
# BALTIC ECONOMIC OUTLOOK

*Spring 2014*

DNB

## Growth in the Baltics to moderate due to external adversities

**The Baltics have been crowning the EU ranking according to the economic growth every year starting with 2011.** Over a span of 2010-2013 Estonia's average annual GDP growth stood at 4.2 percent, Lithuania's and Latvia's – at 3.7 and 3.3 percent respectively. Successful path of internal devaluation, regained competitiveness and strong performance of exports made "the Baltic tigers" to be reborn and to restore economies back to the levels seen before the crisis.

**However, Estonia's economic engine started running out of steam last year.** The economy inched up by meagre 0.8 percent in 2013 and saw a contraction of 1.9 percent y/y in the 1st quarter of this year. The main contributors supporting Estonia's economy were domestic trade, manufacturing and IT sector. Meanwhile, transport, real estate activities, energy sector and weaker performance of exports dragged country's GDP growth to the negative zone. However, the new wave of structural funds and recovering Western markets are seen to propel the country from the temporary stasis. Meanwhile, **the other two Baltic States sustained the growth pace.** Latvia has benefited strongly from the positive sentiment entailed by the preparation for the currency changeover. That added fuel to the country's domestic demand. There are no objective obstacles left for the euro introduction in Lithuania as the country fits the Maastricht criteria comfortably. The country is seen to bridge the output gap this year already meaning that it will start growing at a potential rate again. Lithuanian and Latvian businesses in the past demonstrated exceptional skills in navigating through the external challenges thrown down by the neighbouring Russia. Weaker exports were gradually compensated by the more vivid domestic demand.

However, now **the external environment does not let the Baltics to savour the moment and remains more challenging than ever. Russian economy, one of the core markets for the Baltic exports, chokes despite sweating at maximum capacity.** Apparently, **Russia** has hit its production possibility frontier and the nature of its stagnant performance is structural, not cyclical. The combination of high capital utilisation and the record low unemployment rate at roughly 5 percent produces almost no growth. Supply side is weak and uncompetitive, capital base cries for renewal, employment growth potential is almost exhausted and the shortage of high-quality labour force is evident. Meanwhile, the foreign capital flight and fall in capital investment provide no hope for any positive changes possible in the short or even medium run. Russian-Ukrainian conflict made Russia's macroeconomic problems even more painful. Capital leaving the country amounted to nearly USD50bn in the 1st quarter this year – more than throughout full last year and nearly as much as the costs of the strikingly expensive Sochi Olympics. All these factors translated into the staggering slide of Russia's stock indices and substantial depreciation of the rouble. We believe that rouble will stay weak throughout the year. That affects the Baltics most, as their exports of goods and services become much less attractive comparing to the domestic alternatives in Russia. The Central Bank of Russia struggled to protect the currency by hiking interest rates. However, its room for manoeuvre is very limited due to the combination of mounting inflation (at 7.3 percent in April) and recessionary economy. DNB Markets expect[1] Russia to stagnate at zero this year and to inch up only by 1.5 percent in 2015. Therefore, the best recipe for the Baltics will be to take the opportunity to reduce the reliance on this market.

Meanwhile, **the euro area started its gradual recovery last year.** While annual GDP change in all euro area has still been negative (-0.4 percent), the core economies demonstrated growth. **German economy**, the flagship of the euro area and another major exports market for the Baltics, was rather sluggish last year. German GDP twitched by 0.4 percent. However, rising Markit Composite PMI (at 56 in April) points to much more vibrant industrial and services sectors, setting expectations for higher GDP growth this year.

Even some peripheral economies showed early signs of recovery. The favourable market's sentiment has been dragging peripheral yields to the record lows in years providing these countries with opportunity to improve their fiscal stance. However, the region's economies still remain fragile. The unemployment rate has stuck at close to 12 percent in the euro area, with Greece and Spain taking the outsiders' lead at 27 and 25 percent respectively. The youth unemployment also remains elevated at 24 percent. **The euro area's economic activity is held back by the heavy fiscal debt burden, high structural unemployment, questionable competitiveness, low capital investment and, on the top, the strong euro.** Historically high euro area's current account surplus at 2.3 percent of GDP and much more expansionary monetary policies abroad has not let the euro to depreciate. That put the downward pressure on inflation, which sank far below the ECB's target of 2 percent. We believe that the euro vs. the dollar should ultimately depreciate given the foreseen ECB's efforts to restore inflation to the target levels, strong US economic performance and more "hawkish" posture of the Federal Reserve.

**According to DNB Markets forecasts, the US economy should gather the pace of 2.7 percent this year. This will give additional feed for the economic performance of Germany and the Nordics.** Due to improved external conditions and strong domestic demand the latter region (excluding Finland) will grow much faster than in 2013. **Swedish** economy, driven by the households consumption, strong pick-up in services and gradual manufacturing recovery, should grow by 2.8 percent in 2014. **Norway** and **Denmark** are seen to expand at a more moderate pace of 2 and 1.5 percent. Meanwhile, **Finnish** economy will slowly climb from two-year recession in 2014. Country's manufacturing sector is undergoing critical structural changes mainly due to the fallout in electronics industry. However, this painful stage is well advanced and the European Commission expects the country to perform better this year.

The perspectives of Lithuania's neighbour **Poland** has also improved. European Commission expects the country to expand by 3.2 percent in 2014, i.e. twice faster than last year, and to accelerate further to 3.4 percent in 2015. **The key interest rates at record lows, recovering credit supply, favourable performance of exports and gradual upturn in both private and public investments fuelled by the EU funds are paving the way for solid growth in Poland despite the geopolitical tensions in the country's neighbourhood.**

**Table 1**
**Global macroeconomic forecasts**

| | 2013 | 2014F | 2015F |
|---|---|---|---|
| **World** | **3.0** | **3.5** | **3.7** |
| ***Industrialized economies*** | ***1.0*** | ***1.9*** | ***2.0*** |
| USA | 1.9 | 2.7 | 3.0 |
| Eurozone | -0.5 | 1.3 | 1.5 |
| UK | 1.8 | 2.8 | 2.5 |
| Japan | 1.5 | 1.2 | 0.8 |
| ***Emerging markets*** | 4.9 | 5.1 | 5.4 |
| China | 7.7 | 7.3 | 7.0 |
| India | 4.4 | 5.0 | 6.0 |
| Brazil | 2.3 | 2.5 | 3.0 |
| Russia | 1.3 | 0.0 | 1.5 |
| ***Exports partners*** | | | |
| Germany* | 0.4 | 1.8 | 2.0 |
| Sweden | 1.5 | 2.8 | 2.2 |
| Finland* | -1.4 | 0.2 | 1.0 |
| Poland* | 1.6 | 3.2 | 3.4 |

Source: DNB Markets (NO), *EC forecasts for Germany, Finland and Poland.

[1] The overview is based on DNB Markets (Oslo) forecasts, excluding those for Denmark, Finland and Poland. For these countries the forecasts of the European Commission were cited (http://ec.europa.eu/economy_finance/eu/forecasts/2014_spring_forecast_en.htm).

