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# BALTIC ECONOMIC OUTLOOK

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*Autumn 2014*

## I. Global environment: towards normalization

The global recovery can be described as multispeed. Global growth is pulled by major emerging Asian economies (China, India) and some advanced economies. The US economy is on a firm growth path.

Although US growth in the 3<sup>rd</sup> quarter decelerated to 2.3 percent y/y, the latest economic data – PMIs, consumer confidence, employment – point to continuing and probably accelerating growth. If the economic momentum is maintained, the Federal Reserve should start raising policy rate possibly already in the 1<sup>st</sup> half of next year.

The UK economy also responded to QE experimental cure and now demonstrates robust and balanced growth, driven by both private consumption and business investment. Private consumption is supported by increasing employment, lifting personal income, and improved consumer sentiment. Business investment is aided by low borrowing costs, easing credit conditions, pent-up demand for investments and robust financial position of corporates.

In Asia, Japanese economy is again stalling as the increase in VAT rate led to fallout in personal consumption. Recently the Bank of Japan increased the value of assets the bank purchases to stimulate the economy (QQE) to JPY80tr per year, which is 16.7 percent of country's GDP. The BoJ assets in the next twelve months will swell by 28 percent. The Japanese yen is in a free fall, but we have yet to see the recovery in Japanese exports.

Table 1.1 Global GDP growth forecasts

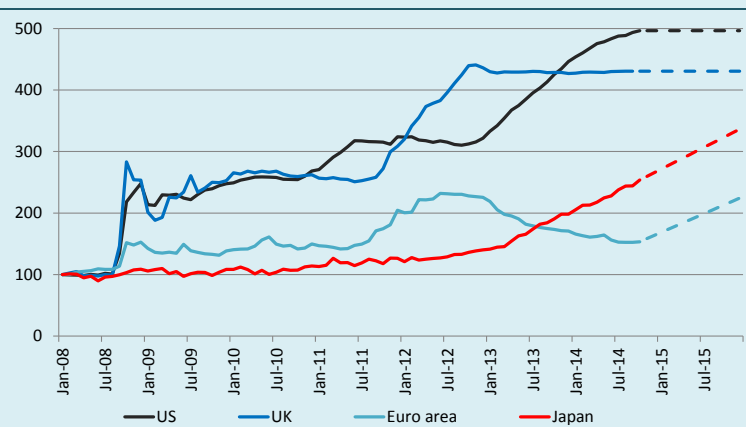
	2013	2014F	2015F
World	3.1	3.2	3.5
<i>Industrialized economies</i>	1.3	1.5	2.0
USA	2.2	2.0	3.0
Eurozone	-0.5	0.7	1.1
UK	1.7	3.0	2.5
Japan	1.5	0.9	1.0
<i>Emerging markets</i>	5.0	4.9	5.1
China	7.6	7.5	7.0
India	4.4	5.5	6.0
Brazil	2.5	1.5	2.5
Russia	1.3	0.0	-1.0
<i>Export partners</i>			
Germany	0.1	1.4	1.2
Sweden	1.5	2.0	2.4
Finland	-1.2	-0.7	0.3
Poland	1.7	2.8	3.5

Source: DNB (Norway)

Economic environment in the euro zone is fundamentally different. In the second quarter euro zone's GDP stalled and y/y growth pace declined to scant 0.7 percent. CPI inflation is stuck at 0.4 percent, far

below the central bank's target. Unemployment rate in the euro area is also persistently high at 11.5 percent, thus creating deflationary pressures. The European Central Bank (ECB) already began a fight against low inflation by cutting policy rates, establishing another credit easing program (TLTRO) and starting direct purchases of financial assets. The governor of the ECB promised that the bank will expand its balance sheet by a third to roughly EUR3tn. It remains a question how far and how fast the ECB will go, but the first result is already evident – the euro is depreciating against the US dollar and other major currencies.

Diagram 1.1 Balance sheet dynamics (2008-01=100), %



Source: Bloomberg

To a large extent the Baltic States depend on the same export markets. Russia is the largest goods export market to Lithuania and also to Latvia, and the 3rd largest to Estonia. Germany, Poland and Sweden are all important trading partners to all three Baltics. Meanwhile Finland is particularly closely linked to Estonia.

