

The Baltic Outlook

Macro Outlook, The Baltic Region, January 2008

HANSABANK MARKETS

Over troubled water



Table of contents

Summary	page 3
General Assumptions	page 5
No quiet times in global financial markets	
Expectations down for global economic growth	
Estonia	page 9
Weaker domestic demand brings down GDP growth	
Consumers' mood shadowed by inflation and unemployment fears	
Exports grows well, imports down	
Latvia	page 15
GDP growth supported by strong exports, domestic demand clearly slows	
Rising inflation dents consumer optimism and consumption growth	
Trade balance improves as imports growth slows down	
Lithuania	page 23
Lithuania's economy shows the first signs of slowdown	
Accelerating inflation hits household consumption and optimism	
External misbalances are expected to diminish	

Abbreviations:

CB- central bank
CEE - Central and Eastern Europe
CPI- consumer price index
CSBL - Central Statistical Bureau of Latvia
ECB - European Central Bank
EKI - Estonian Institute of Economic Research
EP - Eesti Pank (central bank)
ESA- Estonian Statistical Office
EU - European Union
HBM - Hansabank Markets
HICP - harmonized index of consumer prices
LaB - Latvian Banka (central bank)
LDS - Lithuanian Department of Statistics
LiB - Lietuvos Bankas (central bank)
MoF - Ministry of Finance
PPI - producer price index
REER - real effective exchange rate

Photo by: Andreas Meister

Summary

Recent economic developments in the Baltic countries have not brought any surprise. Although global financial markets and economic developments are about to affect the economies of all three Baltic states negatively, as expected, the 3rd quarter economic indicators did not yet show that negative impact. However, in the 4th quarter global developments exerted their influence and we expect them to strengthen further in 2008. The global economic processes and financial market developments were one of the reasons we changed our October forecast. As the uncertainty regarding global developments has grown we cannot rule out the possibility of an even stronger impact on the Baltic economies than we assume now.

We see all three countries in the expected path of an economic cycle: Estonia is clearly in the slowdown phase, Latvia passed the turning point in the 3rd quarter and Lithuania has just reached its peak. We forecast the Estonian economy reaching the bottom of the business cycle in the 1st half of 2008, with a slow recovery emerging in the 2nd half of the year. The Latvian economy is about to bottom in the 2nd half of 2008 and to show recovery in 2009. The Lithuanian economy probably reached the high point in the 3rd quarter of 2007 with the bottom of the current cycle in 2009. We do not expect the Lithuanian economy to build up imbalances similar to those of Latvia and Estonia. As the monetary tightening in Lithuania started in the earlier phase of the economic cycle than in the other two, the economic cycle in Lithuania will, according to the forecast, be flatter than in Estonia and Latvia.

The main cause of the recent economic boom and slowdown is the same - domestic demand, which received a boost from accession to the EU in 2004 and the subsequent monetary expansion. The slowdown in Baltic economies is built up from weaker consumption and investment growth, which is caused by a slowdown in lending and growth in interest rates. Households are increasingly concerned about rapidly growing prices, and the increased probability of unemployment in the near future due to more frequent layoffs. The latter, in turn is caused by hardship facing enterprises in the environment of slowing economic activity. Falling prices and sharply decreased activity in residential real estate market adds even more pessimistic notes to consumers' perceptions of economic developments, and affects harshly both construction companies and real estate developers. Hence we expect that households will continue to curb their spending growth in 2008, and stronger growth rates will emerge in Estonia in the 2nd half of the

year, and in Latvia and Lithuania in 2009. However, we expect Latvia to recover earlier. Nevertheless, the higher consumption growth rates achieved in 2009 will be considerably smaller than the rates of over 10% experienced during the last couple of years. Investments are expected to show a mixed picture. While residential construction is already falling in Estonia and is expected to fall in Latvia, and slow significantly in Lithuania, investments in engineering, and machinery and equipment will remain relatively strong. Significant inflows from EU funds (3-4% of GDP) will support infrastructure investments, while the need to increase efficiency and maintain competitiveness in an environment of rising costs will force exporting companies to invest.

The slowdown in domestic demand growth rates severely cut import growth rates in the 2nd half of 2007 in Estonia and Latvia, and slowed growth in Lithuania. We expect this process to continue in 2008 and 2009. Yet exports in all three countries have somewhat surprisingly shown resilience to global economic processes growing more strongly than expected and not showing a slowdown until now. Still, weaker global demand is about to diminish export growth rates in 2008. However, as imports will fall faster, we expect a quite strong positive impact on GDP growth in Estonia and Latvia from net exports. The diminishing trade and service deficits will also bring smaller current and capital account deficits.

Rapid price growth was one of the biggest concerns in all three countries in the 4th quarter. The impact of external factors (such as oil, other raw materials, and food) has been stronger than had been assumed and is main reason behind our raised expectation for 2008 and 2009. Administrative factors are having rather important influence in the beginning of 2008, though their impact is expected to weaken afterwards. Demand pressures will weaken rapidly. We forecast a slowdown of consumer price inflation in the 2nd half of the year. Estonian consumer price inflation will, according to our forecast, be at the lowest levels compared to other two countries: this is mainly the consequence of having the weakest consumption growth and because convergence forces are weaker in Estonia than in Lithuania or Latvia.

We expect a slight increase in unemployment in all three countries in 2008. In addition we anticipate a decline in wage growth though it will remain relatively strong (10-15% in nominal terms), as the open labour market and shortage of labour supply will keep employees bargaining power strong till the wage levels become similar to those of the main economic partners.

Although current moods in and about the Baltics are rather gloomy, (especially compared to the high optimism of two to three years ago), we see good chances for the smooth correction in all three countries without serious consequences for long-term growth. The flexibility of local companies and resilience of exports to negative global economic processes are major reasons to believe that good performance of local production will be evident in

future as well. The significant inflow of EU funds, the ongoing convergence process with the richer EU countries, the continued structural shift, strong financial systems and strict fiscal policies are other key factors for long-term economic growth that we see are well in place now.

Maris Lauri

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %								
Estonia	8.0	7.2	8.3	10.2	11.2	7.0	5.0	6.0
Latvia	6.5	7.2	8.7	10.6	11.9	10.5	6.0	6.5
Lithuania	6.9	10.3	7.3	7.9	7.7	8.7*	7.5	6.5
EU27	1.2	1.3	2.5	1.8	3.0	2.9	2.4	2.4
GDP, millions €								
Estonia	7,757	8,693	9,582	11,210	13,234	15,150	16,600	18,200
Latvia	9,911	9,978	11,176	13,012	16,180	20,293	24,092	27,710
Lithuania	15,052	16,452	18,126	20,673	23,721	27,999*	32,898	37,139
EU27	9,898,780	10,063,838	10,562,123	11,001,761	11,597,118	12,232,687	12,819,218	13,414,031
Harmonized consumer price growth, %								
Estonia	3.6	1.4	3.0	4.1	4.5	6.7*	6.4	3.7
Latvia	2.0	2.9	6.2	6.9	6.6	10.1*	12.5	6.5
Lithuania	0.3	-1.1	1.2	2.7	3.8	5.8*	8.0	4.8
EU27	2.1	2.3	2.3	2.3	2.3	2.3*	2.4	2.2
Consumer price growth, %								
Estonia	3.6	1.3	3.0	4.1	4.4	6.6*	6.5	3.8
Latvia	1.9	2.9	6.2	6.7	6.5	10.1*	12.5	6.5
Lithuania	0.3	-1.1	1.2	2.7	3.7	5.7*	8.0	4.8
Harmonized unemployment level, %								
Estonia	10.3	10.0	9.7	7.9	5.9	5.0	5.5	6.0
Latvia	12.2	10.5	10.4	9.0	6.9	5.9	6.5	6.5
Lithuania	13.5	12.4	11.4	8.3	5.6	4.3	4.6	4.7
EU27	8.8	9.0	9.0	8.7	7.9	7.1	6.8	6.6
Goods and services balance, % of GDP								
Estonia	-6.9	-7.1	-7.9	-6.3	-11.6	-8.8	-6.0	-4.8
Latvia	-10.0	-12.7	-15.8	-15.2	-22.1	-21.5	-16.0	-12.5
Lithuania	-5.5	-5.7	-7.0	-7.3	-10.4	-12.7	-12.4	-11.7
Current and capital account balance, % of GDP								
Estonia	-8.2	-9.8	-10.2	-8.1	-13.4	-12.0	-8.0	-6.5
Latvia	-6.4	-7.5	-11.8	-11.2	-21.1	-22.3	-15.5	-11.5
Lithuania	-4.7	-6.4	-6.4	-5.9	-9.6	-12.8	-12.2	-11.3
EU27		0.2	0.4	-0.3	-0.7	-0.8	-0.9	-0.9
General government balance (ESA95), % of GDP								
Estonia	0.4	2.0	2.3	2.3	3.8	2.0	-1.8	0.0
Latvia	-2.3	-1.6	-1.0	-0.4	-0.3	0.7	1.0	1.2
Lithuania	-1.5	-1.3	-1.5	-0.5	-0.6	-0.5	-0.5	0.0
EU27	-2.5	-3.1	-2.8	-2.4	-1.6	-1.1	-1.2	-1.1
Estonian, Latvian and Lithuanian forecast by HBM; EU27 forecast by EC (Autumn forecast)								
* for actual data in 2007								

General Assumptions

1. Global Economy¹

The current mood in the global economy is substantially weakened by sub-prime woes and the financial market squeeze. The consequences of the sub-prime crisis will affect economic developments in the developed world, and as long as the sub-prime losses are not cleared out, uncertainty remains an issue heavily affecting the activity of financial markets and through these investments and economic growth as well. Rapidly growing prices of energy, raw materials and food are doing nothing good for consumers and producers moods. Hence the possibility of a recession in Western economies are growing: forecasts expect a significant slowdown in the USA in 2008 (~2% GDP growth), with implications for the EU economy (~1.9% for euro zone, a bit more for the EU27). However emerging markets are expected to weather well the slowdown in the developed world as the growing domestic market will cover the expected losses in richer countries.

Our Baltic forecast is based on the assumption of a slowing of economic activity not only in the USA and EU, but in other countries as well. While the direct impact of the US economy on the Baltic economies is insignificant, indirect influences are already being felt in the local financial sector and the real economy is about to feel it as well. The European economy is expected to slow to the potential level in 2008 with a positive note for 2009. The most important economic partners for the Baltic countries - Germany, Sweden, and Finland (for Estonia) but Russia as well - are expected to perform relatively well, and their economic developments will mostly

Global economic growth forecast, %

	2005	2006	2007f	2008f
USA	3.2	3.3	2.1	2.0
EU27	1.8	3.0	2.9	2.4
euro zone	1.5	2.7	2.6	1.9
Germany	0.9	2.8	2.6	2.0
Finland	2.9	5.5	4.0	3.0
Sweden	2.9	4.5	3.2	2.9
UK	1.9	2.8	3.1	2.0
Denmark	3.1	3.5	1.5	1.5
Russia	6.4	6.7	7.2	6.6

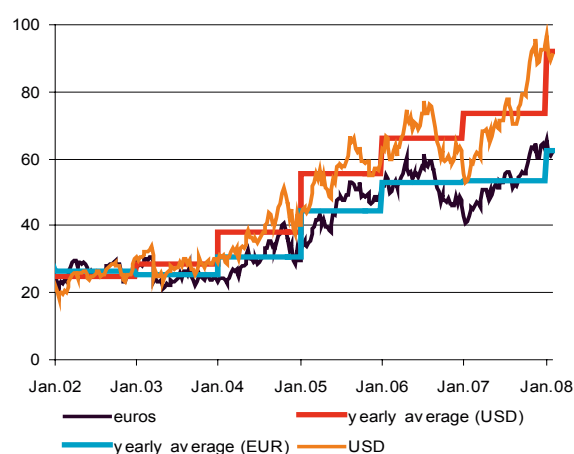
¹ This part was written before Jan 28 and does not cover the most recent processes (e.g. Fed interest rate cut to 3%)

depend on domestic demand. With a strong euro, trade within the European economic zone is about to increase, while exports to other countries are about to suffer (especially to dollar-related countries).

1.1. Prices

The inflation outlook in the global economy is up. While in recent years energy has been the major trigger for supply-side inflation, food products entered the scene as a major player this year and they are not about to draw back in the near future. These two major commodity groups are expected to push up consumer and producer prices, and as the last two to three months show, more than had been assumed before.