# LITHUANIA managed to start the domestic demand engine eventually

- **Lithuania's economy stands on a strong macroeconomic fundament**
- **Despite a few stalling sectors, both domestic and external drivers add strongly to GDP growth**
- **Lithuania fits Maastricht criteria comfortably and paves the way to euro introduction in 2015**
- **Real estate and construction ride is somewhat euphoric and should slow down**
- **The geopolitical risks do not let the country to secure sustainable momentum**

**Lithuania is expected to bridge the output gap this year already and should start growing at its potential rate again.** Such performance is driven by both externally oriented growth engines and the strong rebound in domestic demand. Household consumption has strengthened in Lithuania due to restored pulse of the labour market, improving consumer confidence and fading inflation. In April harmonised consumer price index was only 0.3 percent higher than a year ago and the average annual inflation stood at 0.6 percent, 2.1 percentage points below the level seen in April, 2013. This result fits comfortably below the respective Maastricht criterion. Fiscal deficit at only 2.2 percent and gross public debt at 39.4 percent of GDP also satisfy respective Maastricht criteria with a safe margin, while long term interest rates at 3.6 percent are also well below the expected threshold of estimated 5.4 percent. **Thus Lithuania is seen to satisfy objective criteria and is likely to pass the euro test, however the debate on the structural nature of country's fiscal imbalances still persists.**

The annual value added created in Lithuania expanded by 3.3 percent last year. In the beginning of 2014 the pace was sustained at 3.1 percent. **Gross fixed capital formation was the key growth driver again**, surging by 10.3 percent in 2013 thanks to the rebound in construction activity and growing business propensity to invest. The investments in transport, machinery and equipment ratio to GDP increased by a percentage point up to 6.3 percent. This sort of investments is particularly important for the economy, as it drives modernisation and sets the stage for more efficient growth in the future. This trend will be sustained throughout 2014 due to a new wave of the EU co-funded projects and improving business sentiment. Stronger domestic demand will further support firm imports growth.

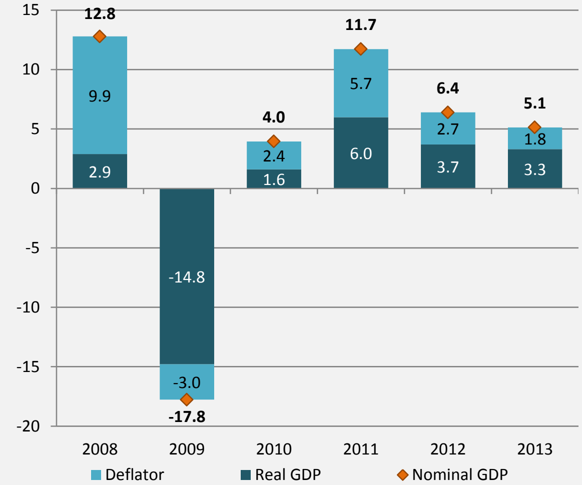
**Labour market conditions have been improving gradually.** The seasonally adjusted unemployment rate shrank down to 11 percent at the end of last year from 13 percent a year ago and approached the respective average of the EU. Wage growth accelerated last year due to growing demand for labour, emerging skill mismatch and minimum wage hike. The average gross wage increased by 4.8 percent y/y and is expected to rise further in the coming years.

**Lithuania stands on a strong macroeconomic footing again, however as a small and open economy the country is vulnerable to external challenges.** Tight economic links with Russia make Lithuania the first target for the geopolitical spillover effects from the conflict between Russia and Ukraine. Russia is the major export market for Lithuanian goods, services and re-exports. Russia was the 3rd largest market for the goods of Lithuanian origin last year receiving 7.1 percent of total exported products made in Lithuania. Raw meat exporters, manufacturers of dairy, meat products, machinery and equipment, means of transport, wood, plastic, rubber and chemicals are the most exposed to the threats from the East. Russia is even more important for Lithuanian service sectors. Lithuania's service exports to Russia made 25 percent of total last year. The two largest categories of service exports to Russia were travel and land transportation accounting for 24 percent and 66 percent accordingly. Land transportation services feed strongly on Lithuania's re-exports to this huge market in the East. Lithuania has been one of the key corridors for the western good flows to Russia, therefore re-exports to this country made up to 43 percent of total Lithuania's re-exports in 2013.

**The 2nd channel, through which Lithuania's economy could be torpedoed by the eastern neighbour is energy dependence.** At the moment Lithuania has no alternatives for Russia's gas. However, due to the mild winter the country has accumulated natural gas reserves sufficient for 30 days of domestic consumption. Moreover, Lithuania is constructing own LNG import terminal. The terminal will start operations at the end of this year. What concerns electricity, Lithuania has enough electricity production capacity of its own, yet local production is relatively expensive and uncompetitive. **All in all, we believe that Russia will not use this joker in this geopolitical poker, as Russia is strongly dependent on energy exports itself.**

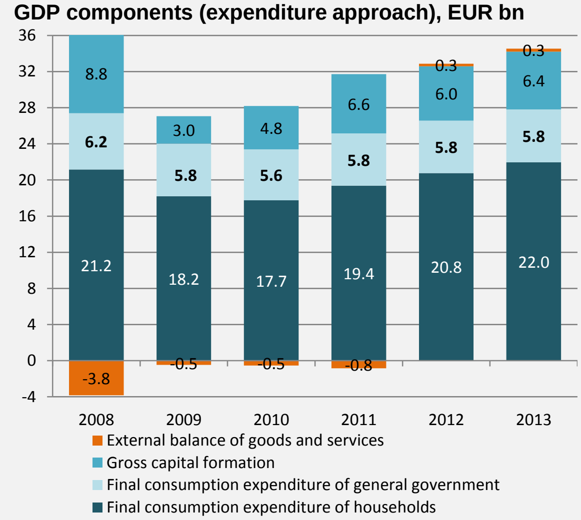
**Lithuania's industry, the main country's exporter, had a weak start of this year.** A drag came from electricity, gas and heating supply economic activity due to unusually warm winter. It dropped by 15.2 percent y/y in the 1st quarter of 2014. Moreover, after growing by 4.7 percent y/y in 2013, manufacturing production shrank by 6.5 percent y/y in the first quarter of 2014. The weakness came mainly from two production sub-sectors – the manufacture of chemical products (i.e.

**Diagram 1**
**GDP, annual change, %**



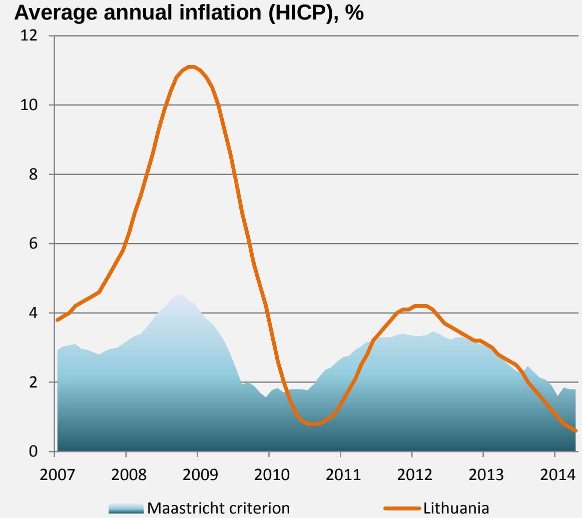

Source: Eurostat

**Diagram 2**
**GDP components (expenditure approach), EUR bn**




Source: Eurostat

**Diagram 3**
**Average annual inflation (HICP), %**




Source: Eurostat

fertilisers) and refined petroleum products. The leading producer of nitrogen fertilisers in Lithuania Achema had a challenging year due to a combination of factors. The prices of fertilisers in the international markets dropped significantly last year due to the cartel collapse between giant Russian and Belarussian fertiliser producers. Secondly, Achema failed to achieve favourable natural gas price in its bilateral negotiations with Russia's Gazprom. These factors curtailed company's performance drastically. Another Lithuanian manufacturing flagman Orlen Lietuva has been facing strong headwinds as well. Decreasing global demand for refined oil products, growing efficiency of transport equipment, wider variety of fuel alternatives and challenging competition with modern oil refineries from Asia thinned margins for European oil refineries considerably. Around 25 oil refineries have been closed in Europe since 2009, another 10 are seen to go bust in five years[2]. Excluding the latter sub-sector, manufacturing output increased by 9 percent y/y in the 1st quarter of 2014.

