been hindered by weak dollar.

All in all, the prospects for industry seem less gloomy than the latest data. In last two quarters, manufacturing has expanded powerfully its employment and its export increases vigorously. The data supports positive views for future developments for industry as a whole. Industrial confidence index, however, indicates low growth rates continuing in coming months.

Investments abroad start to pay off

Services net export responsible for more balanced growth structure

Economic growth structure in 3Q was more balanced thanks to increased contribution from the net export of services. At the same time, net export of goods did little to improve Estonia's external balance and the trade deficit of goods remained large (19.2% of GDP). The improvement of the surplus on the services balance was largely seasonal and provides not much comfort to assume the trend to have changed permanently to the better.

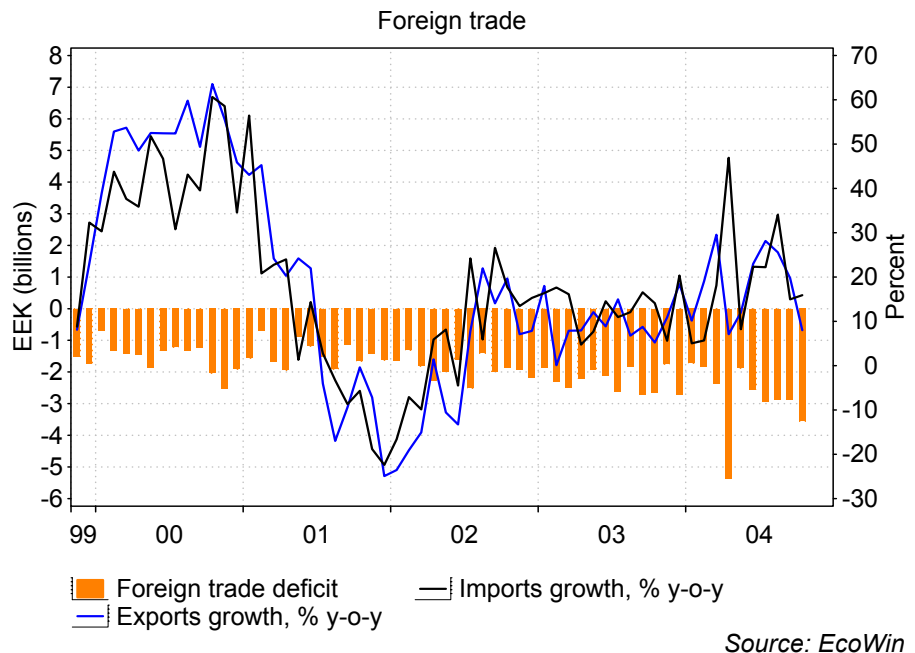


...which together with income growth from abroad brought down current account deficit

In 3Q, current account deficit decreased to 9.2% of GDP. The relief was brought by income from abroad, which jumped dramatically. 4 quarter moving average for current account deficit stayed at 14% of GDP. A seasonal improvement was provided by services account surplus while trade deficit remained huge. The prospects for full year 2004 and for coming years have not changed, a rapid reduction of current account deficit is prohibited by persisting large trade deficit. Recent foreign trade data indicate no encouragement, monthly trade deficits have exceeded 3bn EEK since July.

...while trade of goods provides no comfort

For now we can recognize that the shock in foreign trade figures we have witnessed since May proved to be permanent. Thus, new statistical methods imply we are faced with the new levels of imports, exports and trade deficit. In 3Q foreign trade deficit decreased somewhat compared to the record level in 2Q, but nevertheless remained huge compared to previous periods.



*No significant
reduction of current
account deficit seen
in 2005 either*

Current account deficit will be pressured continuously by high investment activity in 2005. Strong demand for construction, modernisation of production, infrastructure and other investments supported by EU funds – all is adding to strong investment activity. Also consumption growth is expected to be stable. Expansionary fiscal policy in 2005 will support domestic demand.

*Expansionary fiscal
policy in 2005*

In the period of little saving by private sector, it's time for the government to increase the savings for the sake of stabilisation policy. Budget for 2005 is planned with zero-balance, but we expect a small surplus. Some foreign analysts suggest the much higher surplus would be needed in order to restrain the imbalances in economy. Consumers' income will be boosted in 2005 on account of personal income tax rate reduction from 26% to 24% combined with tax-exempt income increase from 1400 EEK to 1700 per month. On the other hand, some indirect taxes will increase somewhat.

