

Latvian economy

(Written by Andris Vilks, Latvijas Unibanka)



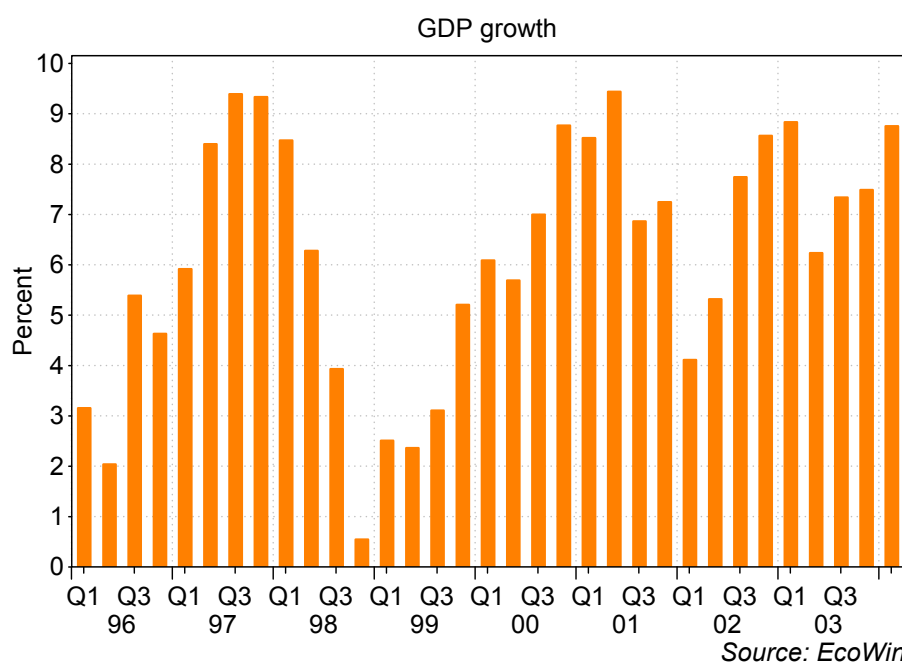
MAIN INDICATORS

	1999	2000	2001	2002	2003	2004E	2005E
GDP real growth, %	3.3%	6.9%	8.0%	6.4%	7.5%	7.3%	7.0%
Export growth	-5.1%	12.2%	11.1%	12.1%	17.2%	19%	18%
Import growth	-8.3%	12.2%	13.8%	13.4%	19.7%	20%	19%
Foreign trade balance/gdp %	-16.9%	-17.1%	-18.3%	-19.1%	-21.2%	-22.6%	-23.4%
Construction production growth	7.8	8.0	6.0	10.8	13.7	13.5	14.0
Retail sales growth	6.0	17.5	2.7	12.4	13.6	12.0	11.0
Total loan portfolio as% of GDP	20.1	23.2	31.7	37.3	47.5	57.0	66.2
CPI growth, yoy	2.4%	2.6%	2.5%	1.9%	2.9%	5.0%	4.0%
Unemployment rate	9.1	7.8	7.7	8.5	8.6	8.6	8.4
Public budget balance as % of GDP	-3.7%	-2.6%	-2.0%	-2.3%	-1.6%	-2.0%	-1.9%
Current account balance as % of GDP	-9.0%	-6.4%	-8.9%	-7.0%	-8.6%	-8.7%	-8.2%
Foreign direct investment inflow	202.7	248.9	102.5	237.5	205.4	240	260
FDI/CAD coverage	53%	83%	22%	60%	38%	39%	40%
Direct investment into Latvia		1,277.0	1,488.0	1,634.0	1,796.0	1,980.0	2,250.0

Strong growth in the end of 2003

4Q03 growth exceeded most forecasts

The 7.4 per cent growth of economy in the 4th quarter boosted the total gross domestic product by 7.5 per cent. We can say though that the results are even better than most of the analysts had forecast.



The performance of two sectors was particularly impressive – in 4th quarter financial services grew by 17 per cent, hotel and restaurant business expanded by 14 per cent. The figures in manufacturing industry and transport and communications sector also improved. Growth in the construction sector was expected to end on a higher note. Luckily the downward direction in the agricultural sector has stopped.

Growth continues to be driven by services

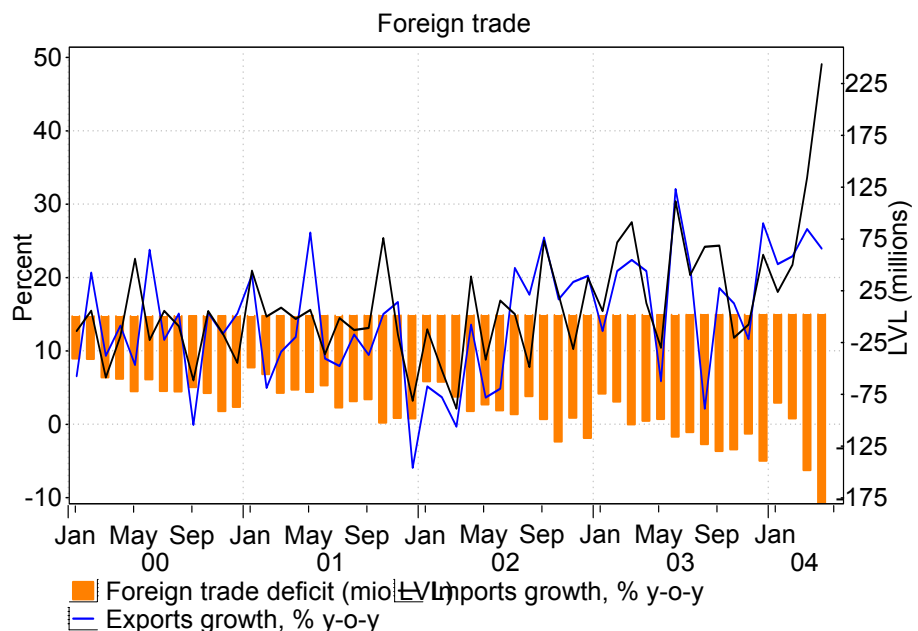
The share of services has continued to grow, reaching 71 per cent of the GDP. The share of trade in the GDP continues to be very high (20%) and, most likely, owing to the high demand, will not shrink in the immediate future. The stable albeit slow growth in the manufacturing industry should be considered positive news. We hope that the steady development will continue. Latvia ought to continue solid upswing in the industry to achieve at least 20 per cent in its GDP structure to gain on the neighbouring Lithuania and Estonia. The boom in the construction industry is not worth mentioning, because the same tempo in the industry is going to run on for years.

Russian-Latvian official relations not a major problem on the way of transit

Results in the transportation and communications sector are superb, because the beginning of the year promised only a marginal increase due to the cut-down of the Russian oil transit. The real business, however, is getting around the politically sensitive obstacles in the Latvian-Russian relations and continues to successfully run its course.

Crouching Tiger, Hidden Dragon...

Although Latvia does not take the first place in the Baltic states by growth of gross domestic product, it keeps up with the leader – Lithuania. Moreover, measured by annual average economic growth since the end of the Russian crisis, Latvia remains the fastest growing “Baltic Tiger”, showing a 7 per cent average upswing in the last 4 years.