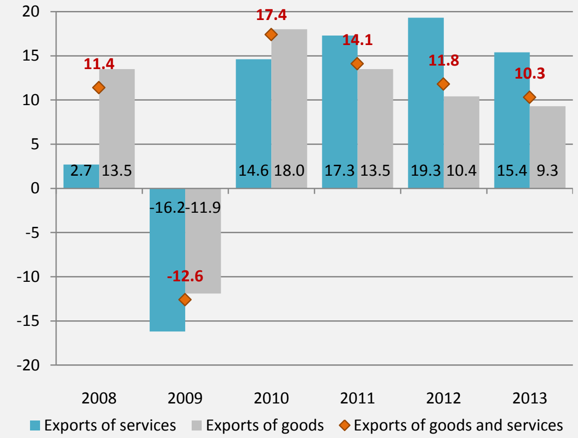
Results in the industry were reflected by the respective trend in exports. In January–March 2014, exports of Lithuanian origin goods dropped by a fifth y/y. The main reason for this was a decrease in exports of petroleum products (by 47 percent), ground vehicles (by 26 percent) and fertilisers (by 24 percent)[3]. Exports of goods of Lithuanian origin excluding mineral products decreased by 2 percent y/y. Geographic breakdown shows, that in the 1st quarter exports of Lithuanian origin to Russia decreased by 3 percent y/y, of which exports of dairy products grew by 6 percent y/y. Lithuanian exports to Ukraine decreased by 24 percent y/y. **Lithuania from time to time faces only familiar Russia's administrative restrictions for food imports. Yet now the competitiveness of Lithuanian goods deteriorated sharply in Russia due to the strong depreciation of Russian rouble.**

**Despite the ameliorating macroeconomic fundamentals, the crediting process in Lithuania remained weak.** After the short recovery in the 1st half of last year, the outstanding amount of loans granted to households proceeded to drop further and in March this year was 0.4 percent lower than a year ago. The loan portfolio to non-financial corporations shrank even more (by 3.4 percent y/y). Consequently, the indebtedness of private sector measured as loans to GDP ratio decreased to 43.3 percent at the end of 2013 from 46.5 percent a year ago. Meanwhile, deposits in Lithuania's banks reached historical height at nearly LTL44bn or 37 percent of GDP. Economic crisis taught both companies and households to live according to their means. The deposits in the banking system surged on the back of increased propensity to save and the lack of trustworthy investment alternatives after the financial market meltdown and the collapse of the real estate bubble in Lithuania. The overall soundness of Lithuania's banking system is improving. The loan-to-deposit ratio decreased to 120 percent in March, 2014 from 130 percent a year ago pointing to lower dependence on the external financing. The capital adequacy ratio at 17.6 percent remained well above required 8 percent benchmark and the share of non-performing loans has improved to 11 percent at the end of last year from 14 percent a year ago.

In the beginning of this year the housing market activity reached pre-crisis levels. The number of real estate transactions soared by 43 percent y/y in the first quarter and was above 10K. Such housing market's performance in Lithuania was observed in 2006-2007 when the housing bubble was almost ripe to burst. The likely euro introduction is the key among the underlying reasons for this spike. **Expectations of higher real estate prices after joining the euro area motivate people to buy real estate now. Additional impulse comes from the efforts to "launder" shadow money via real estate market before the currency changeover.**

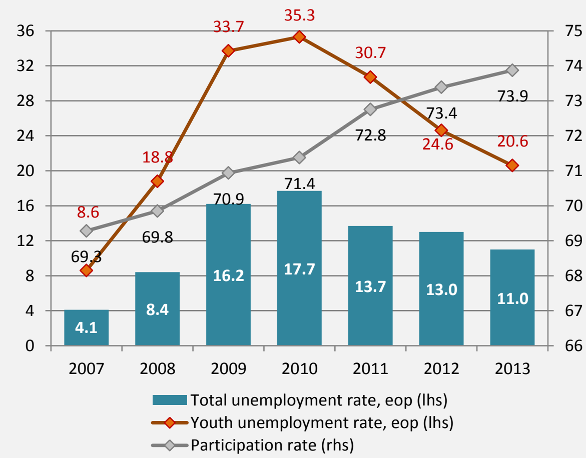
**To sum up, after a rough rebalancing phase Lithuania's economy eventually stands on a strong macroeconomic footing. Domestic demand is playing an increasing role in the country's output, while the majority of exporting industries perform robustly. This ameliorates the prospects of the labour market and consumers' sentiment. However, geopolitical uncertainty and persisting sluggish performance of the western markets do not let Lithuania's businesses and households to savour the moment of respite. We believe the country's economy will grow by 3 percent this year, 0.5 percentage points below our estimate in the Autumn 2013 Baltic Economic Outlook. The downgrade came mainly due to the negative spillover effects from Russia's macroeconomic stasis and the potential impact of its conflict with Ukraine. The transition period for Lithuania's businesses in search for alternative export markets could be bumpy and protracted. We expect a gradual economy's acceleration to 4 percent growth in the second half of next year. However, the overall annual growth should not exceed 3 percent given the expected reduction in the absorption of EU funds, external risks from the East and possible normalization in global monetary policies.**

**Diagram 4**
**Exports of goods and services, annual change, %**



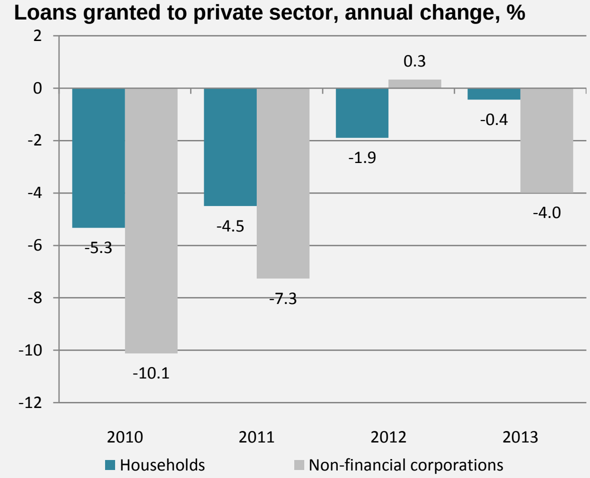

Source: Eurostat

**Diagram 5**
**Labour market indicators, %**




Source: Eurostat

**Diagram 6**
**Loans granted to private sector, annual change, %**




Source: Eurostat

**Table 1**
**Macroeconomic forecasts, %**

| | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|
| Real GDP, annual change | 3.3 | 3.0 | 3.0 | 4.0 |
| Average annual inflation | 1.2 | 0.7 | 1.7 | 2.5 |
| Average gross monthly earnings, annual change, eop | 4.8 | 4.0 | 4.0 | 5.0 |
| Unemployment rate, eop | 11.0 | 10.5 | 10.0 | 9.0 |
| General government budget balance, ratio to GDP | -2.2 | -2.0 | -1.7 | -1.5 |
| Current account balance, ratio to GDP | 1.5 | -0.5 | -1.5 | -2.0 |

Eop- end of period

Source: DNB

[2] "Oil refinery in Mažeikiai faces rough times" by A. Czyżewskis in "Verslo žinios" 2014-05-15
[3] Including re-exports.