Oil price (Brent)

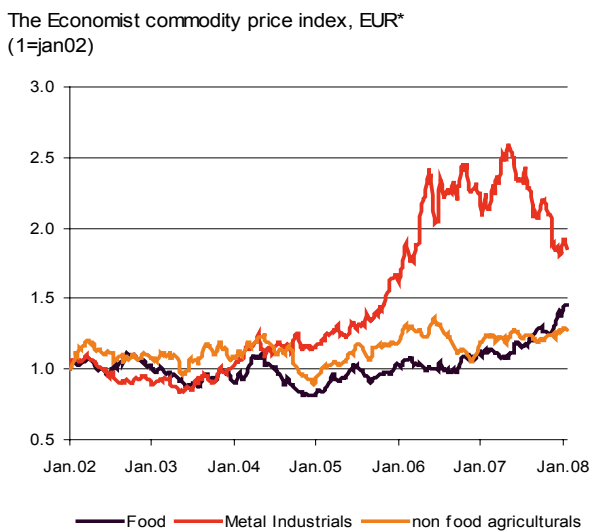


Source: Reuters EcoWin; HBM calculations

Oil price developments, which were favourable in the beginning of 2007, turned out to be highly disturbing during the 2nd half of 2007 and the first weeks of 2008 have not given any comforting signs. The outlook for oil price is grim: with constantly growing demand (oil consumption grows ~1-1.5% p.a., first of all because of emerging markets²) and reluctantly growing supply, prices are set to increase. The economic slowdown in the developed world may affect demand and hence prices, but as emerging markets are expected to show strong economic developments the pressure for oil price growth remains strong. Still price fluctuations will remain as extensive as in the last couple of years, and it is highly probable that market prices may fluctuate easily +/-10% in 1-2 days. We are of the opinion that with such high uncertainty the CPI forecast for the Baltics should assume at least a 5-10% surge in global energy prices.

² According to IEA global demand was up 1.2% in 3Q07, while it fell in the USA 0.7%, in Europe 0.8% and in the FSU 3.6%; in China consumption was up 5.2% p.a.

Price developments of other major commodities vary depending on the commodity. Most of the metal indices show a price fall from May (e.g. The Economist index; LME³) and are reporting negative annual growth rates now. There are clear differences depending on the product, e.g. prices of nickel, zinc and aluminium are declining and the price of copper is approximately at last year's level, while prices of tin, steel and lead are growing. While food prices have already been growing rapidly for more than a year, prices of non-food agricultural products have developed much smoother. In fact, they started to grow only in late-September and even now the price growth is close to the euro's rise vs. the dollar - 7-11% depending on product, which means that prices in euros are actually flat or even falling. Still the trend is clearly up, at least for the 1st half of 2008.



Source: Reuters EcoWin

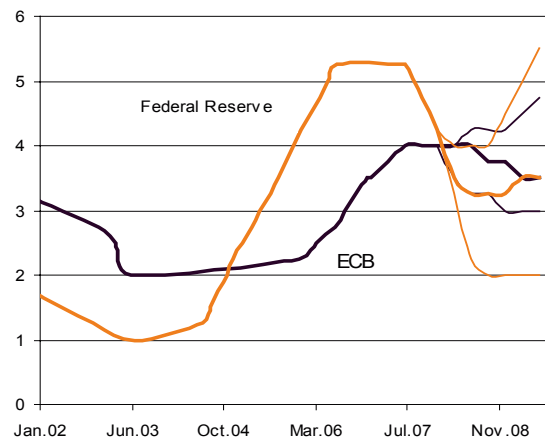
Things are different with regard to food - corn and wheat prices continue to grow rapidly pushing up prices of other cereals, meat and livestock products. There are several reasons behind the strong growth in food prices - growing food demand in the developing world, crop failures in several regions, increasing consumption of bio-fuels and competition-destroying administrative rules, which are giving a distorted picture of demand/supply to name a few major factors -, and they have been extensively discussed in media. The outlook for food prices is not very promising, though it is expected to improve slightly. While demand is expected to grow both for food consumption and bio-fuel production, it is expected that better crops will reduce the supply-demand gap in 2008. Some improvement is expected from the easing of agricultural policy in the EU, though the removal of production quotas is planned only in 2015.

3 LME³ - London Metals Exchange, Metals index, USD

1.2. Interest and Exchange Rates

The American sub-prime mortgage crisis continues to pinch global financial markets as it is still unclear how big the losses are in the balance sheets of banks and financial institutions. Trust has been badly damaged as major financial groups (e.g. Citigroup, Merrill Lynch and UBS) have announced losses of tens of billions of dollars from the sub-prime market. As financial markets are cautious, the situation remains tight in liquidity and interest rates are up. Responding to problems in the money markets, central banks all over the world have made joint efforts to ease the situation and supply funds to the market.

ECB and Federal Reserve base rates, %



Source: Reuters

The money squeeze is expected to last at least until the full year audited results are published in March-April. Although write-offs will affect markets even after that, a clear understanding of losses is expected to calm markets down. Most of interest rate forecasts are bound to that deadline: generally no changes are expected in current policy⁴ prior to that. Thereafter, expectations start to diverge more taking into account different expectations regarding economic growth and inflation. Market consensus expects US interest rates to fall to 3.25% in the spring with a slow recovery in the beginning of 2009. However, the most pessimistic outlook is a continued fall in interest rates to 2% in the 2nd half of 2008 (due to economic recession) and the most optimistic forecast foresees interest rates staying flat and starting to grow in late-2008 reaching 5.5% in mid-2009 (as a result of economic recovery and high inflation). For the euro zone the forecast is more consensus-like: the main expectation is now for slow decline of the interest rate in the 2nd half

4 E.g. easing in the US, flat rates in the euro zone; in January market expectations shifted toward slow easing in the euro zone as well.

of 2008 and in the beginning of 2009 (to 3.5%). Economic slowdown could cut interest rates to 3% for late-2008 and high inflation could push them up to 4.75% in the 2nd quarter of 2009.

The dollar, which has suffered heavily from the financial turmoil since August triggered by sub-prime lending crisis, is expected to remain weak in nearest future touching 1.5 USD/EUR levels in the next 3 months. With an improved outlook for the financial markets and the economy, dollar is forecasted to strengthen gradually. However, as the US economy is expected to enter into recession (or stagnation at best) the strengthening would be very slow.

Interest and Exchange Rates

	28.Jan.08	3M	6M	12M
Fed rate*	3.50%	3.25%	3.25%	3.50%
USD (3M)**	3.35%	2.82%	2.57%	2.58%
ECB*	4.00%	4.00%	3.75%	3.50%
EUR (3M)**	4.38%	4.20%	3.31%	3.76%
EUR/USD**	1.48	1.50	1.45	1.40

* USA Fed and ECB refin rate according to market consensus

** USD and EUR exchange rates and money market rates according to market expectations (based on forward contracts)

1.3. Implications for the Baltic Economies

The Baltic economies are increasingly tied to global economies. The EU economy is the most influential through investments, trade and EU-level regulations. Although we cannot say the Baltic economic cycle is similar to that of the EU or some of its most influential economies, similarities are clearly growing.

The Baltic countries are now in their first largely self-induced economic slowdown (the 1998-99 slowdown was a result of Russian financial turmoil and followed that collapse)⁵, so it is difficult to make any good projections on how the economies will adjust themselves and how long the process might be. There are still some reasons to expect that smaller economic growth of major trading partners will not necessarily mean smaller export opportunities and slower growth here.

1. Although the growth of costs (particularly wage growth) has been very strong in all three countries in recent years, production in the Baltics is still cheaper than in the most EU countries. Hence the Baltics have for now lost their competitiveness vis-à-vis China, India etc, but not within the EU, which may mean that the slowdown in the EU might still encourage

⁵ For Lithuania one could argue that political choices made at that time (i.e. compensation of rouble deposits) made the slowdown longer and deeper than it would otherwise have been.

local exports to the richer EU countries, and investment here as well.

2. The latter scenario might be made more likely by the current slowdown in the Baltic countries, which is leading many companies into financial difficulties and increases the possibility of M&A's initiated by outside investors. The higher profitability and good prospects for strong growth (using increased productivity, technological advancement; growing domestic demand) should encourage long-term investments. There are signs that in the 2nd half of 2007 foreign investors' interest to invest in the Baltic countries has grown.

3. Disbursements from the EU structural funds will be significant in 2008 and in the coming years (ca 3-4% of GDP for every year), encouraging investment and economic development and thus smoothing the negative effects of the aforementioned events.

The impact of global financial turmoil on the Baltic countries has been quite straightforward access to foreign financing (loans) has worsened, while prices (interest rates) have increased. The EU funds, as well as FDI inflows, are expected to alleviate the financial squeeze: however, as the past has shown, these flows fluctuate and are thus hard to forecast. It is quite possible that the 1st half of 2008 will see relatively small flows as the processing of funds for the 2007-13 budgetary period has only started and foreign investors are currently in a searching and thinking mood, and feeling a bit uneasy because of risks in the Baltic economies (real estate market, current account, rapid wage growth etc).

Elections schedule

Estonia

Presidential	September 2011
General	March 2012
Local	October 2009

Latvia

Presidential	June 2011
General	October 2010
Local	July 2009

Lithuania

Presidential	June 2009
General	October 2008
Local	2011
European Parliament	2009

The price developments in global markets are affecting local prices quite straightforwardly as the economies are open to it through the trade. All three countries import energy, albeit to a different extent⁶, and this means that energy prices are

⁶ Estonia can rely on local oil shale as a source for generating

highly dependent on global energy prices, primarily from oil prices. The impact of global food prices is also clear, both through imports (imported grain, meat, etc) but more through exports (exports of milk powder having the strongest impact). The price of raw materials (and intermediate goods) also affects local producer prices, as industries are highly dependent on imported inputs; that in turn has a direct impact on both exports and consumer prices.

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heating and electricity; Latvia uses hydro power to generating electricity and Lithuania has Ignalina nuclear power station to generate electricity (still, the uranium is imported). Natural gas for heating and electricity generation, and all motor fuels are imported; the contribution of other renewable energy is relatively small.

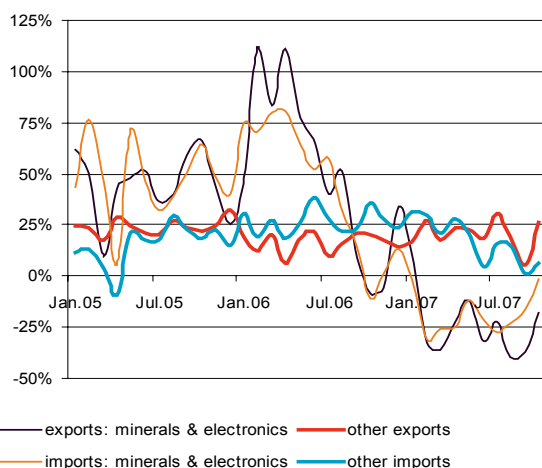
Estonia

1. Recent Economic Developments

Developments in the global economy and financial markets have not left the Estonian economy untouched. As expected, the 3rd quarter results did not show it, while monthly data on the 4th quarter clearly points to strengthened negative factors and, in several cases, weaker than expected results. The 3rd quarter annual GDP growth was 6.4% (7.6% in the 2nd quarter), being mostly affected by slowing domestic demand (7.2% yoy vs. 12.6% in the 2nd quarter).

The growth of foreign trade turnover continued to slow in the 2nd half of 2007 as trade in minerals and cheap electronic products dropped, with imports falling 13.4% and exports 24.5% yoy (July-Nov). The rest of foreign trade has continued to grow well: exports have grown 19.2% yoy, while weaker domestic demand has brought down import growth (7.4% yoy). The trade and service balance improved and was in the 3rd quarter 7.1% of GDP (11.2% a year before); October-November preliminary data are suggesting 40-50% yoy fall of the deficit as well. The improvement of the 3rd quarter current and capital account was ruled out by two processes; first, a surprisingly strong increase in reinvested earnings from FDI in Estonia (9.8% of quarterly GDP, the highest ever result); October-November results do not suggest further significant change. The strong profits from FDI indicate that, despite weaker demand growth and strong wage growth, investments in Estonia are still highly profitable.

Annual Growth of Merchandise Exports and Imports



Source: ESA; HBM calculations

Second, the inflow of EU funds remained extremely weak in the 3rd quarter (current and capital transfers balance was 0.5% of GDP vs. 3.3% a year before). The preliminary data indicate an improvement in transfer inflow in the 4th quarter (EEK 4bn from the EU funds in the 4th quarter or the same as in the previous 9 months). With all this taken into account, the 4th quarter current account deficit is expected to fall very strongly (to 8-9.5% of GDP; 16.7% in 4Q06).

As expected, wage growth started to slow in the 3rd quarter (20.2% yoy). Seasonally adjusted harmonized unemployment has grown slightly, as we were expecting, from 4.8% in Jan-Feb07 to 5.2% in November. Employment has grown ca 1.5-2% compared with 2006¹.

The biggest disappointment was inflation: the average consumer price growth reached 6.6% in 2007 (we expected ~6.4%) based on strongly growing oil and food prices in November-December. Producer prices' average growth was slightly more than expected (8.3%) and the highest since 1997. However, the slowdown of price growth in the 4th quarter suggest that demand factors will ease in CPI and export prices in the 1st half of 2008.

2. Economic Forecast

We have made revisions in our forecast taking into account stronger than expected effects of global economic developments, shifting them toward lower end of our October forecast. However, our story behind the forecast remains the same. We expect that the low-point of current economic cycle will be in the 1st half of 2008, as domestic demand growth rates will dwindle due to weak consumption growth (hit by high inflation and flagging confidence) and falling investments (as construction will suffer severely from tighter monetary conditions and weak demand).

The improvement in the trade and services balance will continue and that will also result in a much better current and capital balance. The state budget tax revenues will fall short of official expectations, and despite high projected surplus, the Government will be forced to look closely at expenditure in the 2nd half of the year.