Source: EcoWin

Strong growth expected to continue

What is to be expected going forward? The situation is not going to change much. Economic growth will continue at roughly 7 per cent. The growth rate may even exceed this figure but at the moment it is too early to draw conclusions. Growth is foreseen in all sectors of the economy. Its development will be determined by both domestic and external demand and the latter (exports) is expected to grow faster. The first fruits of the long-

awaited EU structural funds, expected to give additional stimulus to Latvian economy, will be reaped next year, because it is too early to expect the desired returns already this year. Gross domestic product of Latvia per capita in terms of purchasing power parity last year reached some 42 per cent of the average GDP in the EU, the lowest among the new EU member countries. In the last 10 years, though, Latvia has been on its way to catch its peer group, particularly countries like Poland and Slovakia. If one would consider the volumes produced by shadow economy, which are still imposing, the indicator should grow to 45 per cent of the average in the EU. This is the real level by which one can explain the high cost of living in the Baltic states as well as the high domestic demand for goods and services.

Foreign trade booms

*Export volumes up over
20% y-o-y...*

Compared with the same period a year ago, growth rate of exports has remained over 20 per cent for the four consecutive months to March. In March exports moved up 26.4 per cent. Exports of timber, chemical and machine-building products have been growing particularly fast. In the first three months of the year exports to Great Britain have increased by 19 per cent, but to Sweden – even by 51 per cent. Exports to Germany has been lagging the rest. In total exports to the EU countries have grown also by 26 per cent. Latvian goods have successfully found their way into markets of Lithuania and Estonia. Exports to Estonia have increased by more than half.

*...but imports grow
even faster*

Import volumes, too, keep on growing. In March imports actually skyrocketed by 33.3%. Imports of vehicles and metals have been among the fastest growing commodity groups. It was associated again with the accession of Latvia to the EU, as higher prices have been predicted for cars and steel quotas.

Industrial production growth accelerates

*Widespread growth in
industrial output...*

Industrial output index growth due to growing external demand accelerated to 9.4% yoy, actually the fastest pace in 5 quarters, bringing the sector in the forefront of the key driving forces of economy. The growth has been widespread – in 1st quarter above 20% growth was recorded in a number of industries including metals & metal products, rubber/plastics, chemicals, wood, building materials etc. In the major industrial sector of Latvia – food industry was the largest growth since the Russian crisis.

... and retailing

Despite the increase in inflation, retail trade continues to enjoy volume growth rates above 10% - in first quarter retail trade turnover was up by 13% y-o-y, acceleration was noted towards the end of the quarter. Whereas first quarter marks a slight decrease in retail trade growth rate (in 4Q the growth was 16%), the growth still remains roughly in line with last year's average.

Inflation keeps on rising, Bank of Latvia takes action

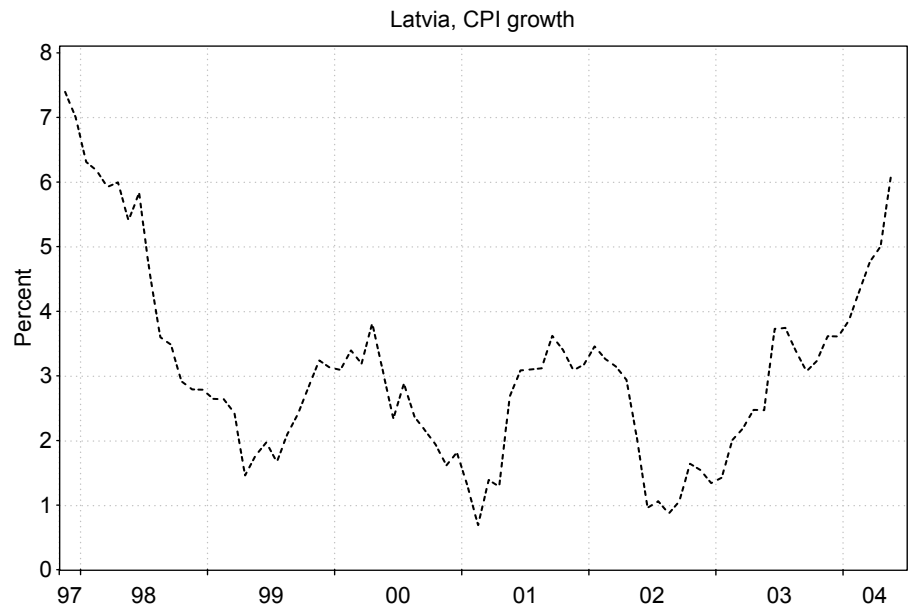
*Expectations of EU
accession fuel inflation
fears*

Consumer prices in Latvia are on a vigorous upward parade, leaving a psychologically depressing impact on the consumer. The speculative factor of the EU accession has played a significant role in it. Although Latvia tends to be the most highly priced country in the Baltics, this year the price difference may have become even more distinct. We have seen no accession-associated psychological price jumps so far in either Estonia or Lithuania. Prices in Lithuania actually have kept on falling and deflation is dominating. CPI inflation in Estonia has been very low until May.

It must be remembered though that only recently Latvia saw a hike of several utility tariffs, while corresponding tariffs in the neighbouring countries remained unchanged. Thus the previously postponed increase of the tariffs rebounded, leading to growth of the prices.

CPI up 5% y-o-y

After long years of low inflation the CPI growth has reached 5 per cent year-over-year in April. The inflation has become fairly broad-based with most notable increases in health care prices (over 12% y-o-y), above average increase has also been recorded in housing (8.8% y-o-y), alcohol and tobacco (6.0%), food (5.5%).



Source: EcoWin

Bank of Latvia hikes rates for the first time

The Bank of Latvia has reacted to the recent consumption boom and the increasing inflation by raising the refi rate in the beginning of March from 3% to 3.5%. It is probably still too early to panic about Latvia's ability to fulfil the Maastricht inflation criterion in medium term, although this year the country will be strongly off the mark.

Large current account deficit in the 1st quarter

CAD hits -9% of GDP...

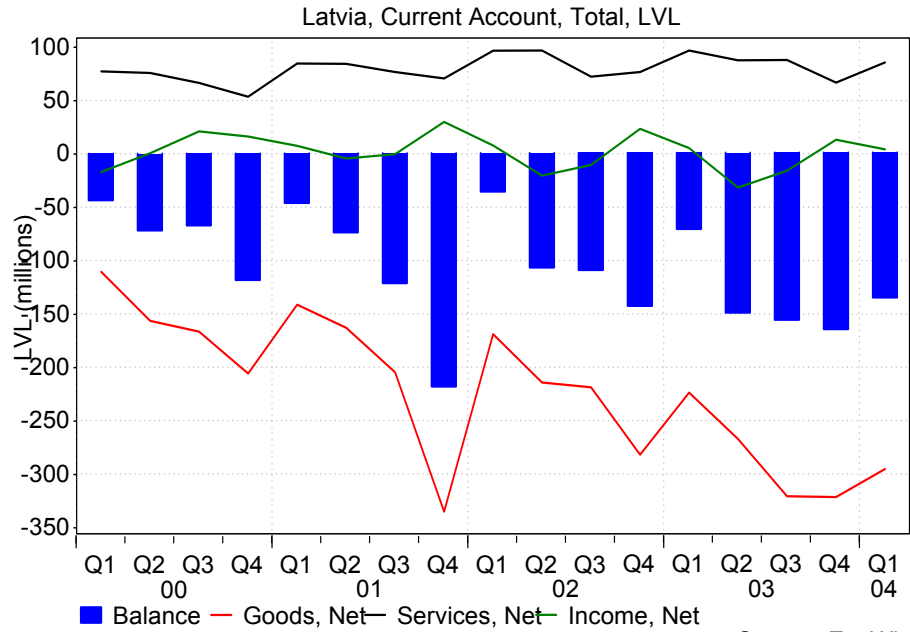
The accessible provisional data on the status of the payment account of Latvia in the first three months of the year is not pleasing news. The obtained data forecast a record high current account deficit in the 1st quarter. It might be close to LVL 135-140 million or around -9 per cent of GDP. It must be reminded that in the last few years current account deficit of the 1st quarter had been solely 3-5 per cent of GDP.

