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Baltic MacroScope

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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%	7,5%	7,0%	7,0%
Export growth (goods)	-5,1%	12,2%	11,1%	12,1%	17,2%	24,0%	20,0%	18,0%
Import growth (goods)	-8,3%	12,2%	13,8%	13,4%	19,7%	23,5%	19,0%	17,0%
Foreign trade balance, % of GDP	-16,9%	-17,1%	-18,3%	-19,1%	-21,2%	-22,5%	-23,5%	-21,0%
Retail sales growth	6%	17,5%	2,7%	12,4%	13,6%	12,5%	11,0%	11,0%
Total loan portfolio as % of GDP	20,1%	23,2%	31,7%	37,3%	47,5%	60,0%	72,0%	81,0%
CPI growth	2,4%	2,6%	2,5%	1,9%	2,9%	6,4%	5,4%	3,5%
Unemployment rate	9,7%	8,4%	7,8%	8,9%	8,6%	8,6%	8,4%	8,2%
Unemployment rate, jobseekers rate (ILO)	14,3%	14,4%	13,1%	12,0%	10,6%	10,3%	10,1%	9,8%
Public budget balance as % of GDP	-3,7%	-2,6%	-2,0%	-2,3%	-1,6%	-1,8%	-1,9%	-1,5%
Current account balance as % of GDP	-9,0%	-4,6%	-7,6%	-6,7%	-8,2%	-10,2%	-9,0%	-8,5%
Foreign direct investment inflow (mn LVL)	203	250	83	157	172	310	350	350
FDI/CAD coverage	53,4%	115,2%	21,1%	41,2%	33,1%	42,5%	48,6%	46,4%
Interest rate, long term national currency loans (annual average)	13,2%	10,3%	10,4%	8,5%	7,5%	9,0%	8,5%	7,0%
Interest rate, short term national currency loans (annual average)	13,9%	12,1%	10,8%	7,5%	5,4%	7,5%	6,8%	6,0%
State debt as % of GDP	12,1%	12,2%	13,7%	13,4%	13,4%	13,8%	13,2%	14,2%

Economic boom gaining force

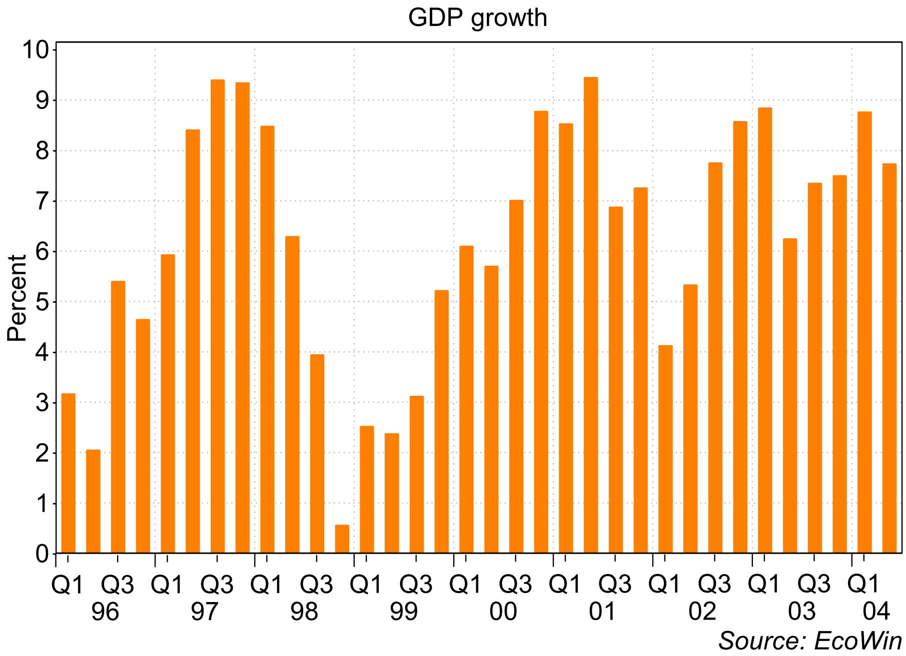
The growth rate still ahead of forecasts

Growth figures of gross domestic product in the 2nd quarter of the year are again higher than expected. In this period GDP grew by 7.7 per cent, whereas the analysts forecast a 7-7.5 per cent increase. Wherewith in the first half of the year economic upswing reached 8.2 per cent, retaining the fastest growth level of economy in the European Union.

The economy of Latvia is driven forth by the unremitting domestic demand for goods and services as well as by increasing external demand for industrial goods and services.

Services outperform manufacturing

Although in the second quarter the growth was slower than in the first quarter (8.8 per cent), a stable rise was observed in all the key branches of economy. Unexpectedly good results were achieved in the transportation and communications industry, where the 11 per cent growth was not envisaged, because port and railway transport produced only slightly better results than last year. An obvious progress was seen in the road transport, passenger traffic, communications service and storage service. Achievements in the building sector did not raise any doubts either and growth rates in the industry will be at the top for a long while. Growth rates in the processing industry and domestic trade declined by a few per cent accordingly to 6 per cent and 8 per cent. This trend is expected to run on also in the 3rd quarter. Growth indicators in the two industries are expected to grow somewhat faster in the last quarter of the year.



Drawing foreign visitors to Latvia

As before 73 per cent of the gross domestic product is made by service industries showing a steady increase. In the 2nd quarter financial and commercial services grew by 9 per cent, hotel and restaurant business expanded by 7 per cent. Banks and the insurance sector are winning substantial gains from the steady economic upswing in the country, concurrently encouraging it. Expansion of the EU has fostered foreign visitor interest in Latvia and we expect a 15-20 per cent annual increase in the sector. The Riga airport is expected to double its passenger traffic.

Too early to assess EU impact

It is too early though to speak about a positive or negative impact of the EU factor on our economy. Competition in the local market has not grown noticeably and redivision of the local market has not yet begun. Many of the major companies in the neighbouring countries have opened their businesses in Latvia. There is no doubt that the fast development and the particularly liberal economic environment will further facilitate inflow of foreign investments and transfer of production units to Latvia. Supported by commercial banks and finance consultancy firms Latvian businessmen are ready to make use of the available structural funds of the EU. As the process will be started this year, we will be able to start seeing its positive returns only next year on.

Cooling expected

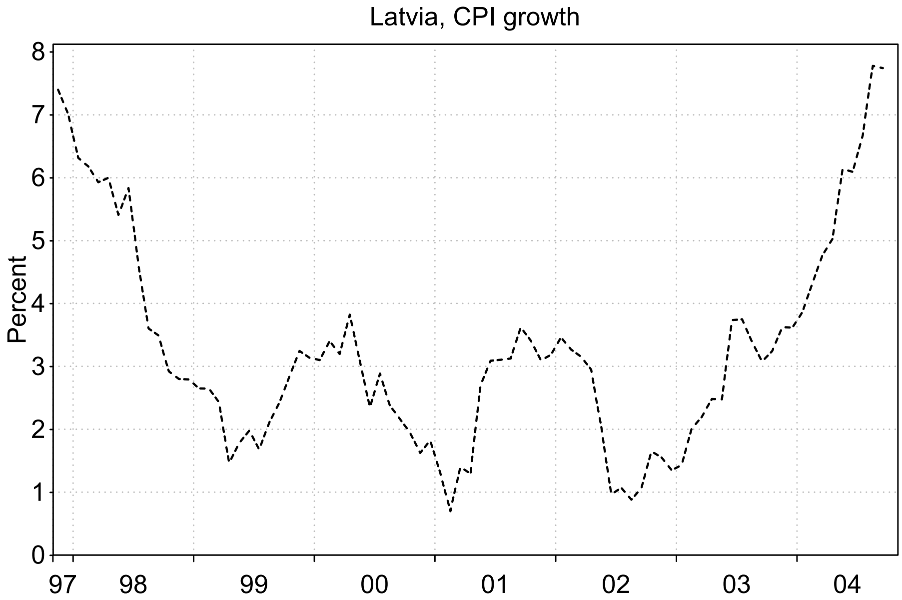
Growth in the 2nd half of the year might somewhat slow down, yet it is hardly unlikely that the rate will fall below 7 per cent. Our forecast for the year 2004 growth is 7.5 per cent and roughly 7 per cent for the next two years. Notwithstanding the fast economic spurt of recent years Latvia remains the most poverty stricken partner of the EU and as before a substantial slice of gross domestic product is not accounted, as companies avoid declaring their gains.

Gross domestic product of the EU states grew slightly above 2 per cent in the 2nd quarter, which is 2 times lower than that in America or Japan, unfortunately. Currently the fastest upswing of GDP in the EU is observed in the Baltic countries, Poland and from Western countries - Ireland.