Consumer prices will continue to grow rapidly in the 1st half of the year, but weak demand will bring the growth rates down quickly in the 2nd half of 2008. The weaker economic situation will smooth wage demands in the private sector, but the average wage

¹ The survey-based results of Estonian Statistics are conflicting with harmonized unemployment data: unemployment was down strongly (from 5.4% in 3Q06 to 4.2% in 3Q07).

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	8.0	7.2	8.3	10.2	11.2	7.0	5.0	6.0
GDP, EURm	7,757	8,693	9,582	11,210	13,234	15,150	16,600	18,200
GDP per capita, th kroons	89.2	100.3	111.0	130.2	154.2	177.0	194.0	215.0
euros	5,709	6,422	7,103	8,329	9,852	11,300	12,400	13,650
Growth of industrial production, %	8.3	11.1	10.5	10.9	7.4	7.0	6.0	7.0
Growth of GDP deflator, %	3.8	4.5	1.8	6.2	6.2	7.6	4.5	3.5
Growth of consumer prices, %	3.6	1.3	3.0	4.1	4.4	6.6*	6.5	3.8
Growth of harmonized consumer price index, %	3.6	1.4	3.0	4.1	4.5	6.7*	6.4	3.7
Growth of producer prices, %	0.4	0.2	2.9	2.1	4.5	8.3*	4.4	2.3
Harmonized unemployment rate, %	10.3	10.0	9.7	7.9	5.9	5.0	5.5	6.0
Real growth of average monthly gross wage, %	7.7	8.0	5.2	6.1	11.2	12.2	4.9	6.0
Growth of exports of goods and services, %	-1.1	9.0	17.4	24.6	18.4	7.0	7.0	6.5
Growth of imports of goods and services, %	4.1	9.7	17.9	21.6	25.7	5.5	3.0	4.5
Balance of goods and services, % of GDP	-6.9	-7.1	-7.9	-6.3	-11.6	-8.8	-6.0	-4.8
Balance of current and capital account, % of GDP	-8.2	-9.8	-10.2	-8.1	-13.4	-12.0	-8.0	-6.5
Inflow of FDI, % of GDP	4.0	9.5	8.1	20.1	10.1	9.7	6.0	6.5
Foreign gross debt, % of GDP	57.9	64.5	76.6	85.3	96.4	103.0	104.0	103.0
General government budget position, % of GDP	0.4	2.0	2.3	2.3	3.8	2.0	-1.8	0.0
General government debt, % of GDP	5.6	5.7	5.2	4.4	3.9	2.7	3.0	3.2

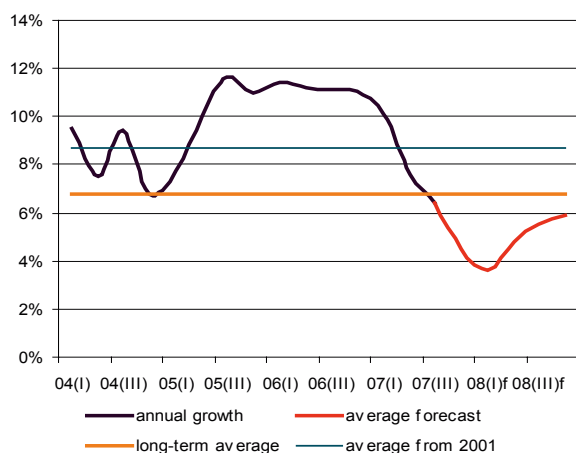
*actual figures

may grow by a healthy 10% supported by structural shifts (diminishing employment of low wage earners). Unemployment is about to increase due to a strong structural shift, which will bring closures of cheap-producing factories². Although we expect that a significant share of the unemployed will find other work, the short-term unemployment will grow in 2008.

2.1. Economic Growth

We expect the Estonian economy to grow ~7% in 2007, with ~4.5% growth in 4Q as consumer spending will slow to ~5% and investments in fixed assets will continue to fall. An improvement is not expected in the 1st quarter, and the 2nd quarter will still bear the gloomy mood of lay-offs, business

Annual Growth Rates of GDP



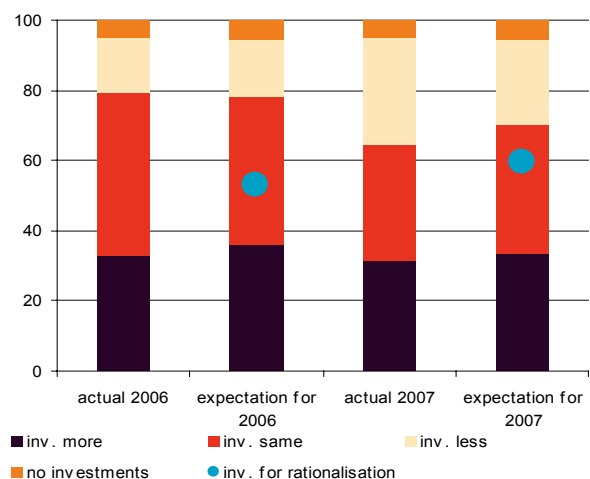
Source: ESA, HBM calculations

² For example one of the biggest of these companies - textile company Kreenholm - is planning to lay-off 1,500 workers during 2008, mostly in the 1st half of the year; this increases the number of officially unemployed persons over 10%.

closures and falling investments. The 2nd half of 2008 will bring better moods, however the government is about to feel the squeeze from tax revenues, and falling inventories will mean that gross investments growth will be negative. We expect domestic demand growth to slow to 9.5-10% in 2007 (15.3% in 2006) and to 1-2% in 2008, with somewhat better developments in 2009 (~3-4% growth).

The big question is with regard to exports and imports. We forecast imports to dwindle quite rapidly and negative growth rates are possible in some months and quarters as investments decrease and consumers cut their spending. However, exports have remained surprisingly strong (excl. oil transit and cheap electronics assembling), which indicates that, despite increasing concerns about growing costs (particularly wages and raw materials) and falling competitiveness, Estonian companies have managed to find products and services to sell

Investments in Manufacturing, % of companies (compared with last year)

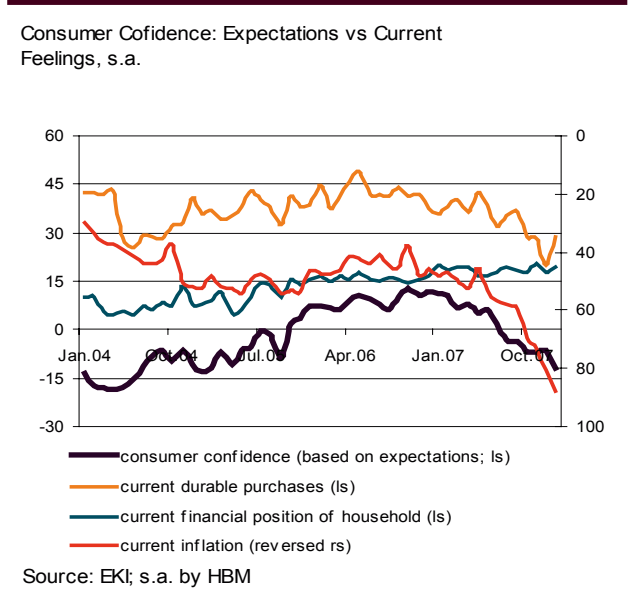


Source: EKI

in external markets. Much is dependent on how companies will be able to adjust to the changing environment in the future - the fact that they have been able to be flexible in the past gives a sort of positive note, however one cannot be sure that this ability won't end at some point because the changes required are too large or there is not enough money to finance the change.

2.1.1. Household Consumption: Income

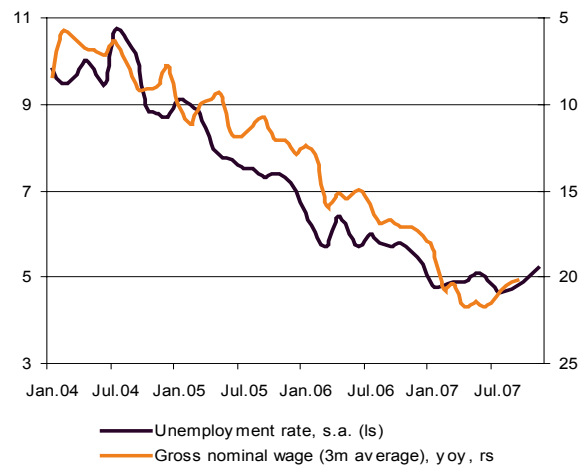
For consumers the 1st quarter might be the worst time of 2008 with inflation hitting over 10% yoy in January-February and for essential goods and services prices growing 15-20% yoy (on average their share in consumer basket is close to 50%, but in winter months significantly higher due to heating costs). The 2nd quarter is expected to show some improvement in consumption, but much depends on how widespread the layoffs are in the closing businesses (e.g. above-mentioned Kreenholm; but other companies as well), and how quickly people can find new jobs (e.g. employment of construction workers depends on weather and how successfully and in what times the public sector runs public offerings).



The main factor which currently influences consumers' decisions is confidence - and that is falling rapidly because of high inflation (and expectations) and unemployment fears. The actual financial situation of a household has changed marginally, being first of all affected by inflation. There is a possibility that if after some time - probably in May-June - households find that their wealth and incomes have not suffered significantly from rapid price growth, they might increase their spending and if they do that, then probably not as much as in 2005-2006.

There are good reasons to expect rather substantial income growth in 2008-2009. With the tight labour market, wages will continue to grow well. We expect ~12% wage growth in 2008 with private sector increasing payments ~10% and public sector 15-20%. In 2009 the nominal wage growth for private sector might improve, while for public sector slow as state budget is expected to see much slower growth than in 2006-2007. Some increase in the average wage will occur because of a structural shift in labour market - the employment of low wage earners will diminish and their share in total employment as well. The increase of many social payments, particularly pensions³ and child allowances, is expected in 2008 and 2009 as well.

Labour Market, %



Although we expect unemployment to increase in 2008, and in certain sectors and regions very heavily (i.e. construction, textiles), we also expect employment to grow. Estonia has entered into short period when relatively numerous generations of baby-boomers (end-80ies, beginning of 90ies) will enter to the labour market. At the same time we will see increased participation rates among those of retirement age: the legal obstacles for remaining employed have been moved, rapid price growth encourages them to find (part-time) jobs and companies are gradually adjusting to more flexible working regimes as the shortage of labour continues to increase⁴. We are of the opinion that open labour markets will give needed flexibility to Estonian households: those who cannot find jobs immediately in Estonia can find contract based jobs for some months in Finland, the proximity of

3 The pension index was changed: while previously it depended equally on CPI and incomes from social tax, now the weights have been shifted toward tax incomes (20:80), so the index growth will be stronger.

4 This is an Estonian long-term risk with falling and ageing population.

which does not necessitate relocation. This practice already has deep roots in Estonia.

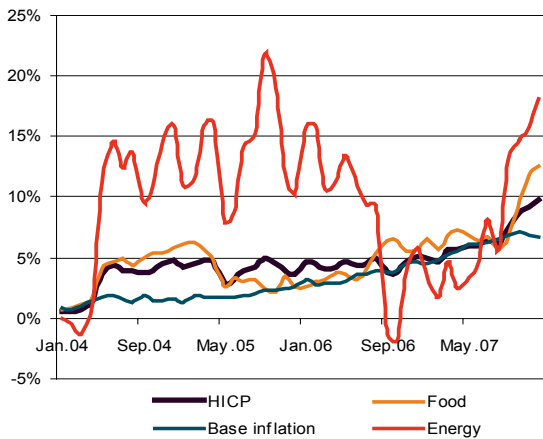
2.1.2. Household Consumption: Prices and Costs

The major factor which affects household consumption is price growth in essential goods and services. This factor dominates heavily starting from the 4th quarter of 2007 when food inflation picked up to 12.3% yoy (7.8% in September). With rapidly growing food, energy and regulated prices, as well as increased consumer taxes⁵, household are left with significantly less money for other purchases. That means prices of those non-essential goods and services - are about to stay flat or fall. We expect consumer durables (e.g. cars, household appliances), and personal services (e.g. repair works, tourism services) to suffer the most. As a result, we forecast that after close to (or even over) 11% yoy CPI growth in February, price growth will start to fall and end up at 3-4% yoy in December 2008, and even less at the beginning of 2009. After that prices are expected to stabilize with administrative increases expected in public services (e.g. public transport) and the energy sector (e.g. electricity).

extensively into Estonian prices. We expect food inflation to slow during 2008, but it definitely will remain high, probably for years, until a supply-demand balance is achieved in global markets, or at least in the EU.

Energy prices in Estonia are highly affected by global markets and forces; two biggest exceptions are year-beginning increase of excise rates, and energy supply, which depends on local producers and supplier. Global oil prices are directly affecting Estonian gasoline and diesel prices, and through export, also the price of some locally produced products (e.g. heating oil produced from oil shale). Gazprom uses its monopolistic power to increase prices of natural gas, but this affects local consumer prices significantly less than in neighbouring Latvia and Lithuania⁷. It is expected that in the summer Estonian Energy will increase the price of electricity quite significantly, but the scope of the increase is not clear yet as the approval is still pending. The reasons for the increase are: more expensive oil shale, the tight labour market, out of date infrastructure and falling short of CO₂ quotas. The latter is expected to affect Estonian electricity prices strongly in the future⁸. We can expect that long-distance heating prices will continue to grow relatively rapidly on growing price of energy, wages and investment needs.