... due to ongoing consumption boom and little support from the services balance

A larger current account deficit has been inevitable in the wake of the upswing in economy and the ongoing consumption boom, both of which are not expected to subside anytime soon. Import volumes are growing fast and the run-up to the EU has lent a helping hand, since the fear of higher prices led to larger volumes of imports prior to the entry. The positive services balance, which was slightly poorer in January and February than in the same months of the previous two years, will not render any salvation either. One of the reasons has been the particularly mild winter, which did not bring to the ports of Latvia additional cargoes like a year before, when the ports of Tallinn and St. Petersburg had to fight the extreme ice conditions in the Baltic Sea, that almost paralysed landing at these ports.

*FDI/CAD coverage
poor in 1Q04*

According to the preliminary data the volume of foreign direct investments in first quarter has totalled LVL 38 million, ending much below the amount received in the first quarter a year before (LVL 62m), in addition to the FDI, the current account deficit has been financed by reversed flows of portfolio (+31m) and other (+74m) investments – last year both mentioned types of investment flows were negative.



Estonian economy

(Written by Ruta Eier, Eesti Ühispank)



MAIN INDICATORS

	1999	2000	2001	2002	2003	2004E	2005E
GDP real growth	-0.1%	7.8%	6.4%	7.2%	5.1%	5.5%	5.7%
Export growth	0.5%	52.2%	7.4%	-1.5%	9.8%	14%	10%
Import growth	-8.6%	43.1%	4.0%	5.9%	12.9%	8%	8%
Foreign trade balance, % of GDP	-18.4%	-19.8%	-16.5%	-19.2%	-21.6%		
Retail sales growth	6.6%	10.5%	13.8%	14.3%	9.9%		
Total loan portfolio as % of GDP	32.7%	36.9%	39.0%	42.8%	55.0%	64.8%	68.0%
CPI growth	3.3%	4.0%	5.8%	3.6%	1.3%	3.5%	3.0%
Unemployment rate	12.2%	13.6%	12.6%	10.3%	10.0%	9.7%	9.6%
Public budget balance as % of GDP	-4.3%	-0.9%	0.6%	1.1%	2.6%	0	0
Current account balance as % of GDP	-4.5%	-5.5%	-5.6%	-11.3%	-12.6%	10.5%	9.5%
Foreign direct investment inflow	4,608.4	6,644.4	9,429.7	4,800.3	11,828.7	11500	9000
FDI/CAD coverage	126%	130%	160%	36%	74%	80%	65%

Foreign demand situation improving

*Global situation
providing more support
this year*

Estonia is the most open economy among the Baltic states, most dependent on its ability to export and therefore also most dependent on developments in EU economies. Estonia's exports amount to about 75% of GDP and imports to 83% of GDP, compared to 50% of both in Latvia and Lithuania. Delayed recovery in EU economies didn't contribute much to Estonian growth in 2003, but as the signs of recovery are witnessed in 1Q 04 at last, global situation will be more supportive in 2004.

*Trade partners' outlook
favourable*

The 2004 growth outlook for Estonian main trade partners, Sweden and Finland, is even better than for EU economies on average. For Sweden 3% GDP growth is forecasted and for Finland close to that, 2.9%.

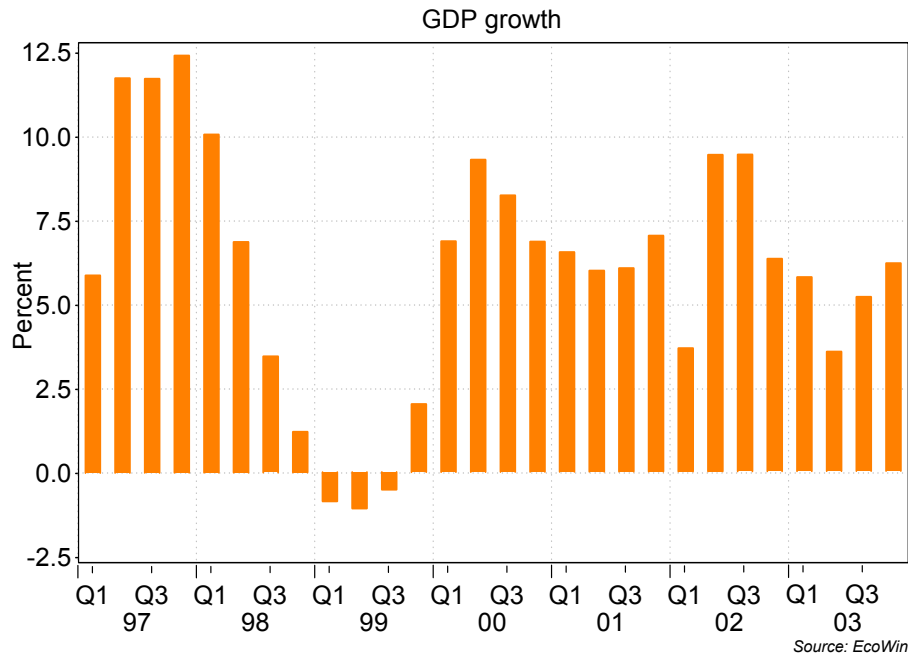
GDP growth to re-accelerate in 2004

*In 2003 GDP growth
based on domestic
demand*

On the back of delayed recovery in euro zone, GDP growth in Estonia decelerated to 5.1% in 2003. Compared to its Baltic neighbours, Estonia may seem among the Baltic tigers like a lazy one, but considering the 0.8% GDP growth in EU25 at the same time and tough export conditions, one could call the actual outcome quite satisfactory.

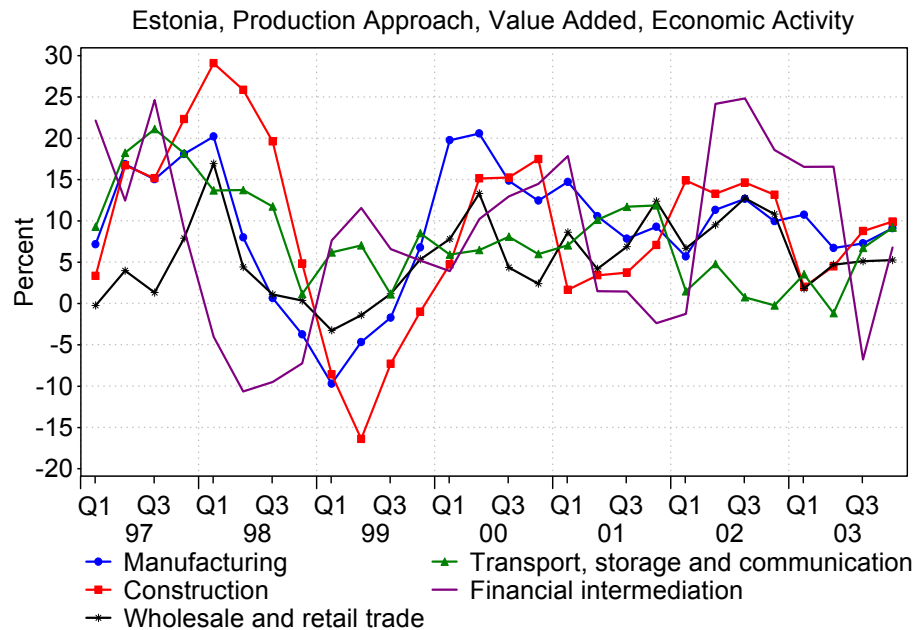
As a result of slowdown in major export markets for a prolonged period, the growth of gross domestic product was continuously based mainly on domestic demand in 2003. As a consequence, this brought along widening imbalances in economy, with net exports contribution increasingly negative in GDP growth.