Inflation does not subside

No traditional deflation in August

After the unexpectedly high inflation in the June and July months analysts set hopes for August – the traditional month of lower prices. They wished to find out whether the rocketing inflation was a temporary reaction to the accession to the EU or a new economic reality to be reckoned with. Unfortunately, the second version seems most realistic and we shall be forced to adapt ourselves, or we shall be adapted to the fast rise of prices also in the following months.



Source: EcoWin

Inflation the biggest obstacle on the way to euro

Albeit August fixed a 0.1 per cent deflation, it was considerably smaller than traditionally observed in recent years. Hence, the 12-month consumer price index has already jumped to almost 8 per cent - namely, 7.8 per cent! Annual average inflation at the moment is still 4.9 per cent, but, anticipating developments in the following months, it will likely finish at 6.3-6.5 per cent. The Bank of Latvia is even more pessimistic. Upon release of August data the Central Bank raised its inflation forecast to 7 per cent and expressed anxiety about the possibility to introduce the euro in the foreseen term, if Latvia fails to fulfil criteria of the convergence.

Prices impacted by many factors, speculation among them

In August, as usually, prices of clothing and footwear declined. Food prices fell inconsiderably. Fuel prices rose and so did prices for hotel and public catering services. In the year's time food prices surged by 11.5 per cent, health services were up 16.3 per cent, transport, housing, restaurant and hotel services – up by more than 8 per cent. In many instances this rise of prices is logically justified, yet, more and more questions do not find sufficiently explicit answers. Given our life is determined by market economy and a real competition, it is quite certain that in the nearest future we may expect re-division of the market, by which in the period of the price boom aggressive market players would act against the rise – keeping the prices flat or even lowering them, in such a way attracting new customers.

Growth of purchase power falls

Inflation eats up salary growth

Monthly growing inflation sent the growth rate of real purchase power down. Inflation grew faster than salaries on average. If a year before the increase of real wage was 7.8 per cent on average, then in the 1st quarter of the current year it closed at 4.9 per cent, finishing at 3.6 per cent in the middle of the year. In June and July these indicators stood at 2.2 per cent and 1.3 per cent solely. Knowing that annual average inflation may reach roughly 6 per cent and that in the middle of the year no increase in salaries can be expected, neither salaries paid in envelopes will reduce, we may forecast that in 2004 increase in real wages and salaries will not be much larger than 2 per cent. It is true that, due to changes made in the expenditure structure of the government budget, part of the funds will be used for the increase of salaries paid to civil servants.

Real wage level hidden in the grey economy

In the 2nd quarter of the year average gross wages and salaries reached LVL 209 (EUR 313) but net wages and salaries – LVL 149 (EUR 222). In the year's time gross wages grew by 9 per cent and net wages by 8.2 per cent. Nevertheless our wages are the lowest amongst the member states of the EU. It means that we are not approaching average figures of the EU States, on the contrary we are withdrawing from them. The private sector declares lower than actually paid out salaries and the so called "envelope salaries" remain a viable reality. The official wages in Latvia continue to fall behind those paid in our neighbouring countries. In the 2nd quarter gross wages grew by 5 per cent in Lithuania (to EUR 354), by 7.3 per cent in Estonia (EUR 474) and by 4.5 per cent in Poland (EUR 540).

Overheating of economy is still arguable

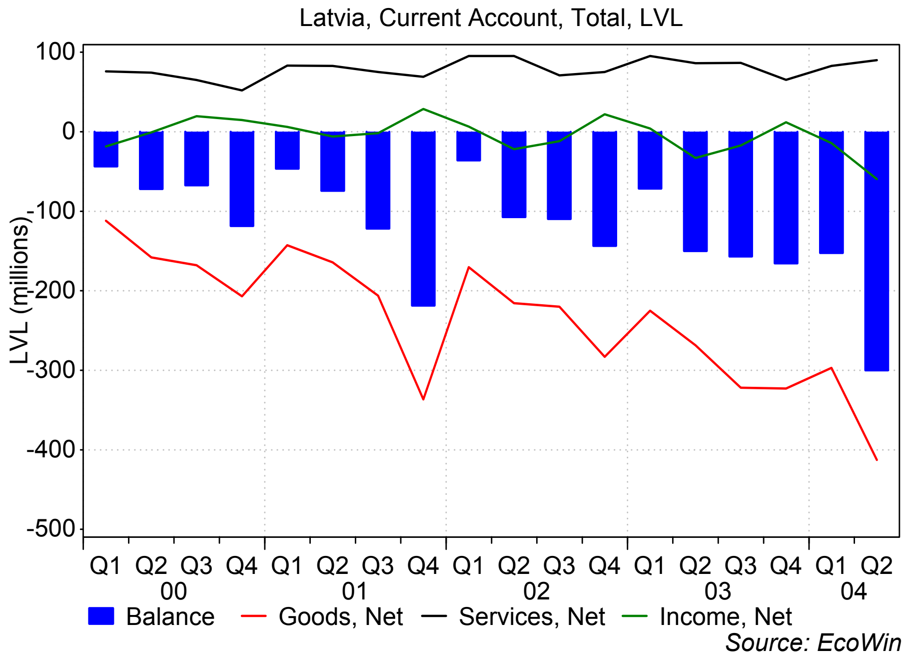
Threat of overheating probably exaggerated

The booming economy, the high and growing inflation, the worsening current account, avid private consumption has sent lending up by more than 40 per cent annually is a constant cause for anxiety about overheating of economy. Most experts oppose the idea while some recognise the visible signs. The prevailing opinion is that growth rate has already started to subside and this year due to accession to the EU was exceptional in that it stimulated price hikes and imports. The central bank's effort to curb consumption by raising the key rate and obligatory reserves of commercial banks was not effective enough as the businesses preferred to use more euros rather than local lats.

Entrance in the EU push up current account deficit

Record high imports before the EU entrance

The accession to the EU brought forth an import boom in March and April but in June the balance of payments regained more or less its general tenor. The import volumes continue to be large but they are not as conspicuous as before. In the 2nd quarter current account deficit jumped to LVL 310 million (17.4 per cent of GDP), which is more than 2 times larger than in the same period a year before! This is a staggering figure and we can only flatter ourselves that in the following quarters the situation will improve. Exports growth is also spectacular. The situation in the services balance is gradually improving, showing a larger positive balance than a year ago. By year-end current account deficit, most likely, will grow to LVL 700-750 million, and, unfortunately, will end above 10 per cent of GDP. In the 1st half of the year the deficit reached LVL 460 million (13.6 per cent of GDP).



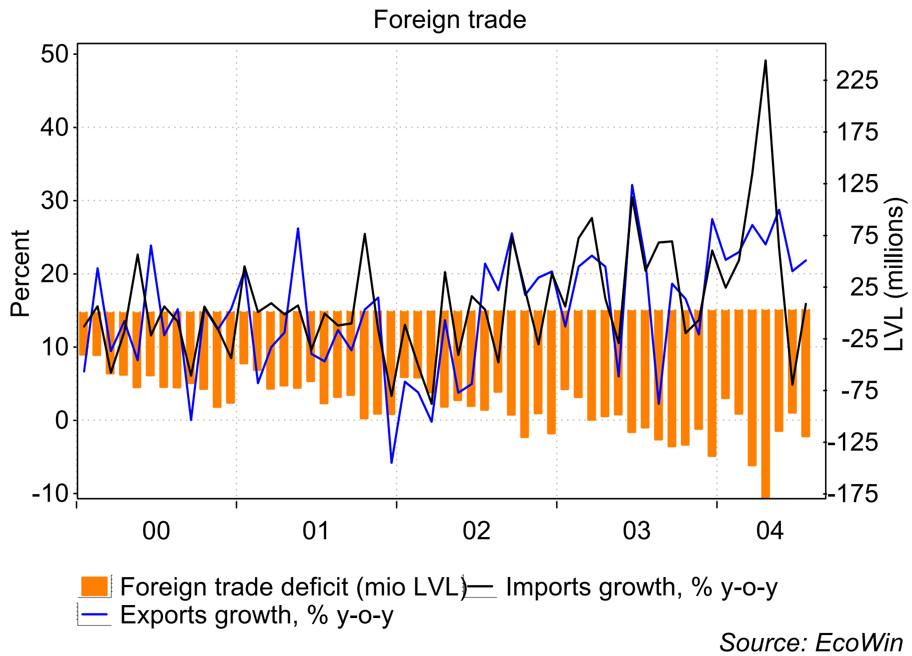
Surge of foreign direct investments

In turn attraction of foreign direct investments gains ground. The volume of foreign direct investments attracted in the second quarter of the year have reached LVL 101 million but the total foreign direct investment stock received in the first half of the year have amounted to LVL 179 million. It roughly covers solely 40 per cent of the current account deficit. The accession to the EU and the NATO, followed by the fast economic upswing and the friendly investment environment, will continue to favour a more substantial inflow of foreign investments in Latvia (LVL 300-320 million this year). We can mention the latest successful project to be implemented in Aizkraukle by the major manufacturer of doors and windows the American company *Jeld-Wen* – producer of hardboard. The project foresees to invest EUR 40 million in its implementation. The company is expected to commence operations in October 2005 and its produce will be exported to the countries of the EU (Great Britain, France, Spain).