Table 1.2 Main export partners: share of total goods exports in 2013, %

	Estonia	Latvia	Lithuania	Lithuania (local origin)
Estonia	:	11.8	7.5	2.8
Latvia	10.4	:	10.0	6.4
Lithuania	5.8	15.8	:	:
Germany	4.5	6.8	7.2	14.1
United Kingdom	2.4	3.3	4.9	5.1
Poland	1.7	6.7	7.4	6.7
Finland	16.1	2.4	1.4	2.5
Sweden	16.8	4.7	3.3	7.2
Russia	11.4	16.0	19.8	7.1

Source: Eurostat, Lithuanian Statistics

Germany, the main pillar of the euro area's economy, fell into a temporary slowdown, with y/y GDP growth of just 1.2 percent in the 2<sup>nd</sup> quarter. But economic growth should pick up going forward. Recent signs in employment, retail sales and services industries are positive. Due to

healthy domestic demand, real imports should accelerate to close to 5 percent rate in 2015 according to the European Commission, making this country an attractive export target for Baltic businesses.

Recently published data points to weak German industrial performance. Germany's manufacturing output dropped by 2.1 percent y/y in August. Production of capital goods fell especially steeply by 5.4 percent. Order books shrank for the first time since June 2013. In response, manufacturers stopped hiring new workers. But depreciating euro and stable global demand may help German manufacturing to recover its previous vigor.

Macroeconomic trends in Sweden are closely followed in the Baltics. Sweden is the largest export market for Estonia and one of the largest for Latvia and Lithuania. **Sweden's GDP growth should accelerate from 2 percent this year to 2.4 percent in 2015. Rather weak external demand has been holding back manufacturing investments. However, construction investments are growing due to growing population, rising home prices and housing shortages in major cities.** Public investments are adding to growth. Going forward Sweden should face improved external environment and better prospects for exports. Growing household incomes, strong employment and low interest rates bode well for consumption and imports. According to the European Commission projections, Sweden's real imports should rise about 5 percent next year, creating opportunities for the country's trading partners.

**Lithuania and Latvia via external trade are tightly linked with Poland. Polish economy entered a temporary**

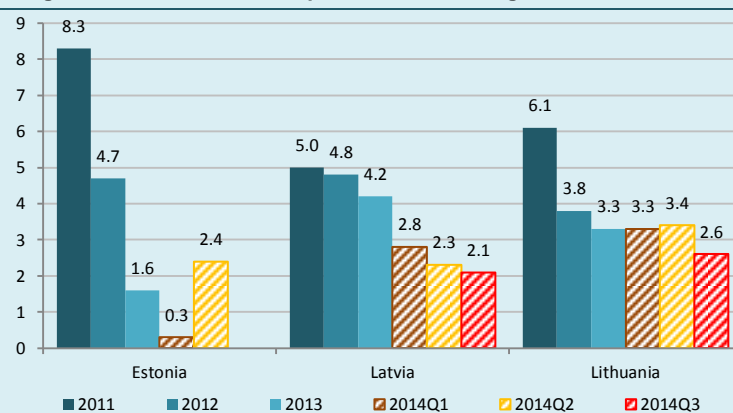
**moderation in growth in 2H 2014 due to geopolitical crisis in Ukraine and slowing euro zone.** These forces limit Poland's exports, but the effect of these factors should fade in 2015. Higher consumer confidence and employment gains should support personal consumption. The new phase of deployment of EU structural funds should spur public investments, with a pace accelerating in 2015. Thus robust domestic demand would lift real imports by around 5 percent in 2015 giving feed for the Baltic exporters to this country. Poland's GDP is expected to expand by 3.5 percent next year.

Finland is the second largest trading partner for Estonia. Moreover, many Estonians are employed in Finland, but frequently travel home and tend to spend their income back in Estonia. **Finland is still undergoing downsizing in electronics and forestry industries. Consumer and business confidence remains weak, and the economy is stagnating.** Corporate investments are held back due to weak outlook and low capacity utilization. Housing investments and consumption are also subdued as households remain cautious over uncertain economic environment. Finland was hit by Russian food trade ban, plunging ruble and general stagnation in Russia, important export market for Finnish goods. As a result, GDP growth this year will remain below zero and less than 1 percent in 2015. Imports will gain a scant 1 percent next year, thus making it a tough environment for exporters to Finland.