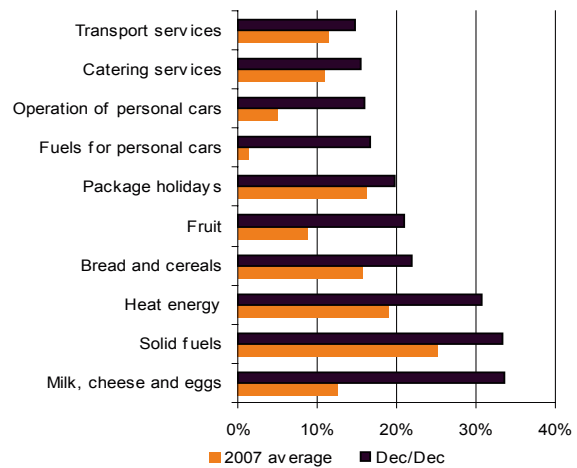
Annual Growth of Harmonized Index of Consumer Prices



Source: Eurostat

Food inflation is expected to remain strong due to external pressure and, despite very good crops in 2007⁶, global price growth has run rapidly and

Price Growth of some items in 2007



Source: Eurostat

The convergence process is a strong undercurrent which will determine Estonia's relatively strong price growth for many years. Although the

outlook for future as well.

7 In Estonia only in some municipalities is natural gas the only or dominant source for generating heating energy. Still, the use of natural gas by households has been on the rise because of recently very low prices.

8 It is not clear how big the CO₂ quota for Estonia will be, but it will be significantly smaller than previously and affect hardly electricity production.

average price level of household final consumption expenditure reached 66.5% of the EU27 in 2006 (more for 2007; 41.6% in 1995) differences between different prices of services and goods in Estonia and in the EU on average are wide. For example, while prices of clothing and footwear were practically the same (99.8% of EU27 in 2006), prices of food and especially services are significantly lower. Prices of food were in 2006 in average 74.1% of EU27, while prices of services 47.8%. Those differences are suggesting that together with growing incomes and wages, prices of services are expected to grow quite rapidly; this applies particularly to public services and those services, whose prices are controlled by the authorities. Hence we expect relatively strong price growth of public transport, central heating, education and health costs, but also catering (helped by growing food prices as well), individual services etc. However, a short-term slowdown in price growth is expected for those services which operate in the competitive environment in 2008-2009.

2.1.3. External Balance

We have made revisions to our expectations regarding the external balance. We expect stronger export growth than in October (~7% vs. ~3.5%), but also stronger imports (mostly because of prices; ~3% vs. ~-2.5%). Although we have increased our expectations for the trade and services balance, we also see that there is a good possibility of a better outcome than our current forecast for the balance (-6% of GDP in 2008).

The change is bigger for the current and capital account because of the performance of the income account and the slow flow of EU funds (see Recent Economic Developments). We were surprised by strong income from FDI in Estonia and we increased the expectations for 2007, but also for 2008 as well.

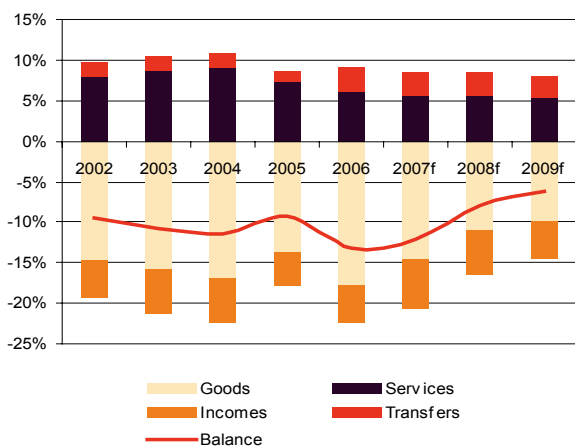
However, we still expect that economic slowdown will affect income from FDI in Estonia and Estonian incomes from the FDI in Latvia and Lithuania, maybe from other countries as well. This is reflected in the lowered expectation of FDI inflow (from ~9% to ~6% of GDP in 2008). We have not changed expectations regarding the EU funds inflow for 2008-2009, although we did replace 2007's expected values with the actual numbers. The increase in the gross debt will slow in 2008 as the cost and access to foreign capital is about to become more restrictive.

2.2. Financial Markets

Estonian financial markets have felt the burden of the increased distrust of global financial markets heavily in recent months. Interest rates in the money market started to increase in late November picking up till mid-December, after which interest rates started to slow to close to previous levels. Overnight interest rates rose from mid-November's 4.75% (taking Nov 20th as a reference) to 5.42% for December 4th. Other interest rates picked up by 190-200bp having fallen 25-70bp for now. The margin over Euribor has increased from a low of 10bp (occasionally even negative) in the 2nd half of 2006 (prior to the expected invitation to the euro zone) to 220-270bp (to 280-286bp in the beginning of December). In early November margins were between 56-80bp.

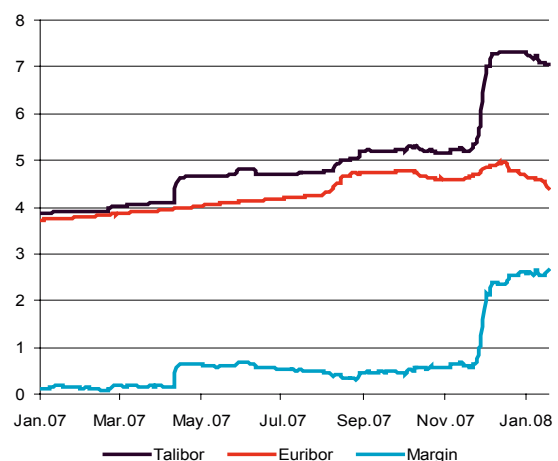
The pick-up in interest rates was a reflection of several processes. First, a gloomy background for Baltic countries has formed with rapidly growing loans, prices, and fears of a possible real estate market collapse. The Estonian economy has shown a smooth slowdown, but Latvian data did not show it in November, which in turn increased fears that a sharp slowdown there would eventually lead to troubles in the Estonian economy as well. Second,

Current and Capital Account Balance, % of GDP



Source: EP; HBM forecast

Money Markets in 2007-08: 3-month Rates, %



Source: Reuters EcoWin

some banks, interested in increasing income from money-market operations in the region, released biased reports and/or articles, speculating about a devaluation of the kroon. This was followed by incompetent reports from some major global banks, and articles in media. Third, the troubled situation in global financial markets and liquidity squeeze in late November and December.

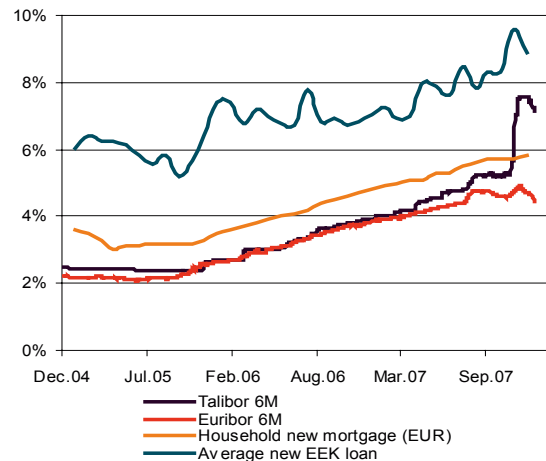
The Estonian money market is small and tightly regulated. Hence the speculations cannot and did not have an effect on the actual exchange rate (this has been proved already in 1997-98⁹). Interest rates started to fall after investors started to look closely at actual developments in the economy, to the (dis)advantage of the devaluation, and monetary regulations. The basic points against devaluation are following:

- The exchange rate of kroon can be changed by a change in the law, which requires several readings in parliament.
- The devaluation is expected to help exports, however Estonian exports has a high share of imported inputs (e.g. energy, raw materials etc). As devaluation would increase import prices, export prices would increase as well.
- The open labour market means that devaluation would push people into poverty, forcing them to leave the country¹⁰, hence labour costs would increase even faster than now.
- Estonian exports are performing well, which shows that Estonian producers have not lost their international competitiveness. In the currency board system all misbalances, which in the fluctuating exchange rate regimes are adjusted via exchange rate, are adjusted via prices (inflation, wages), which forces structural shifts to be faster and timely. A small economy, as Estonia's, can make all structural shifts significantly faster than big countries.

Although interest margins have fallen in Estonia, we do not expect them to fall rapidly in the near future, as we do not expect that mistrust of foreign financial markets will erode soon. We are of the opinion that this might happen after several process take place. First of all Estonian economy will show that it promptly comes out of the current slowdown process - i.e. a recovery in GDP growth rates is expected, with more balanced consumption and

loan growth rates; stabilization of the residential real estate market with growing activity; and a slowdown in inflation and wage rates takes place. Second, improved and balanced developments in the Latvian economy are required to improve the general mood of foreign investors, who take the Baltics as one economy.

Money Market and Loan Interest Rates



Source: Reuters EcoWin, EP

Hence the improvement (stronger capital flows with lower interest margins) could happen only in the 2nd half of 2008, when we forecast a recovery in growth rates and a slowdown in inflation in Estonia. However, only in 2009 could Estonia be bought onto a much smoother development path.

Maris Lauri

⁹ After the crisis in South-eastern Asia and the collapse of the Russian rouble in August 1999.

¹⁰ This fact alone would remove the idea from the head of any politician, as after he/she would probably not find a job him/herself.

Latvia

1. Recent Economic Developments

The 3rd quarter of 2007 was the turning point in Latvia's current economic cycle - after peaking in the 1st half of 2007, the economy has undoubtedly entered the downward leg of the business cycle. While 3Q GDP growth still reached 10.9% yoy (11% in 2Q), it was due to an outstanding 11.1% exports growth - had exports grown by the expected 9%, GDP growth would have lessened to the forecast 9-10%. In line with our forecast, 3Q domestic demand growth moderated to 13.2% yoy from 18.1% a quarter before with slowing observed in both household consumption and investment. The slowdown of domestic demand growth was the result of: (i) slowing credit growth, (ii) rising inflation, and (iii) abating consumer and business optimism. According to leading indicators, these trends continued in 4Q and are expected to lead into 2008 thus further cooling domestic demand towards sustainable levels.

The short term political instability was resolved on December 20 when a new government was formed by the same coalition. Economic policy remains largely unchanged with the key aim being to augment the Anti-inflation plan (which was instrumental in slowing credit growth and overall optimism)¹ by supply-side measures to raise overall economic efficiency and export potential. This new Stabilisation Plan is to be approved by the government in February and the full list of measures has still to be seen. In November Mr Rimševics was re-elected as Governor of the LaB thus ending speculations on his successor and likely monetary policy changes. On January 17 the LaB announced that it will cut reserve ratio for bank liabilities with maturity of over 2 years from 8% to 7%.² Monetary policy remains tight and this cut does not significantly ease credit growth - it is a signal that the LaB sees the economy cooling and will proactively support a soft landing by adjusting its monetary policy, which is welcome news and improves the likelihood of the success of a controlled slowdown.

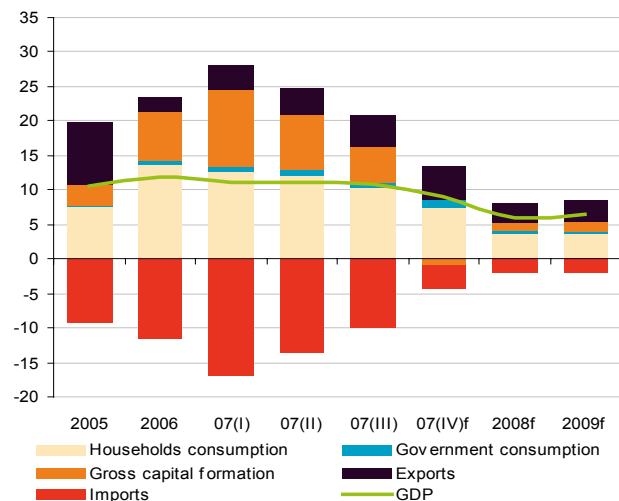
Though easing, internal and external imbalances remain acute. CPI inflation rose to 14.1% yoy in December (10.1% in 2007). Even though 3Q 2007

¹ For a detailed description of the plan, see Baltic Outlook May 2007 and Baltic Outlook October 2007.

² In addition, interest on overnight deposit facility paid by the LaB to commercial banks will be raised from 2% to 3%. Both decisions come into force from February 24.

trade balance deficit stood at 21.7% of GDP, it was considerably below the 23.8% of a year ago. October and November data suggests a further improvement in the trade deficit, as export growth remains strong while that of imports is melting away. The labour market continued to tighten, but the December unemployment data suggests that the tightening may have started to bottom out. The overall consumer and business confidence has continued to weaken from the exuberant levels of early 2007 but remains supportive for a soft landing.³

Contributions to GDP Annual Growth, pp



Source: Eurostat

2. Economic Forecast

2.1. Summary of the Forecast

In terms of forecasts the situation is very uncertain. The pace and breadth of the cooling of domestic demand is still difficult to assess, and stronger than expected weakening of the global environment adds uncertainty to CAD financing via funding cost, commodity prices, and external demand.⁴ While the underlying drivers weaken, they remain

³ Medium term sustainable GDP growth rate is estimated at 6-8% pa. By soft landing we mean adjustment towards such a sustainable level during which GDP growth does not dip significantly below 4% (it does not exclude negative growth in certain sectors, e.g. residential construction). A hard landing means about zero or negative GDP growth rates, i.e. recession. GDP growth in the 0-4% interval could be characterised as a "grey area" and it is very unlikely that it would remain there for a prolonged period of time without swinging in either direction. If GDP growth falls below 4%, the negative impact on expectations and real estate prices may become overwhelming and risks of slipping into a hard landing significantly rise as it may become impossible to support reasonable domestic demand growth. Growth of less than 4% in Latvia was previously observed only following the 1995 domestic banking crisis and the 1998 Russian default.