Exports steadily growing

Exports up by 23 per cent, some new destinations

Compared with the same period a year before exports has been on an upward direction for seven months in succession, up 20 per cent each month. In July it grew by 21.4 per cent but since the beginning of the year it has added 23.4 per cent to its volumes. July was noted also for a sizeable growth of exports to Russia (+69 per cent) and Switzerland (up 18 times, due to growing exports of mineral products). The share of the EU in the exports structure reduced from 76 per cent to 72.6 per cent. In July exports of mineral products and vehicles increased sizeably although their proportion in the exports structure is still negligible. The major export items continue to be timber albeit their proportion has gone down to 32 per cent. In July it was smaller than in June and smaller than last year. In any case growth was observed in practically all commodity groups. Although exports to Great Britain and Germany shrank in July the two countries remain major exportation partners of Latvia. It must be mentioned that exports to Estonia, Lithuania, Denmark and Sweden has grown considerably.



Source: EcoWin

22 per cent growth expected this year

In July imports increased by 15.5 per cent but since the beginning of the year it has risen just like exports – by 23.4 per cent. As was already expected after the fast bounce in spring its growth in summer slowed down. In July imports of mineral products went up by 21 per cent, growth of imports in the remaining commodity groups was less noticeable - 5 per cent and less.

The situation in the foreign trade sector is not going to change much in the remaining months of the year and both the volumes of exports and imports are expected to grow by 22 per cent.

Slowing growth rates in industry and retail trade

Growth in industry down from 8 per cent to 3.5 per cent

The data of the recent months show that industry can speak only about a moderate growth in the sector. If in the 1st quarter production grew by 8.5 per cent, then in the 2nd quarter it shrank to 6 per cent. Compared with last year in June industrial production was up by 6 per cent, and in July only by 3.5 per cent. As of the beginning of the year production volumes in industry have grown by 7.9 per cent, in the manufacturing industry – by 8.4 per cent.

Although the slowdown is explained with the impact of the EU factor, it is too early to complain that our rivals from the EU have begun to undermine our industry. Some of the orders might have been made before May 1 and might have been followed by a small anticlimax but summer is not the best time to predict future events. In May and June growth rates in chemical industry were above average and took the industry up to the top. Good results were achieved also in woodworking and production of rubber and plastic ware, as well as in the manufacturing of electric apparatuses and machines and garment industry. Fluctuations by months were observed in several branches of industry. We, however, foresee faster growth of the production in autumn.

This spring's purchasing boom gone in autumn

Retail trade turnover is maintaining a high level of growth, up by 13.8 per cent in the 2nd quarter of the year (13.1 per cent in the 1st quarter). A gradual decrease has been observed since April, though, (in June +11 per cent, in July +9 per cent). A sufficiently large increase in turnover was observed in the following commodity groups: food products, wearing apparel and footwear, household goods and mechanisms. In the first quarter of the year car trade jumped by 21 per cent, but, most likely, this tempo will slow down because in spring the purchase boom was caused by Latvia's joining the EU.

In the 3rd quarter retail trade turnover is expected to be smaller than in the first half of the year and may again move up towards the end of the year. Annual growth in the sector is believed to finish at around 12-13 per cent.

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%	5.6%	6.2%	6.4%
Export growth	0.5%	52.2%	7.4%	-1.5%	9.8%	23.0%	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	6.6%	10.5%	13.8%	14.3%	9.9%	12.4%	11.5%	10%
Total loan portfolio as % of GDP	32.7%	36.9%	39.0%	42.8%	55.0%	64.8%	68.0%	70.3%
CPI growth	3.3%	4.0%	5.8%	3.6%	1.3%	3.2%	3.0%	2.9%
Unemployment rate	12.2%	13.6%	12.6%	10.3%	10.0%	9.7%	9.6%	9.4%
Public budget balance as % of GDP	-4.3%	-0.9%	0.6%	1.1%	2.6%	0.30%	0	0
Current account balance as % of GDP	-4.5%	-5.5%	-5.6%	-11.3%	-13.2%	-13.4%	-12.2%	-11.1%
Foreign direct investment inflow	4,608.4	6,644.4	9,429.7	4,800.3	12,470.9	11,500.0	10,000.0	10,000.0
FDI/CAD coverage	126%	130%	160%	36%	75%	-62%	-54%	-54%
Public sector balance, % of GDP	-4.3%	-0.9%	0.6%	1.1%	2.7%	0.3%	0.0%	0.0%
Public debt, % of GDP	6.5%	5.0%	4.7%	5.7%	5.8%	5.0%	4.7%	4.6%
3m interest rate, end of period	5.1%	6.1%	4.0%	3.5%	2.6%	2.4%	2.9%	3.9%
Long-term interest rate, EEK loans	8.56%	8.86%	10.14%	6.56%	5.13%	5.39%	5.6%	6.45%

More support from foreign demand

Global situation providing more support this year

Global situation is now in quite a healthy state and giving more support for economic growth. GDP growth in eurozone is still lagging US, but clearly out of recession. Difficult times for eurozone have given more opportunities for CEEC countries, as eurozone companies are faced with cost cut pressures.

Trade partners' outlook even more favourable than half a year ago

The 2004 growth outlook for Estonian main trade partners, Sweden and Finland, is revised even higher than half a year ago. Sweden's economic performance has been very positive in 1H 2004 and GDP growth will be 3.4% in 2004. Also Finland is doing much better than the EU economies on average. For Finland 2.8% GDP growth is forecasted in 2004.

EU membership left its trace

EU brought along changes in statistics

Being a member of European Union since May 1 together with ten Central and Eastern European countries, since then a lot of changes have happened in overall macroeconomic picture. Statistics was brought in line with EU standards. That resulted in higher GDP growth rates in 1993-2003 and higher nominal level now. Also, as now approximately 80% of imports and exports are related to the EU, statistical accounting of foreign trade is based on different methods, which make foreign trade data not comparable to previous ones. Besides statistical effects EU membership brought along also large real deviations in several indicators.

First effects of EU accession are more tourists…

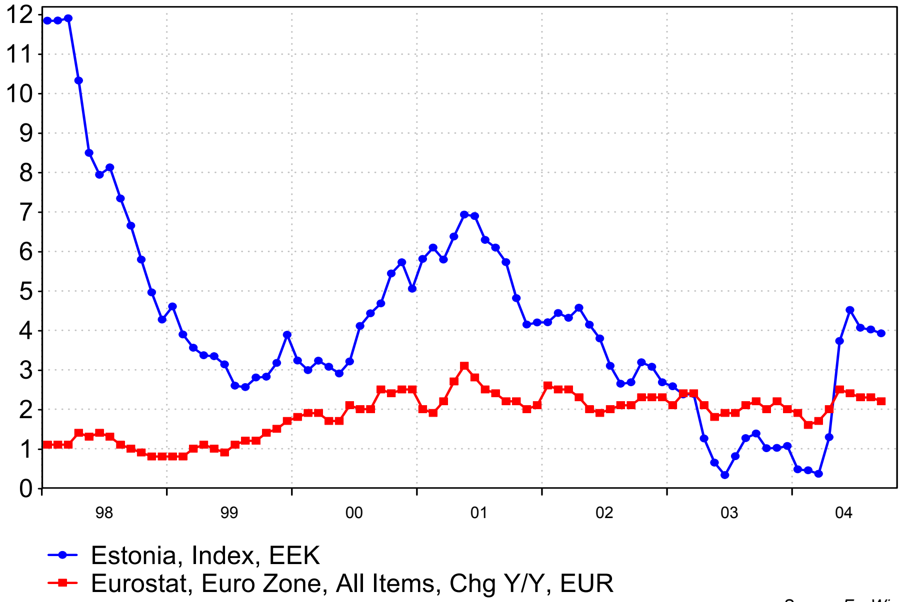
Although it is obviously too early to start counting the effects of being the member of EU, the first real effects are already evident. The number of tourists have increased and given an additional boost to the economy. Tourism sector constitutes an influential 8% share in GDP.

In April, retail sales went through a drastic jump of 23% yoy, fuelled by local consumers that were hit by shopping fever and built up stocks of various products ranging from sugar to cars in the fear of rising inflation after May.

…and price rise

Rise in inflation was another most evident and also expected direct effect of EU accession. Despite exaggerated expectations of consumers concerning inflation, the actual inflation turned out to be pretty much as forecasted by analysts. In May, monthly price increase accelerated to 2.1% from approx 0.3% mom in the beginning of the year. The added excise tax on fuels and import tariffs on products from non-EU countries increased primarily fuel and food prices.

