BALTIC ECONOMIC OUTLOOK

Spring 2015

DNB

External tests for the Baltic economies

After a passage of sound recovery the economic resilience of the Baltics was tested again last year. The region has faced direct spillover effects from the Russia-Ukraine conflict. A general sense of geopolitical uncertainty weighed on domestic demand, while some exporters suffered severely from the Russian food ban and loss of competitiveness due to the depreciated currencies in the CIS. Moreover, Russia fired off a new salvo of restrictions on transport in November at the Kaliningrad border almost halting cross-border traffic.

Russia's economy has been sluggish in recent years due to the structural bottlenecks: uncompetitive manufacturing as well as exhausted labour and capital capacity. The aggressor's reputation only accelerated country's journey down the hill. Currency crisis and the freefall of the rouble last year hit Russia's private consumption – the final pillar still supporting growth. Currency depreciation and food embargo fuelled the surge in consumer prices weakening the purchasing power of households – real wages dropped by a tenth y/y. Moreover, western sanctions cut the financing for Russian enterprises, while spiking interest rates forced borrowers to arrears. Two major rating agencies sent Russia's credit rating to "junk" territory making borrowing for Russian entities even more complicated. The efforts of the central bank of Russia to support the rouble were useless – the currency sank and USD130bn of foreign reserve assets were poured down the drain. However, the ultimate stab in country's economy last year was a dramatic plunge in the oil price. Thinning oil revenue, the vital umbilical cord for Russia, only deepened fiscal and financial strains. **Given all these factors Russia will face sharp downturn this year and may hardly recover in 2016.**

The geopolitical headwinds from the East undermined economic performance of the Baltic States and forced them to search for the fast and effective solutions. Cutting dependence on Russia's market and bridging new external trade links were the core tasks for both politicians and business society. However, looking from today's perspective **we can tentatively state that the Baltic States once again proved their exceptional flexibility and a talent to adjust.**

Much more positive news came from the West. The global economic outlook has improved partly due to the strong rebound of the US economy. Today's economic health of the US proves that Fed's quantitative easing (QE) experiment has started bearing fruit. Country's GDP grew by 2.4% last year and should gather the pace up to 3.4% in 2015. **Moreover, there are signs that the US labour market healing process is coming to an end.** The unemployment rate at 5.5% has already reached the pre-crisis levels and solid non-farm employment growth has been robust for many successive months. Intensive hiring cuts the slack in the labour market and will soon translate into faster wage growth giving a fresh kick to private consumption.

Better US economic conditions let the Fed to change the monetary policy gear. After the QE tapering reached the finish line at the end of last year, the Fed started to warm the markets up with an idea of gradual monetary tightening with the first rate hike expected in the 2nd half of this year. Such behaviour contrasts strongly with the monetary policy dictate on this side of the Atlantic. **Risky combination of deflation and anaemic economic performance in the euro area cornered M. Draghi to use his ultimate *trump*.** The ECB joined the QE train and announced its program of large scale asset purchases on Jan-22nd this year. Total monthly purchases are equal to EUR 60bn per month and the buying should last from March to at least September, 2016. So the total volume of printed money should reach EUR1,140bn. The ECB designed the program so that 80% of asset purchases would be made by the national central banks, thus largely keeping the risks inside individual countries. This decision was determined by the polarisation in the Eurozone and the thrive of euro-sceptical political parties in peripheral countries (i.e. Greece and Spain). Anti-austerity Greek government is being forced to give up all its populist promises and stick to the troika's dictate, but Grexit still remains an option. Ailing banking sector crippled by depositors' run, ECB's restrictions for funding and tight debt refinancing schedule leave Greece without almost any room for manoeuvre. The country can only count on troika's mercy or face default. Yet it seems that the patience of Germany and other creditors is wearing thin.

The divergence of economic health and monetary policy paths on both sides of the Atlantic resulted in the weakening of the euro against the dollar. Euro depreciated by 25% y/y, hitting the bottom of 1.05 in the mid of March. **Weak euro has a positive effect on the euro area's economy and should help the Baltic exporters in their mission of redirecting exports and finding new markets.** Moreover, the freefall of oil price outpaced the drop in the euro, so both consumers and producers in the region benefit strongly from the lower energy costs. These trends set the stage for the euro area's recovery and the first signs of improved macroeconomic beat are being noticed already. Consumer confidence at the pre-crisis levels, strong rebound in retail trade volumes and solid PMI data reflect recovering consumers appetite in the euro area, supported by the weak euro and lighter energy bill. The sustainability of this new trend will be tested, still it weighs positively on the Baltic outlook.

The main trading partners also demonstrate robust development. **Germany**'s economic growth is expected to remain stable (see table 1) maintained by both domestic and external drivers. Sound labour market, improving credit conditions and lower energy costs will support domestic consumption, while cheap euro and global economic recovery will provide boost to exporting sectors. Public initiatives will remain the key for investment recovery providing feed for private sector. **Swedish** economy gathered momentum last year due to stronger internal drivers. Exceptional fiscal and monetary stimuli fuelled private consumption and investments, while external drivers still remain subdued. This year Swedish economy should expand by 2.3% and to sustain similar pace in 2016. In the meantime, **Norwegian** economy is living up with the consequences of the oil price tumble. The mainland economy is expected to grow only by 1.2% this year, less than half the rate of last year. However, Norway has proper guns to fight: expansionary monetary and fiscal policies support private consumption and the weak NOK improves terms of trade. **Finland** is expected to climb from the three-year recession in 2015 and register a meagre growth of 0.8%, which should improve further in 2016. **Poland**, an important market for Lithuania and increasingly so for Latvia, enjoyed a notable upturn in its business cycle. Despite the military conflict in neighbouring Ukraine, the country grew by 3.3% last year rising to the top of the EU rank. **We expect Poland to sustain its dynamic performance in the medium-term**.

Table 1. Global macroeconomic forecasts

	2014	2015F	2016F
World	**3.2**	**3.4**	**3.5**
Industrialized economies	***1.6***	***2.2***	***2.0***
USA	2.4	3.4	2.8
Eurozone	0.9	1.2	1.3
UK	2.6	2.5	2.4
Japan	0.4	1.0	1.5
Emerging markets	***4.4***	***4.4***	***4.7***
China	7.4	7.1	6.7
India	7.5	6.0	6.5
South Korea	3.7	3.5	3.5
Russia	0.6	-5.0	0.0
Exports partners			
Germany	1.6	1.4	1.4
Sweden	2.1	2.3	2.4
Finland	-0.1	0.8	1.8
Poland	3.3	3.0	3.3

Source: DNB Markets (NO)

LITHUANIA: domestic and Russian factors to hamper growth in the 1st half of 2015

- **Lithuanian economy will slow this year, but long-term outlook remains healthy**
- **Russian factor is weighing on growth, particularly in transport and logistics sectors**
- **A hustle in real estate sector and in consumption of durable goods before the adoption of the euro has given way to some sluggishness until pent up demand recovers**
- **More dynamic growth in the EU should bolster export flows westwards**
- **Ongoing EU support will remain a lasting positive driver**

In 2014 Lithuanian GDP expanded by 2.9%. The main growth drivers were household consumption and gross fixed capital formation, which grew 5.6 and 8% respectively. The y/y GDP growth decelerated to 2.6% in the 2nd half of the year, as consumption, investments and exports gradually lost pace. There is a mixed outlook for exports and investments for this year. **On one hand, geopolitical and economic uncertainty in Russia is a drag on business confidence, exports and investments. Yet on the other hand, we see resuming growth in major EU partners, which will contribute to the demand for imports and create opportunities for Lithuanian exporters.** In addition, the 2014-2020 EU support program is gaining traction, and this will bolster private and public investments this year and further into the future.