*Are we eating up
future consumption
or enhancing future
incomes?*

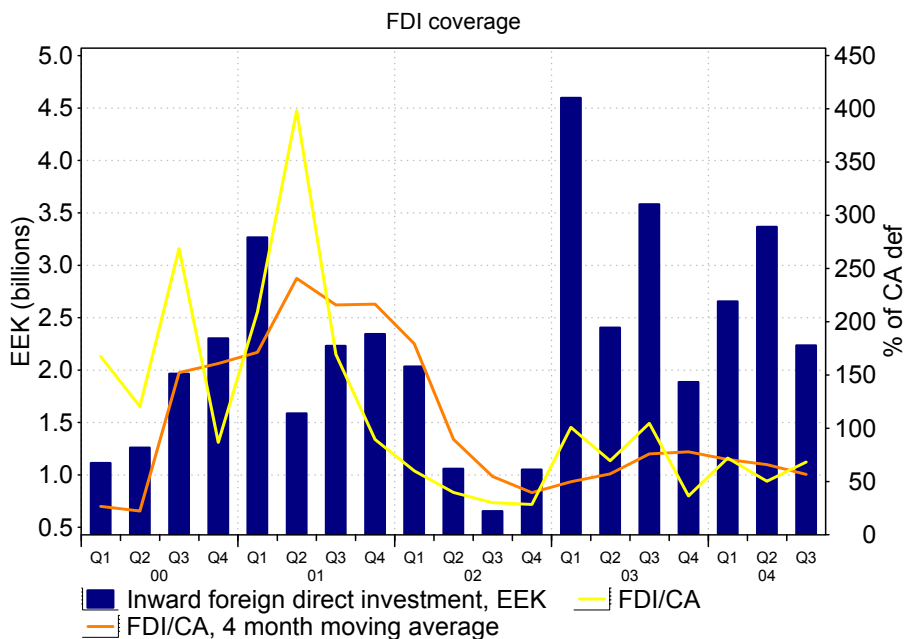
Under the scenario we depict for interest rates in 2005, borrowing seems for consumers still more attractive than saving. That, again, will not enable reduction in current account deficit, which means that the country needs to borrow from abroad to finance its current expenditures.

As Estonia is an interest rate taker in global market, we face a low interest rate level which exacerbates lending and reduces saving. Given that capital lent is invested reasonably, we should enjoy higher income in the future. To the amount that lending is used for smoothing of consumption, it also means more consumption now on the account of the future.

Which is the case in Estonia, currently? Are we eating up future consumption or are we just using financial leverage in a reasonable way to enhance our future possibilities? We think it's both, but more, it's related to investments.

As is the case with transition economies generally, Estonian economy is in the position of net debtor. This is exaggerated by the current state of economic cycle. Current account deficit indicates that domestic savings are not enough for investments and we need to finance it with the money from abroad.

We take some comfort from the fact that large part of the current account deficit is still financed by incoming FDI and loans from foreign parent companies, which is implicitly also FDI.



Real estate market and credit boom fuelling economic growth

No end to credit boom seen on the horizon yet

Economic growth is currently highly supported by credit growth. Domestic borrowing demand is continuously exceeding domestic savings and lending boom is fuelled by foreign capital. High credit growth rates were sustained in the end of 2004, exceeding 40%yoy in November. As far as year 2005 is concerned, no factor making an end to high credit growth rates is seen on the horizon. Real wages keep on growing, interest rate hike in the eurozone might be postponed to the end of 2005, aggressive new real estate supply and tough competition in the banking market make all the necessary conditions for a fruitful field for further credit growth.

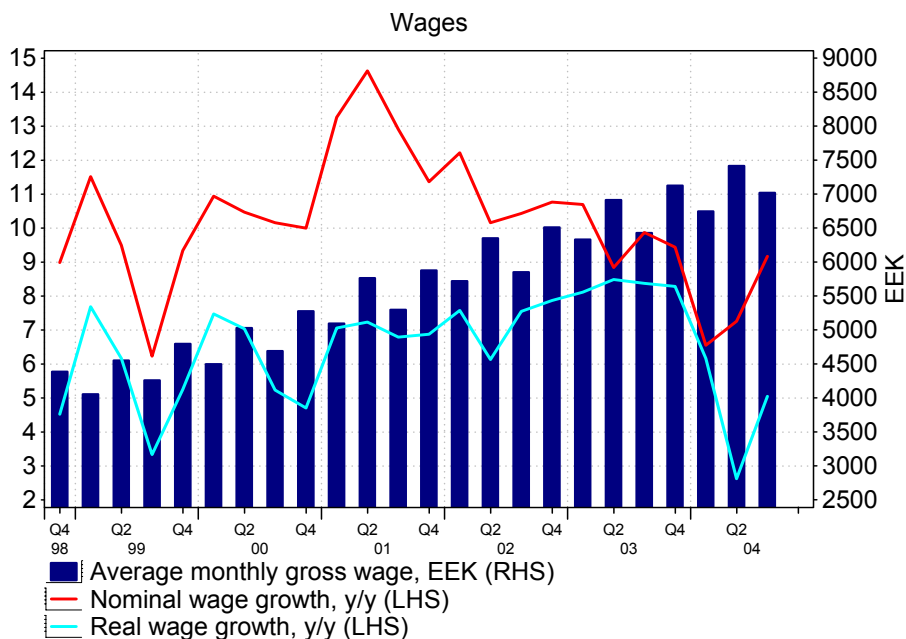
Overheating in real estate market down to road?

Credit growth is also behind the real estate boom where there is no sign of cooling yet. Price increase in 3Q was 29% yoy (we have used average price for a 2-room flat in Tallinn). That, in turn, has contributed to economic growth. Low interest rates fuel profits in real estate. Rising real estate prices in turn, encourage credit growth further – higher value of collateral enables to take more loans and thus fuel demand for more expensive real estate. Hunger for buying real estate is huge and high demand combined with limited supply is driving rapid price increase. In some cases, expectations about future profits from real estate market might be too optimistic, which is also driving price increase.

Real estate prices in some areas have reached a very high level already. Although it is possible for prices to appreciate further, if we consider the current levels of prices, private income and indebtedness, a reasonable assumption would be that the slowdown in growth rates of real estate prices should begin during the course of 2005. High growth rates will persist in areas outside Tallinn. However, if price appreciation should not decelerate, the market may come to overheating in a couple of years.