# ESTONIA: a temporary pause and more moderate growth outlook

- **External and local factors drove economic growth below zero in Q1**
- **The drought in EU-funded projects to end towards the end of the year**
- **Given no change in banks' lending policies, private investments will pick up slowly**
- **Household consumption and housing market to remain robust**
- **Inflation to remain low, while employment growth will shift to lower gear**

Last year Estonian economic growth slowed to just 0.8 percent. The slowdown was generally attributable to reduction in net exports and lower public investment. In the 1st quarter of this year the country's GDP even declined by 1.9 percent y/y. A number of factors caused negative growth in Q1. Export markets remained weak. **One headwind to better export performance is shrinking revenues from oil transit to Russia, as oil volumes are increasingly diverted to the newly built Ust-Luga port in Russia. In addition, winter in Estonia was unusually mild, thus reducing demand for heating. Finally, in the 1st quarter Estonia opened electricity link with Finland EstLink 2.** Cheaper electricity imports from Finland reduced local electricity generation. Weather factor should fade in the future. Yet other factors are more structural and will remain longer, thus moderating economic growth in 2014 and 2015.

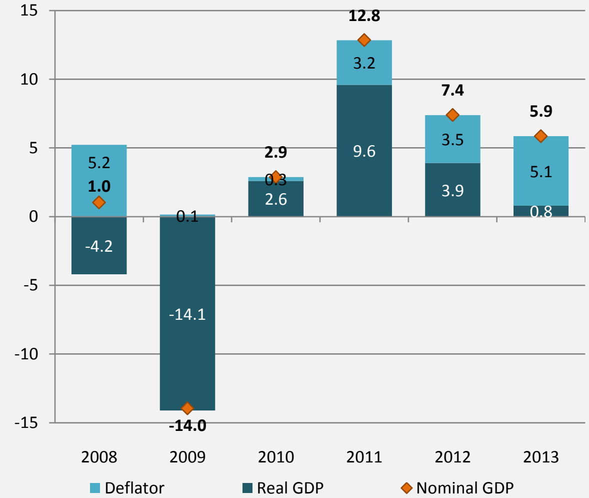
The annual change in Estonian exports of goods and services decelerated from 5 percent in 2012 to -0.7 percent in 2013. **The main driver for lower exports was reduction in outbound shipments of petroleum oil from EUR1,47bn to EUR0,82bn. Exports of this product alone reduced total exports by nearly 4 percent.** Invisible exports increased by 5.1 percent last year, however exports of goods fell by 2.6 percent. Exports to the key markets such as Germany and Russia declined. Exports to Finland and Sweden inched up less than 5 percent, and only exports to Latvia and Lithuania increased at double digit rates. There was still no breakthrough at the beginning of this year, on the contrary, the exports of goods in 1Q 2014 dropped by 8 percent vs. the same quarter a year ago. **The outlook for Russia and Finland, which receive 29 percent of total Estonian exports, is bleak. Yet better growth is expected in other Baltic countries, also Sweden and Germany.** Thus the 1st quarter data and frail prospects in some trading partners signal deterioration in exports for all 2014.

**After swift growth in 2010-2012, investments are levelling off.** Gross fixed capital formation increased by 1.1 percent in 2013, roughly in line with the real GDP growth. This year we expect modest decline in investments due to more cautious business sentiment and falling public investments. Public investments should accelerate in 2015 as the second wave of EU funds is deployed. **In longer-term we expect investments to grow in line with a general economy as the share of investments in GDP is already solid 25 percent.** For comparison, the ratio of investments to GDP for the EU is 17 percent and Estonia's ratio is the highest among all EU members.

Household consumption expanded by 4.2 percent in 2013, thus being the main economic growth driver. Consumer confidence maintains positive trend and should support consumer spending this year. Real wage growth was solid 6.2 percent y/y in Q4 2013, the highest growth among Baltic counterparts. **The pressure on wages should diminish somewhat as employment growth moderates. Yet the advances in household income will be sufficient to maintain robust consumer spending growth.**

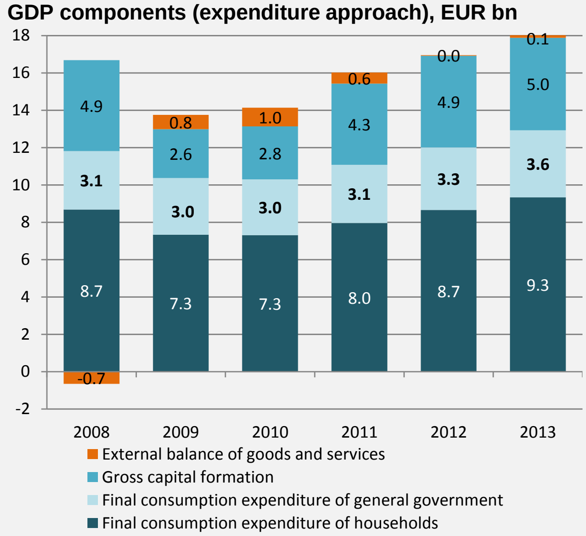
**Estonian banking sector is further improving its already healthy position.** Banks are increasing the share of local deposits in their funding base and are reducing external funding from the parent banks. Total deposits in credit institutions increased by 8.2 percent over 2013. The ratio of local deposits to total banks' assets increased from 65 percent in Dec-2012 to 69 percent in Dec-2013. Loans-to-deposits ratio is steadily declining. The quality of loan portfolio also continues to improve as the bad loans are restructured or written-off. The share of loans overdue 60 days or more in the total loan portfolio shrank from 3 percent in Dec-2012 to 1.8 percent in Dec-2013. Meanwhile lending to private sector increased for the second consecutive year in 2013, however by a very modest 0.7 percent. The lending growth remains below nominal GDP growth, thus private sector deleveraging carries on. The growth in corporate loans slowed to 1.4 percent: generally weaker economy caused demand for corporate credit to fall. **While bank loans to corporate sector stood at EUR 6.36bn in Dec-2013 (35 percent of GDP), these loans make up only 48.4 percent of total corporate debt.** Total debt also includes borrowings from abroad and from other sources. Thus the ratio of total corporate debt to GDP is 77 percent, indicating still a rather high, albeit declining leverage by Estonian non-financial companies. The stock of loans to households remained the same throughout 2013 despite increased real estate transactions and rising home prices. The number of real estate transactions in 2013 was 41,848 units, 29 percent more than in 2012. **The share of real estate**