However, 2003 was the year when exports slowly started to emerge from recession going on since 2001. And, as domestic demand growth without accompanying exports revenues isn't sustainable in longer perspective, there was a significant slowdown in growth rate of domestic demand in 2003.



Manufacturing, construction and transportation the main growth drivers

In 2003, the growth by economic sectors was not as prominently related to domestic demand as before. The fastest growing and also most influential sectors were storage, communications and transportation sector, construction and manufacturing. Fast growing sectors in 2002 - financial intermediation, retail and wholesale - have slowed down their growth rates in 2003.



Construction boom in 1Q03

Construction is likely to continue expand rapidly, as long as there is shortage of new living places and demand from companies' side. Rising real estate prices boost demand for construction. In first quarter 2004 extraordinary growth rate in construction volumes was registered, +28% y-o-y. This could be boosted also by the fact that from the May1 a higher VAT is added to new buildings and companies try to take advantage of yet lower VAT rate. Rising real estate prices enable private individuals to increase their loans by higher value of collateral, which could become an accelerator of real estate boom. Such behaviour could lead to a bubble, should there be no alignment between growth rates of income and real estate prices.

*Growing contribution
from exports to GDP in
2004*

In 2004 GDP growth acceleration is expected. Given the favourable background of euro zone recovery and additional impetus from becoming a member of European Union hardly anyone could expect something different. 1Q preliminary estimation for GDP growth reached 6.8%, marking increased buoyancy compared to 4Q 03 (6.2%) and 2003 as total (5.1%). In addition to that, growth was boosted by export growth, improving the macroeconomic outlook from the perspective of sustainability.

*Private consumption
strong, but slowing
down...*

When last year a solid consumption growth was supported by favourable developments in labour market – steady rise in employment and record high real wage increase, adding to this low interest rates leaving more money for consumption and boosting consumer confidence and optimism about economic growth perspectives, then these trends will be somewhat different this year.

*...pressured by
consumer confidence,...*

All-time high consumer confidence in 2002-2003 started to deteriorate in the second half of 2003 and in the first half of 2004, consumers have been very pessimistic. Consumer confidence has fallen because of a fear of price rises in the wake of the EU accession.

*...growing debt
burden,...*

We do not expect any major changes in monetary environment this year, meaning no pressure for wallets of consumers with already existing loan burden from increasing interest rates, but current interest rates and strong competition in banking market is keeping loan growth figures high. Debt burden of private individuals is growing much faster than their income on average and that will trim consumption growth going forward.

*... and decelerating
wage growth*

In addition to that, there will also be a combination of higher inflation and decelerating wage growth this year, putting stringent pressure on consumer's willingness to consume. At the same time, consumers with the tightest budgets are supported by a rise in tax-free minimum amount of income.

*Investments supported
by FDIs, construction
and EU funds*

Low interest rates have certainly contributed also to the growth of investments, in addition to re-investments of corporate profits, which have been tax-free since 2000. Companies' confidence has always exceeded the one of consumers, which has also provided a ground for investments growth. Industrial confidence has risen sharply in the first months of 2004.

In 2004, one could assume that most of the investments needed for compliance with the EU standards have been done, and the impact of large-scale investments into transportation and energy sector of previous years is negative this year because of base effect. New placements into economy are expected by foreign investors this year, though. And of course state investments, mostly into infrastructure projects, which are supported by incoming EU funds. Still, for 2004 not much impact from EU funds is expected, yet.

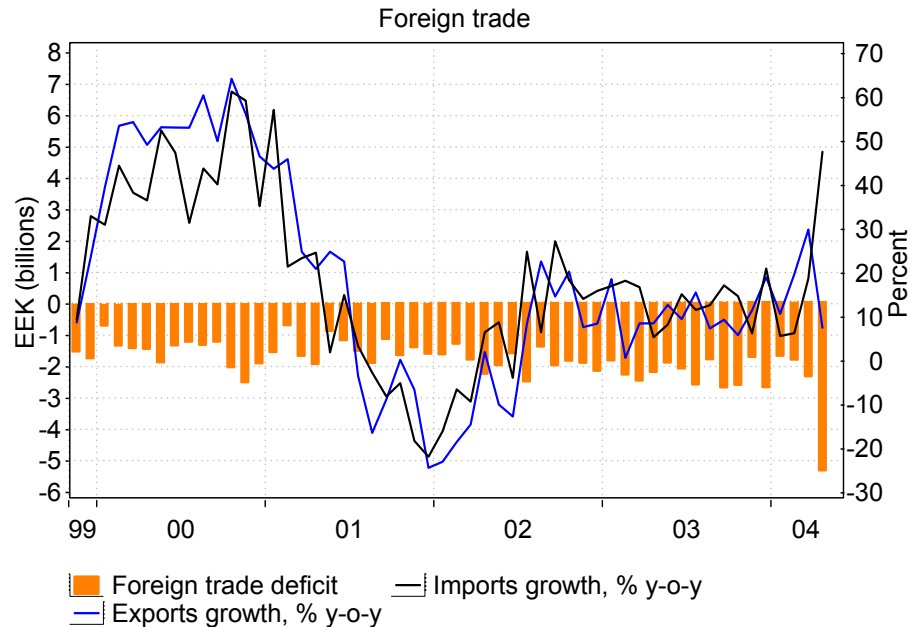
Reversal in foreign trade

*Export more value-
added, stronger
rebound expected in
2004*

Although not comparable to the pace of growth of imports, merchandise exports emerged from recession last year. After declining in 2002, exports increased by 10% in 2003. However, the peak levels of exports reached in the beginning of 2001 were achieved only at the end of 2003. But on a positive side, this time the growth wasn't so much based on subcontracts, as was the case some years ago, but was triggered by a rapid growth in normal exports. This means that Estonian export structure has become of more value-added. Telecom equipment subcontracts, once the real engine for total export

volumes, did not show a significant recovery in 2003, but is seen as giving a powerful impetus again in 2004, as the main telecommunication equipment subcontractor is doubling its production capacities.

In 1Q 2004, exports went through a significant recovery, posting 20%y-o-y increase. That was just about twice as much as imports growth. So, in the beginning of 2004, trends in foreign trade have reversed. Nevertheless, huge accumulated imbalances in foreign trade are not going to vanish rapidly, trade deficit in 1Q was just about the size of it at the end of 2002.



Source: EcoWin

Import growth expected to decelerate

Similar to its Baltic neighbours, imports growth outpaced that of exports in 2003. Last year, import demand was fuelled by strong domestic demand. Imported inputs are needed for production and especially for subcontracts, for modernisation of technology, enhancement of production capacity and investments to comply with EU regulations. An additional boost to import demand was given by large-scale transportation infrastructure investments, both in transit trade (railway cars) and passenger transport (ships). These investments are going to support further services exports growth, already this year. There is already some evidence of that - in the first three months, services' export has showed a solid performance.