Real wage slowdown in 2004 will be temporary

Consumer confidence was lower in 2004 than in 2003. Higher inflation has contributed to lower confidence through real wage increase deceleration. Real wage increase decelerated significantly in the beginning of 2004 and remained relatively sluggish in Estonian context also in 3Q (5%).



Source: EcoWin

Prospects in labour market seen stable

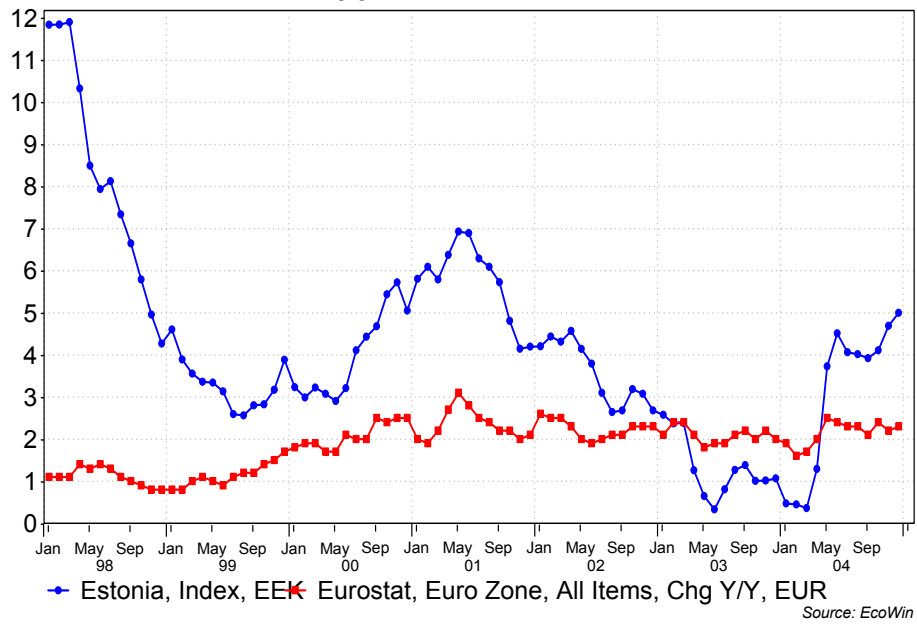
Favourable trends in the **labour market** have stopped in 3Q, too. For the first time after 3 years, employment didn't increase in 3Q, but decreased 2%. The reason was the lower extent of seasonal work, because of bad weather. Therefore, also unemployment remained at 10% as in two previous quarters and did not go through a seasonal improvement as was expected. We assume, however, that fundamentally no adverse trends have occurred in labour market and favourable trends in labour market to continue in 4Q and 2005.

Inflation in 2005 in similar range as in 2004

In 2004, **inflation** remained at 3%, that is lower than predicted in the beginning of the year. After tax increases in May, the main factors driving inflation were globally risen fuel prices, housing services and food prices.

In 2005, the same factor as in 2004 - strong euro and thus kroon - will continue to subside inflation. Tightening competition in retail trade and telecommunications will contain inflation, too. At the same time, some tax increases, among them electricity price increase, which was postponed to April 2005 and excise taxes on fuel, alcohol and tobacco will have an upward pressure on the price level.

CPI y/y in Eurozone and Estonia



Lithuanian economy

(Written by Alge Budryte, Vilniaus Bankas)



MAIN INDICATORS

	1999	2000	2001	2002	2003	2004E	2005E	2006E
GDP real growth, %	-1.7	3.9	6.4	6.8	9.7	6.8	6.8	6.5
Export growth*, %	-14.9	28.9	20.6	11.7	11.2	18.5	14.0	11.0
Import growth*, %	-13.7	12.8	16.1	13.4	7.1	16.5	13.0	10.0
Foreign trade balance, % of GDP	-17.3	-14.7	-14.7	-16.2	-14.6	-14.8	-15.0	-14.8
Retail sales growth, %	n/a	12.9	7.2	12.4	14.3	11.0	10.0	10.0
Total loan portfolio, % of GDP	12.8	12.1	14.3	15.6	21.5	27.1	31.8	36.5
CPI growth (y-o-y), %	0.3	1.4	2.0	-1.0	-1.3	3.0	2.8	2.5
Unemployment rate (ILO), %	14.6	16.4	17.4	13.8	12.4	11.0	10.1	8.9
Public sector deficit (ESA'95), % of GDP	n/a	-2.5	-2.0	-1.5	-1.9	-2.8	-2.5	-2.0
Current account balance, % of GDP	-11.0	-5.9	-4.7	-5.2	-6.9	-9.5	-7.0	-6.8
FDI inflow, % of GDP	4.5	3.3	3.7	5.2	1.0	3.8	4.5	5.1
FDI/CAD coverage, %	40.7	56.1	77.7	99.8	14.3	40.0	65.0	75.0
Interest rate, national currency loans, %	13.0	11.0	8.1	6.1	5.1	6.0	6.5	6.5