As planned, in January this year Lithuania adopted the euro and became 19th member of the euro zone, joining Latvia and Estonia in the club. The euro brings considerable long-term benefits such as elimination of FX risks, lower borrowing rates, cheaper money transfers within the euro area, and potentially higher foreign direct investments. Three largest commercial banks in Lithuania are now under supervision of the ECB and have access to the ECB funding if needed.

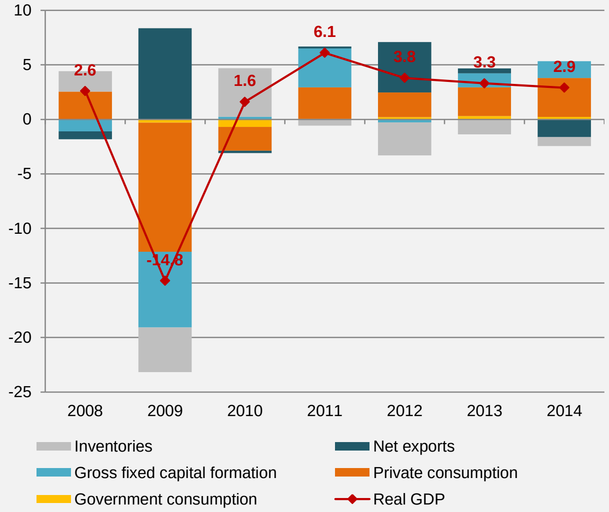
Yet some of the euro-related boost in national output already took place in 2014. Consumption of durable goods and real estate purchases were brought forward in the expectation of the euro last year. Household consumption advanced 5.6% in 2014. Number of housing transactions last year increased by 11% y/y. Net personal transfers from abroad surged and reached EUR 1b or 2.7% of GDP in the last twelve months to Sep-2014, thus fuelling housing market and consumption. These forces will be less vibrant this year. Consumption growth should moderate to 2%. Activity in the housing market should also cool, and the data for January and February this year indicate 31% fewer housing transactions vs. the number last year. **Slower household consumption and housing sector will weigh on growth this year, particularly in the first two quarters. Year-on-year growth rates will improve in 2H 2015 and further in 2016.**

The main headwind for Lithuanian economy is coming from ailing Russian economy. Depreciating currency and falling households' purchasing power in Russia are only aggravated by political decisions. Confronting the West over the war in Ukraine, Russia introduced trade embargo on main food products in August. This hit Lithuanian dairy and meat producers and food merchants engaged in food exports to Russia. In November Russia started detailed and lengthy inspections for all cargos coming from Lithuania or carried by Lithuanian transport companies. Since then Lithuanian exports to Russia, including both Lithuanian-origin goods and re-exports, are shrinking sharply. In 3 months to January Lithuanian-origin goods exports to Russia plunged 40% y/y. Re-exports declined 15% y/y and the trend is deteriorating. Lithuanian manufacturers are searching for the new markets and redirecting exports elsewhere. **Russia's share in Lithuanian-origin goods exports shrank from 7.1% in 2013 to 5.7% in 2014, and Russia is no longer among top 5 Lithuanian goods export destinations.** However, Russia's obstruction to all goods from Lithuania or transported by Lithuanian carriers was a significant strain for the vital Lithuania's transport and logistics sector. We cautiously note that these measures were eased at the end of March, thus the 1st quarter is likely to have been the bottom for this sector.

Labour market continues its gradual recovery. In 2014Q4 unemployment rate descended to 10.1% vs. 11.4% a year ago. Employment rose 1.8% over 2014 while expansion in the labour force was modest 0.3%. Gross wages increased by 5.8% y/y in Q4 2014 while real wages advanced 6.1% as consumer prices inched lower. **Sustained growth in employment and wages will continue to support households' income and consumption.**

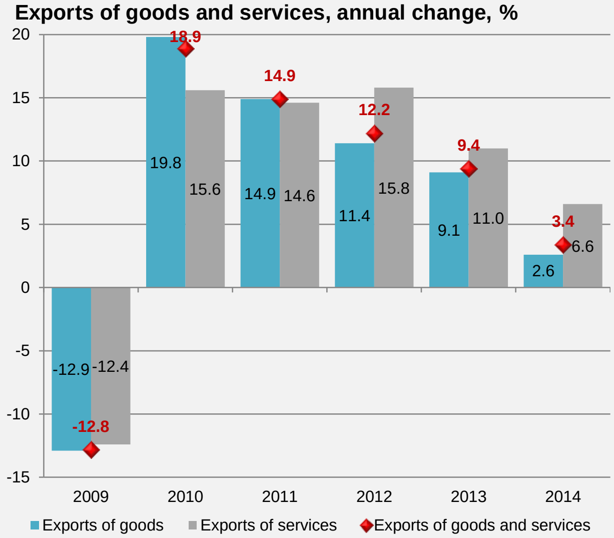
In 3 months to January **exports** of Lithuanian origin goods excluding oil products increased 3.6% y/y. This is a deceleration from 4.4% y/y growth in full 2014. Among major categories, exports of dairy and plastics declined, while exports of fertilizers, tobacco products and furniture rose. Export flows to Russia are shrinking, and in some categories such as dairy and meat halted completely due to embargo. Nevertheless, Lithuanian exporters are demonstrating ability to

Diagram 1
Annual real GDP growth and contributors, %



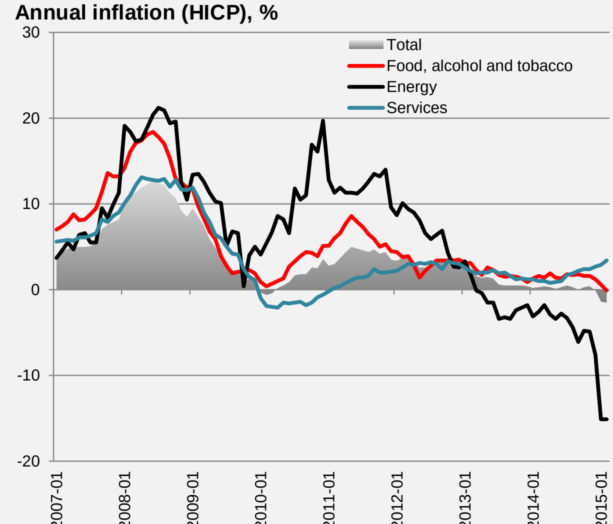
Source: Eurostat

Diagram 2
Exports of goods and services, annual change, %



Source: Eurostat

Diagram 3
Annual inflation (HICP), %



Source: Eurostat

adapt, shifting focus to the EU and other more distant markets. All 5 largest destinations for Lithuanian-origin goods in 2014 were EU countries: Germany, Sweden, Poland, Latvia and the United Kingdom. These countries are in a healthy position and are expected to grow imports. Moreover, growth in the rest of the EU is also picking up. Demand for Lithuanian goods from the EU should offset export losses in Russia, but total exports dynamics this year will be more subdued.