**Diagram 1**
**GDP, annual change, %**



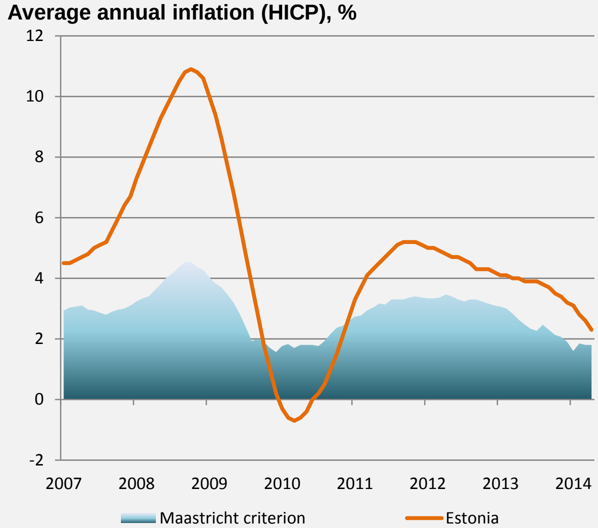

Source: Eurostat

**Diagram 2**
**GDP components (expenditure approach), EUR bn**




Source: Eurostat

**Diagram 3**
**Average annual inflation (HICP), %**




Source: Eurostat

**transactions financed by housing loans was 60 percent in 2013, much lower than the share seen in the boom years. This indicates a robust and conservative credit environment in the housing segment.**

The slowdown in GDP growth, particularly as recorded in the 1Q 2014, was also reflected in employment statistics. **Although unemployment rate declined to 8.5 percent in Q1, the drop was due to falling labour participation.** Labour participation rate fell from 67.7 percent in Q1 2013 to 66.8 percent in Q1 2014. **Lower participation may portray some secular trends such as aging in population, but also more short-term factors such as confidence in the job market or emigration.** Employment in the 1Q 2014 dropped by 0.7 percent y/y - the first year-on-year decrease since 2010. Similarly falling labour participation rate and decline in employment was observed in the youth segment. Generally new jobs creation will be slower in the next few years as economic growth moderates.

Consumer price inflation in Estonia stalled at just 0.2 percent in April y/y. This is dramatic deceleration from 3.1 percent rate in Apr-2013. The main drivers for falling inflation were: lower electricity prices (-7.4 percent y/y) due to cheaper imports from Finland, lower prices of heat energy (-4.4 percent y/y), lower prices of motor fuel (-3.4 percent y/y) due to lower global oil prices. Strong euro versus the US dollar also put a downward pressure on inflation. **Low inflation increases consumer's purchasing power, thus having a positive effect on the economy.** On the other end, prices rose for alcohol, tobacco and dairy.

Estonia's fiscal deficit to GDP stood out at 0.2 percent in 2013. We expect fiscal deficit to GDP ratio to rise to 0.4 percent this year. **In the medium-term Estonia targets structural budget surplus.** Historically solid fiscal cushion has allowed the government to execute countercyclical fiscal policy with the flexibility to support country's economy with fiscal measures, when needed. Gross public debt to GDP stayed in 2013 at 10 percent, the lowest level among EU members.

**Estonia's economy *was sneezing* in 2013 and *caught a cold* in the 1st quarter of this year. Yet the economy is expected to recover from negative y/y growth in Q1. Estonian growth will be limited by struggling Russian and Finnish economies, yet healthy domestic demand led by household spending and also a new phase of EU-funded projects will help economy to recover. Thus we forecast 1 percent GDP growth for all 2014, which implies average 2 percent y/y growth for the rest of 2014, and 2.6 percent growth in 2015.**

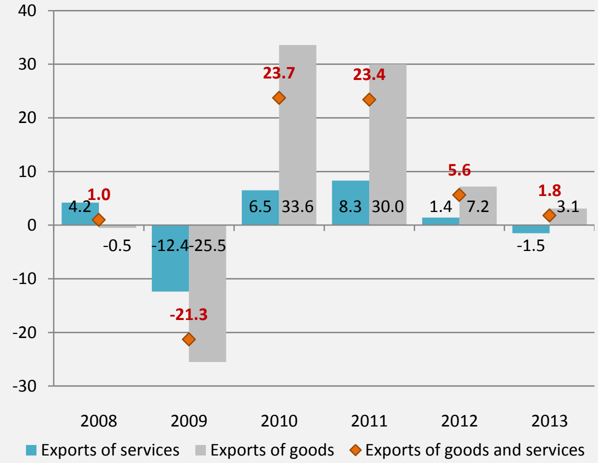
**Table 1**
**Macroeconomic forecasts, %**

| | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|
| Real GDP, annual change | 0.8 | 1.2 | 2.6 | 3.0 |
| Average annual inflation | 3.2 | 1.0 | 2.0 | 2.0 |
| Average gross monthly earnings, annual change, eop | 7.6 | 5.5 | 4.0 | 4.0 |
| Unemployment rate, eop | 8.6 | 8.0 | 7.5 | 7.0 |
| General government budget balance, ratio to GDP | -0.2 | -0.4 | -0.4 | -0.4 |
| Current account balance, ratio to GDP | -1.0 | -2.0 | -2.5 | -2.5 |

Eop- end of period

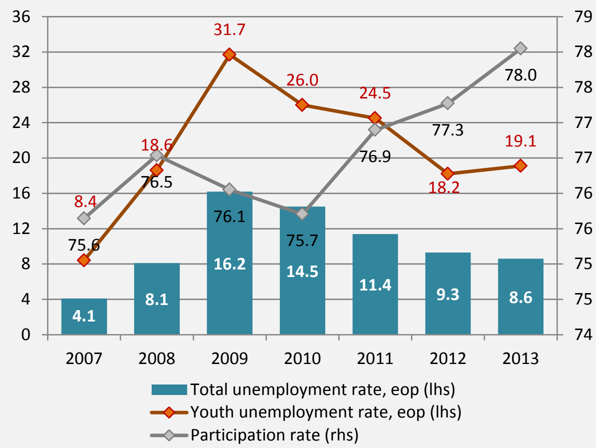
Source: DNB

**Diagram 4**
**Exports of goods and services, annual change, %**



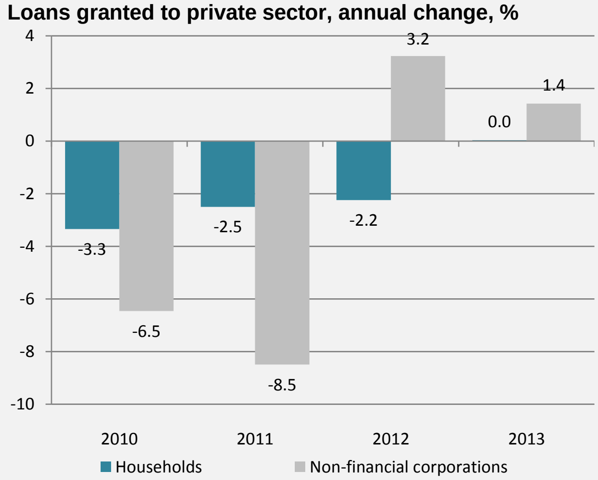

Source: Eurostat

**Diagram 5**
**Labour market indicators, %**




Source: Eurostat

**Diagram 6**
**Loans granted to private sector, annual change, %**




Source: Eurostat

# LATVIA: the EU front-runner in terms of growth for two years in a row

- **Latvia entered the single currency zone in the beginning of 2014**
- **Exports slowed due to falling shipments of base metals**
- **Households consumption supported by robust wage growth is likely to remain an important driver**
- **Capital investments disappointed last year, however there is strong potential for the rebound**
- **Housing market is still suppressed by the ongoing deleveraging process**

**Latvia's economy continued to power ahead at 4.1 percent GDP growth rate in 2013, maintaining growth leadership in the EU.** This growth was achieved despite a high-profile stoppage of Latvia's largest manufacturer Liepajas Metalurgs (LM) in Q2 2013 and ensuing bankruptcy. While growth in Latvia should moderate to 3.5 percent due to external uncertainties, the pace will remain one of the highest in the EU in 2014. We assume that trade relations with Russia will be preserved, and the Latvian economy will only be slightly hit from weak rouble and stagnating Russian economy. We view a sharp deterioration in relations with Russia as a low probability scenario, which yet cannot be ruled out completely.