CPI y/y in Eurozone and Estonia



Source: EcoWin

Inflation has stabilized

Inflation was very low until May when actually some tax increases took place. Inflationary expectations were reflected to some extent in some pressure to inflation in April, but these expectations subsided afterwards and didn't fuel into additional upward pressures after May. The annual inflation ended up at 3.7% yoy in May and 4.2% yoy in June. Price increases were one-off and did not spread further into other fields of economy in next months. Inflation has stabilised since the middle of the year and no additional inflationary pressure is seen to come in the second half of the year. Tightening competition in retail market, especially in food products, does have an inflation-mitigating impact. Even when the price for goods from outside the EU is now higher by added customs tariff, that has only limited impact on inflation. That's because the share of imports coming from outside the EU is only about 20%. Another reason is the interaction between demand and supply, which total impact seems to tilt toward lower prices. The third factor is strong euro. The major factor having upward pressure on inflation is world oil prices at its new life-time highs.

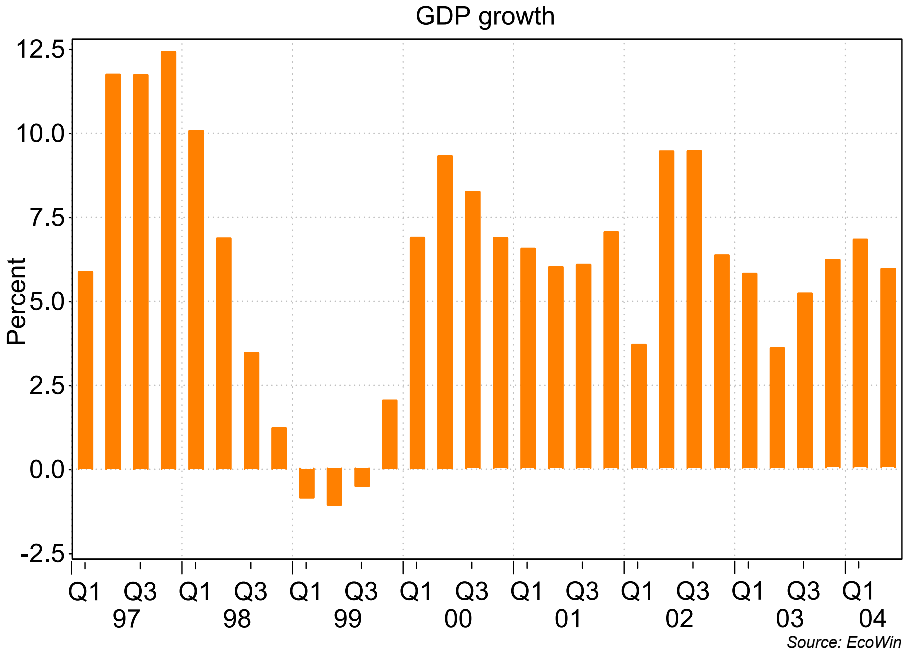
In the second half of year global oil prices main inflationary source

Estonian quick entrance into the ERM2 as a sign of solid economic grounds

Shortly after EU accession, in late June, Estonia entered the ERM2 mechanism, the transitional phase on the way towards euro adoption. That event was of equally crucial importance for Estonia besides EU accession. Together with Lithuania and Slovenia Estonia was one of the first countries which were ready for this. With that step Estonia confirmed its commitment for euro adoption as soon as possible, which increases the confidence of investors into Estonian economy.

GDP growth acceleration in 1H04

With a support from relatively good shape of global economy and vital domestic demand economy's growth rate continued acceleration compared to last year in both quarters of 2004. In the first half of 2004, GDP growth was 6.3% yoy on average.

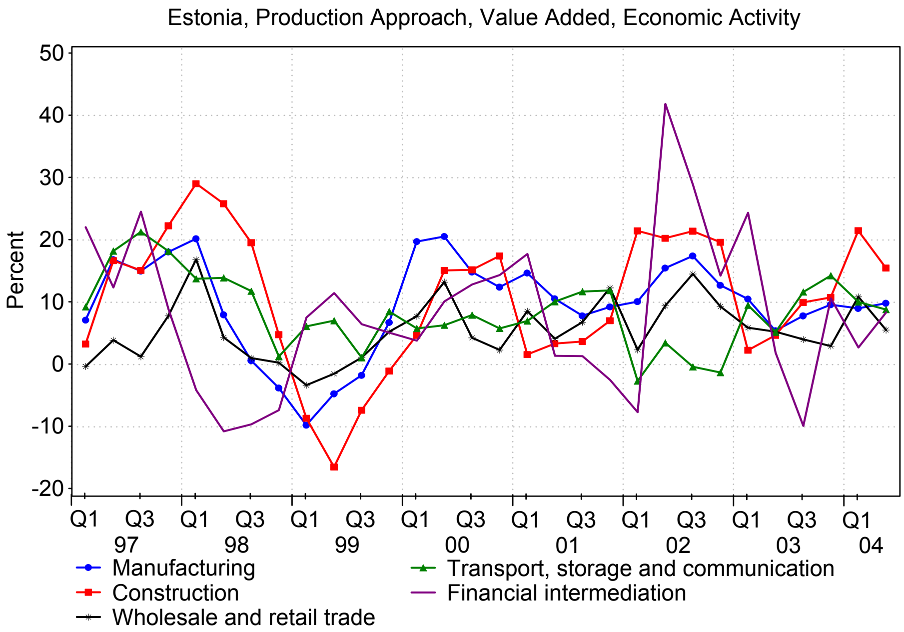


In 2003 GDP growth based on domestic demand

Despite acceleration of exports growth, **GDP growth was more relying on domestic** demand in 2Q than in 1Q. Domestic demand constituted 108% of GDP. In 1Q, the overall trends were towards favourable direction. In 2Q, these trends were somewhat broken. Exports trend remained favourable, but imports surprised on the negative side. However, 2Q04 cannot be considered as an ordinary period in economic developments and so far it's not known yet whether import shock is of temporary or permanent nature. The increase in private consumption and investments was not as prominent as in imports.

Main contributors to GDP manufacturing, transport and construction

By production side, quite logically, current economic environment characterized by low interest rates and high credit demand have been extremely favourable for economic branches like financial intermediation (8.4% yoy in 2Q) and construction (15.5%yoy in 2Q). But main contributors to GDP growth were also manufacturing (9.9% yoy) and transport, storage and communications (8.9% yoy). The latter indicates that transit trade has overcome the bad times.



Source: EcoWin

Construction boom continued

Construction sector enjoyed really good times in 1H04. Growth rates were much higher than these used to be on average. The reason behind this besides favourable credit conditions was lying in the jump in VAT for new buildings since May. So far, the higher VAT has not been reflected in real estate prices, but gradually during the year this will happen and bring construction volumes growth down to usual levels.

Industries are healthy, neither additional boost nor difficulties seen

The situation in manufacturing could be described as a stabile growth. No significant fluctuations have occurred during this year. There was a slight slowdown in growth rates in early summer, but have reversed to higher rates in later months. Major industries are doing fine. There are still difficulties for fishing and clothing industry metals production has come to the end of rapid expansion.

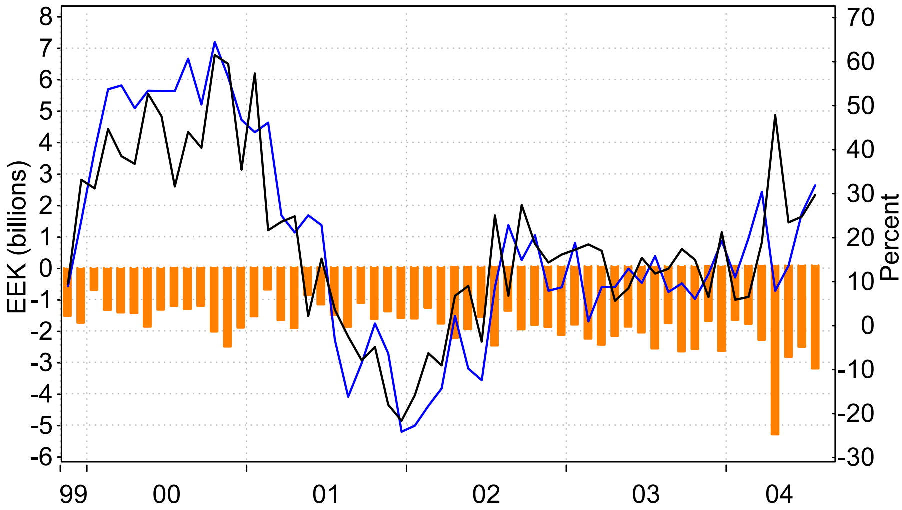
Shock in imports

Import shock – temporary or permanent?

A strong domestic demand triggered a very strong **import** demand. In April import increased 47% yoy, which was related to stockpiling both by consumers and retailers. It would have been reasonable to assume a significant drop in import volumes in next months, but surprisingly, that didn't happen. Instead, import growth continued to range in 20% yoy.