Lending market in Lithuania remains dormant. **Loans** to households edged up 0.4% y/y in January. Likewise, lending to non-financial corporations contracted 2.5%. Businesses remain cautious and prefer to use internal resources or EU funds to finance own activities. The trend in **deposits** was altered by the euro; many customers brought cash to banks before the Jan-1st, the changeover date. Thus in December deposits spiked 7% y/y, but deposits were reduced in January by €1.28bn to €20.2bn and y/y deposit growth rate receded to 2.8%. The banks' capital adequacy ratio was up to 21.3% in 2014Q4 while share of non-performing loans in loan portfolio dropped to 6.5%. Loans-to-deposits ratio in the banking system broke parity in 2014 and fell to 90.6% in 2014Q4. To give a perspective, the ratio was 175% at the end of 2008. Hence banks' reliance on external funding diminished. Commercial banks stand on a much firmer ground today and conservatism prevails.

The approved state budget plan for 2015 is considered as overoptimistic. The Ministry of Finance projected a fiscal deficit of 1.2% of GDP. Yet the plan was built on rather aggressive assumption of 5.5% revenue growth, whereas expenses were projected to grow by 6%. Making more realistic assumption that state revenues grow by 3% and leaving projected expenditures intact, the deficit may rise to 1.7% of GDP.

A landmark LNG terminal was completed and started operations in January. Lithuania entered into contract with Statoil to purchase at least 540m m^3 of natural gas per year, which will ensure continuous terminal operations. The government ordered natural gas customers to purchase proportional shares of natural gas from the terminal. The customers should also bear the infrastructure costs incurred when constructing the terminal and using LNG. The LNG price now is around 30% higher than the price of natural gas supplied by Gazprom. This raised discontent by major gas users such as utilities. But the main protesting party is major fertilizer producer Achema, which consumes around 52% of imported natural gas. Achema declined to pay the required price for the natural gas from the terminal, and claimed that price premium should be covered by the government. To lower the infrastructure component in LNG gas price, Lithuania has to expand volumes flowing via terminal. Falling natural gas consumption in Lithuania worsens the situation. This makes it critical to attract gas orders from neighbouring countries. LNG terminal can process up to 3b m^3 of natural gas per year. **LNG terminal in Lithuania was built for one key political reason – to reduce dependence on Russia's gas. Short-term fluctuations of natural gas price should not be considered as proper argument against it.**

To sum up, Lithuanian growth potential is temporarily capped by the sickly Russian market. Moreover, euro-related positive expectations caused households to accelerate purchases of durable goods and real estate in 2014, thus causing a transitory pause in economic activity this year. Yet long-term economic outlook remains bright. **Recovering job market and rising households' income will support consumption. EU support program for 2014-2020 is gaining pace, which will bolster investments. Many sectors such as infrastructure, healthcare and education will benefit. Low debt levels in the private sector and sustainable state finances will facilitate growth. Russia for now remains the main risk factor for the economy, but this risk is being mitigated by closer ties with the EU and other markets. Slower growth this year is transitory and will be followed by acceleration in 2016.**

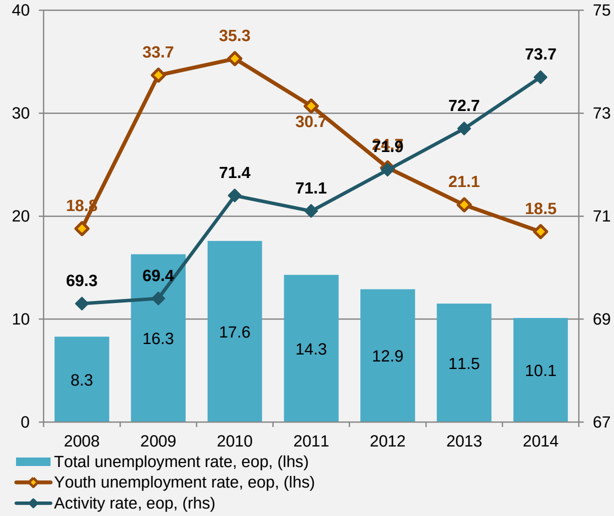
Table 1
Macroeconomic forecasts, %

	2014	2015F	2016F	2017F
Real GDP, annual change	2.9	2.6	3.0	4.0
Average annual inflation	0.2	0.0	1.5	2.0
Average gross monthly earnings, annual change, eop	5.4	4.0	5.0	5.0
Unemployment rate, eop	10.1	9.0	8.2	7.5
General government budget balance, ratio to GDP	-2.1	-1.7	-1.0	-0.5
Current account balance, ratio to GDP	0.1	-0.5	-2.0	-2.0

Eop- end of period

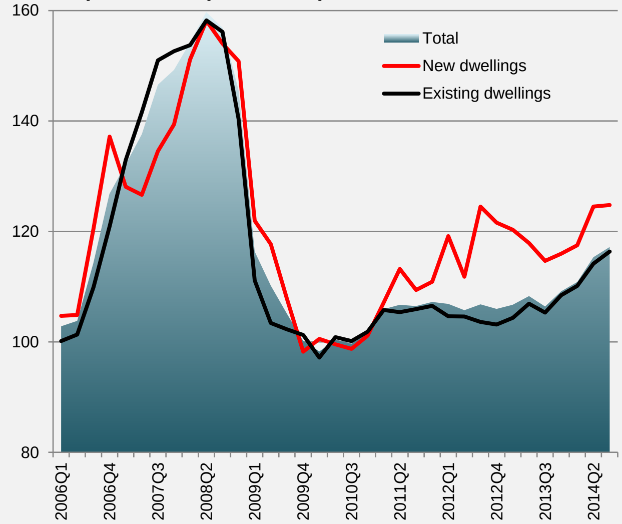
Source: DNB

Diagram 4
Labour market indicators, %



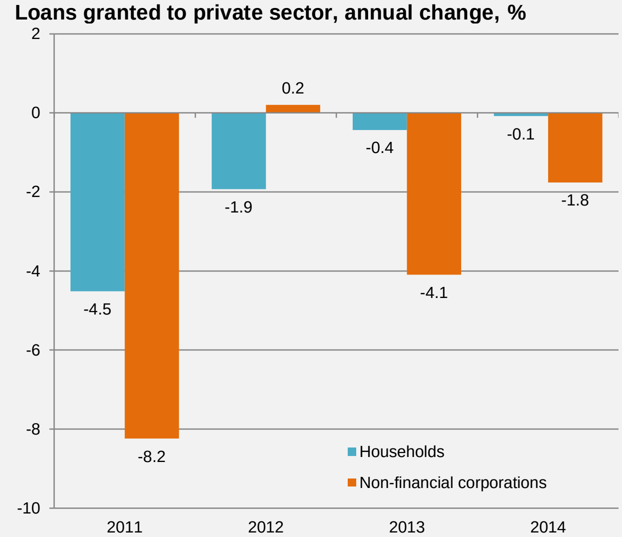
Source: Eurostat

Diagram 5
House price index (2010 = 100), %



Source: Eurostat

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



Source: Eurostat

ESTONIA: gradually crawling out of economic slowdown

- **Household consumption was the only pillar supporting growth last year**
- **Investment will feed from the breakthrough in banking lending and resumed EU funding**
- **External environment looks foggy due to persisting geopolitical tensions and weak Finland**
- **Imported deflationary trends and dynamic labour market will stimulate purchasing power**
- **Fiscal measures are taken to boost domestic demand**

After an impressive surge in 2011-2012 Estonia's economic growth steamed out. It dropped sharply to 1.6% in 2013 and reached the bottom of just 0.5% in 2014Q1. Economic slowdown was caused by the dried-up EU support, weaker investments and a couple of external one-off factors: spillover effects from the electronic industry collapse in Finland – Estonia's key trading partner, launch of a new rival port (*Ust Luga*) in Russia, which took over a significant share of oil transit from Estonia's ports. However, country's economy has been gathering momentum since then. Despite threatening geopolitical background and elevated uncertainty economic activity picked up last year with GDP annual growth at 3% in 2014Q4. Economic growth is projected at 2.5% in 2015, rising toward expected potential growth of around 3%-4% in the medium term.