**The beginning of 2014 was marked by the introduction of the euro.** The transition to the euro has made little immediate impact on the economy. **Longer term the accession to the euro zone will increase Latvia's economic and financial stability as the country integrates closer with a developed and prosperous euro area.** The biggest worry of Latvian public before changeover was a jump of inflation. The euro has indeed accelerated the increase of some labour intensive service prices, but prices for most goods have been affected very little or not at all. The overall result has been shift from small deflation (y/y CPI change was -0.3 percent in Q4, 2013) to small inflation (0.4 percent in Q1, 2014). During 2014 inflation will pick up as wage-price spiral gradually sets into motion and also due to the declining base effect, affecting CPI rate of change in 2013. We expect annual inflation in Dec-2014 to reach 2.0 percent.

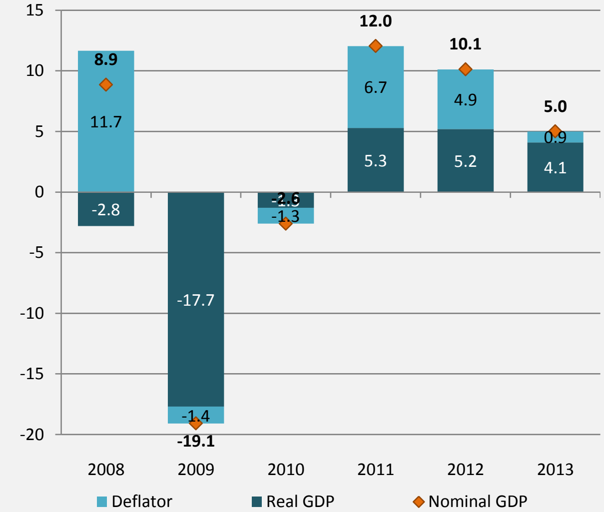
**Export volumes, after 3 consecutive years of double-digit growth, stalled in 2013. The slowdown was largely attributable to steel production and biofuels sectors.** Exports of base metals and articles declined 23 percent (EUR 312m) mainly due to the stoppage of Liepajas Metalurgs. While manufacturing output was flat in 2013, employment and wages in manufacturing sector increased. Output and exports grew in such manufacturing activities that have relatively long value chains in Latvia such as food processing, higher value added timber, machinery, furniture and particularly electronics. Export of services other than transport and tourism rose by 18 percent to 1374 million euros, continuing the fast expansion recorded in previous years. This category includes mainly high value added services in sectors such as business services, IT and communications, financial services. Despite geopolitical tensions with the West, the outlook for tourism business is good. On the other hand transportation services are expected to face more muted trends, particularly those for oil and coal commodities, as part of the flow of these commodities may be diverted to other ports in Russia.

Starting with Q2, y/y exports of goods and services are expected to record improved growth as the lower base effect of LM stoppage kicks in and most other sectors continue to expand. Yet some sectors like fish processing, apparel and machinery production may suffer from instabilities in Russia and weaker rouble. **We believe that manufacturing, the main exports sector, is likely to record around 3 percent growth in 2014.**

Household consumption sustained robust growth at 5.4 percent in 2013. In 2012 the growth was 5.8 percent. Personal consumption is likely to remain an important growth driver in 2014. Robust growth in wages and household income will support consumption this year. Employment is also vital factor for personal consumption. The average number of working people in 2013 grew by 2-3 percent depending on the source; yet the growth in people employed decelerated towards the end of 2013 to 0-2 percent y/y rate, reflecting increasing difficulties for employers to find suitable candidates. **We expect household consumption real growth rate to moderate to around 3.5 percent rate in the next few years.**

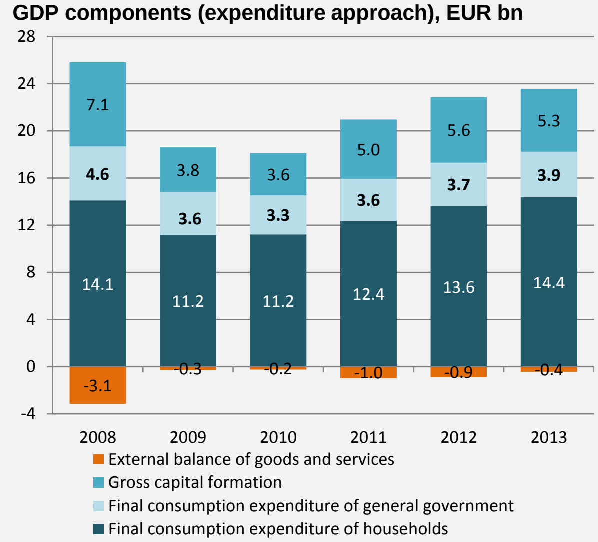
**Investment in gross fixed capital formation fell by 4.3 percent in 2013.** Growth in investment expenditure is likely to improve in 2014 and in following years. 2013 results were affected both by high base effect (completion of large industrial projects in 2012) and timing of EU-funded investment programs. Imports of capital goods, an indicator of capital investment, fell by 13 percent in Q1 2014, though the drop can be explained by fluctuating re-export flows. Businesses have financial ability to invest judging from mounting corporate deposits. T**he main factor limiting investment growth is not capacity, but insufficient external demand.** The demand in some export markets such as Russia, Finland and Estonia is slowing. Yet Latvia managed to quadruple its share in global exports since mid1990s, proving country's competitiveness. Latvia is capable of growing further its share in exports. In the new EU funding cycle (2014-2020) much greater

**Diagram 1**
**GDP, annual change, %**



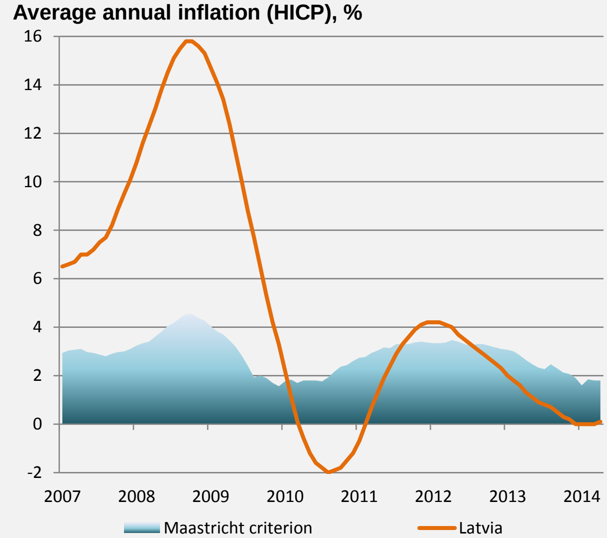

Source: Eurostat

**Diagram 2**
**GDP components (expenditure approach), EUR bn**




Source: Eurostat

**Diagram 3**
**Average annual inflation (HICP), %**




Source: Eurostat

share of resources will be devoted for promoting applied research, product development, cluster effects in Latvian industry while subsidies to “purely” physical investment projects will be cut sharply. That is a wise strategy.