Statistics compatibility problem is not enabling us to identify, how much of this large import increase is statistical effect and how much the external imbalances might have really worsened. When we compare imports growth to other related indicators, then these don't support the view of significant worsening. Receipts of VAT indicate high jump in April but not afterwards. Private consumption and investments have accelerated somewhat but not to justify imports increase in that extent. Thus, as for this day, it is not clear whether the import shock proves to be of temporary or permanent nature. If it proves to be a permanent one, bringing imports to new levels, then, despite the fact that we cannot estimate the change of situation, we cannot dismiss the fact that new import data show macro picture in darker lights. Whether the shock is permanent or not, has a crucial importance from the point of view of current account deficit reduction and external imbalances decrease.

Foreign trade



Source: EcoWin

Consumption acceleration in 2Q temporary

Large-scale import does not imply a consumption boom, though. **Private consumption** accelerated in 2Q somewhat, growing 6% yoy. However, the acceleration can be considered as temporary, provoked by shopping fever on the eve of EU accession fuelled by the fear of price increase after May. We expect private consumption to grow at slightly slower, but stable pace in 2H04.

Investment demand persists strong

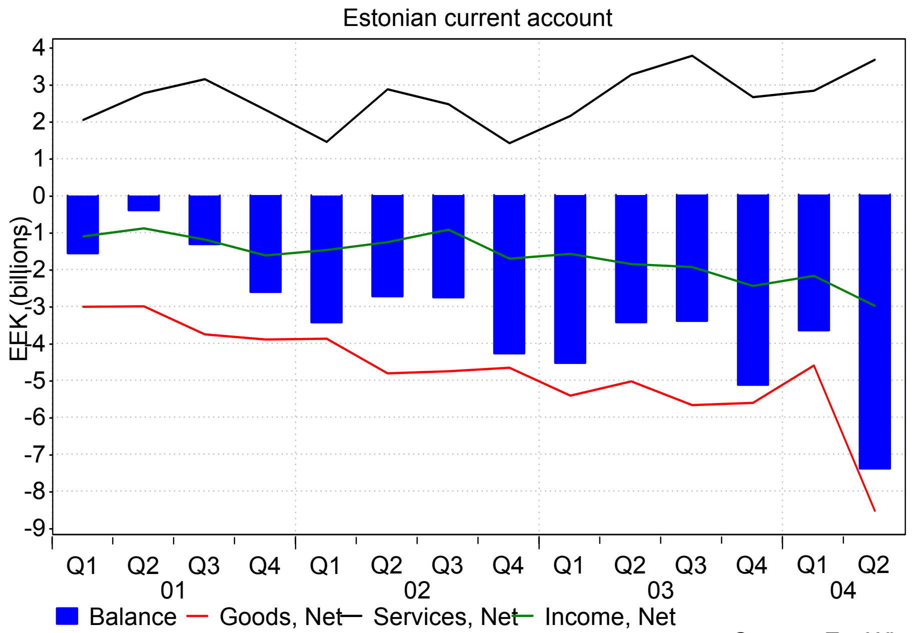
Investment activity remained strong, close to 30% of GDP in 2Q, supported by low interest rates, continuing boom in real estate market and foreign investments inflow. Last year, huge current account deficit was to large extent associated with large-scale infrastructure investments, which all does not pay off in short term, but in longer perspective. This year, investments are still much related to real estate sector, but also production. We expect domestic demand to remain vital also in coming years. At the same time, we expect more and more support from exports side, which should be supported by investments made in recent years.

Exports growth rather solid

Whether the fact of joining the EU has given an additional boost to **exports** already, is not so evident. Nevertheless, export growth rates have been solid throughout the whole year, in 1Q 20% yoy and in 2Q 15%, especially accelerating in June and July (31% yoy). The real impacts of EU accession on exports seem rather limited so far, though. There are also some statistical effects present, though in lesser extent than on imports side. Exports growth has been strong in all months in this year, which was also expected already last year.

New records in trade balance and current account in 2Q

Despite solid growth rates in export, import shock led to largest **foreign trade balance** deficit in the country's history in 2Q04. Trade balance deficit reached 11.8 bn EEK or 23% of GDP. In 2003, the ratio stayed at 21.6 % of GDP. Huge trade deficit couldn't end up in anything else than record-sized **current account deficit**. A new record in deficit were posted not only by trade but also by income account balance, given a boost by large profits of FDIs which is increasing income outflows.



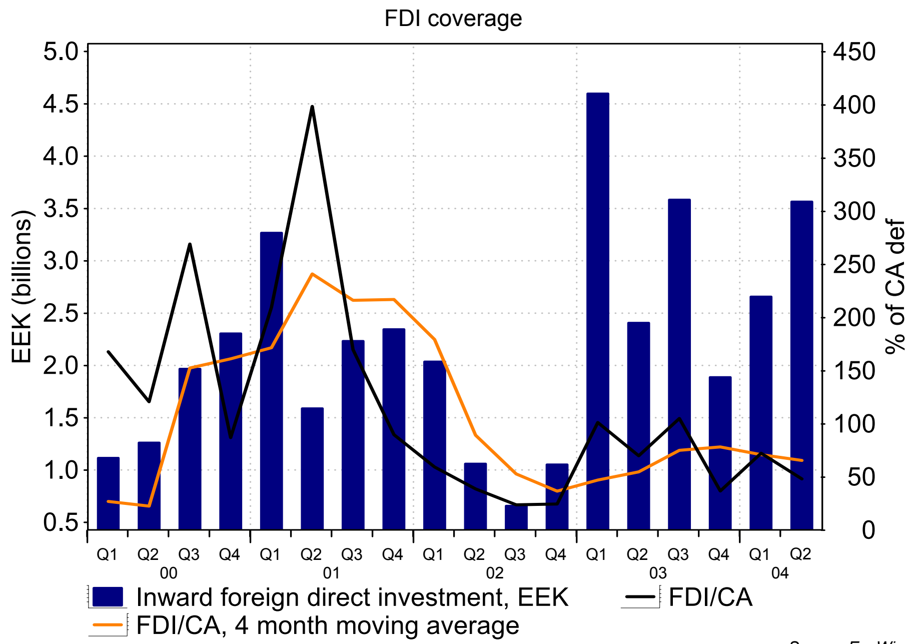
Source: EcoWin

Current account deficit may hit -13.4 of GDP in 2004

Current account deficit reached 20.4% of GDP in 2Q04. In terms of **4 quarters moving average**, current account deficit stayed at 14.9% of GDP. In absolute terms, this is more than twice as much as in 2Q03 and 1.5 times more than last record in 4Q03.

Income balance deficit reached 8.3% of GDP. Financing of current account deficit was less FDI covered than earlier, by 48%. Nevertheless, FDI inflow was quite solid as the flows did not lag much behind the flows in the same time last year.

The outlook for current account deficit reduction has worsened because of recent imports data. If imports shock prove to be permanent, current account deficit may hit -13.4% of GDP by the end of the year.



Source: EcoWin

Credit boom not surrendering yet

Credit growth strong on the back of negative real interest rates

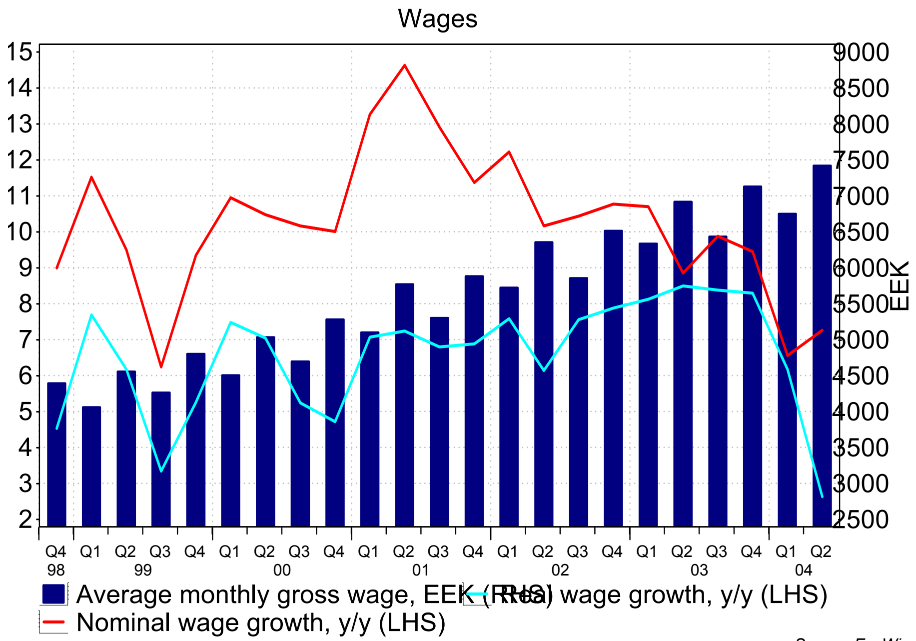
Rapid credit expansion in the economy is continuing and revealing no signs of fatigue. More aggressive loan supply from credit institutions has brought interest margin lower. On the back of slow recovery of eurozone, interest rate increase is not on the horizon before the beginning of 2005. Rising real estate prices, stable situation in labour market and optimism about economic prospects keep credit growth rates high.