Capital spending, the main engine of Estonia's economic sprint in 2011-2012, has been anaemic for second year in a row. Gross fixed capital formation contracted by 2.8% last year dragged down by poor results in the 2nd half of the year, as both main investment categories shrank. Capital investments in machinery and equipment decreased (-5.4%) for the 1st time since the crisis, while investment in constructions dropped by 3.2%. Investment in dwellings decreased in the 2nd half of last year. However, this trend should be reversed shortly due to robust housing demand supported by climbing real estate prices. According to the Dwelling Price Index, housing prices in Estonia increased by 13.7% y/y in 2014. The prices of apartments and houses surged by 15.5% and — 9.1% respectively. Capital spending on other buildings and structures dropped given weak public investment activities and early exhaustion of the EU funds.

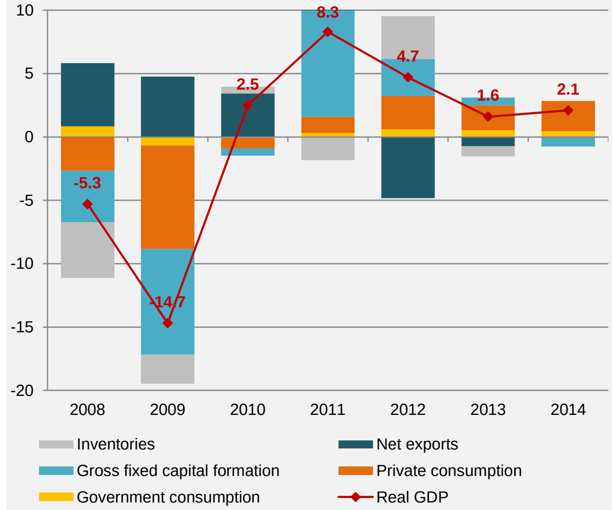
Despite poor dynamics last year, Estonia still remains the top performer in the EU according to the relative investment level. Estonia's gross fixed capital formation to GDP ratio stood at 25.8% last year, exceeding that of Latvia and Lithuania by 2.6 and 6.6 p.p. respectively. **Estonia has been an excellent example of a country modernizing its capital base and setting the stage for future growth.** According to the level of productive investments to GDP, Estonia crowned the EU rank in 2012-2013, giving up the 1st place to Czech Republic last year. Spending on productive investments reached 10.8% of GDP, 6% of GDP were spent on machinery and equipment (respective average in the euro area was 3.7%) and 2% – on ITC equipment (0.7% in the Eurozone and 1.2% in Lithuania). **Investment in Estonia will be supported by a fresh wave of EU funds and recovering credit market, while geopolitical uncertainty and foggy outlook of the key exports partners will weigh on the downside.**

Estonia has been setting a prominent benchmark of fiscal prudence, discipline and efficiency. It restored the public budget back to surplus last year of 0.6% of GDP. Moreover, the country has scheduled to remove crisis tax burden for both businesses and households in 2011 with the effect from 2015. The flat rate of personal income tax was cut from 21% to 20% and the headline corporate income tax was also corrected accordingly (to 20%). In addition to that, pensions, family benefits and minimum wages were increased and total unemployment insurance contribution rate paid by employers and employees was reduced from 3% to 2.4%. **Despite this fiscal stimulus, Estonia's budget balance is expected to remain almost neutral in the medium term with slight negative discrepancies in the short-run having no effect on the lowest in the EU Estonia's public debt.**

Private consumption has been the major driver of growth in recent years. The benign macroeconomic environment – rising salaries, low interest rates, decreasing tax load, non-existing inflation and shrinking energy costs – added positively to consumer confidence and fuelled household consumption. Consumer spending grew by 4.6% last year and was especially strong in the 2nd half of the year providing feed for internally oriented businesses. **Looking ahead, households will continue to enjoy favourable trends, as shortage of labour spurs wages up and positive effects from the changes in tax burden kick in.**

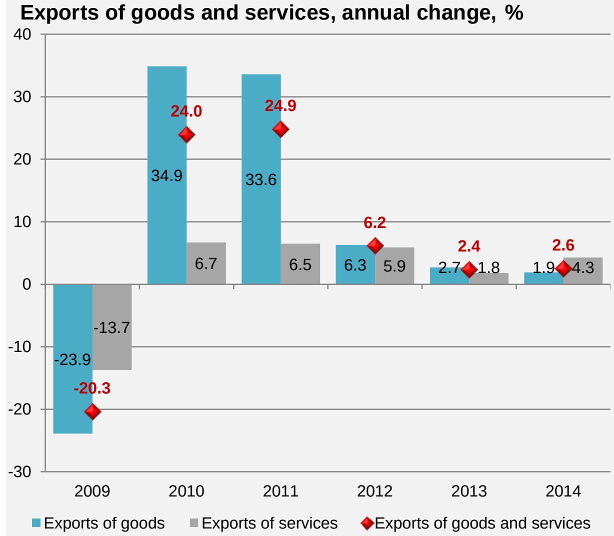
The pulse of Estonia's labour market has accelerated in recent years. The unemployment rate has dropped by 2.2 p.p. y/y to 6.6% in 2014Q4 – the lowest level in 6 years. Given current labour market situation, this is not the bottom yet. Labour factor is being exhausted by growing demand for human capital and due to structural market bottlenecks, unfavourable migration and demographic trends. Youth employment has also improved significantly. Youth jobless rate at 14.8% in

Diagram 1
Annual real GDP growth and contributors, %



Source: Eurostat

Diagram 2
Exports of goods and services, annual change, %



Source: Eurostat

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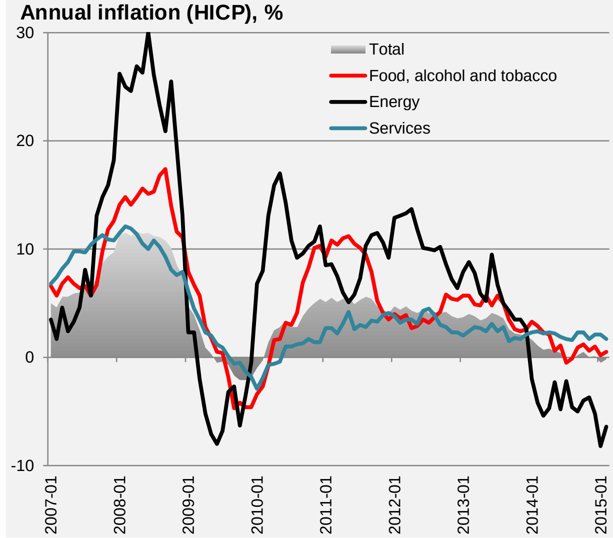
Annual inflation (HICP), %



2014Q4 was much lower than the euro area's average (23.4%) and respective indicators in the other two Baltic States.