⁴ Namely, global financial turmoil has made external borrowing more expensive as market risk aversion has risen; commodity prices are likely to decrease as demand for industrial goods backs off, which reduces import cost and export proceeds; lower external demand slows export growth.

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.5	7.2	8.7	10.6	11.9	10.5	6.0	6.5
GDP, EURm	9,911	9,978	11,176	13,012	16,180	20,293	24,092	27,710
GDP per capita, euro	4,238	4,291	4,832	5,655	7,072	8,916	10,641	12,305
Growth of GDP deflator, %	3.6	3.6	7.0	10.0	11.1	13.5	12.0	8.0
Growth of consumer prices, %	1.9	2.9	6.2	6.7	6.5	10.1*	12.5	6.5
Growth of harmonized consumer price index, %	2.0	2.9	6.2	6.9	6.6	10.1*	12.5	6.5
Growth of producer prices, %	1.0	3.2	8.6	7.8	10.3	16.1*	na	na
Harmonised unemployment rate, %	12.2	10.5	10.4	9.0	6.9	5.9	6.5	6.5
Real growth of average monthly net wage, %	6.0	7.8	2.4	9.4	15.7	20.0	4.0	4.0
Growth of exports of goods and services, %	8.7	14.4	21.2	31.4	15.3	23.0	14.0	12.0
Growth of imports of goods and services, %	9.1	19.5	26.8	27.4	31.3	22.8	6.0	6.0
Balance of goods and services, % of GDP	-10.0	-12.7	-15.8	-15.2	-22.1	-21.5	-16.0	-12.5
Balance of current account, % of GDP	-6.6	-8.1	-12.9	-12.5	-22.3	-23.9	-17.0	-13.5
Balance of current and capital account, % of GDP	-6.4	-7.5	-11.8	-11.2	-21.1	-22.3	-15.5	-11.5
Net FDI, % of GDP	2.7	2.4	3.8	3.6	7.4	8.2	6.5	6.5
Foreign gross debt, % of GDP	72.7	79.6	93.2	100.7	112.8	121.0	118.0	113.0
General government budget position, % of GDP (ESA)	-2.3	-1.6	-1.0	-0.4	-0.3	0.7	1.0	1.2
General government debt, % of GDP	13.5	14.4	14.5	12.0	10.0	8.5	7.8	7.0

* actual results

supportive to solid growth rates - e.g. 2007 profits form a good base for 2008 spending, wages rise (albeit at a slower pace) as do emigrant transfers, the export sector demonstrates good income generating capability and credit growth slows but remains sizeable. Negative global slowing risks also have their mitigating factors - e.g. lower commodity prices mean less import expenditure while globally lower interest rates support consumption and investment via lower debt service and borrowing costs. In general, we see the slowdown bottoming out in 2H 2008 and 1H 2009 followed by an upturn driven by a recovery of the world economy, stronger EU funds inflows and export restructuring.

It seems that 2007 yielded faster growth while in 2008 growth will be somewhat weaker than in our October 2007 forecast. Our current forecast stands at 10.5% GDP growth in 2007, i.e. marginally above the earlier forecast due to high 3Q growth. 2007 growth was supported by ca 15.5% yoy household consumption growth and ca 12.5% gross fixed capital formation growth. The better trade balance was likely to improve 2007 CAD to ca 24% of GDP (previous forecast 25%). In 2008 we see GDP as growing by ca 6% (6.5% before) with a slight chance of slipping a notch below this level due to the higher 2007 base and stronger than expected global downside risks. It is on the low side of our previous forecast range because of slower household consumption growth of ca 5% (5-8% before) and gross fixed capital formation growth of ca 3% (4-7% before). Export ability is expected to remain vibrant supported by structural change in export industries. Thus, while slower expansion of domestic demand will mean slower import growth, negative net export contribution will be smaller and will support GDP despite weaker domestic demand. In 2009 GDP is forecast to grow by ca 6.5% driven by ca 5% growth in household consumption, ca 4%

growth in gross fixed capital formation and ca -3.5% growth in net exports.

In response to larger than expected administrative price rises and inflationary expectations, CPI inflation in 1H 2008 is set to exceed our previous forecast and average at 12-13% in 2008 (previous forecast 9-10%), slowing to 6-7% in 2009. We retain the forecast of unemployment rising from the current level of below 5% towards 6-7% in 2008 and 2009 as the economy cools. The real net wage growth forecast is retained at ca 20% in 2007 and reduced to 3-6% (4-7% before) in 2008 and 2009 due to higher inflation. Nominal wage growth is unlikely to considerably exceed previously forecast growth rates of ca 15% in 2008 and 10% in 2009 as it would put companies at risk of losing their competitiveness while budget is unlikely to have sufficient resources to raise wages further as economic growth starts to slow down. In 2008 and 2009 a swifter improvement of CAD is expected to 16-18% and 12-15% of GDP (20-22% and 17-20% before) due to stronger import growth contraction and the improving income account (as rising interest payments are expected to be counteracted by lower income on foreign investment in Latvia with the economy slowing).

We do not see a significant possibility of an external speculative currency attack as financial markets are thin and sealed off by the LaB.⁵

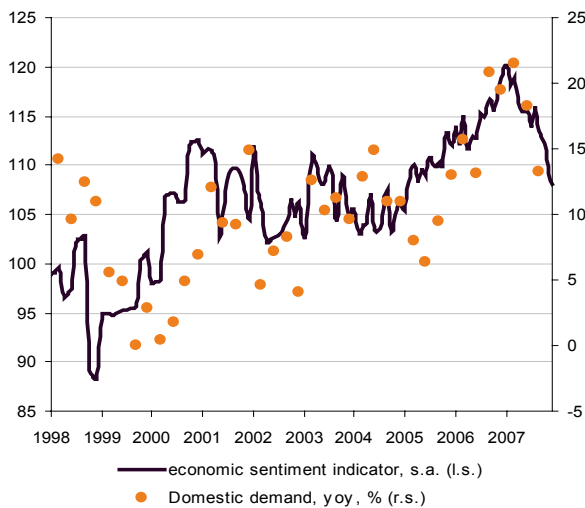
2.2. Domestic Demand

We expect domestic demand to have grown by ca 14% yoy in 2007 and its growth to slow to ca 4% in 2008 and 2009 (previous forecast 5-7%). Growth in domestic demand will retreat as consumer and

⁵ For a detailed discussion on financial stability, see Baltic Outlook May 2007.

business confidence is expected to continue to weaken, and credit growth in 2008 is set to halve to ca 20% from 37% in 2007. To support domestic demand during 2007, households and businesses reduced their rate of saving (13.6% of GDP in 9M 2007 vs. 19.1% in 2006), which reduces further potential for growth in domestic demand - i.e. they will have a smaller stock of financial assets they could draw on when income growth recedes. The Economic Sentiment Index⁶ suggests that domestic demand growth continued to lose pace in 4Q 2007.

Economic Sentiment and Domestic Demand



Source: Eurostat

2.2.1. Household Consumption

With economic growth slowing, we expect the situation of the labour market to ease and for the harmonised unemployment rate to rise towards 6-7% in 2008 and 2009. We saw the first hints of this in the 2nd half of 2007. In 3Q employment grew by 1.9% yoy, which is by far the slowest rate over the last two years. Officially registered unemployment level in December was 4.9%, i.e. 0.1pp above that in November⁷. While it is only a marginal increase (+660 unemployed), it is the first instance for the past two years where the unemployment level has risen. Expectedly we can see that some sectors are increasingly feeling the monetary squeeze and have started to shed labour (e.g. residential real estate and related sectors as loan growth slows), while others (e.g. food retail) are still looking for labour to fill their long standing vacancies. Yet, the labour market still remains very tight with unemployment rate below its natural level (we estimate it to be at ca 7%)⁸. While in 4Q nominal wage growth must have

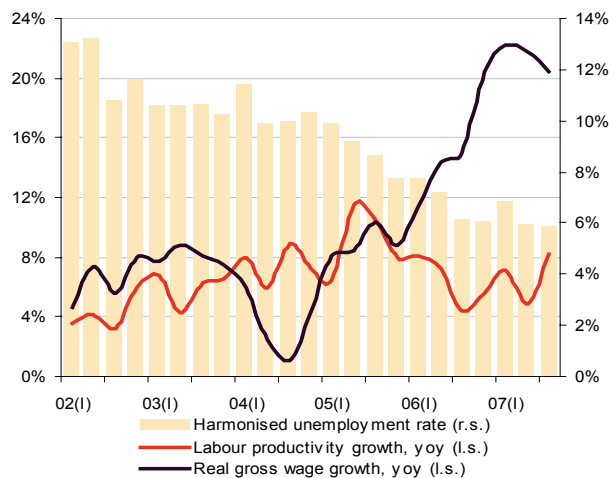
6 Economic Sentiment Index is the weighted average of the industrial confidence indicator (40%), services confidence (30%), consumer confidence (20%), retail trade confidence (5%), and construction confidence (5%).

7 Harmonised unemployment level was only 4.9% in November 2007 (6.1% a year ago).

8 In Riga officially registered unemployment was 3.1%,

remained at above 30% yoy, with rising inflation (see below) we expect real wages to have grown by ca 20% in 2007 (22.4% in 1H 2007). In 2008 nominal wage growth is forecast at ca 15% (i.e. ca 4% in real terms).⁹ Thus, we expect Latvia a return to a situation in which productivity growth exceeds real wage growth. The actual decrease in the rate of growth is not that dramatic after all, as the 2007 data has been distorted by income legalisation (it is estimated that ca 1/3 of the wage growth in private sector might be explained by this factor). In 2008 the pace of legalization may decrease, as with rising inflation and cooling demand companies may try to ease their cost squeeze by less active income legalisation. With cooling demand, employees' ability to demand income legalisation (e.g. to increase social security payments) may diminish. Yet, one must note that with free labour mobility within EU it is unlikely that a rapid rise in unemployment rate and rapid reduction in wage growth will be seen. It may happen if the EU economy sharply slows thereby precluding labour emigration from Latvia and diminishing employer's bargaining power.

Labour Market Indicators



Source: CSBL, Eurostat

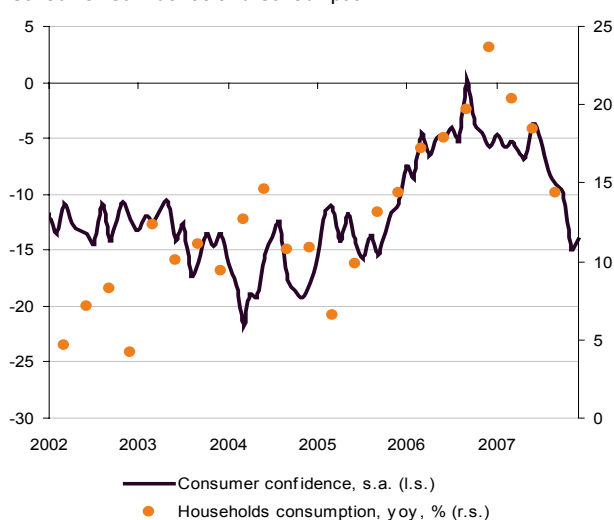
With wage and credit growth retreating from their current unsustainable levels, we expect the pace of consumption growth to decelerate to ca 5% in 2008 and 2009. For primary goods we will see a slowing demand growth, while for items which are not essentials we expect growth rates to turn to the negative. For instance, new car registration has decreased from 90% yoy in January 2007

while high unemployment regions have nearly halved their unemployment rates over the past year, e.g. Ludza region to 14% in December 2007 from 23% a year ago.

9 State budget outlays suggest about 15% rise in the public sector while the private sector has indicated 10-15% wage growth. The increase in the minimum wage increase from LVL 120 to LVL 160 from January 2008 makes at least a 3pp contribution to nominal wage growth; the non-taxed minimum was raised from LVL 50 to LVL 80 - this increases net wage.

to only 14% in December. The weakening trend of consumption growth is clearly seen from mid-2007 driven by several mutually enhancing factors. Firstly, restricted access to credit as interest rates rose (also due to global financial turmoil) and the tightening of income legality requirements.¹⁰ Household credit growth slowed to 42% yoy in November from 78% in January. Secondly, the shrinking residential real estate market¹¹ cut confidence and income from real estate sales available for consumption. Thirdly, rising inflation cut into consumer spending, especially for those with low incomes. In line with these leading indicators, we expect household consumption to have slowed to 9-11% yoy in 4Q, resulting in 15.5% growth for 2007.