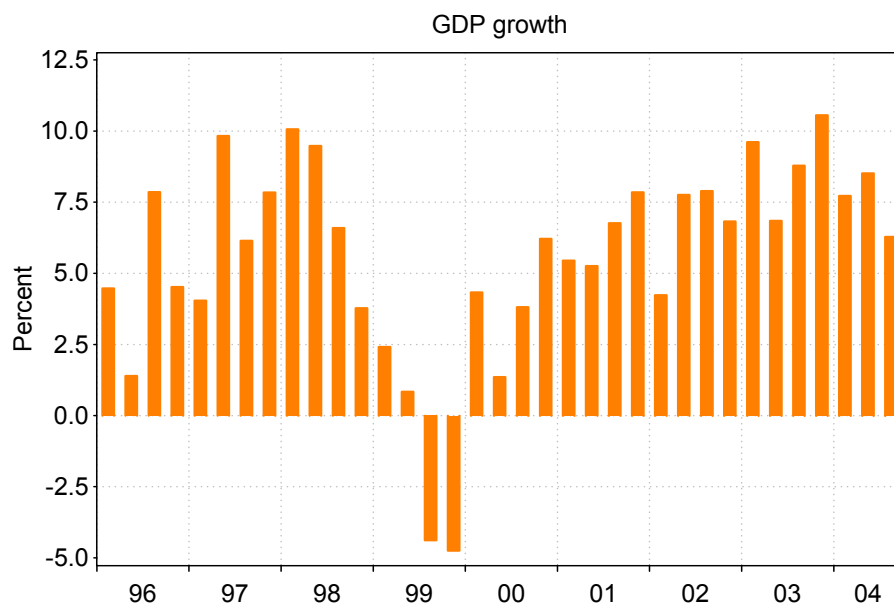
Strong economic performance trapped by contradicting factors

Lithuania's economic growth is piping down

According to the well-known saying, do not count your chickens before they are hatched. Today statistical data for the whole year 2004 are not yet available, and thus it could be a bit premature to see how the last year stands out in Lithuania's economic development. On the other hand, statistical information is released for the most of 2004 and allows drawing conclusions that are not likely to change in the near future. One of them is undisputable – in 2004, Lithuania's economic growth rate bounced back.

Economic forecasts caught the trend but are likely to come a bit too optimistic

According to the recently released statistics, in the first 9 months of 2004, compared to the same period a year ago, Lithuania's real GDP grew by 6.7%. Due to, at least, the effect of high statistical base (in the 4th quarter of 2003, the real GDP showed an increase of even 11.5%), actual data for the 4th quarter of 2004 will not be impressive, thus leaving no doubts that the whole year's GDP figure will be slightly less than expected and that such robust rates as almost 10% per year is already a history.



Source: EcoWin

Instability of macroeconomic environment – one of the slowdown's roots

The noticeably slower growth rate of GDP in 2004 can hardly be explained only by the economy turning its wheel back to the potential. Another reason behind this is instability of macroeconomic environment triggered by several factors: tension in the global markets of oil, metals and other raw materials, the hopping exchange rate of the euro to the US dollar, sluggish economic recovery in the “old” European Union, increased political uncertainty in the Eastern trade partners of Lithuania (for instance, the Ukraine). Since most of these economic factors are difficult to forecast, it is worth to sketch more than one scenario for the country’s economic development in the nearest years, i.e. to see what could be the most realistic, the best and the worst case.

What are the most realistic, the optimistic and the pessimistic outlook for Lithuania’s economic growth?

Under the most realistic scenario (see Table below), in 2005 and in 2006 Lithuania’s GDP would grow at annual rate of 6-7%. This forecast is based on the following assumptions: economic growth in the euro zone and the CIS countries continues to be similar to that of 2004; the global oil prices go down from the current level; the exchange rate of EUR relative to USD is within a range of 1 to 1.30–1.35, respectively; inflation in Lithuania is moderate; and there is only a slight increase in nominal interest rates.

Table: Three scenarios for Lithuania’s economic growth in 2005 and in 2006

	Economic growth in euro zone and CIS	Global oil prices	Inflation in Lithuania	Euro zone's interest rates	EUR/USD exchange rate	Corporate profitability and investments in Lithuania	Expectations of households and companies in Lithuania
Most realistic: GDP growth of 6-7%	similar to that of 2004	go down to 35-40 USD per barrel	moderate, about 3%	increased by 25-50 base points	1,30-1,35 USD per EUR	not shrinking a lot, since higher production costs are offset by rising productive efficiency	good, but accompanied by lower borrowing rates
Optimistic: GDP growth of 7-9%	puts on pace, compared to 2004	go down to 25-30 USD per barrel	decelerates down to 1,5-2,5%	do not change	1,35-1,40 USD per EUR	increase as a result of lower oil prices	very optimistic, accompanied by the same borrowing rates as in 2003-2004
Pessimistic: GDP growth of 2-3%	comes to a halt in the euro zone and noticeably slows down in the CIS	higher than 40 USD per barrel	accelerates up to 4-5%	increased by 100-150 base points	1,10-1,20 USD per EUR	decrease due to higher production costs	gloomy, accompanied by overreaction and drastic cuts in borrowing

Meantime weakening of US dollar is not a threat

If the above-mentioned trends were very strong, the country’s economy would be on a road to the optimistic forecast for growth of even 7-9% per annum. It is worth to point out that weakening of the US dollar relative to the euro and, automatically, to the litas is more beneficial for Lithuania than the opposite process, because the greenback is a more popular settlement

currency in import operations than in export operations of the country. To a certain extent, the strong litas relative to the US dollar helps to outweigh the impact of high global oil prices on the domestic market (since imports of raw oil are usually paid in USD), thus preventing an outbreak of inflation. Although strengthening of the litas has a negative effect on Lithuania's exports to the US, Russia and other countries orienting their national currencies to the US dollar, not all possibilities (e.g., EU subsidies for exports to third countries, vigorous growth of domestic demand in Eastern countries, etc.) to stimulate sales in these markets have been exploited. Of course, these possibilities would become of secondary importance, if the US dollar reached the record-breaking depth of 1.35-1.40 per 1 euro, and 1 US dollar cost below 2.5 litas.