Persisting labour market squeeze put a hard pressure on wage growth. Gross monthly wages have been climbing by 6% average annual growth rate since 2011 sustaining the pace at 5.4% y/y in 2014Q4. **Looking ahead, long-lasting and rapid salary growth will have several negative macroeconomic effects.** Firstly, when wage growth rate outpaces productivity growth, it starts eating business competitiveness. Estonia entered this red territory in 2013 and is expected to remain there in coming years. Secondly, persisting growth of household income may result in demand-driven inflation surge, which would be hard to control. However, given current trends in international commodity and energy markets, and stagnant external demand this is not a short-term worry.

After the massive surge in 2010-2011 Estonia's exports have lost momentum. Real exports had been growing by less than 3% for the 2nd year in a row. Weakness came from merchandise exports (1.9%), while invisible exports grew at a more pronounced rate (4.3%). The main reasons for poor external trade results were persisting stasis in western markets and contagion effects due to military conflict in Ukraine. The main market for Estonia's exports was Sweden, receiving 18% of total country's exports, mainly electrical equipment, wood and its products. Expansionary policies and robust consumption growth in this market will sustain demand for imports. The other major destinations for exports were Finland, getting 15% of Estonia's exports, Latvia (11%) and Russia (10%). **Estonia was hit the least by Russia's embargo in the Baltics, but Russia's internal problems, rouble depreciation and consequent fall in purchasing power left a significant footprint on Estonian exports to this country and casted a thick shadow on transport and logistics activities.** The main categories of exports were electrical equipment (22% of total visible exports), mineral products (11%), agricultural commodities and food (10%). Exports of transport equipment, chemicals and mechanical appliances dropped last year, while electrical equipment and wood industry production increased.

Estonia's credit market, the only in the Baltic region, has already forgotten about deleveraging – it bottomed out in the 1st half of 2012 and has been tentatively recovering since then. Loan portfolio to private sector grew by 2.6% y/y with more pronounced growth in corporate credit category. Outstanding amount of banking loans for house purchase increased by 2.8% y/y in December last year, consumer credit rose at a slower pace of 1.9% y/y. Private indebtedness in Estonia stood at 69% of GDP last year – 36 p.p. lower than the level seen in 2009, but well above the respective indicators of Latvia (50%) and Lithuania (41%), where private sectors are still shedding debt. However, Estonia's banks demonstrate the best loan portfolio quality in the Baltics, with the share of overdue loans over 60 days from loan portfolio at a meagre 1.7% at the end of 2014. Deposits continued to grow rapidly. The deposits of private non-financial sector were up 7.9% over the year. Given growth in deposits have been outpacing credit growth, loan-to-deposit ratio has improved by 6 p.p. y/y and stood at 110% at the end of last year.

To conclude, household consumption will proceed, playing key role in Estonia's output dynamics. It will be supported by robust labour market and wage growth. Investment and exports should add to growth later in the forecast horizon after faster recovery of western markets fuels demand for Estonian goods and services and wider flows of the EU funds reach economy. Consequent to that we believe Estonia's GDP will grow by 2.5% this year and will gather the pace up to 3% in 2016. However, geopolitical uncertainty and its effects on business and consumer behaviour may tilt this growth forecast to the downside.

Table 1
Macroeconomic forecasts, %

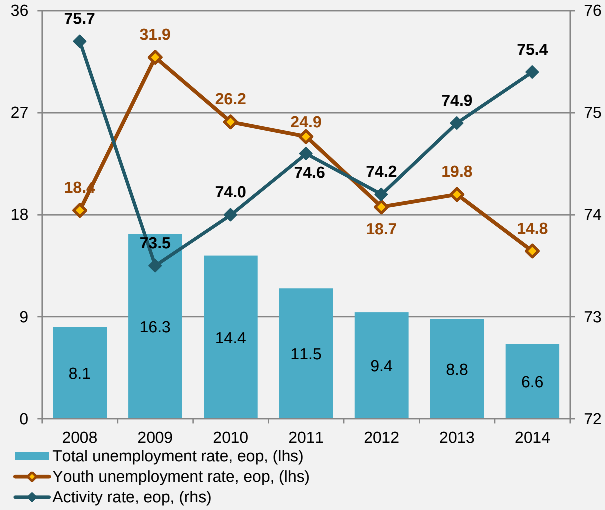
	2014	2015F	2016F	2017F
Real GDP, annual change	2.1	2.2	2.8	4.0
Average annual inflation	0.5	1.5	1.7	2.0
Average gross monthly earnings, annual change, eop	5.4	4.0	5.0	5.0
Unemployment rate, eop	6.5	6.5	6.0	5.5
General government budget balance, ratio to GDP	0.6	-0.5	-0.5	0.0
Current account balance, ratio to GDP	-0.1	-1.0	-1.5	-1.5

Eop- end of period

Source: DNB

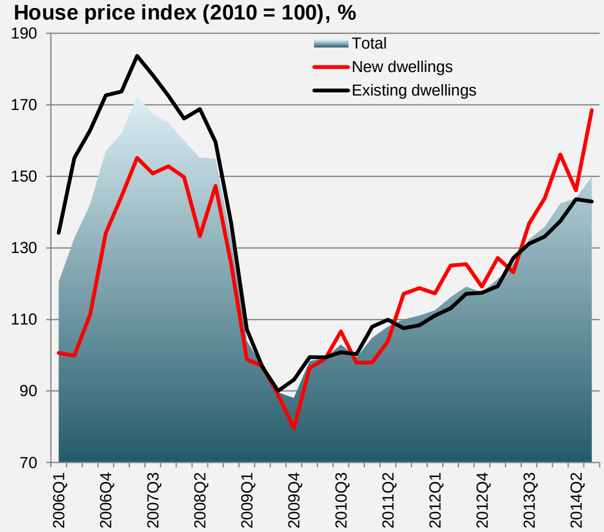
Source: Eurostat

Diagram 4
Labour market indicators, %



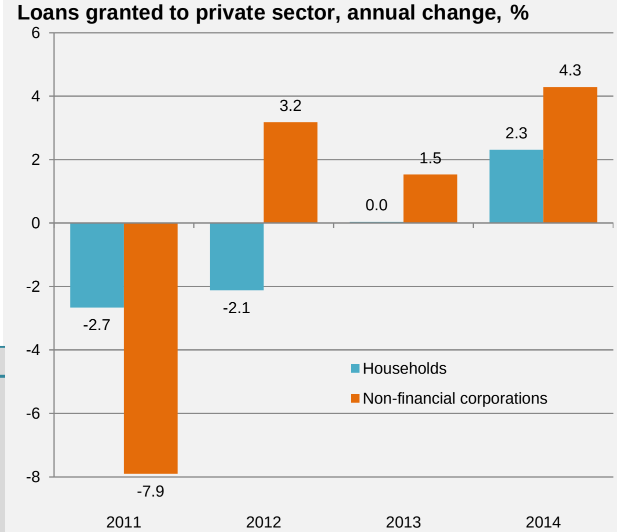
Source: Eurostat

Diagram 5
House price index (2010 = 100), %



Source: Eurostat

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



Source: Eurostat

LATVIA: growth to stay subdued in 2015, but accelerate in 2016

- **Consumption slowed last year, but will recover in 2015, supported by wages**
- **Export growth inched up in 2014, further improvement likely in 2015 and especially in 2016**
- **Investment remained relatively subdued in 2014, near term outlook uncertain due to geopolitics**
- **There has been almost no let-up in the deleveraging process, but it can't last forever**
- **Country has pursued mostly sensible economic policies, but tax reform is required**

Latvia's economic growth slowed down from more than 4% in 2011-2013 to 2.4% in 2014. The main reasons were external political events, psychological impact of numerically larger prices after the euro introduction and persistent troubles in metals production.