Situation in labour market favourable

Labour market conditions have been supportive for consumers' confidence, which also supports strong credit growth. Unemployment stayed in 2Q stable at 10% and both employment and economic activity kept growing for the forth year in a row. Especially good news was that employment increased on account of large employment expansion in manufacturing, which is giving hope in terms of exports favourable outlook.

Wage growth slowing down in 2004

What's more, it's encouraging that in manufacturing also wages keep on growing faster than in economy on average. Overall real wage growth has dropped significantly this year, most remarkably in 2Q: 3.9% compared to 8.3% in 2003. This could be explain by sticky nominal wages, which were the factor of record high real wage growth in 2003 and also for this year, driving real growth down because of higher inflation. Although inflation was expected, no adjustment with inflation has occurred so far. Probably it's not affordable to most companies, especially for small companies where pay hikes are really non-visible, but also some room for manoeuvre is given by new income tax law which raised the tax-free proportion of wage. In next years, income tax rates will fall and give space for lower wage hikes, too. On the other hand, public sector workers have got more active in demanding higher wages and this will be an upward driving factor. Companies are more and more faced with shortage of labour and appealing wage offers for skilled labour from EU, which will have a powerful pressure on wages upwards. This will be a driving force for wage growth acceleration in the middle-term perspective.



Source: EcoWin

Another potential for wage growth in longer perspective is shadow economy. The same provides also potential for employment and credit growth.

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*, %	-19	26.8	20.3	10.7	9.1	12		
Import growth*, %	-16.6	12.9	16.4	12.4	6	14		
Foreign trade balance, % of GDP	16.7	14.5	14.6	16	14.3	15.9		
Retail sales growth, %	0	13.1	8	12.6	14.3			
Total loan portfolio, % of GDP	12.8	12.1	14.3	15.6	21.5	27.2	31.9	36.6
CPI growth (y-o-y), %	0.3	1.4	2	-1	-1.3	2.4	2.5	2.5
Unemployment rate, %	14.6	16.4	17.4	13.8	12.4	11	10.1	8.9
Public sector deficit (ESA'95), % of GDP		-2.5	-2	-1.5	-1.9	-2.8	-2.5	-2
Public sector debt (ESA'95), % of GDP		23.8	22.9	22.4	21.4	22.5	23.1	23.3
Current account balance, % of GDP	-11	-5.9	-4.7	-5.2	-6.9	-7	-7	-6.8
FDI inflow, % of GDP	4.5	3.3	3.7	5.2	1	3.5	4.5	
FDI/CAD coverage, %	40.7	56.1	77.7	99.8	14.3	50	65	
Interest rate, national currency loans, %	13	11	8.1	6.1	5.1	6	6.5	6.5

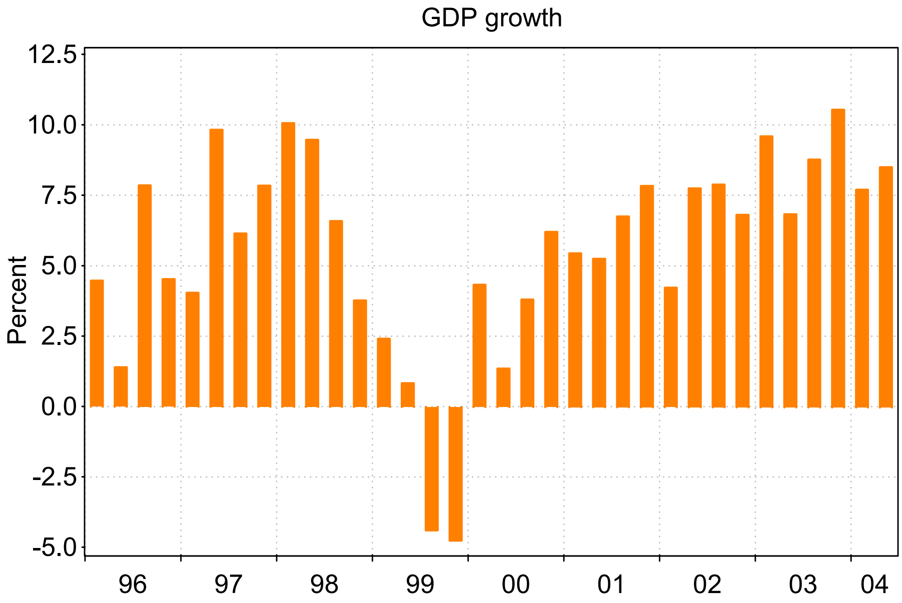
Economic boom continues

Going into lower gear?

The latest revision of GDP data for 2003 brought a pleasant surprise – last year Lithuania's economy grew at an annual rate of even 9.7% instead of previously released 9.0%. This year the economic growth speed is gradually piping down but still continues to be impressive. In the first half of 2004, compared to the same period a year ago, real GDP showed an increase of 7.2% on a year-on-year (y-o-y) basis. The news about a slightly slower tempo was not striking. In recent years, the country's economic growth rate has stepped over the potential line and kept increasing, thus hardly anyone could expect it to gather pace forever.

Domestic demand is still an engine of growth

Like in 2003, this year domestic demand is the main driving force of economic growth. Although many economists have projected a boom in the sector of financial services to continue, a few of them could imagine its huge extent. Indeed, in addition to other factors, favorable crediting conditions have played a crucial role for an increase in both private consumption and gross domestic investment. In the first half of 2004, private consumption (measured in constant prices) showed a y-o-y rise of 11.1%, whereas gross investment went up by even 24.3%. A closer look at components of gross investment leads to, at least, two conclusions. First, gross fixed capital formation grew by 15.9%, and this is a welcome fact in terms of country's long-term growth potential. Second, stocks of inventories were increased by almost 175%. This suggests that the need to restock can be lower in the nearest future, and thus a certain slowdown in production should not be ruled out.



Source: EcoWin

Net exports are becoming more negative

Not surprisingly, in line with growing domestic demand, imports of goods and services were on the rise. In the first six months of this year, as compared to the same period a year ago, imports (measured in constant prices in national accounts) were by 14.8% higher. Another reason for robust import growth is related to Lithuania's membership in the EU. As a result of abolishing many trade barriers, substitutability of Lithuanian agricultural, food and other products for analogous goods from other EU countries has noticeably improved and caused a large increase in imports. On the other hand, entering the single market of EU makes better conditions for exports of Lithuanian products. The current economic revival in the EU also favors the growth prospects for Lithuanian exports. Despite these facts, in the first half of 2004, export growth was only 5.2% y-o-y and did not beat import growth.

Economic success story is not over yet

In the near future, Lithuania's economy is expected to stand its grounds and show quite rapid growth results. The country's GDP is forecasted to grow at a rate of 6.8% this year, 6.8% in 2005 and 6.5% in 2006. If the global oil prices continue to skyrocket and have serious negative outcomes for the economy, a need to downgrade the above-mentioned forecasts will surface. Another threat for robust economic growth comes from uncertainty about the future of one of the largest Lithuanian companies – *Mazeikiai Refinery,* because its Russian controller *Yukos* (which guarantees a supply of raw materials) faces serious problems. Nevertheless, the role of *Mazeikiai Refinery* for Lithuania's economy is often exaggerated. The value added (measured in current prices) by this company accounts for, approximately, 1.7% of the country's GDP. It is worth pointing out that our forecasts take into account the envisaged shutdown of *Ignalina Nuclear Power Station* (it is planned to close the first block in 2005 and then the second block in 2009).

Almost all economic sectors are on the rise

Manufacturing industry does not come down the stage

In the first half of 2004, compared to the same period a year ago, a majority of economic sectors showed an increase in their value added. Like in the past, the manufacturing industry was a key player on the stage, not only feeding the rapid growth of the entire economy but also ensuring its consistency. The value added (measured in constant prices) by the manufacturing sector was by even 14.3% higher than a year ago. Whether this sector will continue to lead the country's economic growth in the future depends on many factors. Since the manufacturing industry sells a lion's share of its output abroad, the challenge of staying competitive on the international scale should be overcome. Another task is to ensure efficient use of EU structural funds. Despite the fact that the financial plan for 2004-2006 does not promise a significant EU support for manufacturers directly, a positive effect on their activities should come from projects implemented by other economic sectors, for instance, from improved infrastructure. Like in the case of Lithuanian exports in general, an economic recovery in the EU as well as improved trade conditions with other EU members is advantageous to Lithuania's manufacturers.