Probability of the worst scenario is not significant

It is always wise, while hoping for the best, to plan for the worst. The worst would come if Lithuania's economy made its way at a sluggish rate of 2-3% a year. If such scenario were in place longer than for a couple of years, Lithuania's economic convergence with the advanced EU members would become interminable. Luckily, most of the necessary preconditions (see Table above) for the darkest case are not in place at present.

Leading economic sectors are becoming tired to pull a sled of the laggards

In terms of Lithuanian economy's structure, the recent growth slowdown can be explained by the following. The robust development of manufacturing industry and other economic sectors, primarily focusing on domestic markets, no longer compensates for the stagnation or even slump of other sectors to the same extent it used to.

Agriculture, fishing and mining industries cause a headache

The value added (measured in constant prices) by agriculture, by fishing and by mining industries were those that suffered a decline. In 9 months of 2004, compared to the same period of 2003, they decreased by 0.1%, 4.1% and 7.9%, respectively. The insignificant decrease in the value added by agriculture shows that this sector has almost got back on the growth track. On the other hand, the deep decline in the value added by mining industry suggests that this is becoming a long-lasting phenomenon, which can be stopped only by an essential breakthrough in investment and exploring policy of Lithuanian miners.

Manufacturing industry continues to be "number one"

The sectors of manufacturing, domestic trade, and transport and communications were "cream of the crop," growing faster than the whole economy. In January-September 2004, compared to the first 9 months of 2003, their value added showed an increase of 12.0%, 10.8%, and 8.3%, respectively. Lithuanian manufacturers have managed to make use of new export opportunities brought by the country's membership in the EU. Furthermore, geographical diversification of their sales markets can help "keep in the saddle" even when the development of domestic markets slows down. The sector of domestic trade will continue to develop at a stable rate, at least, until the borrowing boom fades away and the real estate market dips into stagnation. It is worth to mention that repatriated earnings of Lithuanian emigrants will be an additional stimulus for the development of domestic trade sector in the nearest future. The transport sector finds itself in a less favorable situation, however, and its growth swing is obviously shrinking. One of the key challenges for this sector is the significantly increased scope of competition after the country entered the EU (for example, Lithuanians started to compete directly with Poles) and, at the same, rising production

Energy sector undergoes radical restructuring

costs due to rising wages, prices of fuels, etc.

In the discussed period of 2004, the values added by the rest of economic sectors (energy, construction, hotels and restaurants, financial intermediation, etc.) showed an increase ranging from 1.2% to 6.0% year-on-year. In the immediate future, the energy sector will face, probably, most radical challenges driven by such fundamentals as shutdown of one of the Ignalina nuclear power station's reactors and the increase in the regulated prices of electricity and gas.

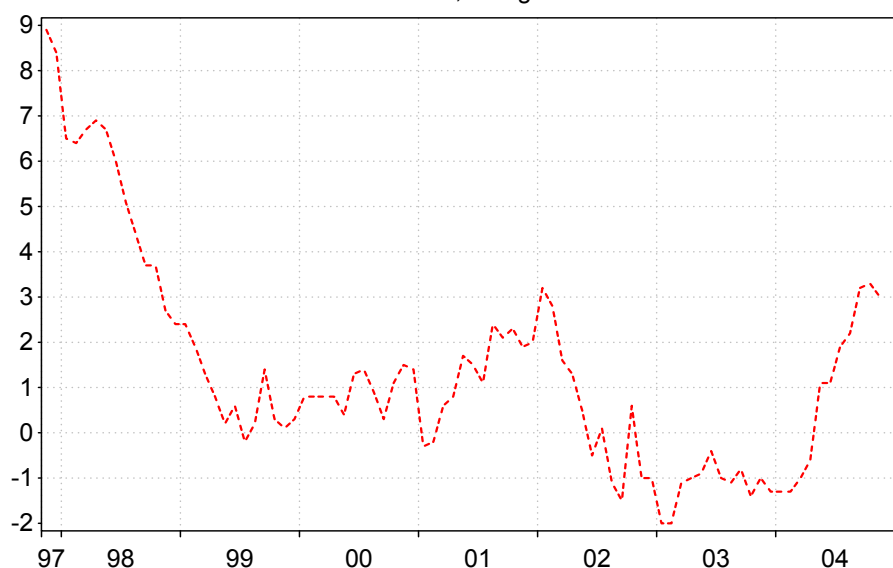
Inflation makes its run

Inflation picks up the pace but is still the lowest in the Baltics

Last year Lithuania's inflation rate was noticeably lesser than that of Estonia or Latvia. The causes of this observation mainly stem from differences in CPI basket structure, in competition conditions and in productive efficiency growth rate of the three Baltic States.

In December 2004, if compared to the same month of 2003, the CPI in Lithuania increased by 2.9%. This was almost the same inflation rate as forecasted (3.0%). On the other hand, the initial forecast for a year-on-year (yoy) change in Lithuania's price level in 2004 was revised up a couple months ago.