## II. Test for the Baltics' economic resilience

The bitter recipe of structural reforms, internal devaluation and fight for competitiveness has served the purpose in the Baltic States. All three countries savoured some years of the fastest growth in the European Union and set a good example of how rebalancing works for other problematic Member States. Driven by vibrant exports growth, all three Baltic States healed their current account imbalances and approached the sustainable stage of economic development. Productivity growth in these economies has been outpacing the growth of wages improving competitiveness. External economic boost gradually started to fuel the recovery of domestic demand and the growth model became more balanced.

Diagram 2.1 GDP at constant prices, annual change, %



Source: Eurostat, national statistics offices.

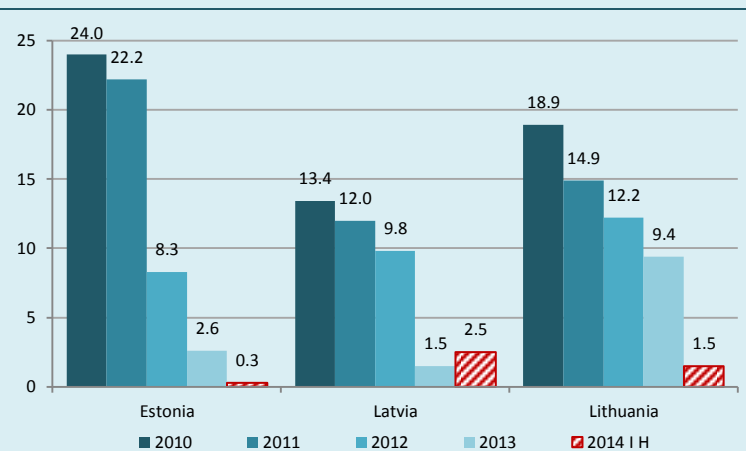
Such economic performance helped the Baltics to climb further the convergence ladder despite the recent boom-bust roller-coaster. Lithuanian gross domestic product per capita in Purchasing Power Standards surged from 64 percent of the EU average in 2008 up to 74 percent last year, in the meantime Latvian indicator mounted by 9 percentage points up to 67 percent and Estonian – by 4 percentage points up to 69 percent.

However, being small open economies the Baltics are tightly dependant on the development of their key exports markets and vulnerable to the external challenges. The exports driver started losing momentum last year due to the slack coming from both the West and Russia. As a result, GDP growth in the Baltics has moderated significantly with more pronounced slowdown in Estonia.

Baltics were directly hit by Russia's import ban on major food products, announced on August-6<sup>th</sup>. In addition, many other major export markets remain sluggish, thus creating another headwind for the region's exporters.

The Baltic economies share many same economic growth drivers: EU support, demographic and labor trends, external trade links.

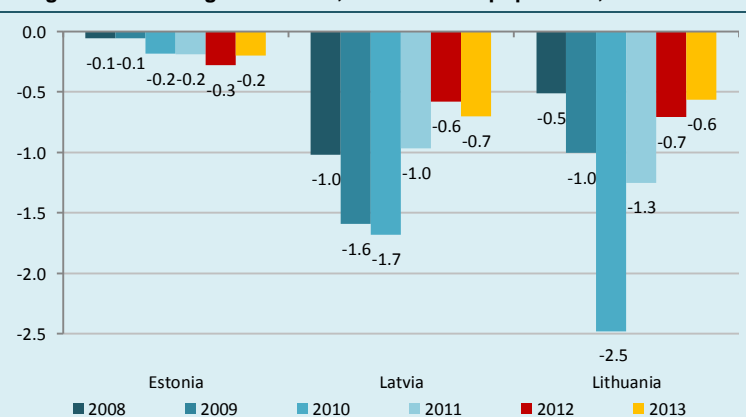
Diagram 2.2 Exports of goods and services, annual change, %



Source: Eurostat, national statistics offices.