The introduction of the euro became an even smarter move in the light of geopolitical conflict in Ukraine. However, at least the immediate economic impact was not as favourable as hoped. **Private consumption was quite weak for most of 2014 and that was especially notable in sales of big-ticket items. Prospects for 2015 are better, as factors for more intensive consumption growth are in place** — wages are rising quite rapidly and consumer confidence is rather strong. Retail trade started 2015 on a high note, real turnover grew by 6.7% on an annual basis in January. Despite GDP growth slowdown, employees last year picked the richest rewards so far during this recovery. On top of strong nominal gross wage growth (6.8% in 2014) came the impact of tax cuts, pushing real net wage growth to 8.0% (up from 5.6% a year ago). Increasing incomes were mostly diverted to savings: annual growth of household deposits peaked at 14% in autumn. Such behaviour is unusual for Latvians and is not likely to last.

Government consumption remained quite strong, growing by 3.5% as the heavy drag of austerity was gradually removed and country was preparing for the EU Presidency in the first half of 2015. New geopolitical challenges mean that this GDP component will remain dynamic. State Revenue Service finally seems to be getting its act together with systematic "sweeps" of grey activities across problematic sectors, helping to keep tax revenue/GDP ratio roughly constant despite tax cuts. As the net impact of tax policy measures will probably be positive in 2016 and deficit reduction will not be a top priority in the current circumstances, there will be funds to pay for it.

Gross fixed capital formation grew by 1.6% in 2014, a slight improvement from 1.4% in 2013. Investment has been very unpredictable in Latvia historically, partly because large projects cause sharp fluctuations in a small economy. Completion of large investment projects by Latvian Railways might make an outsized positive statistical impact this year. While the previous EU financial framework ended already more than a year ago, the flow of its funds for road construction is peaking just now, subsidies to private investment in export sectors are also at a high level. Spending of funds from the purse of 2014-2020 period is picking up in parallel. There are also promising signs from financial sector — **volume of new loan contracts was rising in the 2nd half of 2014 after a steep decline in the year ending in Q2, 2014.**

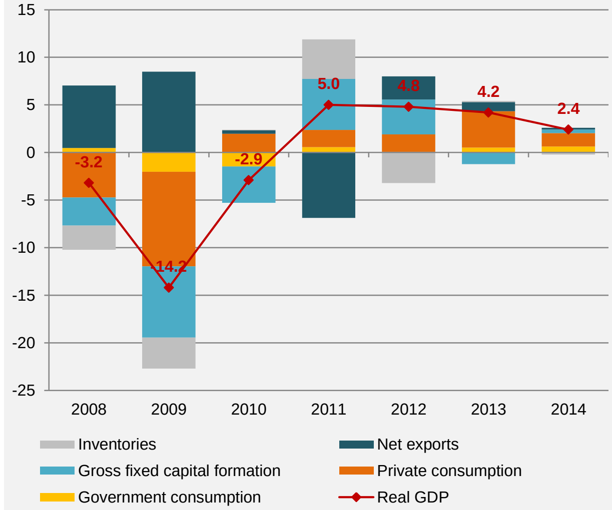
Media has created a perception of uncertainty due to the Russia's aggression in Ukraine. However, more rigorous surveys of entrepreneurial mood like the European Commission's Business and confidence indicators (BCI) show that the actual effect has been very small at most. **Capacity usage hovers at a high level and improving prospects in western export markets might push businesses to invest more actively.**

Consumer surveys indicate that the share of households planning a house purchase or construction is at an all-time high. In February 2015 a long-running uncertainty about mortgage legislation was resolved. During the election campaign the parliament introduced law amendments allowing only non-recourse mortgage loans, but after elections the idea was dropped. A roll-back of measures that would have increased uncertainty for lenders is an important political signal and will encourage banks to lend.

Export performance in 2014 was below expectations, real exports of goods and services grew by 1.9% – a rate that is not sufficient to assure dynamic growth for such an open and small economy. Notably the developments in export markets have been unfavourable and consequences of mismanagement in several metal production companies brought growth down further.

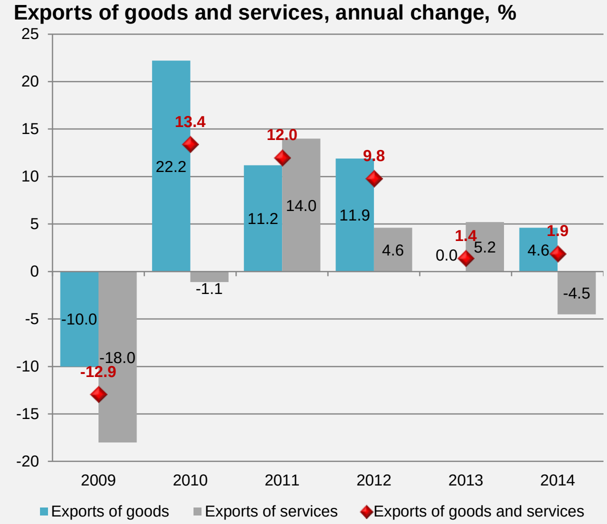
In January 2015 merchandise exports grew by 5.4% y/y despite still unfavourable external circumstances. The baseline scenario is gradual, but steepening upward path in 2015 as some of negative factors fade and the recovery in western markets finally starts. Internal factors for manufacturing sector are favourable. Sector's investment surged last year by 21%, largely propelled by grants from the EU funds. The impact of this program will stretch into this year contributing to output this year and in 2016 particularly. *Liepajas Metalurgs* has restarted

Diagram 1
Annual real GDP growth and contributors, %



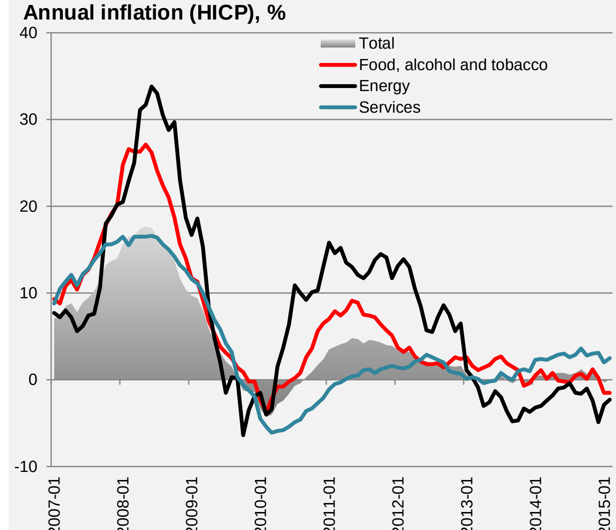
Source: Eurostat

Diagram 2
Exports of goods and services, annual change, %



Source: Eurostat

Diagram 3
Annual inflation (HICP), %



Source: Eurostat

operations in February, but the plant's production has a far bigger impact on manufacturing turnover than value added.