Lithuania, CPI growth



Source: EcoWin

What makes inflation to accelerate?

The reason behind the larger than expected inflation rate is obvious – nobody could anticipate the global oil prices to break historic record highs. Obviously, Lithuania (as well as other Baltic countries) could not stand aside this happening. The skyrocketed global oil prices had a significant effect on the prices of gasoline, diesel and liquid gas, passenger transport services, etc., which belong to the commodity group of transport in the CPI basket. In November 2004, the commodity group of transport showed a yoy rise of even 11.1%. Having in mind that this group's relative share accounts for 9.4% in the CPI basket, it can be concluded that the increased global oil prices pushed the inflation rate up by 1 percentage point.

Indirect effect of higher global oil prices is still on the way

So far, it is difficult to measure the indirect effect of amplified global oil prices, which manifests itself through rising prices of other commodities caused by fuels and other energy materials that have become more expensive.

No doubt, this impact has been getting stronger in recent months, and its potential is far from being exhausted.

There are other determinants of inflation as well

Other two “scapegoats” of inflation in Lithuania last year were the increased prices of health care and food products, which account for almost 5% and 30% in the CPI basket, respectively. At the end of 2004, the services and commodities of health care showed a yoy rise of 11.1%, whereas the analogous figure for food products was 4.8%. Both of these price changes were somehow related to Lithuania’s entry to the European Union. For instance, because of improved opportunities for exports of food and agricultural products within the enlarged EU, their supply domestically shrank and thus pushed their prices up. Similarly, due to changed conditions for trade with the third countries, imports of certain medicines became more costly. The changed lists of medicines subsidized by the government as well as changes in the extent of certain compensations contributed to the general price increase of health goods and services, too. Another factor lifting their prices up was the decision to tax certain health products (which were previously untaxed) with VAT.

How likely is the spiral of price and wage growth?

When the annual inflation rate reaches 3–4%, the so-called money illusion vanishes and the employees start to call their employers to compensate for a loss in the purchasing power. In case the employee’s requirements are met, labor costs per production unit go up (depending on the extent of labor productivity growth), and this turns into self-inducing cost-push inflation (also known as a spiral of price and wage growth).

It is worth to point out that the government can cause the above-mentioned phenomenon by initiating widespread schemes of automatic income indexation or by increasing salaries of public officers. So far, the government has not yet declared such intentions and it must avoid them in the future, especially having in mind Lithuania’s goal to introduce the euro at the beginning of 2007 and the need to meet the Maastricht criteria.

Inflation should not trip the intro of the euro up

We believe that this year the yoy inflation rate in Lithuania will not overstep the psychologically important threshold of 3%. Pressure for the price level to increase will mainly come from the supply side rather than from that of demand (see previous issue of *Baltic MacroScope*). Production costs will be mainly driven up by the higher prices of energy and raw materials as well as other increased expenditures (for quality improvement, meeting environmental standards, etc.), whereas rising wages will be, at least, partly offset by improving labor productivity. It is worth to mention that starting from 2005 the regulated prices of both electricity and gas were increased. The decision to do this now is wise (although already a bit late), because postponing the said price increases could strengthen the probability of failure to meet one of the Maastricht criteria on the eve of euro introduction.

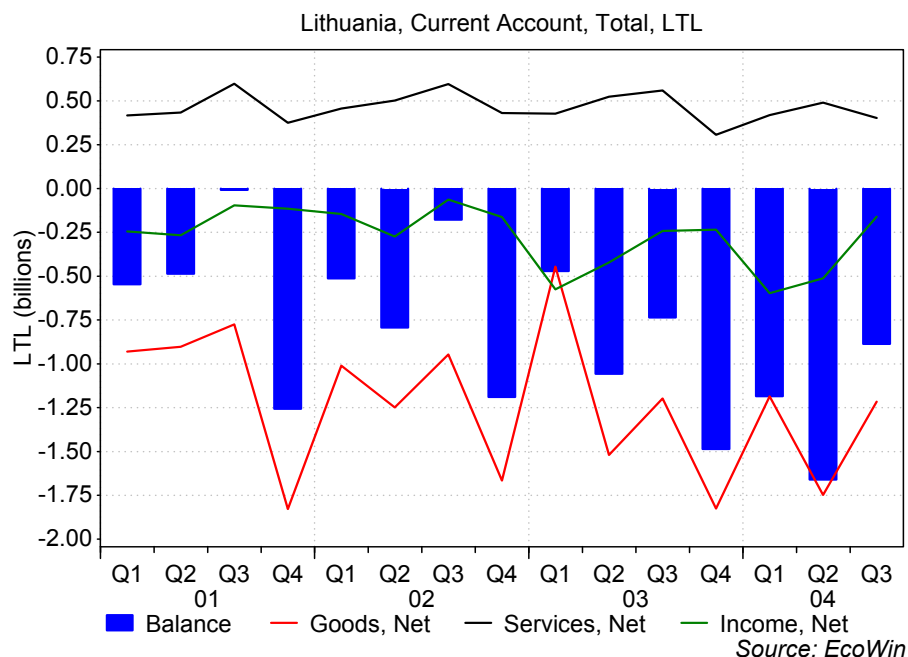
Higher inflation will hardly lift nominal interest rates up

Interestingly, some analysts believe that the accelerating inflation rate in Lithuania will necessarily cause higher nominal interest rates. On the other hand, we think that the current inflationary trends will not have a significant effect on nominal interest rates, because tough competition among credit institutions presses them to keep net interest margins at a minimum. Therefore, the increasing price level will, first of all, result in lower real interest rates, while the level of nominal interest rates will continue to stay more or less constant. This will last until the European Central Bank decides to raise base interest rates in the euro zone.