The EU structural funds support many similar projects in the Baltics and drive public and private investments. The new wave of EU funds started this year. Total allocations from the European Structural and Investment Funds (ESIF) for 2014-2020 are: €4,42bn for Estonia, €5.62bn for Latvia and €8.5bn for Lithuania. This equals to about 24 percent of each country's 2013 GDP. The largest allocations from the ESIF are to the assistance for less developed regions, rural development and to the Cohesion Fund, which earmarks funds mainly for the construction of transport networks. These programs take time to launch and gain pace and we expect more substantial contribution to economic growth in 2015 and 2016. Notably the transitional pause in the EU-funded programs is restraining growth this year.

Diagram 2.3 Net migration flows, share of total population, %



Source: Eurostat, national statistics offices.

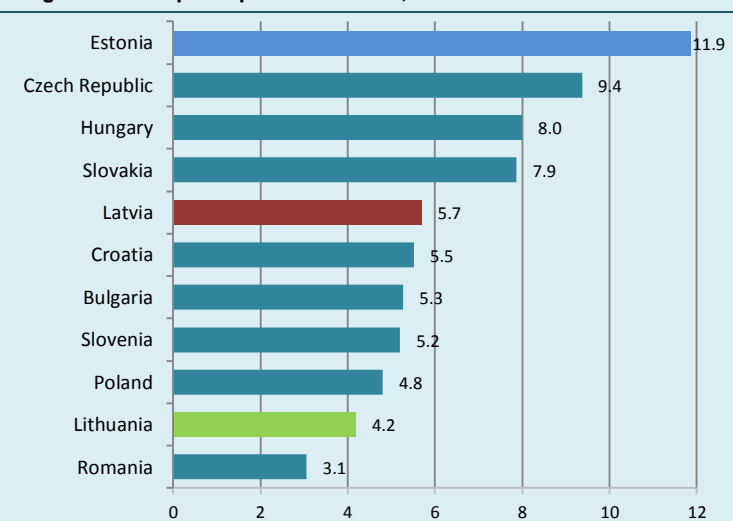
Emigration remains a problem in Latvia and Lithuania, less so in Estonia. Since 2008 every year on average net about 1.1 percent of population emigrated from Latvia and Lithuania. The emigration peak was reached in 2010. Since then the emigration flows are gradually abating. Moreover, more citizens are increasingly returning to the Baltics. In Lithuania, 22K persons immigrated in 2013, 0.74 percent of

population and the largest number when historical data is available. Surprisingly, negative migration has some positive effects on the economy. First of all, emigrants are sending money home and many buy properties in the home countries. In Lithuania in the last twelve months net personal transfers to the country made LTL 3.5bn or 2.8 percent of GDP. Such money inflows have a considerable positive effect on the recipient country's current account and domestic demand.

**Emigration and negative population growth lead to declining labor force.** Since the Q4 2008 economically active population declined by 4.7 percent in Estonia, by 3.9 percent in Lithuania and by 12.8 percent in Latvia. Lithuania's active population decreased less comparing to the one of the Baltic peers due to the improvement in labor participation rate from 69 to 74 percent since Q4 2008. Meanwhile Latvia's and Estonia's labor participation rate changed by +0.6 and -1.2 percentage points. The exceptional fall in the active population in Latvia was also due to particularly sharp bust in the housing and real estate bubble.

**Another effect of shrinking labor supply is a shortage of skilled and qualified labor. Thus despite still elevated unemployment, wage pressures started to emerge.** In Q2 2014 the annual growth in wages was 6.4 percent in Latvia, 4.6 percent in Lithuania, and 4.8 percent in Estonia. Wages in the Baltics remain one of the lowest among the EU Member States, thus to some extent wage growth is supported by the convergence factor. Besides, higher wage growth is backing household disposable income and personal consumption. So far personal consumption remains a major contributor to overall economic growth in the Baltics: the European Commission projects this year consumption to grow at 3.6 percent in Latvia and Estonia, and at 3.9 percent in Lithuania.