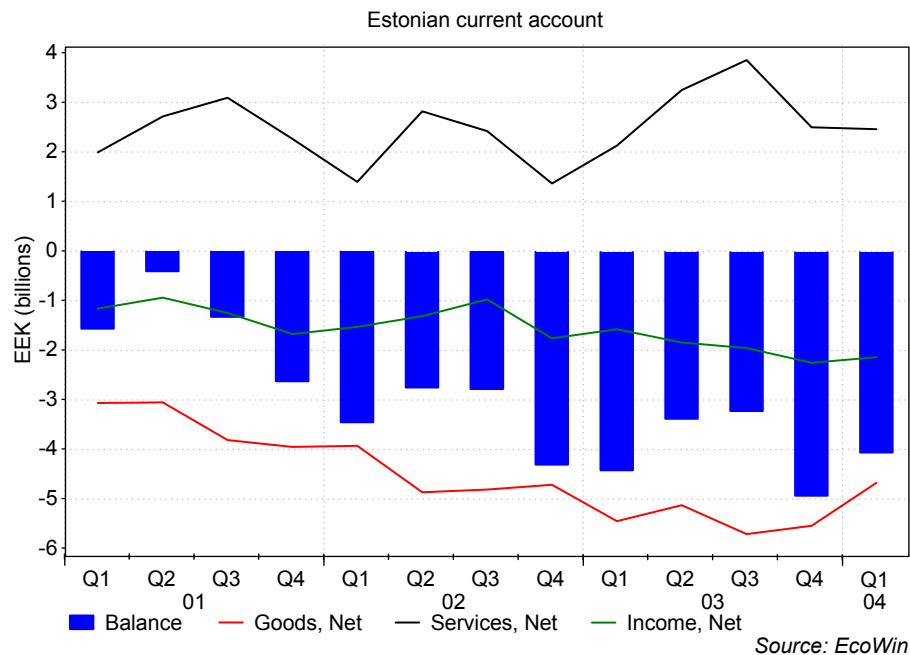
As there were a few factors irregular by their nature boosting imports in 2003, in 2004 we expect some slowdown in the pace of merchandise import growth. This was indeed happening in the first 2 months of 2004, when import growth slowed down to about 5% y-o-y. In March the growth rate accelerated and sky-rocketed in April to 47% y-o-y. This was mostly because of EU-effect, meaning that before a price hike accompanying with EU accession in several commodity groups many firms and consumers built up stocks to smooth the price rise. This should mean also lower imports a couple of months onwards.

Current account deficit hit -12.6% of GDP in 2003

Widening trade deficit was the main cause for all-time-high current account deficit in Estonia last year reaching -12.6% of GDP. But that was not the only reason. The surplus of services balance offset about a half of trade balance deficit. At the same time growing profits of companies with foreign direct ownership contributed to the worsening of the current account balance, meaning increasing outflow of income. Minor negative influence was also registered from less net transfers to Estonia. Most of the income outflow was,

however reinvested in Estonia (about 62% of income) boosting therefore the level of incoming FDI.

Large current account deficit increases the vulnerability and reflects the imbalances of the economy. Gross foreign debt has increased rapidly, to 69% of GDP as of the end of 2003. In comparison to mature economies, this is rather small, though (in Sweden, over 150% for example), but high compared to the other CEE economies. There is also a link between accumulating current account deficit and low interest rates. Also the other Baltic states are struggling with similar problem, albeit in a less prominent way.

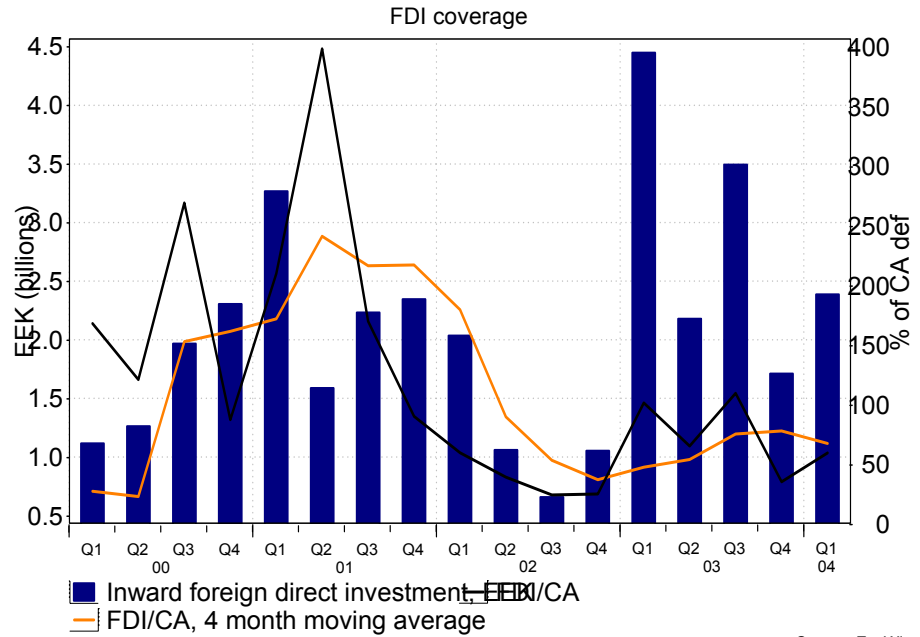


Current account deficit decreased in 1Q, but still high

In 2004, current account deficit is expected to decrease, supported by better performance of both goods and services balances. Along with an improvement of goods and services balances current account deficit decreased by 8% y-o-y in 1Q. However, current account deficit was still large, by preliminary estimations about 12.8% of GDP. For income balance, larger deficit is expected in 2004 and also less net transfers compared to 2003, because incoming EU funds will move through capital account while Estonian transfers to EU are accounted on balance of transfers.

FDI record inflow in 2003 expected to continue in 2004

Although FDI inflows also reached record level in 2003 (12bn EEK), these were not enough to cover the grown current account deficit for a second consecutive year. FDI covered 74% of current account gap in 2003. With strong FDI inflow expected to continue and current account deficit to diminish, the coverage will be better in 2004. In 1Q, FDI/CAD was 59%.



Source: EcoWin

Strong FDI inflow in 2003 had most probably something to do also with the expected EU accession. The fact of accession will contribute to FDI inflow also this year and going forward. In 2004, more greenfield investments are foreseen than previously, which is a welcome development. The FDI inflows will continuously be attracted by huge wage differential which will remain in place for many years despite rapid wage growth. Wages in Estonia are about 7 times lower than in EU on average.

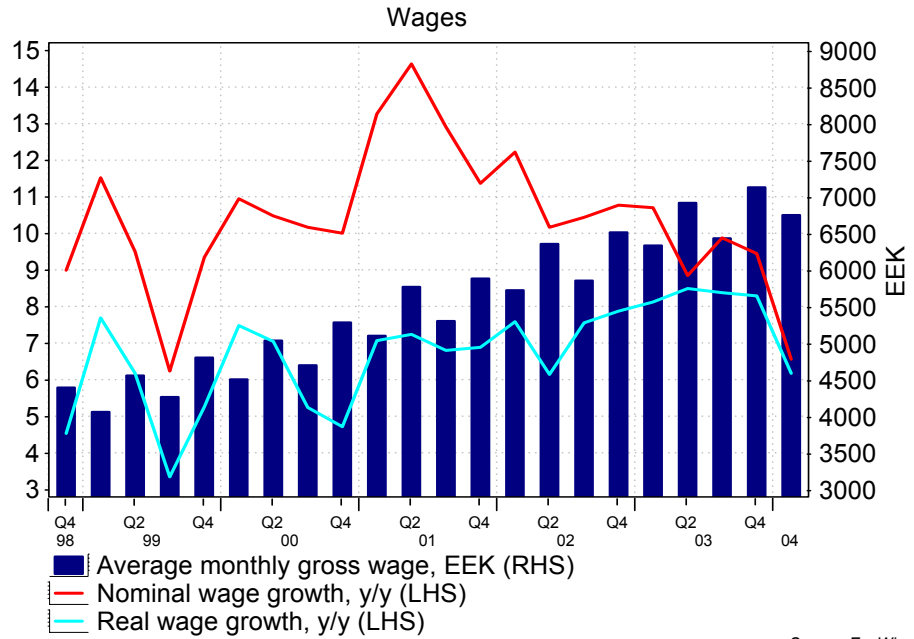
Sticky labour market

Unemployment at 10%

In fact, FDI inflow itself will contribute to higher wage increase and to overall positive developments in labour market in coming years. Recently, developments in labour market have been favourable. Unemployment rate fell to 10% in 2003 and stayed at 10.1% in 1Q. The number of employed continued expanding in 1Q, for a third year in row, and so did the amount of economically active people. A rapid fall in unemployment is still hindered by structural unemployment.