Consumer Confidence and Consumption



Source: Eurostat

2.2.2. Investments

Gross fixed capital formation for 3Q 2007 grew by 12.7% yoy (15.9% in 1H), i.e. almost exactly as forecast. In 4Q 2007 it is expected to have further slowed to 7-8%, largely on account of domestic demand sectors. This corresponds to 12-13% in 2007, which is in line with our previous forecast. Being the most pro-cyclical of domestic demand aggregates (and most sensitive to global uncertainty), gross fixed capital formation typically leads the cycle. We expect it to expand by ca 3% (4-7% before) in the two coming years. In some sectors (e.g. residential real estate, and car retail) investment growth will be negative with a slight possibility that it briefly

¹⁰ State Revenue Service notice is necessary to confirm personal income if a loan above 100 minimum wages is taken, dramatically reducing access to mortgages and large consumer credit for those with undeclared income. For mortgages and leasing, an obligatory first down payment of 10% has also been introduced.

¹¹ During May-December 2007 residential real estate prices for Soviet era dwellings in Riga have fallen by ca 17%, the number of deals has about halved from those at the beginning of the year.

drags total gross fixed capital investment into negative growth in 2H 2008. Investment growth in construction will depend on how successful the shift from residential to industrial and infrastructure projects is (supported by the government and EU funds). Although rising energy costs (natural gas, electricity) will put significant pressure on profit margins and thus the ability of businesses to invest, it will be a stimulus to investment in efficiency.

The breakdown by NACE sectors of nominal non-financial investments reveals a cooling of most overheated sectors. In real estate, renting and other business activities, nominal investment growth was nil in 9M 2007 (88.4% yoy in 9M 2006).¹² In other key sectors nominal investment growth has slowed but remains strong. Exceptions are manufacturing with 29% growth in 9M 2007 (-4% in 9M 2006) and public administration with very high 91% growth rate (34.3% in 9M 2006).

2.2.3. Government Consumption

Fiscal policy remained expansionary in 2007, but is set to tighten in 2008 and 2009. Government consumption accelerated to 6.1% yoy in 3Q and we expect it to have remained strong at ca 5.5% in 4Q. This would produce ca 5.5% growth in 2007, which is above the previous forecast of 4-5%. The general government budget surplus in 2007 was 0.7% of forecast GDP, which is above the planned 0.4%. This surplus was achieved solely by the 2.7% of GDP surplus of the social security budget as both basic and municipality budgets had a 1.9% and 0.2% deficit, respectively.

General Budget, Annual Growth Rates %

	2005	2006	2007	2008*
Net revenues	26.7	25.7	33.5	21.0
Tax revenues	26.3	30.3	34.4	19.8
Personal income tax	16.9	29.1	35.1	15.6
Social tax	17.1	28.1	37.7	20.9
Corporate income tax	41.3	40.5	57.5	38.2
VAT	39.1	37.4	29.3	26.1
Excises	31.2	16.6	22.3	21.9
Customs	12.2	7.6	34.4	9.5
Non-tax revenues	19.3	13.1	21.7	6.0
Net expenditures	25.7	24.4	28.0	19.2
Current expenditures	33.8	23.3	28.8	21.1
Capital expenditures	31.3	63.1	49.0	6.5
Budget balance, % of GDP	-0.4	-0.3	0.7	1.0

Source: State Treasury, State Revenue Service
*budget plan

¹² Nominal non-financial investments were particularly poor in residential buildings (-62.5% yoy in 9M) and commercial buildings and structures (-1.1% yoy). Quarterly data is very volatile and cumulative figures provide a more comprehensive picture; across the quarters of 2007 there is no clear downward trend.

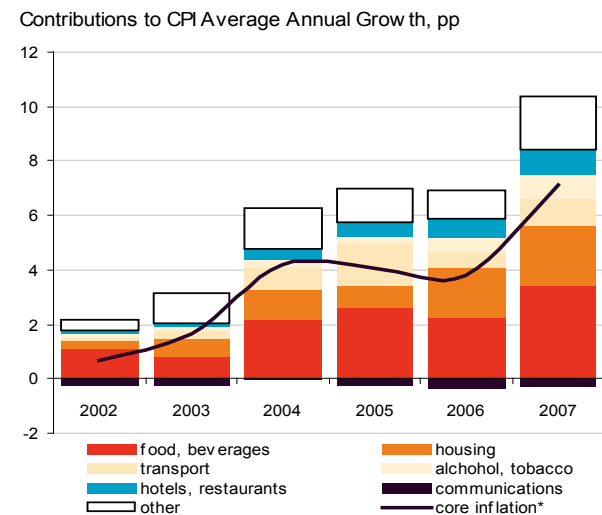
2008 general government consumption is forecast at ca 3% yoy, but it is likely to be raised if the government gives in to public sector trade union pressures. There is an obvious risk that higher inflation and somewhat slower than anticipated economic growth (2008's Budget Law was built on the assumption of 6.3% inflation and 7.5% GDP growth) will put the planned 1% general budget surplus under pressure unless public sector efficiency is considerably improved.

2.2.4. Inflation

Inflation will exceed our previous forecasts. For 2008 we have revised upwards the average CPI inflation forecast to ca 12.5% (from 9%) due to broader and higher than anticipated rises in administrative prices, e.g. the increase of tariffs on public transport, gas, heating, electricity, as well as tobacco and fuel excise jointly contribute ca 3pp directly. Strong inflationary momentum has strengthened inflationary expectations and thus second round effects. Consumer prices are expected to peak in March-April. As the situation in the labour market eases and no considerable increases in administrative prices are further planned, inflation is expected to start to slow down in 2H 2008. The dynamics of world food and energy prices is the other key factor determining the inertia of price growth this year.

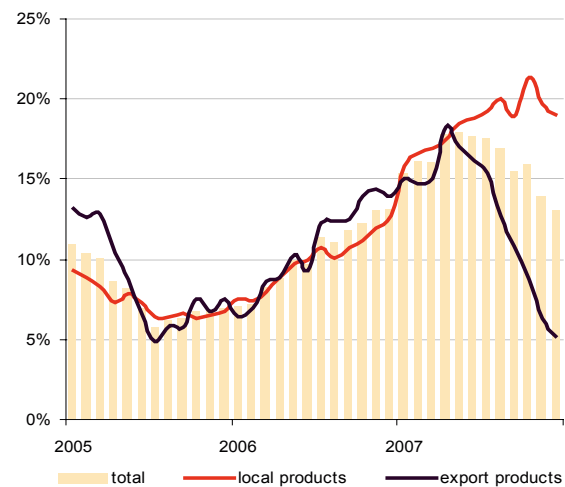
domestic demand pressures than in 2006 (ca 58%). The major contributor to inflation was food prices (3.4pp to average annual inflation or 13.5% yoy) due to globally rising prices and arguably due to rising mark-ups within the domestic supply chain. Other large inflation drivers were housing expenses (2.2.pp), and tobacco excise and transport (ca 1pp each). Inflation hurt particularly households with low incomes.

Producer price growth continued its gradual deceleration since May and decreased to 13.1% yoy in December (16.1 % for 2007). It is important to note that deceleration occurred on account of slower growth of export product prices, while price growth for locally sold products remained strong (12.8% vs. 18.6% average in 2007).¹⁴ We expect that moderating domestic demand will result in deceleration of PPI growth in home markets in 2008. If production costs do not recede accordingly, it may imply a reduction of producer profit margins, as it is unlikely to compensate them in a slowing foreign market.



Source: CSBL, LaB
*HBM forecasted for Dec.07

PPI Growth, yoy



Source: CSBL

The seeds of high inflation were sown by the excessive optimism of 2006 and early 2007. Beating all records of the past ten years, 2007 ended with 14.1% yoy CPI inflation in December reaching an average of 10.1% in 2007, which is in line with our October forecast. Core inflation¹³ comprised on average 70% of CPI growth, reflecting stronger

2.3. External Balances

2.3.1. Current and Capital Account

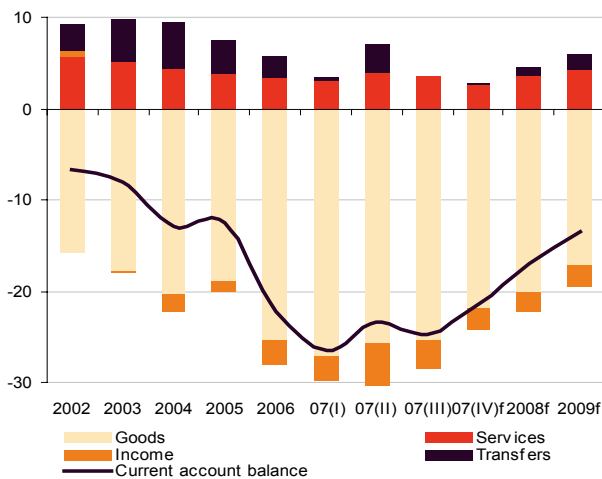
We are of the opinion that in 4Q 2007 CAD improved to ca 21% of GDP (24.8% in 3Q) thereby reducing the annual CAD to ca 24% of GDP (25% before). We are of the opinion that the improvement was driven by the trade balance improving to ca 19.5% in 4Q (21.7% in 3Q) as export growth remained strongly above 20% yoy while imports growth has been melting away

13 I.e. excluding fuel, administratively regulated prices and unprocessed food

14 While goods produced for home and foreign markets do differ, one likely explanation of such a difference is that producers cross-subsidize their profits, i.e. compensate for the inability to raise prices in foreign markets by higher prices (profits) in their local market. An example is the rising cost of labour.

since August. The profitability of foreign investment in Latvia remains strong, being reflected in ca 3% of GDP income account deficit. The joint current and capital account deficit is expected to moderate to just below 23% of GDP in 2007, supported by inflows of EU funds. The Latvian economy remains an attractive investment destination, as in 3Q net FDI remained strong at 5.3% of GDP, over 9 months reaching 8.2% of GDP (7.3% in 2006).

Current Account, % of GDP



Source: LaB

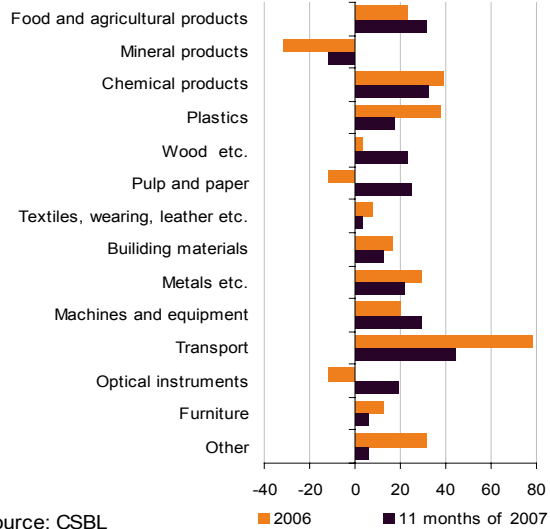
We have revised CAD forecast to 16-18% in 2008 and 12-15% in 2009 (previously 20-22% and 17-20%, respectively) due to a deeper slowdown of import growth (the trade deficit improving to ca 16% in 2008 and 13% in 2009) and a stronger income account (rising interest payments expected to be counteracted by lower income on foreign investment in Latvia as the economy slows).

2.3.2. Foreign Trade

Nominal export growth is expected to reach ca 23% in 2007 (11M 2007 growth at 23.1% yoy) with strong performance in all key commodity groups. Goods exports growth is expected to remain strong as seen in 2007 data and we do not believe it to be abruptly reversed. We expect 12-16% in 2008 and 10-14% in 2009 (before 16-20% for both years) nominal export growth stimulated by producers refocusing on export markets as domestic demand cools, climbing up the value added chain that permits higher margins, efficiency gains due to reducing labour dependency, and banks increasingly lending to export industries. A reflection of structural changes can be seen in manufacturing, which is the key exporting sector. Specifically, while overall real manufacturing growth was nil yoy for 9M 2007, exports growth was buoyant - low value added industries like textiles have been giving place to higher value added businesses. We have lowered

the growth forecast intervals due to: (i) the high base of 2007, and (ii) the stronger global slowdown, which will have a downward effect on both export volumes and prices.

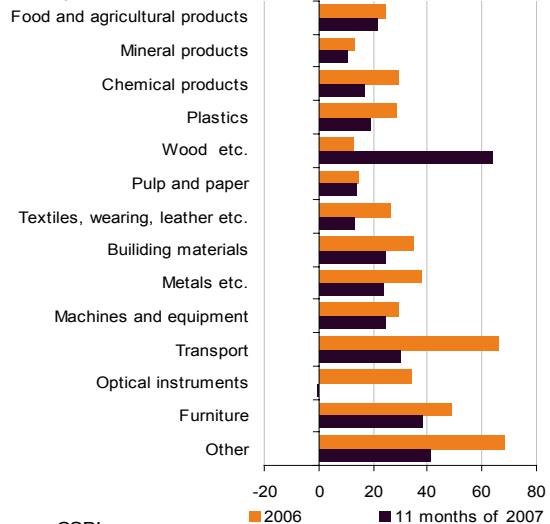
Commodity Export Annual Growth, %



Source: CSBL

Nominal imports growth is expected to reach 23% yoy in 2007 due to rapid growth in the first seven months of the year, although import growth rates have been slowing rapidly since August reaching only 9.4% yoy in November. In 2008 and 2009 nominal import growth is expected to moderate further to 5-10% (10-14% before) both due to the moderation in domestic consumption and investment, and slower price growth as the global economy slows. Again, the forecast is reduced on account of the somewhat lower domestic demand growth forecasts and slowing price growth as the world economy slows.