Situation with service exports is more complicated. **For transit business the beginning of 2015 was flat and near term prospects are mediocre.** Transport makes up around a half of total service exports. 2014 was another lucrative year for Latvian tourism industry as weak flow of Russian visitors was amply offset by increasing flow of tourists from the other Baltics and Western Europe. It is hard to predict short-term fluctuations in tourism, but the sector has grown significantly in the last 10 years except during global financial crisis in 2008-2009. The expansion of "intellectual" service exports — business outsourcing, IT, communications, finance – slowed down last year.

Price rises were remarkably subdued during 2014, the average inflation was just 0.6%. Tightening labour market was reflected in accelerating service inflation (2.9%), but that was partly outweighed by falling import (especially energy) costs that pulled down the prices of goods (-0.2%). Inflation is expected to stay at a similar level in 2015, but to increase in 2016 as import costs rise again and local cost push factors strengthen further.

Employment growth slowed down sharply last year. The number of job positions according to Enterprise Survey grew by 1.1% (annual average) while in previous three years the growth fluctuated between 3.1% and 4.2%. **The ability of companies to increase employment is obviously hindered by availability of workers, reflected in accelerating wage inflation and a squeeze on business profitability in 2014.** So companies have to exert ever greater efforts to find additional workers in a society where the echo of post-Soviet birth drop is reducing the generation just entering labour market. That leads to better employment terms that in turn start to address the problem. Net flow of international labour migration is improving and currently it is unclear whether the net flow is positive or negative. Besides, there are internal sources for employment growth – migration and increasing pension age. Level of registered unemployment in Riga is just 5%, very close to the historic minimum, around 10% throughout most of the country and close to 20% in the east. Overall employment should gradually rise in the future.

Financial system sent mixed signals last year. **The slump of loan portfolios even accelerated. Low interest rate environment is a strong negative for profitability. At the same time, the euro introduction and changing consumer habits opened new business opportunities.** The number of payments with cards increased by 21.2% and volume by 12.0%. Banks that specialise in serving non-resident costumers are profiting from increasing uncertainty and capital outflows from Russia. Rising incomes and caution in spending combined pushed household deposit growth well into double digits in 2014 though the pace is subsiding. The sharp drop of credit losses and even cost reversals in some instances improved profitability across the sector. The sector's health indicators like deposit to loan ratio and weight of non-performing loans continued to improve. Deleveraging after large credit bubbles typically lasts for 6-7 years. This year seven years will have passed since lending peaked in Latvia in late 2008.

To sum it all up, Latvia's economic growth in 2014 slowed down due to geopolitical uncertainty and internal one-off factors. These factors will weigh on growth also in 2015, but gradually dissipate. Latvian economy is likely to remain quite dependent on domestic consumption for most of this year, but growth will rebalance in the second half of this year. We believe that Latvia's economy will accelerate in 2016 and later on moving back closer to its potential growth rate.

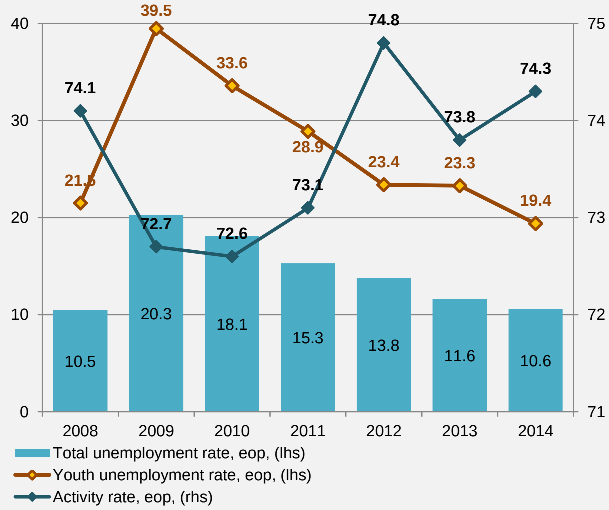
Table 1
Macroeconomic forecasts, %

	2014	2015F	2016F	2017F
Real GDP, annual change	2.4	2.8	3.5	4.0
Average annual inflation	0.7	0.5	2.0	2.5
Average gross monthly earnings, annual change, eop	6.6	4.0	5.0	6.0
Unemployment rate, eop	10.2	9.0	8.0	7.5
General government budget balance, ratio to GDP	-1.0	-1.0	-1.0	-0.5
Current account balance, ratio to GDP	-3.1	-2.5	-3.0	-3.0