**Diagram 2.4 FDI per capita in Dec-2013, EUR thousands**



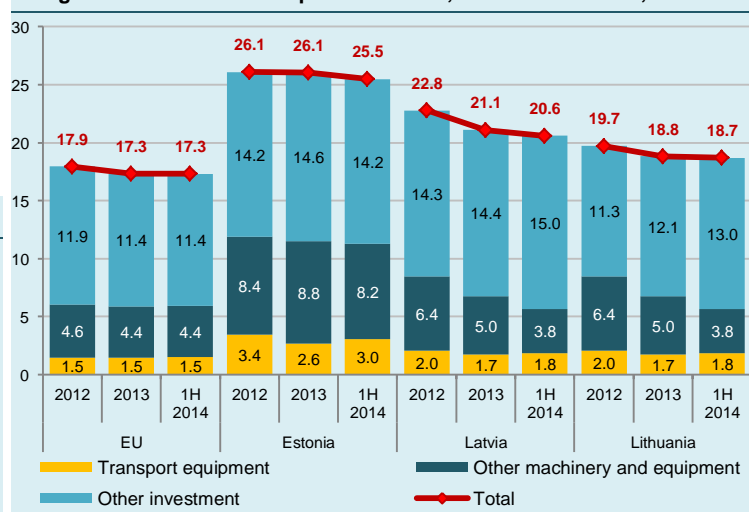
Source: Eurostat, national statistics offices.

**The adoption of the euro is a major milestone for all the Baltic States.** Estonia entered the euro zone in Jan-2011,

Latvia – in Jan-2014 and Lithuania is set to join the euro zone in Jan-2015. Inward foreign direct investments data on Latvia and Estonia indicate increased FDI inflows in the first and the second year preceding the euro adoption. Mere compliance with the Maastricht criteria and anticipation of the euro attracts foreign investors. **Lithuania recorded net FDI outflows this year due to the state's purchases of stakes in Lithuanian infrastructure companies Lesto, Amber Grid and Lietuvos Dujos from Gazprom and E.ON.** Yet academic research concludes that the euro adoption helps to entice foreign direct investments to the new member. So far Lithuania's FDI per capita is one of the lowest among CEE peers.

**Year-on-year investment growth rates were slightly negative in Latvia and Estonia in the last available quarter after exceptionally strong advance in 2011 and 2012. Lithuanian investment cycle is lagging the cycle of other Baltic peers** – in Q2 annual investments growth rate in Lithuania was still solid 8 percent. Yet the near-term outlook for investments in the Baltics is less certain due to adversities with Russia. It is normal for businesses to respond to uncertainty by cutting down on investments. Transport equipment, making slightly more than 10 percent of total investments in the Baltics, is likely to be suspended first. Longer-term investment in the Baltics should gradually pick up and rise in line with the economic growth. Lithuania's investments to GDP ratio remains the lowest among other Baltic states, while Estonia historically has high investment rates.

**Diagram 2.5 Gross fixed capital formation, as a share of GDP, %**



Source: Eurostat

Real estate sector has picked up in the Baltics. In Q2 home prices over the year surged 14.5 percent in Estonia, increased 8.2 percent in Latvia and 6.5 percent in Lithuania. **Rising wages and households purchasing power as well as positive economic sentiment was fueling dwelling prices in early 2014. However, the latest signs are that the supply of dwellings in residential real estate sector is rising and prices are stabilizing.** Estonia is particularly at risk of overinvestment, as in 1H 2014 dwelling investment

as a share of GDP reached 3.7 percent, almost double the respective share recorded in Latvia and Lithuania. Yet majority of dwellings in Estonia are sold out prior to the launch of new project's construction phase. This factor diminishes the risk of housing oversupply. In Lithuania housing market, measured by the number of transactions, was also very active in Q1 and Q2. Yet the activity diminished in the 2<sup>nd</sup> half of this year. Housing prices remain well below the peak levels recorded before the 2008 downturn. In Latvia prices are 34 percent below the Q1 2008 level, in Lithuania – 25 percent, and in Estonia – 10 percent.

Estonian government deficit to GDP is set to rise modestly to 0.6 percent in 2015. The public wage bill is expected to grow by more than 5 percent. Pensions are planned to increase by around 6 percent. Child benefits are set to roughly double. Labor and capital taxes will also be eased in 2015. **Yet the government expects to raise more funds from state-owned enterprises and by further increasing indirect taxes. Government debt to GDP should stay below 10 percent.**

**Latvia will gradually reduce personal income tax rate from current 24 percent to 22 percent in 2016.** In 2015 government will collect less dividends from state-owned enterprises as more profits will be retained for business investments. The government will implement pension indexation, increase child benefits and compensation of electricity costs to the poor. Deficit to GDP should stay at around 1 percent in 2015. Latvia has built significant cash reserve, which will be paid out in 2015 to cover debt to the EU. After that, debt to GDP will move below 36 percent to GDP in 2015.