Clouds are hardly possible in the sky of domestic trade

In terms of growth rate, the sector of domestic trade took second place. In the first half of this year, compared to the same period of 2003, its value added was by 11.4% higher. The growth prospects for this sector look rosy for, at least, several reasons: domestic demand continues following an upward sloping trend; the number of new cars and certain other long-term consumer goods per 100 thousand inhabitants is still lower in Lithuania than in other western economies and even the Baltic countries; the flow of tourists with strong purchasing power is increasing; some new international trade giants are likely to enter the Lithuanian market (e.g., *Lidl* from Germany has already started to look for staff). It is worth pointing out, however, that the financial results will not necessarily go up in proportion to business expansion, as competition in the trade sector is extremely tough, and the applied price mark-up is already insignificant.

Services of transport, storage and communications make their way forward

The third fastest growing economic sector of Lithuania during the first half of 2004 was the industry of transport, storage and communications, showing a 7.9% y-o-y rise in its value added. In a longer run, the growth of transportation and storage, as a rule, positively correlates with the growth of the entire economy. From January to June 2004, compared to the same period a year ago, cargo transportation via Lithuania's railways was by 10.2% higher. This is a very good result, having in mind that the railwaymen are still burdened with a bunch of problems: shortage of finance for a radical improvement of the technical stance of railways; non-accorded tariff policy of cargo transportation to Klaipėda and to Kaliningrad, etc. Air transport was another locomotive of the whole sector's growth. In the discussed period of 2004, the number of passengers carried by Lithuanian airline companies showed a y-o-y increase of 49.3%, and the goods (freight and mail) traffic was by 64.6% larger.

Construction sector will hardly have a chance to take breath

The construction sector also grew faster than the average of the whole economy – its value added (measured in constant prices) was by 7.5% higher than in the first half of 2003. Currently, there are several factors favoring construction business: rising household income in line with decreasing unemployment; still low indicator of living space per capita relative to Western Europe; attractive crediting terms (low interest rates and etc.); increasing demand for industrial and commercial properties. Whereas the market segment of commercial offices is peaking, there is still much room for growth in the areas of residential property and especially industrial, transportation and storage infrastructure (having in mind EU financial support). In the nearest future, the construction boom should move from large cities to province regions, assuring a continuous and rapid development of this sector for at least 2-3 years.

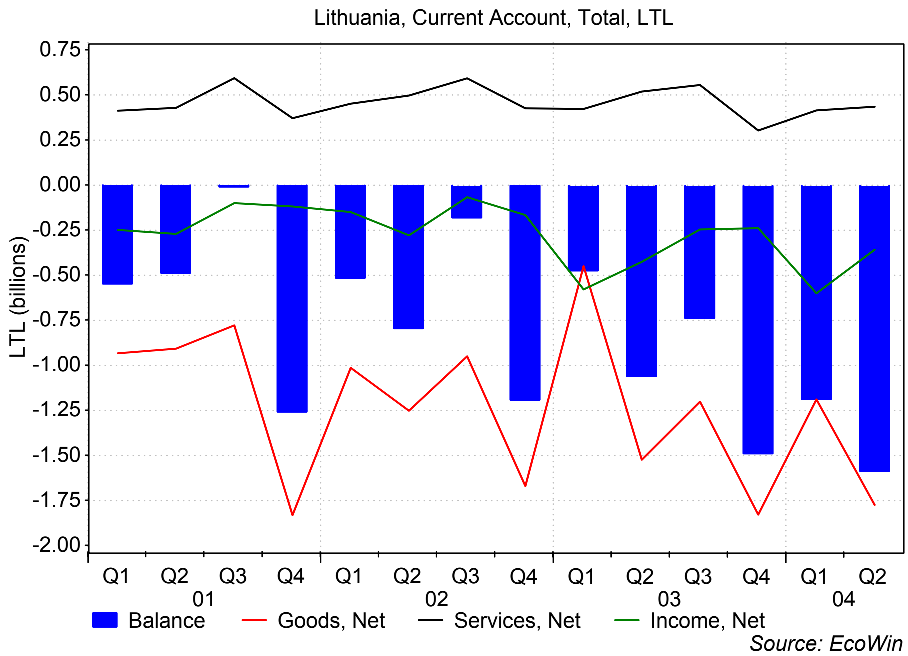
Few economic sectors are overboard

The value added by other economic sectors was also on the rise but its growth rate was lower than the average of the economy. For instance, the value added by hotels and restaurants (measured in constant prices) grew by 4.5% y-o-y, financial intermediation – by 4.1% y-o-y, education – by 4.0% y-o-y, energy sector – by 3.3% y-o-y, etc. On the other hand, the ranks of outsiders were scarce - the value added declined only in the sectors of fishing, mining and real estate, lease and other business activities (by -10.8%, -7.2% and -0.2%, respectively). The drop in the value added by the latter economic activity is hardly explainable, having in mind the currently booming real estate market and other business activities (advertising, public relations, etc.).

Current account losing its shape but FDI climbing up

CAD is broadening in all three Baltic countries…

In the first half of 2004, all three Baltic States faced a substantial deterioration of their current accounts. After being pretty "slim" in 2000-2002, Lithuania's current account deficit (CAD) has noticeably "put on weight" this year – in January-June, compared to the same period of 2003, it was by 74% larger, reaching LTL 2.4 billion or 9.9% of GDP. In addition to this depressing view, Lithuania cannot boast of having good financing of CAD by foreign direct investment (FDI). In the discussed period of 2004, the ratio of FDI to CAD was only 46.2%. Active banks' borrowing abroad plays an important role in financing the country's CAD.



… due to same reasons

The main reason underlying the larger CAD was a deepening deficit in foreign trade. Again, this was the case in all three Baltic countries. In January-June 2004, compared to the same period a year ago, Lithuania's balance of foreign trade grew worse by 84%. Furthermore, the gloomy dynamics of trade balance in Lithuania were accompanied by deterioration (of 9.0% and 40.5%, respectively) in both balance of income and balance of current transfers. To a large extent, the latter was the result of Lithuania transferring its payments to the EU budget but not yet recording the envisaged receipts.

Future should prove the CAD is not a threat

Sad but true, the prospects for the second half of the year do not look encouraging. If the 3rd quarter is to be better (due to seasonal factors and inflows from the EU structural funds), the 4th one promises no joy. Since the profitability of Lithuanian companies has been improving, the last quarter of 2004 is likely to evidence a large outflow of dividends to foreign investors. On the other hand, the coming years should be at least by a jot luckier. Both exports of goods and services as well as transfers of income and financial support (e.g. EU structural funds) from foreign countries are expected to pick up steam. Thus, our forecast for CAD stays at 7.0% (but might go higher) in 2004, 7.0% in 2005 and 6.8% in 2006.

FDI in Lithuania gathers speed

After ill fortune in 2003, FDI has recovered this year. In the first half of 2004, the flow of FDI went up by 39.6% y-o-y, with accumulated FDI reaching LTL 14.7 billion or LTL 4260 per capita. On June 30, 2004, the manufacturing industry held 33.0% of total FDI, trade sector – 16.8%, transport and communications – 15.5% and financial intermediation – also 15.5%. Denmark, Sweden and Germany continued to be the leading foreign direct investors in Lithuania. The relative shares of FDI by those three countries accounted for 15.8%, 14.0% and 9.3%, respectively. Improving investment environment of Lithuania as well as global economic upturn ensures the necessary preconditions for further increase in FDI.

Foreign Trade Picking up the Pace

Entry to the EU brought a headache of data compatibility

After entering the EU, statisticians of all new member states have faced many tasks, first of all, related to data for foreign trade. Lithuania is not an exception. Since May 1st, 2004, collection and dissemination of foreign trade data have been essentially changed, which rings an alarm bell about the likely problem of incompatibility. Indeed, data released previously are not compatible with those announced according to Extrastat and Intrastat after May 1st. Nevertheless, Lithuanian statisticians have already put some efforts in adjusting this year's foreign trade data to the methodological and structural changes. Although foreign trade data for 2004 are not yet entirely reliable, they illustrate, at least, general trends.