Commodity Import Annual Growth, %



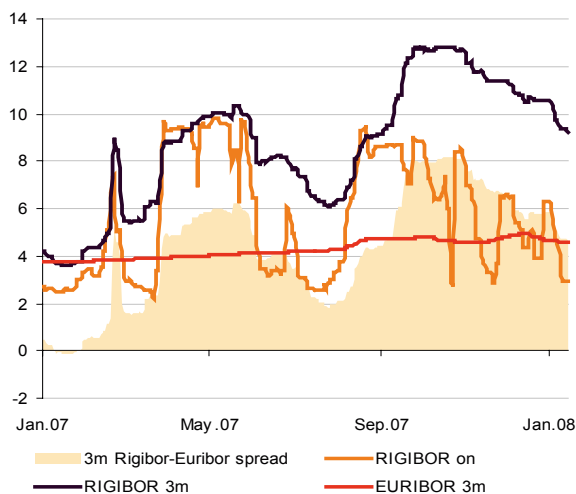
Source: CSBL

3. Monetary Policy and Interest Rates

The LaB continues to pursue a tight monetary policy. Growth of monetary base MO and broad money M3 has more than halved from respectively 40% yoy and 45% yoy in January to 17% and 20% in November. Due to low liquidity in the lats market, RIGIBOR rates topped close to 13% in October (not seen since December 1998). Liquidity tightening was achieved by: (i) the LaB limiting credit facilities to slow down credit growth and excessive optimism; (ii) the government running a budget surplus, which means that by September lats in the amount 2.5% of GDP had been withdrawn from circulation and deposited at the LaB, and not leaked into the money market; and (iii) still swift credit growth, which requires reserves to be held at the LaB denominated in the lats¹⁵.

In mid-November the situation eased as the State Treasury ran down the accumulated budget surplus thus supplying lats to the money market. Slowing credit growth helped to ease the reserve requirement. In December, 3M RIGIBOR slipped under 11% and then further to under 10% in January 2008. The spread between 3M EURIBOR and RIGIBOR has decreased from 820bp in early October to 419bp in late January. However, the spread is still above its historic average (2001-2006 average spread was 160bp), and RIGIBOR interest rates by ca 200bp exceed the level of August 2007, i.e. that before the US credit crunch. Due to the tight monetary policy average weighted lats' lending rates (predominately

Interbank Interest Rates, %

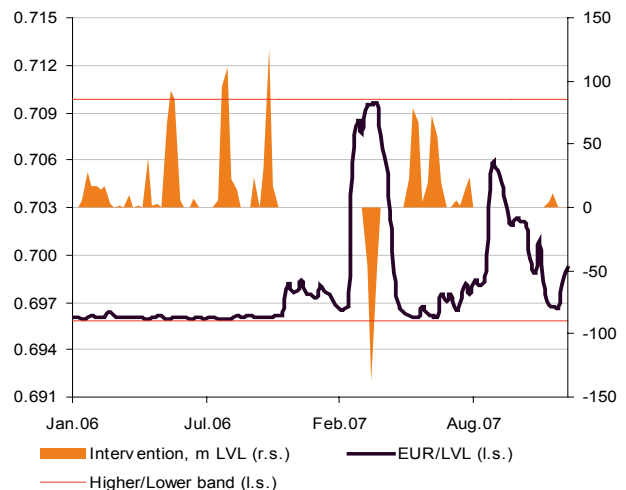


Source: LaB, Reuters

for consumer credit and working capital) continued to rise reaching 15.6% in November. The average weighted euro lending rates, which reflect the largest part of lending) shrank to 6.5% in November (6.7% in October).

The exchange rate situation remains stable and the Latvian lat has strengthened against the euro, spending most of 2H 2007 on the strong side of the band. In December the LaB intervened to buy forex for the total amount of EUR 21m.

EUR/LVL Spot Rate and LaB Interventions



Source: LaB, Reuters

On January 17 the LaB announced that its monetary policy will be relaxed slightly as the economy has started to slow down and credit growth has considerably moderated. With the new reserve requirement period starting on February 24, 2008 the reserve ratio for bank liabilities with a maturity of over 2 years has been cut from 8% to 7%. This will not ease significantly credit growth - rather it is a welcome and timely signal that the LaB will act proactively by adjusting its monetary policy in order to support a controlled soft landing.

Mārtiņš Kazāks
Jurijs Māsāns
Ivonna Slapiņa
Dainis Stikuts
Lija Strašuna
Pēteris Strautiņš

¹⁵ Hence, even if banks borrow and lend in the euro, they are obliged to hold 8% of their borrowed funds at the LaB. As a result, low lats liquidity makes commercial banks bid up the lats' interest rate to finance their lending.

Lithuania

1. Latest Economic Developments

At the end of 2007, economic developments in Lithuania were broadly in line with our expectations: inflation remained in an upward trend, the labour market was very tight and domestic demand continued to boom. In 2007 the Lithuania's economic growth was 8.7%, slightly lower than we expected. According to preliminary data, the Lithuanian economy slowed down to the 7.9% yoy real growth in the last quarter of 2007 (10.8% in 3Q). The real GDP growth was hurt by notably accelerating prices: GDP deflator was up 10.5% yoy in 4Q (6.3% in 3Q). The key drivers in gross value increase were construction, wholesale and retail trade, transport, storage and communication, as well as agriculture.

Investment rose by 19% yoy in first three quarters of 2007, stimulated by healthy growth in construction. Although the pace slowed down, household consumption continued to rise (12.3%) because of vigorous real net wage growth (10.9% in 3Q 2007, a somewhat lower rate is expected in 4Q), a record-low unemployment rate (3.9% in 3Q) and a rapid increase in credit stock (~64%). Domestic demand continued to drive imports, and their growth rates remained higher than the rates of exports. Consequently, the current account deficit deteriorated to 13.5% of GDP over Jan-Nov 2007.

In December, consumer price inflation soared to the highest level in the last decade, reaching 8.1% yoy. Primary goods and services remained the main source of price growth: food and housing costs accounted for 70% of total inflation. Therefore, low income households were the most affected ones

by unfavourable price developments. The average inflation in 2007 climbed to 5.7% and significantly exceeded the price increase of 3.8% in 2006.

The overall mood was shadowed by unfavourable developments in the US economy and global financial markets. Consequently, consumer optimism fell from its peak in July, and business confidence followed at the end of the year, leaving the economic sentiment indicator at 6, the lowest level in almost two years. The real estate market faced stagnation: price growth has, in general, stopped, and the number of transactions fell twice in December 2007, compared to the same month in the previous year.

The Fitch Ratings revised the outlook on Lithuania's long-term foreign currency and local currency ratings from stable to negative. According to the international rating agency, the negative outlook reflects rising inflationary pressures, a further prospective delay to euro adoption. Fitch does not expect Lithuania to adopt the euro before 2013. In addition, a marked deterioration in Lithuania's external imbalances and uncertainty over how the country will secure a gradual adjustment to a more sustainable growth path have had an impact on the Fitch Ratings assessments.

Due to budget laxity which it said would be difficult to manage during an upcoming economic slowdown international ratings agency Standard & Poor's downgraded Lithuania's long-term credit rating to A- from A and lowered its short-term credit rating to A-2 from A-1.

2. Highlights of the Forecast

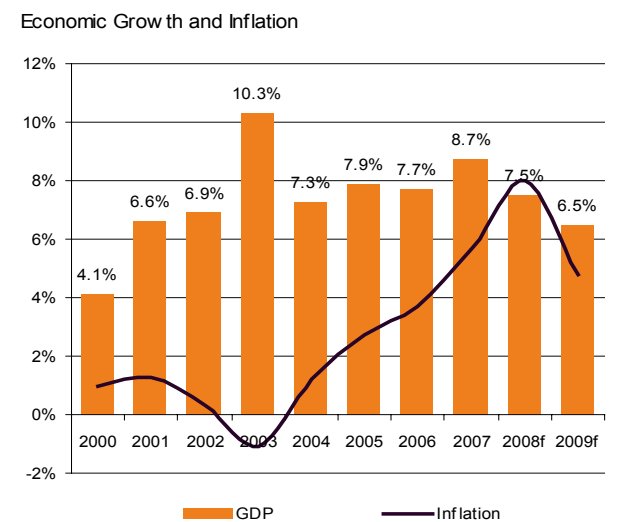
Our forecasts of main indicators have been largely retained (except for inflation) from the previous issue (October) of the Baltic Outlook. This year,

	2002	2003	2004	2005	2006	2007f	2008f	2009f
Economic growth, %	6.9	10.3	7.3	7.9	7.7	8.7*	7.5	6.5
GDP, EURm	15,052	16,452	18,126	20,673	23,721	27,999*	32,898	37,139
GDP per capita, euros	4,329	4,763	5,276	6,055	6,989	8,295*	9,795	11,108
Growth of industrial sales, %	3.1	16.1	10.8	7.1	7.3	4.0*	7.0	6.5
Growth of GDP deflator, %	0.1	-0.9	2.7	5.7	6.6	8.5*	9.3	6.0
Growth of consumer prices, %	0.3	-1.1	1.2	2.7	3.7	5.7*	8.0	4.8
Growth of harmonized consumer price index, %	0.3	-1.1	1.2	2.7	3.8	5.8*	8.0	4.8
Growth of producer prices, %	-2.8	-0.5	6.0	11.5	7.4	7.0*	10.5	7.0
Harmonized unemployment rate, %	13.5	12.4	11.4	8.3	5.6	4.3	4.6	4.7
Real growth of net wage, %	3.8	9.3	4.9	6.8	14.9	17.7	10.5	6.7
Growth of exports of goods and services, %	13.4	6.2	12.0	27.0	17.9	9.3	15.0	14.0
Growth of imports of goods and services, %	13.1	6.9	14.2	26.1	23.1	14.5	15.0	12.6
Balance of goods and services, % of GDP	-5.5	-5.7	-7.0	-7.3	-10.4	-12.7	-12.4	-11.7
Balance of current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-14.0	-13.5	-12.5
Balance of current and capital account, % of GDP	-4.7	-6.4	-6.4	-5.9	-9.6	-12.8	-12.2	-11.3
FDI inflow, % of GDP	5.1	1.0	3.4	4.0	6.1	5.5	3.6	3.7
Foreign gross debt, % of GDP	39.5	40.5	42.4	51.2	60.9	66.0	67.6	68.7
General government budget position, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.6	-0.5	-0.5	0.0
General government debt, % of GDP	22.2	21.2	19.4	18.6	18.2	17.8	17.5	17.3

* actual result

the economy will grow rapidly, though at a slower pace than in 2007 due to price pressures and rising cost, decreasing optimism as well as tightening of credit conditions and negative changes in the global environment. As predicted, Lithuania's economy has already showed some signs of slowdown, which we will be discussing in the following sections in more detail. We maintained the 7.5% GDP growth forecast for 2008 and expect a further slowdown (to 6.5%) in 2009. However the risks are on the downside as the slowdown of domestic demand may appear even more extensive than forecasted. The driving forces of growth will remain the same, as pointed out in the previous issue of the Baltic Outlook: household consumption and investment, although the growth rate will be somewhat smaller. The strong price growth is major reason for household spending slowdown, while companies will hurt by growing costs and weaker domestic demand.

Thus we expect that economic developments will continue to follow the soft landing scenario. This means that domestic demand growth rates will gradually diminish and the external deficit will therefore improve. In 2008, recovered exports should also add more momentum to the economy's growth. The biggest exporter, the Mazeikiu Nafta oil refinery, should show better results, due to last year's lower comparable base. At the same time, the growth rates of imports should shrink, due to the aforementioned slowing of domestic demand. The major risk factors for this scenario are the same: expansionary fiscal policy, high inflation and stronger than expected household consumption. On the other hand, economic growth may fall more slowly or rapidly depending on the reactions of economic agents to the current developments.



Source: LDS, HBM forecast

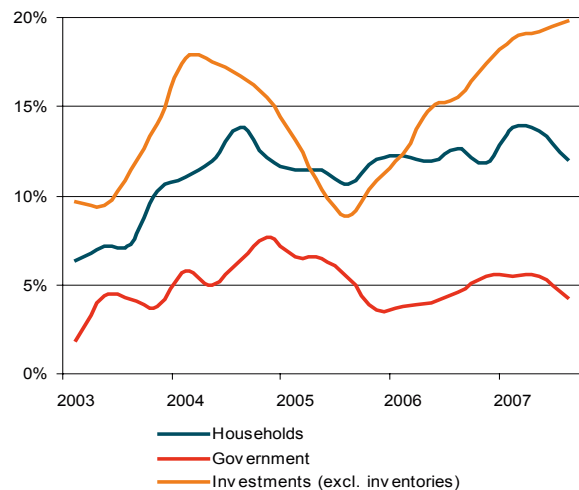
We increased the average annual consumer price growth forecast for this year from the previous 6.8% to 8% and retained the 4.8% forecast for 2009.

We expect inflation to start to slow down in the 2nd quarter of this year as the effect of administrative increases made in January (gas prices and excise duties for fuel, alcoholic beverages) and March (cigarettes) will erode. However, due to inertia we do not exclude the possibility of even higher inflation this year.