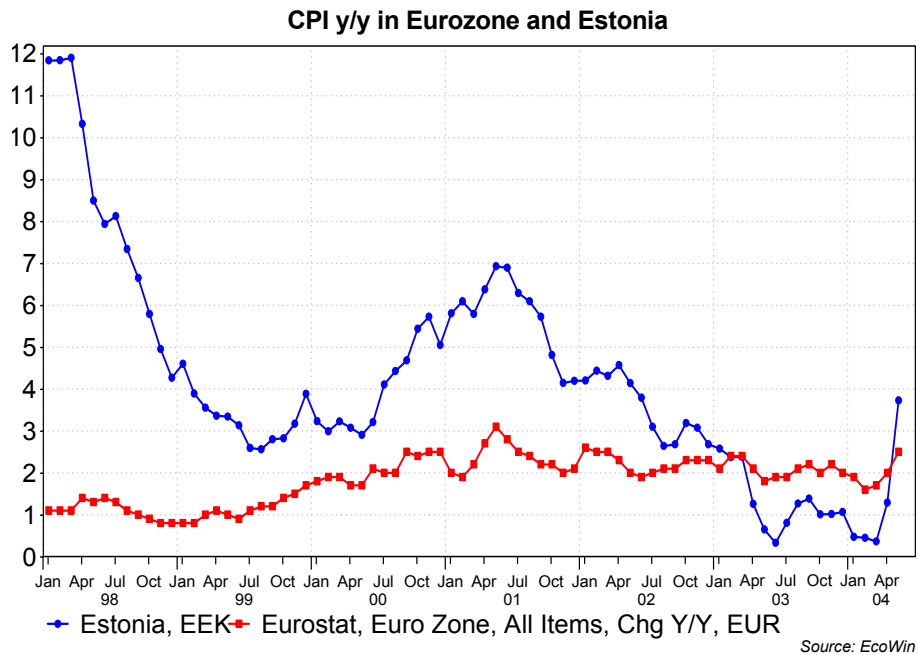
Real wage growth decelerated to 6.1% in 1Q

Unexpectedly low inflation rate in 2003 (1.3%) led to record high real wage increase (8.3%), while nominal growth rate decelerated. In 1Q 04 companies re-adjusted their behaviour, striving for wage growth which was more in line with productivity growth. Thus, both nominal and real wage growth decelerated in 1Q, to 6.1% in real terms. With rising inflation from May on, real wage growth will continue to be suppressed in 2004.



Inflation suppressed until May

In 1Q consumer prices continued the trend of low inflation prevailing in 2003, increasing only 0.4% y-o-y. Some acceleration of inflation occurred in April (1.3% yoy) and a more sudden jump was revealed in May (3.7% yoy). The rise in May was expected and related mostly to the EU-effects, represented by increase in fuel excise tax, sugar price increase and introduction of several import tariffs. The increase of fuel prices was also affected by increase of global oil prices and stronger dollar.



Lithuanian economy

(Written by Alge Budryte, Vilnius Bankas)



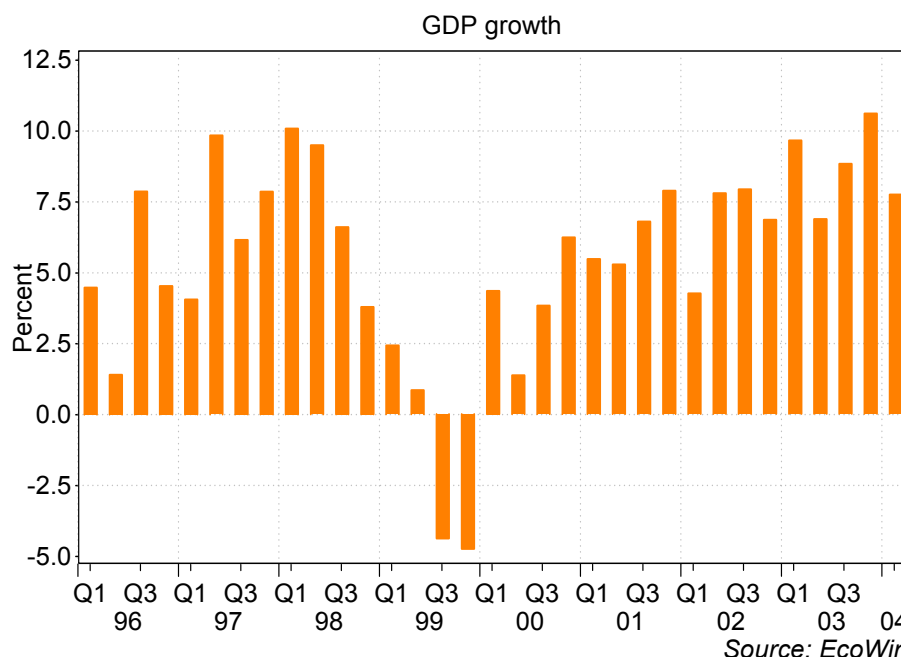
MAIN INDICATORS

	1999	2000	2001	2002	2003	2004E	2005E	2006E
GDP real growth, %	-1.7%	3.9%	6.4%	6.8%	9.0%	6.8%	6.8%	6.5%
Industrial sales growth, %	-11.2%	2.2%	16.0%	3.1%	16.1%			
Export growth, %	-19.0%	26.8%	20.3%	10.7%	9.1%			
Import growth, %	-16.6%	12.9%	16.4%	12.4%	6.0%			
Foreign trade balance, % of GDP	-16.9%	-14.5%	-14.6%	-16.0%	-14.6%			
Construction production growth, %		-17.8%	7.5%	21.8%	16.0%			
Retail sales growth, %		13.1	8.0	12.6	14.3			
Total loan portfolio, as% of GDP	12.5%	12.7%	14.3%	16.4%	23.4%	27.6%	32.5%	37.4%
CPI growth, %	0.30	1.40	2.00	-1.00	-1.30	1.50	2.00	2.50
Unemployment rate, eop %	10.0	12.6	12.9	10.9	9.8	6.7	6.2	5.4
General budget balance, % GDP (ESA'95)		-2.3	-1.9	-1.4	-1.7	-2.8	-2.5	-2.0
Current account balance, % of GDP	-11.0%	-5.9%	-4.7%	-5.2%	-6.6%	-6.0%	-6.0%	-5.8%
FDI/CAD coverage	40.7%	56.1%	77.7%	99.8%	15.0%			
FDI inflow as % of GDP	4.5%	3.3%	3.7%	5.2%	1.0%			

Fast growth in 2003

Fastest growing economy in the Baltics

In 2003, Lithuania's economy grew by 9% year-over-year, which is the highest rate since the country regained its independence thirteen years ago. The 4th quarter showed the best growth result of even 10.6%. This came as a nice surprise not only to foreign but also local analysts and placed Lithuania among the fastest growing economies in the world. If measured in current prices, last year Lithuania's GDP totalled LTL 55 737 million (EUR 15 884 million) or LTL 16 136 (EUR 4 599) per capita.