CAD and FDI continue shedding no luster

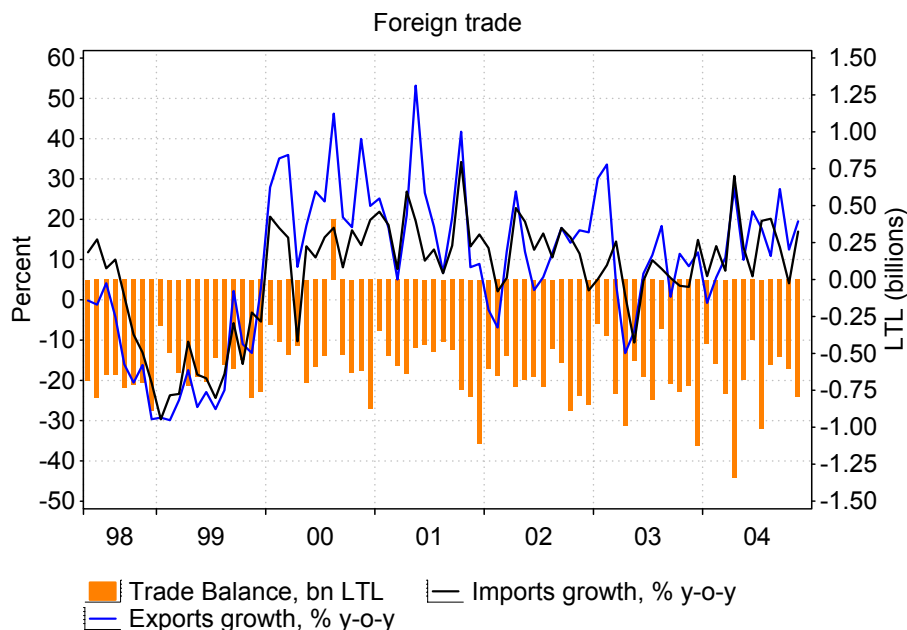
The 3rd quarter did not break the ice

After a noticeable deterioration of Lithuania's balance of payments in the first half of 2004, the 3rd quarter did not bring encouraging news either. In July through September, the current account deficit (CAD) made up 7.7% of GDP, and the respective figure for the first 9 months came to 9.2%. The FDI flow accounted for only 42.2% of the CAD. The only good indicator of CAD sustainability was the fact that the latter lagged behind the growth rate of nominal GDP (9.5%).



Net export of services is the key buffer for CAD deepening

Three out of four sub-accounts of CAD rolled down the hill. In the first 9 months of 2004, compared to the same period of 2003, the deficit of trade in goods grew deeper by 44.3% reaching LTL 4 785.3 million (EUR 1 385.9 million). Obviously, this was the key trend underlying the CAD worsening. The negative balance of income, which showed a further decrease of 32.5% down to LTL 1 666.1 million (EUR 482.5 million), was another determinant of the CAD deepening. As a result of vigorously increased reinvested earnings, the negative balance of investment income puffed up by 35.7%, and this change was not offset by a 73.2% improvement in the positive balance of employment income. The positive balance of current transfers did not get the situation off the hook either. In the discussed period, this balance shrank by 11.9% year-on-year (yoy) down to LTL 550.0 million (EUR 159.3 million). The positive effect of EU structural funds on the CAD did not surface to the expected extent, because the lion's share of this money went to finance investment projects, which are recorded in the capital and financial account. The positive balance of services was the only account blocking the CAD worsening. It went up by 11.2% yoy and reached LTL 1 757.4 million (EUR 509 million).



Source: EcoWin

Actual CAD in 2004 can hit five years' record highs

As in the previous issue of *Baltic MacroScope*, we foresee no brighter days in the 4th quarter of 2004. The trade deficit is likely to get deeper. Furthermore, the end of a year usually sees larger outflows of income to foreign investors (e.g., dividends). No doubt, our initial forecast for the CAD to GDP ratio in 2004 was overly optimistic, thus we upgraded it to 9.5%. The actual result, most likely, will overstep the threshold of 10%, if not 11%. Forecasts for CAD figures in the coming years will be reviewed in the next issue of this publication.

FDI flow is increasing but not spilling out like from the horn of plenty

In 2004 foreign direct investment (FDI) was on the rise. In 9 months of 2004, compared to the same period a year ago, the FDI inflow was as much as 8 times larger and came to LTL 1 741.2 million (EUR 504.3 million). Most of FDI went to manufacturing industry (54.8%), energy sector (15.4%), domestic trade (14.4%) and financial intermediation (15.4%). On the other hand, the cumulative FDI on September 30, 2004 was only by 12.7% higher than on the same date of 2003, accounting to LTL 14.98 billion (EUR 4.34 billion). Although this Lithuanian figure was the second largest in the Baltic States, FDI per capita made up only LTL 4 364 (EUR 1 264) and put the country to the lowest position.

Is it worth to worry about overheating?

Certain signals can be easily traced but...