In Lithuania the reclassification of deposit insurance fund to the general government increased deficit in 2013, as compensations were paid to failed Utkio Bankas depositors. This fund should reduce budget deficit in 2014 and likely going forward assuming no further incidents in the Lithuanian banking sector. The deficit in 2015 is expected to rise moderately due to higher government spending, particularly in the agriculture, environment and public defense sectors. Higher spending for the environment is due to housing renovation program, which is co-financed by the EU. Meanwhile the budget which the Ministry of Finance presented to the Parliament relies on optimistic income projections. Thus actual budget deficit in 2015 may exceed Ministry's projections.

**We revised our economic forecasts for the Baltic States. For Year 2015 GDP growth estimate for Lithuania was lowered from 3 to 2.6 percent, for Latvia – from 3 to 2.5 percent, for Estonia – from 2.5 to 2 percent. Baltic countries are facing uncertain external environment due to Russia's confrontation with the West. This risk is putting pressure on business confidence and investment. Household's economic sentiment and consumption growth will moderate, yet will remain supportive for growth.** Construction activity will gradually slow down from bustle seen in the 1<sup>st</sup> half of 2014. Next year will be a testing time for the Baltics economic resilience. But growth should recover in 2016 as external headwinds subside and regained competitiveness push the economies forward.

**Table 2.1 Macroeconomic forecasts**

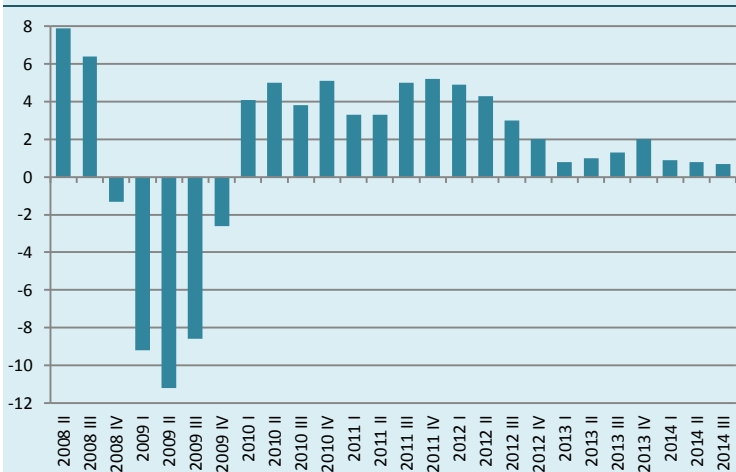
	Lithuania			Latvia			Estonia		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
Real GDP, annual change, %	2.8	2.6	3.0	2.4	2.5	3.5	1.7	2.0	3.0
Average annual inflation, %	0.2	1.2	2.0	0.8	1.5	2.0	0.7	1.5	2.0
Average gross monthly earnings, annual change, eop, %	4.5	4.0	5.0	6.0	4.0	5.0	4.0	3.0	4.5
Unemployment rate, eop, %	11.0	10.0	9.5	10.5	9.0	8.5	7.3	6.5	6.0
General government budget balance, ratio to GDP, %	-1.5	-1.8	-1.0	-1.0	-1.0	-0.5	-0.4	-0.4	-0.4
Current account balance, ratio to GDP, %	0.7	-0.5	-2.0	-3.0	-2.0	-3.0	-2.0	-2.5	-2.5

Source: DNB

### III. Russia is hiding behind aggressor's facade

**Russia's economy is rolling downhill, despite industry maintaining moderate dynamics.** Real GDP was marginally up y/y at 0.7 percent in Q3. Industrial production ticked up by 2.8 percent y/y in August and manufacturing PMI is holding above 50 threshold for a few months already. Unemployment rate remains at impressively low level of 4.9 percent.