Domestic demand booming...

The key to Lithuania's success story is booming domestic demand. In 2003, gross investment spending (measured in constant prices) was by almost 13% higher than in 2002, while private consumption showed only a bit slower growth of 11%. Having in mind bottoming out interest rates, brightening

business and household expectations as well as rising income, it is no wonder that domestic markets were on the rise.

....so that strong exports growth is outpaced by imports

What surprises more is that exports of goods and services were also increasing pretty fast, despite the European economy (which is the main export market of Lithuania) still fighting with its slings and arrows and despite the strengthening litas. Export growth was, unfortunately, slower than import growth, thus causing the net exports of goods and services to decrease by 39.5% y-o-y.

Strong growth prospects ahead

In fact, Lithuania's economic situation is favourable not only due to high GDP growth rates, but also due to steadiness in such growth, which is even more important. Both domestic and foreign experts agree that Lithuania's economic growth prospects for the coming at least two or three years are quite rosy. The country's membership in the EU will cause structural funds to flow in and thus will stimulate green-field investments. The situation in domestic markets will continue to be favourable, while export growth will depend on the economic development of the main foreign trade partners. The preliminary estimate for the country's GDP growth in the 1st quarter of this year stands at 7.5% and suggests that forecasters' optimism is not without reason.

Good resistibility to external and domestic shocks

Value added growth wide-spread by sectors

The year 2003 was successful for almost all economic sectors. Industries focusing on both domestic and foreign markets were among top performers, thus proving good economy's resistibility to external and local shocks.

In terms of expansion rate, the energy sector was an obvious frontrunner, as its value-added (measured in constant prices) grew by 24.8%, compared to 2002. Despite slight slowdown in the second half of the year, the annual growth result of construction was pretty impressive, namely, a 17.0% increase in its value-added. The value-added by manufacturing and mining industries also expanded considerably faster than the whole economy and showed an annual rise of 14.1% and 13.0%, respectively. The value-added by domestic trade companies went up by 11.1% y-o-y.

Manufacturing and domestic trade main contributors

With a relative share of almost 18%, the manufacturing industry continues to be in the leading position in the structure of Lithuania's GDP. On the other hand, the domestic trade sector is hot on the heel, since it produces 16.1% of the country's yearly output. As compared to 2002, last year the relative significance of manufacturing activities for Lithuania's economy was unchanged, but that of the domestic trade sector improved by 0.4 percentage points.

Rapid credit growth posing risks

It looks like robust economic development leaves no reason to worry, and we can peacefully plunge into a slumber. However, the possibility of economic risks surfacing in two to three years should not be ruled out. One of the main reasons why last year's economic growth results appeared to be better than many forecasters had indicated was the undervalued effect of crediting on domestic demand. In 2003 a boom in the financial sector (for instance, the portfolio of loans hiked by 52.3% y-o-y) was the outcome of not only notably cheaper services, but also (which is probably more important) the very low penetration level of financial services. As the financial services in Lithuania are gaining more popularity and approaching the penetration level of more developed countries, it is obvious that the current growth boom will start coming to an end. This can turn out to be a serious challenge for the country's economy, which has become used to an annual GDP growth of almost 10%.

Luckily, the 1st quarter of 2004 did not justify such worries yet, as the loan portfolio of commercial banks showed an impressive increase of even 58.3% over the same period a year ago.

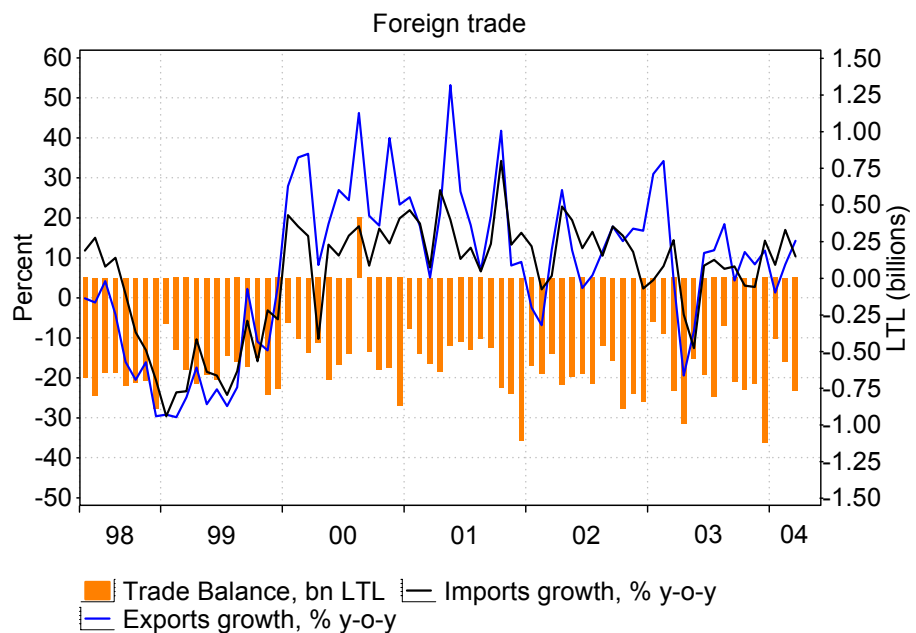
EU accession having different effects on sectors

Essential changes in the economic sectors after joining the EU can pose another problem. For instance, the effect of rising wages on separate economic sectors will be different, because some of them are less labour-intensive than others, and wage growth rates in different segments of the market will, most likely, be not the same. In any case, more investments are likely to be made into labour-efficient technologies and equipment. Of course, such possibilities are much less in the service sector than in the production sector.

Increasing Foreign Trade Volumes

Exports growth outpaced imports growth in 2003

In 2003, exports of goods grew at a considerably faster pace than imports, though the development of foreign trade, as compared to 2002, was noticeably slower. According to the data of Statistics Lithuania, merchandise exports increased by 9.1% up to LTL 22,145 million (EUR 6414 million), while imports climbed by 6.0% up to LTL 30,269 million (EUR 8767 million). The overall trade result was a deficit of LTL 8,124 million, a bit down from LTL 8,272 million deficit in 2002.



Source: EcoWin

Among export products marked by fastest growth were furniture and bedding (35.1% year-on-year), electric machinery and appliances (27.5%), fertilizers (16.6%) and mineral products (13.4%); textile industry, however, reduced its exports by 2% in 2003, as compared to the previous year. Over the year 2003, the sharpest rise among imported goods was registered in iron and steel articles (32.9% y-o-y), machinery and mechanical appliances (18.8%) and mineral products (8.3%). Imports of textiles were by 0.2% lower, as compared to 2002.

Exports to the “old” EU members stood at 41.9% of the total, and the EU-15 share in the imports structure made up 44.7%. Thus, the EU-15 remained Lithuania’s key foreign trade partner, though the export share by 7 percentage points. Exports to the CIS countries accounted for 16.9% of total exports, whereas goods imported from the region comprised 25.5% of total imports.

Relative significance of the CIS as an export market also went down from 19.2% in 2002. A positive trend is that Lithuania is strengthening its trade relations with the new EU countries: exports to these countries increased by 8.6%, and imports from them went up by 11.7%.