Eop- end of period

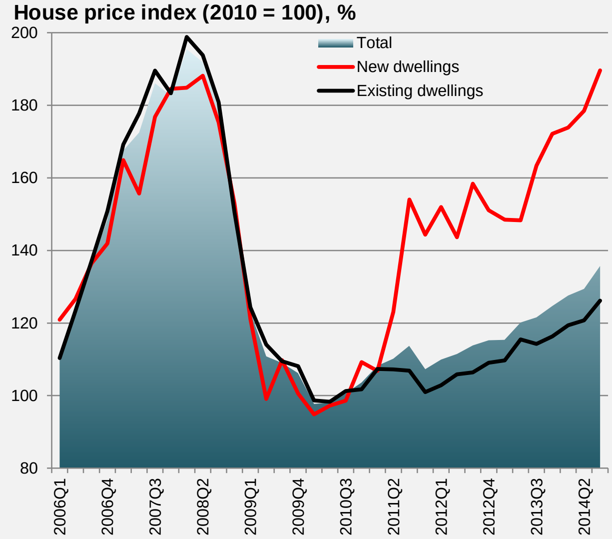
Source: DNB

Diagram 4
Labour market indicators, %



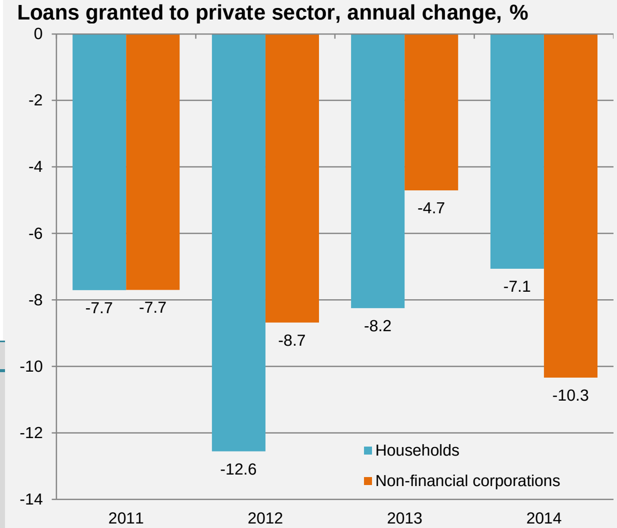
Source: Eurostat

Diagram 5
House price index (2010 = 100), %



Source: Eurostat

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



Source: Eurostat

ANNEX

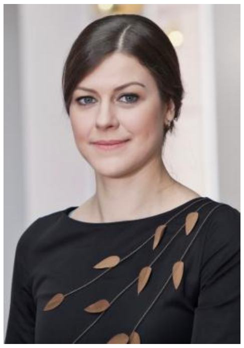
	2010	2011	2012	2013	2014
NATIONAL ACCOUNTS					
GDP, EUR billion					
Estonia	14.7	16.4	17.6	18.7	19.5
Latvia	18.9	20.3	22.0	23.2	24.1
Lithuania	28.0	31.2	33.3	35.0	36.3
Euro area (19)	9,540.1	9,799.5	9,845.6	9,930.6	10,110.9
GDP per capita, EUR thousand					
Estonia	11.0	12.3	13.3	14.2	14.8
Latvia	8.7	9.9	10.8	11.5	12.1
Lithuania	9.0	10.3	11.2	11.8	12.4
Euro area (19)	28.4	29.1	29.1	29.3	29.8
Real GDP, annual change, %					
Estonia	2.5	8.3	4.7	1.6	2.1
Latvia	-2.9	5.0	4.8	4.2	2.4
Lithuania	1.6	6.1	3.8	3.3	2.9
Euro area (19)	2.0	1.6	-0.8	-0.4	0.9
Final household consumption, real, annual change, %					
Estonia	-1.6	2.5	5.1	3.8	4.6
Latvia	3.1	2.9	3.0	6.2	2.3
Lithuania	-3.4	4.6	3.6	4.2	5.6
Euro area (19)	0.8	0.2	-1.3	-0.7	1.0
Gross fixed capital formation, real, annual change, %					
Estonia	-2.6	32.7	10.9	2.3	-2.8
Latvia	-20.0	24.2	14.5	-5.2	1.3
Lithuania	1.4	19.4	-1.6	7.0	8.0
Euro area (19)	-0.4	1.7	-3.7	-2.5	1.0
Exports of goods and services, real, annual change, %					
Estonia	24.0	24.9	6.2	2.4	2.6
Latvia	13.4	12.0	9.8	1.4	2.2
Lithuania	18.9	14.9	12.2	9.4	3.4
Euro area (19)	11.1	6.6	2.5	2.1	3.7
Imports of goods and services, real, annual change, %					
Estonia	21.2	26.5	11.8	3.3	2.7
Latvia	12.4	22.0	5.4	-0.2	1.6
Lithuania	18.7	14.2	6.6	9.0	5.4
Euro area (19)	9.8	4.4	-1.0	1.3	3.8
BALANCE OF PAYMENTS					
Current account balance, % of GDP					
Estonia	2.8	1.8	-1.8	-1.0	-0.1
Latvia	2.3	-2.8	-3.3	-2.3	-3.1
Lithuania	0.1	-3.7	-0.2	1.5	0.1
Euro area (18)	0.1	0.1	1.4	2.4	2.3
FDI net flow, % of GDP					
Estonia	7.7	8.0	2.6	2.4	2.9
Latvia	1.6	5.2	3.9	2.9	1.5
Lithuania	2.2	3.3	0.8	1.0	0.5
Euro area (18)	-0.8	-1.1	-0.7	-0.3	0.9
PUBLIC FINANCE					
General government balance, % of GDP					
Estonia	0.2	1.0	-0.3	-0.5	0.6
Latvia	-8.2	-3.4	-0.8	-0.9	-1.0 (p)
Lithuania	-6.9	-9.0	-3.2	-2.6	-2.0 (p)
Euro area (18)	-6.1	-4.1	-3.6	-2.9	-2.6 (p)
General government debt (ESA95), end-of-period, % of GDP					
Estonia	6.7	6.1	9.8	10.0	10.0
Latvia	46.8	42.7	40.9	38.2	38.0 (p)
Lithuania	37.8	38.3	40.5	39.4	41.1
Euro area (19)	85.5	87.4	90.7	92.6	92.1 (p)

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

Source: Eurostat, national central banks, ECB

	2010	2011	2012	2013	2014
PRICES, LABOUR MARKET & EARNINGS					
Annual average inflation (HICP), %					
Estonia	2.7	5.1	4.2	3.2	0.5
Latvia	-1.2	4.2	2.3	0.0	0.7
Lithuania	1.2	4.1	3.2	1.2	0.2
Euro area (19)	1.6	2.7	2.5	1.3	0.4
House price index (2010 = 100), annual change, %					
Estonia	12.9	11.8	5.8	15.6	13.2 (q3)
Latvia	-2.4	3.6	7.4	8.2	11.7 (q3)
Lithuania	1.4	5.6	-1.2	3.0	10.1 (q3)
Euro area (18)	1.1	-0.2	-2.1	-1.8	0.5 (q3)
Employment, end of period, thou					
Estonia	589.8	608.7	615.4	616.1	630.3
Latvia	862.4	876.7	892.8	900.2	882.1
Lithuania	1,276.2	1,258.7	1,269.4	1,298.6	1,322.4
Euro area (19)	143,202	142,336	141,209	140,969	142,539 (q3)
Harmonised average unemployment rate, %					
Estonia	16.7	12.3	10.0	8.6	7.3
Latvia	19.5	16.2	15.1	11.9	10.9
Lithuania	17.8	15.4	13.4	11.8	10.7
Euro area (19)	10.2	10.2	11.4	11.9	11.6 (q3)
Average gross monthly earnings, eop, EUR					
Estonia	849	918	957	1,028	1,068
Latvia	681	712	730	775	824
Lithuania	595	610	628	661	699
Average gross monthly earnings, eop, annual change,%					
Estonia	4.9	8.1	4.2	7.4	3.9
Latvia	3.0	4.6	2.5	6.2	6.3
Lithuania	0.2	2.5	2.6	4.8	5.4
FINANCIAL MARKET					
Up to 1y lending rates, to NFC in euros, EoY %					
Estonia	8.1	4.3	3.1	3.0	2.6
Latvia	5.4	5.2	3.5	3.2	3.2
Lithuania	4.3	4.2	2.5	2.5	2.5
Euro area (18)	3.5	4.3	3.7	3.6	3.1
Loans to households and non-financial corporations, % of GDP					
Estonia	92.5	78.8	73.6	69.8	68.8
Latvia	94.7	78.0	63.3	56.3	49.9
Lithuania	58.4	49.2	45.8	42.7	40.7
Euro area (18)	107.1	105.5	103.0	99.7	93.8
Loans to non-financial corporations, end-of-period, % of GDP					
Estonia	43.9	36.2	34.9	33.3	33.0
Latvia	49.3	40.6	33.6	30.3	26.5
Lithuania	30.1	25.0	23.5	21.5	20.4
Euro area (18)	50.8	50.0	47.7	45.3	42.3
Mortgage loan portfolio, end-of-period, % of GDP					
Estonia	40.6	35.9	33.1	31.5	31.1
Latvia	36.4	29.7	24.0	21.8	19.6
Lithuania	21.4	19.0	17.6	16.9	16.5
Euro area (18)	40.4	40.1	40.3	40.2	38.2
Consumer credit, % GDP					
Estonia	4.6	3.7	3.4	3.2	3.1
Latvia	5.1	4.3	3.5	2.2	1.8
Lithuania	3.3	2.2	2.0	1.9	1.7
Euro area (18)	7.0	6.7	6.4	6.0	5.6
Deposits, % GDP					
Estonia	71.4	70.5	71.5	72.8	76.2
Latvia	84.6	75.9	77.8	83.1	86.8
Lithuania	76.4	64.7	60.7	57.4	59.2
Euro area (18)	60.4	64.9	62.5	55.9	53.7

This report was prepared by DNB Economic Research Team



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