Merchandise exports speed up …

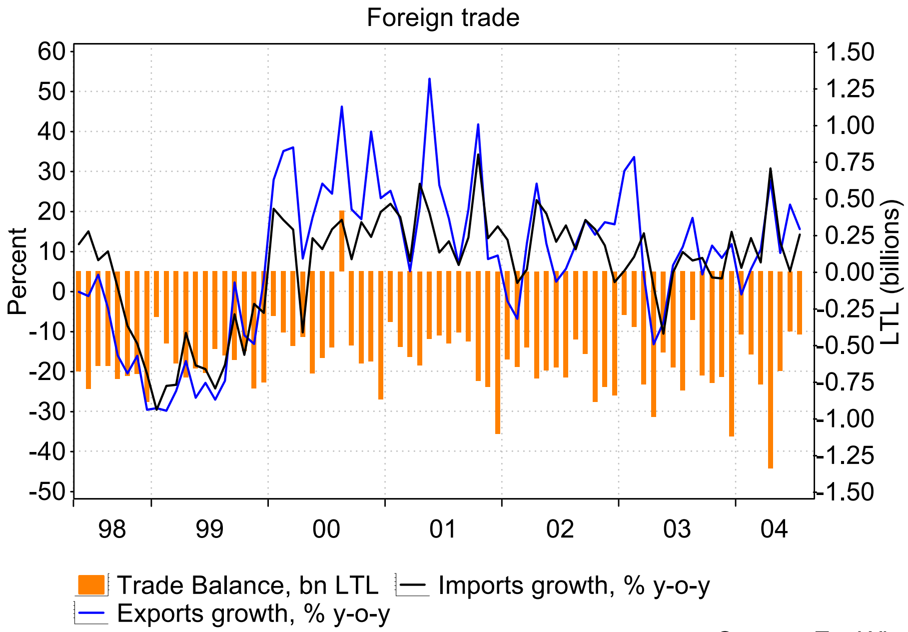
According to data released by *Statistics Lithuania*, in the first six months of 2004, merchandise exports increased by 16.2% y-o-y up to LTL 11,586 million (EUR 3,356 million) (according to Special Trade System). This was a much faster growth rate than, for example, in 2003 or 2002.

… at different rates

In the discussed period of this year, exports of fuels and metals showed the highest hikes of 41.1% and 47.7% y-o-y, respectively. This suggests that, to a large extent, export growth figures reflected the recently soaring prices of oil and metals on international markets. On the other hand, exports of other goods showed impressive growth rates apart from price factor, e.g., exports of machinery and equipment were up by 43.6%, those of agricultural and food products – by 27.3%, and those of furniture – 21.4%.

Structure of main export markets changed a bit

Mineral products continued to dominate in Lithuania's export structure. Their relative share reached 23.3% of total exports. Exports of machinery and equipment (13.0%) were in second place, those of textiles (12.7%) – in third, and those of transport vehicles (10.5%) – in fourth. In the first half of 2004, after a certain break Germany (10.2% of total exports) regained the position of main export partner, whereas ex-leader Switzerland was the second (9.7%). The EU member countries received 62.4% of total Lithuanian exports. On the imports side, Russia is still the most important import market (19.7% of total imports). Germany is hot on Russia's heels (17.6%), and Poland stays at a longer distance in third place (7.2%).



Source: EcoWin

Breaking the deflationary spell

Projections of higher prices come true

After two years of deflationary trends, in 2004 Lithuania follows the projected scenario and has stepped into the stage of inflation. In August, the consumer price index (CPI) showed a y-o-y increase of 2.2%. This was mainly the result of increased prices of food products (+5.3%), transport services (+7.1%) and health works (+9.2%).

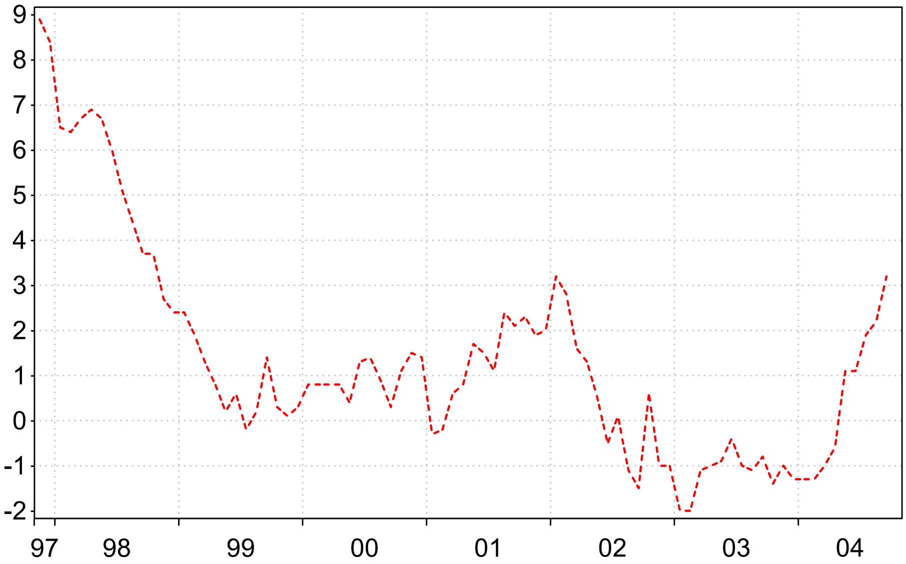
Some obvious factors have a positive effect on the CPI …

This year inflation is driven by several economic factors. The lately skyrocketed global oil prices have certainly affected the dynamics of CPI. A boost for the price level also comes from easier exports of Lithuanian products to the EU and less favorable terms of imports from certain third countries. Some products went up in price due to changes in the indirect tax (VAT, excise duties) policy, which were made as a part of EU tax harmonization. It is worth pointing out that in recent months the exchange rate of the litas relative to the US dollar has stabilized, thus losing its role as a key driver of price acceleration.

… but others work to the opposite direction

Hardly anyone would expect inflation to become an unbearable problem in Lithuania in the near future. Strong positive correlation between rising solvent demand and the CPI is not a rule for such a small and open economy as Lithuania, particularly having in mind the existing currency regime of fixed exchange rate. The price level is being pushed down by the significantly improved possibilities after entering the EU to substitute locally produced goods for cheaper imports. Labour productivity is still increasing faster than average wages in many economic sectors. Last but not least, some markets – retail trade and telecommunications – continue to be characterized by a sharp competition and are engaged in the "price war."

Lithuania, CPI growth



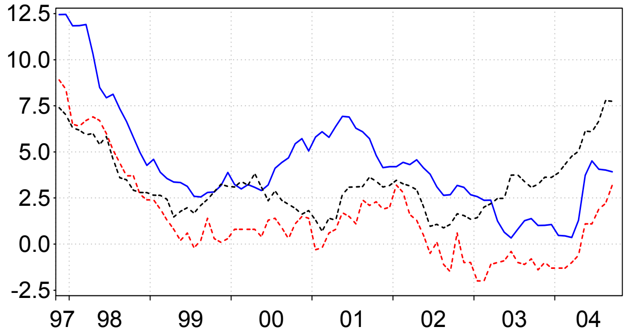
Source: EcoWin

Skyrocketing global oil prices call for forecasts' revision

Mainly due to soaring global oil prices, however, the inflation forecast for 2004 is lifted from 1.5% up to 2.4%. Gradually strengthening inflation expectations provide grounds to revise the CPI forecast for 2005 as well. In the next year the CPI is expected to show a y-o-y rise of 2.5%, instead of the previously projected 2.0%. In 2006, the price level is likely to increase at the same pace as in 2005.

Baltic states in figures
Baltic states in figures

Source: EcoWin



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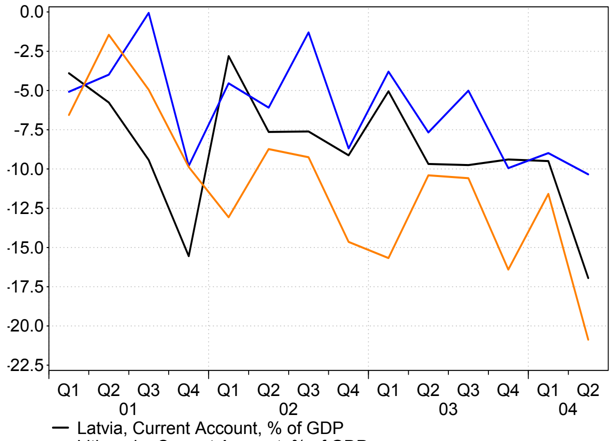

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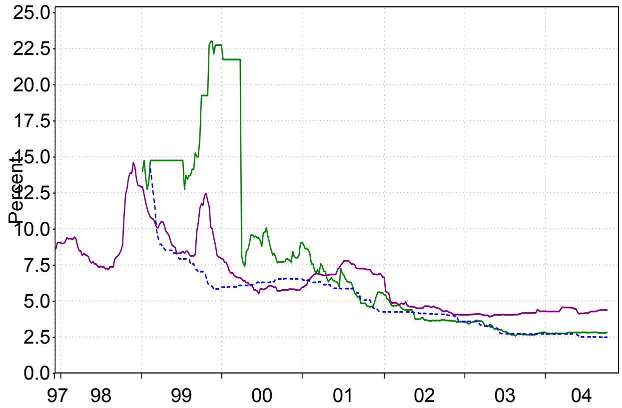

Source: EcoWin

Market and Sector Research *A/S Latvijas Unibanka* *Unicentrs, Ķekavas pagasts* *Rīgas rajons LV 1076* http://www.unibanka.lv	*Analyst: Andris Vilks* *Telephone: 7215597* e-mail: andris.vilks@unibanka.lv