Following the real estate boom after the accession to the EU, **investment in housing has been depressed, but should gradually recover.** There is a lot of pent-up demand, housing stock mostly consists of low or mediocre quality apartments from Soviet era. Many of whose residents are or will be able to afford better dwellings as economic growth proceeds. Housing investment is held back by ongoing deleveraging in the banking sector. Loans to households have shrunk by 34 percent since Nov-2008 and are still declining at 8 percent annual rate. Debt reduction is bound to end and this turn will improve Latvia’s medium term growth prospects. **Yet for now deleveraging is repressing household consumption and housing investment.** Household debt to GDP ratio in Latvia is 26 percent, one of the lowest in the EU.

**Banks have been successful in attracting non-financial sector deposits, while credit market remained dry.** The deposit base was boosted by the introduction of the euro. Handing over cash to the banks was the easiest way to convert old currency lats to new euros. Annual growth of deposits was 12 percent in December 2013 and monthly growth in December alone was 4.7 percent. The total loan portfolio contracted by 4 percent in 2013. The value of loans to non-financial corporations declined 6 percent. Increase in deposits and reduction in loans is the long-term trend in commercial banking after the 2008 crisis. **The banking system is already repaired as equity to assets ratio is 9.8 percent, and loan to deposit rate is sound and conservative 0.79x.** 2013 was a good year for the banking system, but that was largely the merit of banks serving non-residents that kept increasing their relative role and enjoyed excellent profitability. The financial sector as a whole achieved a solid 4.2 percent growth in value added for the first time after five years of decline or stagnation.

**We expect growth in 2014 and 2015 to be sustained at 3.5 percent.** EU-funded pick up in manufacturing investment in 2014 will be a positive for merchandise exports. In 2015 economies of Russia and Estonia should recover, also improving outlook for Latvia’s exports. On the other hand, still sluggish lending and subdued advances in employment will moderate economic growth.

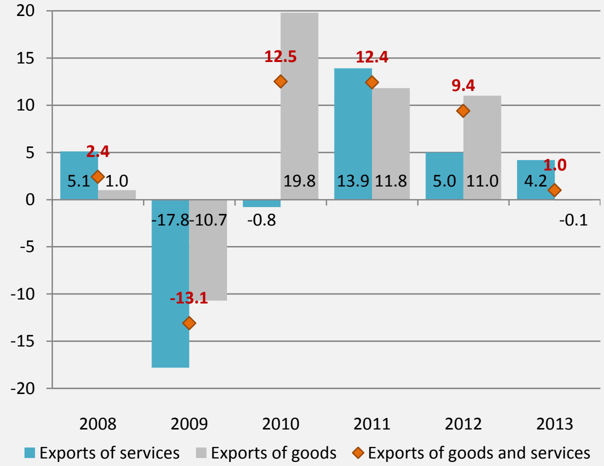
**Table 1**
**Macroeconomic forecasts, %**

| | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|
| Real GDP, annual change | 4.1 | 3.5 | 3.5 | 4.0 |
| Average annual inflation | 0.0 | 1.0 | 3.0 | 2.0 |
| Average gross monthly earnings, annual change, eop | 4.8 | 5.0 | 5.0 | 5.0 |
| Unemployment rate, eop | 11.6 | 10.5 | 9.0 | 8.5 |
| General government budget balance, ratio to GDP | -1.0 | -1.0 | -1.0 | -0.5 |
| Current account balance, ratio to GDP | -0.8 | -1.0 | -1.5 | -2.0 |