Reversal of trends in foreign trade in 1Q 2004

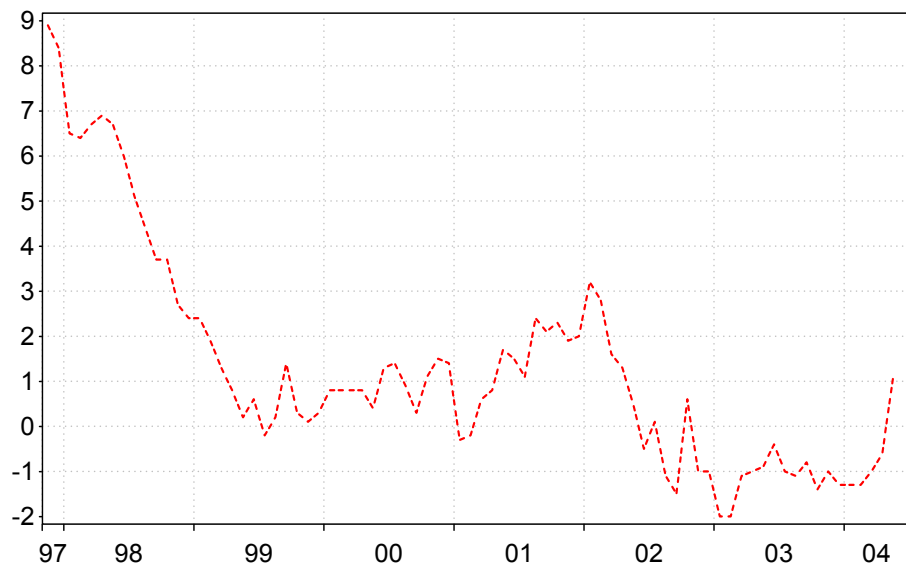
The 1st quarter of this year witnessed a turning point in foreign trade trends: export growth slowed down, while import growth gained speed and, as a result, the latter outpaced the former. According to preliminary data, exports and imports showed an increase of 8.5% and 11.3%, respectively.

“Harmless” deflation still on the stage

Weak US dollar led to deflation in 2003

In 2003, Lithuania recorded a deflation for the second consecutive year. At first sight, an annual drop in the consumer price index (CPI) by 1.3% looks strikingly, especially having in mind that domestic demand was the main driving force of swift economic growth. On the other hand, the essential factors causing deflation solve this puzzle. One of them is appreciation of the litas relative to the US dollar. As a result, imports of raw materials (which are necessary for production of a majority of goods and services) and consumer goods (which can be substituted for domestic products) have become relatively cheaper, thus pulling the price level down. A pressure to cut prices came from sharp competition in many domestic markets. Thanks to increasing labour productivity, many companies were able to earn large profits despite falling prices.

Lithuania, CPI growth



Source: EcoWin

EU accession will not leave even Lithuanian inflation untouched

Many analysts agree that in 2004 deflation will finally turn into inflation. Although we support the opinion that after Lithuania’s entrance to the EU the number of products going up in price will sooner or later outweigh the number of products going down in price, we do not foresee any drastic price hikes in the nearest future. Production costs are expected to increase due to such objective factors related to EU membership as harmonization of indirect taxes (VAT and excise duties) and regulated prices, adherence to more stringent environmental and quality requirements, etc., though this does not necessarily mean that the price level will rise to the same extent. Whether it is possible to put higher production costs on goods prices depends on both the purchasing power of consumers and behavior of competitors. Furthermore, imports of various goods from the countries outside the EU (US, China,

Ukraine, etc.), which are likely to become more expensive due to changes in foreign trade policy, can be substituted for similar imports from the enlarged EU.

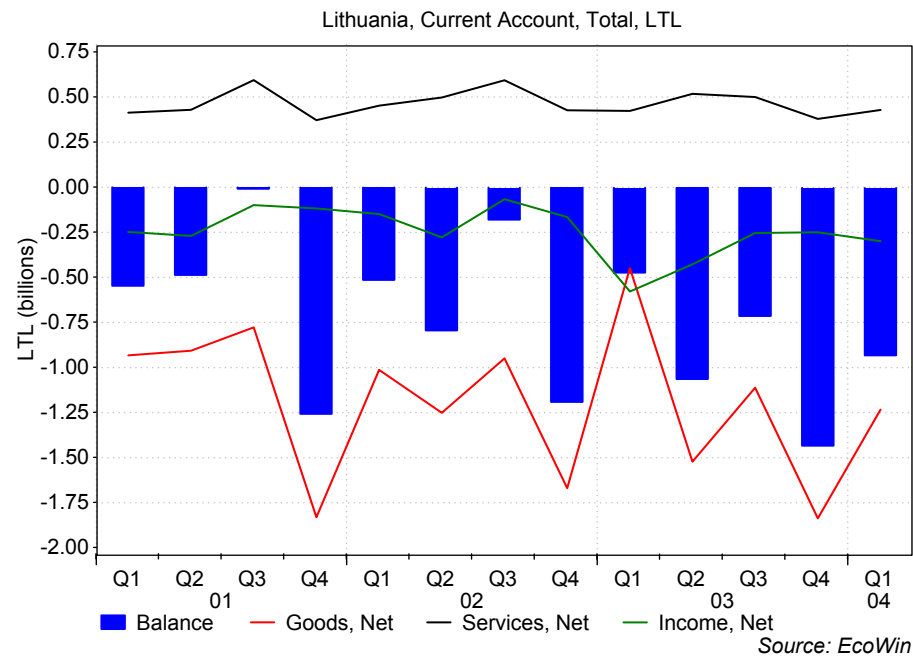
Inflation inching up

The beginning of this year evidences deflationary trends stepping down the stage. In both March and April a month-over-month increase in the price level stood at 0.5% and 0.4%, respectively, though a y-o-y change continued to be negative. It is worth mentioning that the positive change in the CPI was the primary result of seasonal fluctuations and increasing global oil prices rather than euro-integration issues. There were only few products the price rise of which could be attributed to EU membership (for instance, tobacco products). Interestingly, as the rising global oil prices recently hit their record highs and this phenomenon overlapped with Lithuania's membership in the EU in terms of date, a large number of the population has hurried up to include the increase in the fuel prices and transportation costs into the "black list" of euro-integration outcomes, though it is a mere misunderstanding.

CAD Still the Lowest among the Baltic States

CAD 6.6% of GDP in 2003

As expected by many economists, last year the current account deficit (CAD) increased, yet continued to be the lowest in the Baltic States. In 2003, the CAD reached 6.6% of the GDP, or LTL 3,67 (billion) million, going up from 5.3% of GDP in 2002. The discussed figure in Latvia and Estonia stood at 10.2% and 12.6%, respectively.



Income outflow push up CAD

The results of foreign trade in goods and services were satisfactory, but the main "culprit" of the higher CAD was the more-than-doubled negative income balance. Some foreign owned companies (Omnitel, Bite GSM, etc.), encouraged by more advantageous taxation, paid out large sums of dividends. Furthermore, the improving financial results of enterprise operations have spurred a higher volume of profit-financed reinvestments.

CAD outlook flat for coming years

This year merchandise exports are expected to grow at an annual pace of 10-12%, and import growth should not lag behind it. The arguments for fast expansion of imports are positive household and business expectations as well as robust credit growth stimulating the expansion of domestic markets and imports simultaneously. The positive effect of EU structural support on

demand for imports should not be overlooked, too. Thus, in the period of 2004 through 2006 the CAD to GDP ratio is expected to be rather constant, standing at 6.0%, 6.0% and 6.5%, respectively.

Market and Sector Research

A/S Latvijas Unibanka
Pils iela 23, Rīga LV 1050
<http://www.unibanka.lv>

Analyst: *Andris Vilks*

Telephone: 7215597
e-mail: andris.vilks@unibanka.lv

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