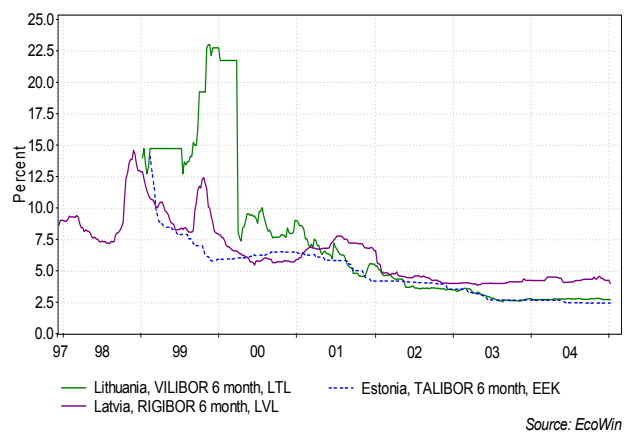
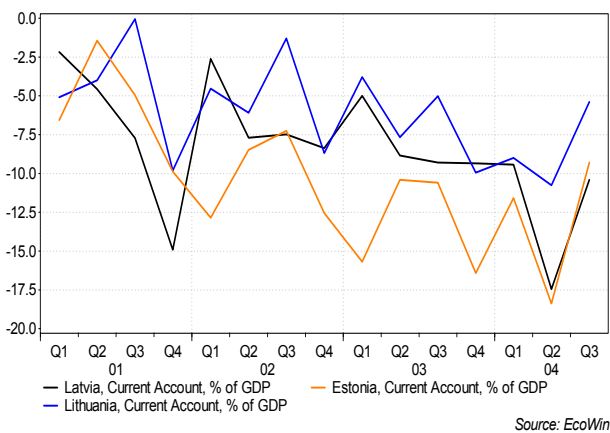
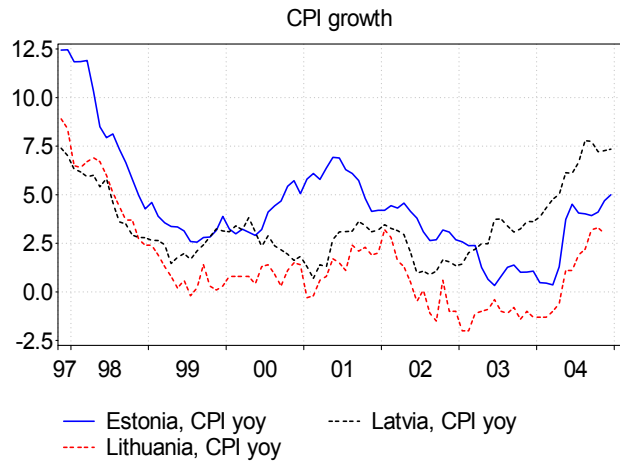
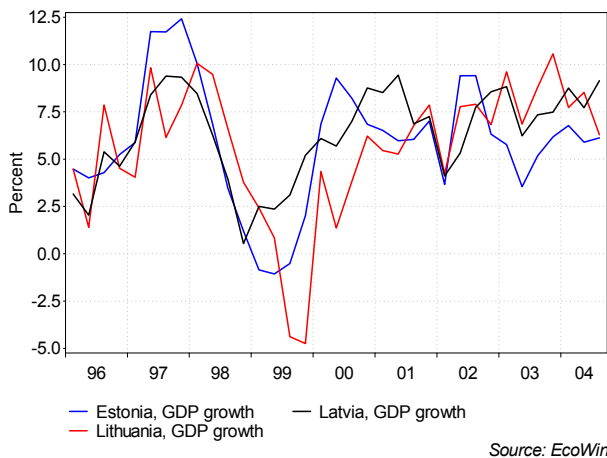
Some analysts are concerned about the threat of overheating in the Baltic economies. In this respect, Lithuania is not an exception. Indeed, hardly anyone would dispute the fact that certain signals of overheating are present in the country: inflation makes its run, CAD worsens, borrowing rates are persistently high, real estate market continues to boom, the stock exchange is on the constant rise. On the other hand, we think that there are no reasons to lose sleep. Let's take a brief look at some arguments.

... their causes leaves no room for anxiety

As mentioned earlier, inflationary trends in Lithuania are mainly driven by the factor of supply rather than that of demand, and this obviously contradicts the idea of overheating. Furthermore, the relatively high CAD is not a *rara avis* in emerging transitional economies, where domestic production factors are insufficient or invalid to assure sustainable economic development, thus causing larger imports and/or borrowing abroad. Third, having in mind the

low level of indebtedness of Lithuanians (which has yet not reached even that of Latvia or Estonia), the impressive growth rates of borrowing should not be surprising. It is worth to point out that in 2004 they noticeably decelerated. Fourth, the probability of “bubble burst” in the real estate market or the stock exchange is insignificant. Presently, Lithuanians are in high demand for real estate to meet their private needs, whereas the scope of speculative activity, i.e. acquiring real estate in order to earn profit by selling it later, is trivial. Although temporal price slumps of certain shares are unavoidable, the general growth trend on the stock exchange of Lithuania is hardly disputable – the market is driven by such fundamentals as former undervaluation of shares and, especially, first signs of arriving investment culture in the country. Last but not least, the economic growth of Lithuania is already losing its pace, thus leaving no chances for overheating.

Baltic states in figures



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