Eop- end of period

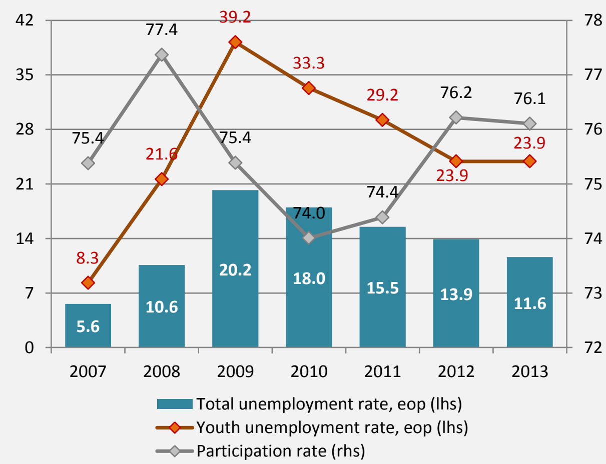
Source: DNB

**Diagram 4**
**Exports of goods and services, annual change, %**



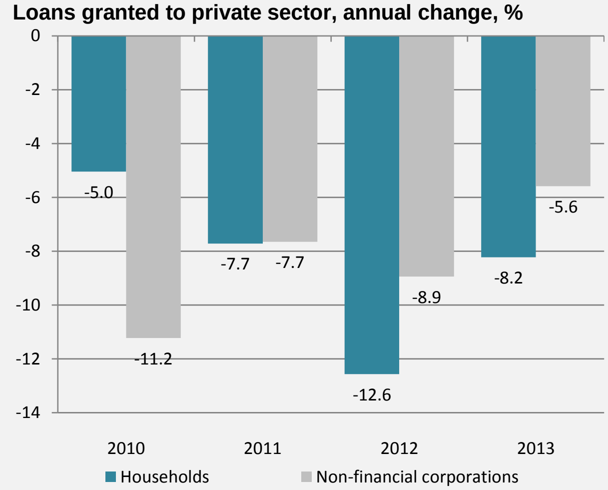

Source: Eurostat

**Diagram 5**
**Labour market indicators, %**




Source: Eurostat

**Diagram 6**
**Loans granted to private sector, annual change, %**




Source: Eurostat

# ANNEX

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **NATIONAL ACCOUNTS** | | | | |
| **GDP, EUR billion** | | | | |
| Estonia | 14.4 | 16.2 | 17.4 | 18.4 |
| Latvia | 18.0 | 20.2 | 22.3 | 23.4 |
| Lithuania | 27.7 | 31.0 | 32.9 | 34.6 |
| Euro area (18) | 9185.7 | 9444.0 | 9505.2 | 9600.5 |
| **GDP per capita, EUR thousand** | | | | |
| Estonia | 10.7 | 12.1 | 13.0 | 13.8 |
| Latvia | 8.6 | 9.8 | 10.9 | 11.6 |
| Lithuania | 8.9 | 10.2 | 11.0 | 11.7 |
| Euro area (18) | 27.6 | 28.3 | 28.4 | 28.6 |
| **Real GDP, annual change, %** | | | | |
| Estonia | 2.6 | 9.6 | 3.9 | 0.8 |
| Latvia | -1.3 | 5.3 | 5.2 | 4.1 |
| Lithuania | 1.6 | 6.0 | 3.7 | 3.3 |
| Euro area (18) | 1.9 | 1.6 | -0.7 | -0.4 |
| **Final household consumption, real, annual change, %** | | | | |
| Estonia | -2.6 | 3.8 | 4.9 | 4.2 |
| Latvia | 2.3 | 4.8 | 5.8 | 5.4 |
| Lithuania | -3.6 | 4.8 | 3.9 | 4.7 |
| Euro area (18) | 1.0 | 0.3 | -1.3 | -0.7 |
| **Gross fixed capital formation, real, annual change, %** | | | | |
| Estonia | -7.3 | 37.6 | 10.9 | 1.1 |
| Latvia | -18.1 | 27.9 | 8.7 | -4.3 |
| Lithuania | 1.9 | 20.7 | -3.6 | 12.8 |
| Euro area (18) | -0.4 | 1.6 | -4.0 | -3.1 |
| **Exports of goods and services, real, annual change, %** | | | | |
| Estonia | 23.7 | 23.4 | 5.6 | 1.8 |
| Latvia | 12.5 | 12.4 | 9.4 | 1.0 |
| Lithuania | 17.4 | 14.1 | 11.8 | 10.3 |
| Euro area (18) | 11.6 | 6.5 | 2.5 | 1.3 |
| **Imports of goods and services, real, annual change, %** | | | | |
| Estonia | 21.1 | 28.4 | 8.8 | 2.6 |
| Latvia | 11.8 | 22.3 | 4.5 | -1.7 |
| Lithuania | 17.9 | 13.7 | 6.1 | 10.3 |
| Euro area (18) | 10.0 | 4.5 | -0.9 | -0.1 |
| **BALANCE OF PAYMENTS** | | | | |
| **Current account balance, % of GDP** | | | | |
| Estonia | 2.8 | 1.8 | -1.8 | -1.0 |
| Latvia | 3.0 | -2.2 | -2.5 | -0.8 |
| Lithuania | 0.1 | -3.7 | -0.2 | 1.5 |
| Euro area (18) | 0.1 | 0.1 | 1.4 | 2.4 |
| **FDI net flow, % of GDP** | | | | |
| Estonia | 7.7 | 8.0 | 2.6 | 2.4 |
| Latvia | 1.5 | 4.9 | 3.2 | 1.5 |
| Lithuania | 2.2 | 3.3 | 0.8 | 1.0 |
| Euro area (18) | -0.8 | -1.1 | -0.7 | -0.3 |
| **PUBLIC FINANCE** | | | | |
| **General government balance, % of GDP** | | | | |
| Estonia | 0.2 | 1.1 | -0.3 | -0.2 |
| Latvia | -8.1 | -3.6 | -1.3 | -1.0 |
| Lithuania | -7.2 | -5.5 | -3.4 | -2.2 |
| Euro area (18) | -6.2 | -4.1 | -3.7 | -3.0 |
| **General government debt (ESA95), end-of-period, % of GDP** | | | | |
| Estonia | 6.7 | 6.1 | 9.8 | 10.0 |
| Latvia | 44.5 | 42.0 | 40.8 | 38.1 |
| Lithuania | 37.8 | 38.3 | 40.5 | 39.4 |
| Euro area (18) | 85.5 | 87.4 | 90.7 | 92.6 |

(p) - provisional data; : - no data;

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **PRICES, LABOUR MARKET & EARNINGS** | | | | |
| **Annual average inflation (HICP), %** | | | | |
| Estonia | 2.7 | 5.1 | 4.2 | 3.2 |
| Latvia | -1.2 | 4.2 | 2.3 | 0.0 |
| Lithuania | 1.2 | 4.1 | 3.2 | 1.2 |
| Euro area (18) | 1.6 | 2.7 | 2.5 | 1.3 |
| **House price index (2010 = 100), annual change, %** | | | | |
| Estonia | 5.7 | 8.5 | 7.3 | 10.7 |
| Latvia | -11.0 | 9.9 | 2.5 | (p) 6,8 |
| Lithuania | -7.4 | 6.6 | -0.2 | 1.2 |
| Euro area (18) | 0.8 | 0.8 | -2.1 | (p) -1,9 |
| **Employment, end of period, thou** | | | | |
| Estonia | 570.9 | 609.1 | 624.4 | 621.3 |
| Latvia | 940.9 | 861.6 | 875.6 | 893.9 |
| Lithuania | 1247.7 | 1253.6 | 1275.7 | 1292.8 |
| Euro area (18) | 141967.5 | 142335.0 | 141406.9 | 140441.9 |
| **Harmonised unemployment rate, %** | | | | |
| Estonia | 16.7 | 12.3 | 10.0 | 8.6 |
| Latvia | 19.5 | 16.2 | 15.0 | 11.9 |
| Lithuania | 17.8 | 15.4 | 13.4 | 11.8 |
| Euro area (18) | 10.1 | 10.1 | 11.3 | 12.0 |
| **Average gross monthly earnings, eop, EUR** | | | | |
| Estonia | 813.9 | 865.2 | 916.4 | 986.3 |
| Latvia | 647.0 | 676.0 | 700.0 | 735.0 |
| Lithuania | 614.4 | 629.9 | 646.4 | 677.8 |
| **Average gross monthly earnings, eop, annual change,%** | | | | |
| Estonia | 3.9 | 6.3 | 5.9 | 7.6 |
| Latvia | 3.4 | 4.5 | 3.6 | 5.0 |
| Lithuania | 0.2 | 2.5 | 2.6 | 4.8 |
| **FINANCIAL MARKET** | | | | |
| **Long-term interest rates, EMU convergence criterion, %** | | | | |
| Convergence criterion | 5.2 | 6.0 | 3.8 | 3.8 |
| Latvia | 10.3 | 5.9 | 4.6 | 3.3 |
| Lithuania | 5.6 | 5.2 | 4.8 | 3.8 |
| **Loans to households and non-financial corporations, % of GDP** | | | | |
| Estonia | 95.5 | 80.3 | 75.0 | 71.4 |
| Latvia | 97.3 | 80.1 | 65.1 | 58.1 |
| Lithuania | 59.6 | 49.9 | 46.5 | 43.3 |
| Euro area (18) | 107.1 | 105.5 | 103.0 | 99.7 |
| **Loans to non-financial corporations, end-of-period, % of GDP** | | | | |
| Estonia | 45.4 | 37.0 | 35.6 | 34.1 |
| Latvia | 51.9 | 42.7 | 35.4 | 32.2 |
| Lithuania | 31.0 | 25.4 | 24.0 | 21.9 |
| Euro area (18) | 50.8 | 50.0 | 47.7 | 45.3 |
| **Mortgage loan portfolio, end-of-period, % of GDP** | | | | |
| Estonia | 41.5 | 36.2 | 33.6 | 32.0 |
| Latvia | 36.4 | 29.7 | 24.0 | 21.7 |
| Lithuania | 21.6 | 19.2 | 17.8 | 17.0 |
| Euro area (18) | 40.4 | 40.1 | 40.3 | 40.2 |
| **Consumer credit, % GDP** | | | | |
| Estonia | 4.6 | 3.6 | 3.5 | 3.2 |
| Latvia | 5.1 | 4.3 | 3.5 | 2.2 |
| Lithuania | 3.4 | 2.2 | 2.0 | 1.9 |
| Euro area (18) | 7.0 | 6.7 | 6.4 | 6.0 |
| **Deposits, % GDP** | | | | |
| Estonia | 54.5 | 51.0 | 51.9 | 51.6 |
| Latvia | 41.9 | 38.2 | 37.4 | 41.7 |
| Lithuania | 40.3 | 36.9 | 37.5 | 37.5 |
| Euro area (18) | 80.4 | 80.0 | 82.8 | 84.7 |

Source: Eurostat, national central banks, ECB

## This report was prepared by DNB Economic Research Department


**Indrė Genytė-Pikčienė**
Chief analyst
Indre.Genyte-Pikciene@dnb.lt
+370 5 2393 678



**Donatas Brazdžius**
Senior analyst
Donatas.Brazdzius@dnb.lt
+370 5 2393 402



**Latvia**
**Peteris Strautiņš**
Macroeconomist
Peteris.Strautins@dnb.lv
+371 6 7 777 266