Diagram 3.1 Russia's real GDP, annual change, %



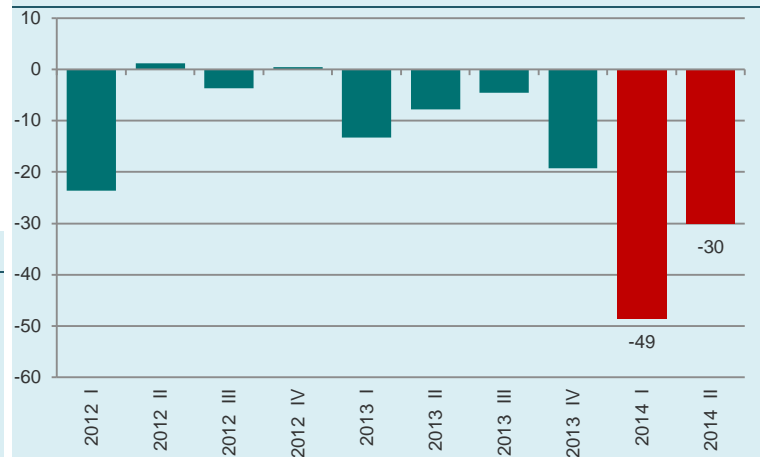
Source: Bloomberg

Yet other economic details are less encouraging. In the 2<sup>nd</sup> quarter the main driver for positive GDP growth was shrinking imports, while **business investment, the barometer of economic health, was down 2.1 percent y/y, the second consecutive quarter of negative growth.** Personal consumption, for extended time a major positive contributor to growth, in Q2 decelerated sharply to just 0.8 percent y/y rate. Inflation is trending higher, pulled by weak currency and wide structural supply constraints in the economy. In October the reported CPI y/y rate was 8.3 percent, well above the central bank's target 5 percent. Moreover, food inflation spiked to 11.4 percent to a large extent due to the Russia's food import ban imposed early in August. This inflation affects the most the poor, who spend larger share of their budgets on necessities.

**Underperforming and depressed equity markets, steadily depreciating ruble and tumbling foreign reserves all indicate that foreign investors are giving up on Russia.** The roots of Russian economic problems are clearly not only local governance, but also destructive foreign policy and the war with Ukraine.

**Russia faces another external headwind – lower oil prices.** Two thirds of all Russia's visible exports are oil and gas. Yet the impact from low oil prices on country's finances is mitigated by the falling ruble, which cushions collection of oil tax revenues in rubles and limits the budget deficit. Yet another burden on state finances is expanding military spending – 20 percent of public spending goes to the military modernization.

Diagram 3.2 Russia's financial account flows, \$ bn



Source: Bloomberg

The war with Ukraine, confrontation with the West and lower oil prices have a heavy economic toll. Yet at this moment wide public is lulled by carefully drafted internal propaganda, and we sadly do not see the prospects of change in government action. Thus the economic outlook for Russia remains clouded and wide economic difficulties should persist.

#### Baltics exposure to Russia

Baltics have close trading ties with Russia. In 2013 Russia was the largest destination of exported goods for Lithuania (19.8 percent of total goods exports) and for Latvia (16 percent of total goods exports), and the third largest destination of exported good for Estonia (11.4 percent of total goods exports). **The trading climate became much less predictable in 2014 as Russia started assault on Ukraine, the EU initiated economic sanctions on Russia and Russia retaliated with food import ban in early August.**

Food is one of the main commodities exported to Russia. Russia banned from the EU imports of fish, meat, dairy, vegetables and fruits. Banned products made 4 percent of total goods exports in Lithuania in 1H 2014. However, banned products of Lithuanian origin made only 0,9 percent of total goods exports. In Latvia the same share of banned products to Russia made 1 percent, in Estonia – 0.4 percent.

**The Baltic food sector took a hit from Russia. Moreover, early indicators show that food companies are readjusting by directing products banned in Russia to new markets or manage to sneak back into the Russian market. Temporary state support will also help these companies and farmers to live on.**

**An important question now is will the rest of Russian economy stays open for trade. Baltic businesses are facing increased risk and uncertainty in Russia. The right approach is continue working in this market while preparing for the worse.**

## This report was prepared by DNB Economic Research Department



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