3. Economic Growth

The outlook for growth in 2008 remains favourable. GDP growth for 2008-2009 is forecasted to slow down gradually but remain robust at 7.5% and 6.5% respectively. This year, economic growth is projected to stay at the average level of 2004-2006. Domestic demand will continue to be the growth engine of cooling Lithuania's economy. Increasing household consumption, domestic investments and government consumption (elections in October) will be fuelled by traditional factors, such as a low unemployment rate, higher wages, growth in borrowing (although at a slower rate), transfers from emigrants and EU support. At the same time, the strengthening (mainly due to last year's lower comparable basis of mineral products export) of export-oriented industries will maintain the sustainable base of economic development.

Domestic Demand (12 month rolling real growth)

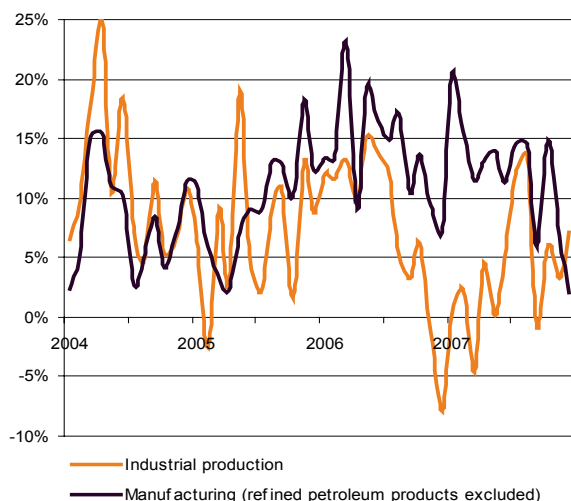


Source: LDS

Even though the economy is still booming, one could detect the first indications of slowdown. It increases the possibility of a soft-landing scenario and confirms our short term outlook. This year, we expect the limiting factors to become more evident, and in 2009 the slowdown will continue.

- The economic sentiment indicators give a picture of decreasing optimism. The latest indicators have weakened substantially: compared to November, the Lithuanian economic sentiment indicator halved (-6pts) in

Industrial Production growth, yoy



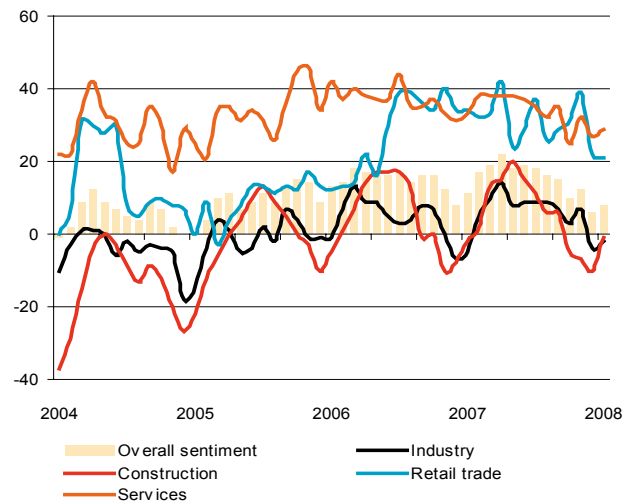
Source: LDS

December and stood at 6. Declining confidence can be observed in retail (-17pts), industry (-11pts), service (-5pts) and construction (-3pts) sectors. The worsening confidence among all business sectors stems from a shortage of labour (especially in services) and lower prospects for demand. In an annual comparison, all indexes (with the exception of industrial) have deteriorated.

- Household consumption, which was accelerating during the 1st half of last year, slowed in the 2nd half: growth eased down from 14.2%, on average, in 1st half to 9% in 3Q. For the current and next year we forecast household consumption to increase by approximately 10% in real terms and will still grow faster than the overall economy. The prediction lies on the assumption that disposable income will grow and borrowing will still continue (however, loan growth should be slower). Increasing nominal spending will also be related to higher central heating, electricity and fuel prices as well as more expensive services due to stronger demand and the considerably higher cost of hiring labour. Moreover, inflation started to curtail consumer purchasing power and decreased optimism. This tendency will be especially evident this year, as inflation is likely to reach a peak and will definitely have an effect on consumption.

- Excessive **consumer optimism declined** already in 4Q (confidence was -8pts yoy in December) of last year. Despite the cut in the personal income tax rate from 27% to 24% starting from January 2008, and the increase in pensions, the outlook for consumers is dim. We can observe a decrease in consumers' expectations of their financial

Confidence Indicators

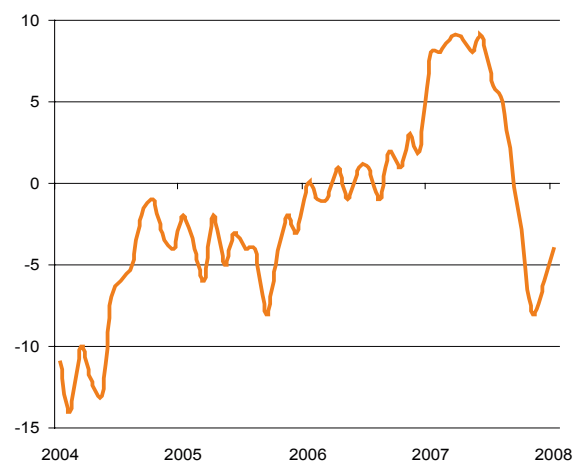


Source: LDS

standing and general economic situation.

- As we expected, **wage growth slowed down** in 3Q of last year, due to a higher comparable base in 2006, then personal income tax was cut from 33% to 27% and from that time the effect of legislation could be observed. In 3Q 2007, the average net monthly salaries in the entire economy soared by 17.4% yoy to LTL 1,455 (EUR 421) and real average wages rose by 10.9%. It was partly stimulated by the increase in minimum monthly wages to LTL 700 since the 1st of July last year and the rise in the general non-taxed minimum from LTL 290 to 320 since January 2007. Due to a continuously high demand in the labour force and the effect of income legislation (due to the personal income tax rate cut in 2008) we maintained our previous forecast for real wage growth. We expect wages to

Consumer Confidence Indicator

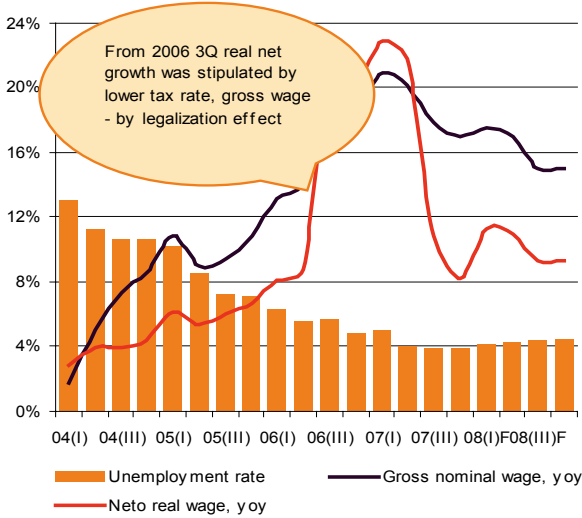


Source: LDS

increase strongly enough to exceed GDP growth: wage growth will reach ~10.5% this year and ease to 6.7% in 2009. In addition, at the beginning of this year we can also see significant bonuses for the previous, highly economically successful, year.

(26.5%). Household debt is dominated by mortgages, but the rapid growth of consumer loans implies that obligations related to those loans might suddenly become very burdensome for some families despite rapidly growing incomes. Looking forward, we expect increasing borrowing, but at a notably slower pace.

Labour Market

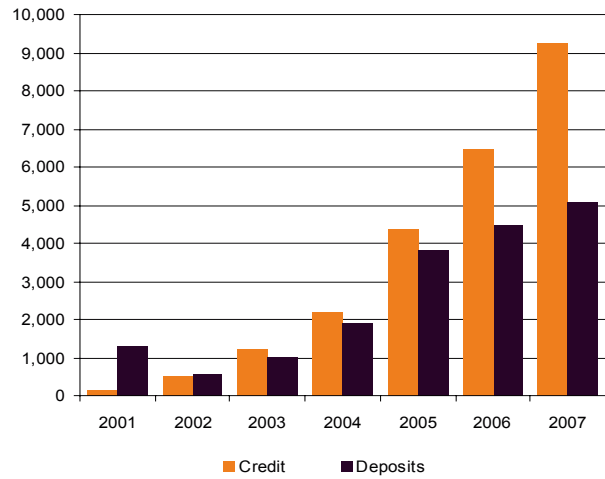


Sources: LDS, HBM forecast

- Last's year **unemployment rate** reached its lowest level in recent history and will remain approximately at the same level, with a slight **upward projection**, in 2008 and 2009. The unemployment rate over the first three quarters of last year stabilised between 3.9-5%. Looking forward, we expect the unemployment rate to reach ~4.5-4.7%, on average, in 2008-2009. Although the retail and service sectors generate an increasingly strong demand for employees, some other sectors can be expected to reduce employment and thus increase the pool of unemployed. Moreover, when the economy slows down, the growth of job vacancies will begin to contract as well. Economic development and the shortage of labour will start to affect companies' personnel politics. The creation of new jobs will diminish and this will also affect employment growth, whereas the unemployment rate and the number of unemployed may show the tendency to increase.

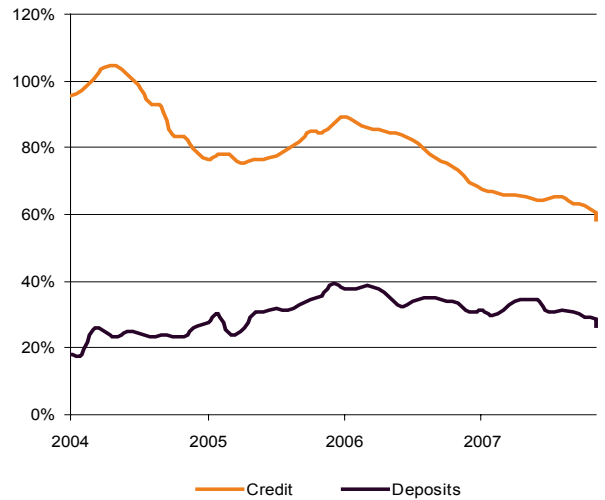
- Higher interest rates, rising inflation as well as a weaker future outlook and tightening bank policies slightly **slowed the booming growth of household credit**. At the end of 2007, the annual growth rate of the banks' mortgage portfolio slightly slowed to 61.9% from 63.1% the year before. In the meantime, all loans to households increased by 58.5% (69.3% the year before) and still strongly outpace the increase in deposits

Household Finances (transactions), LTL m



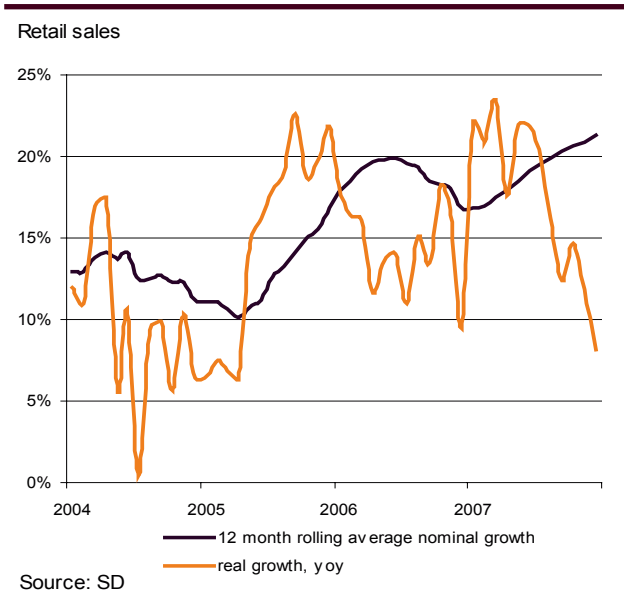
Source: LiB

Household Credit and Deposits Growth, yoy



Source: LiB

- Retail trade real turnover growth, which reflects household consumption, declined from 21.3% yoy in 1H 2007 to 11.9% in November and 8.2% in December. In December 2007 business tendency survey results in the retail trade also showed that demand grew, but at a slower rate. The same is true for the financial situation of companies - the improvement was moderate.

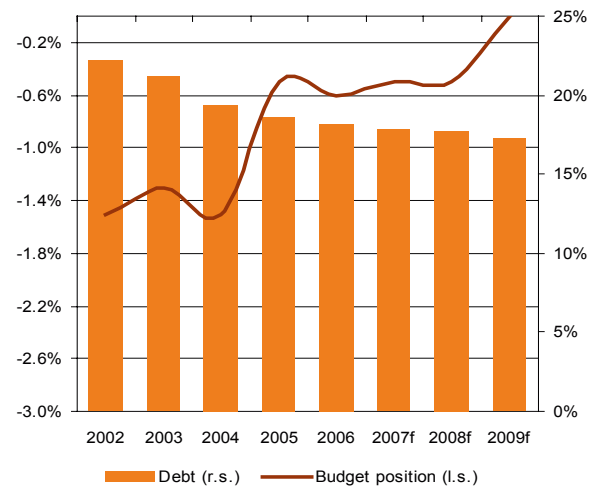


• **Government policy is contradictory**

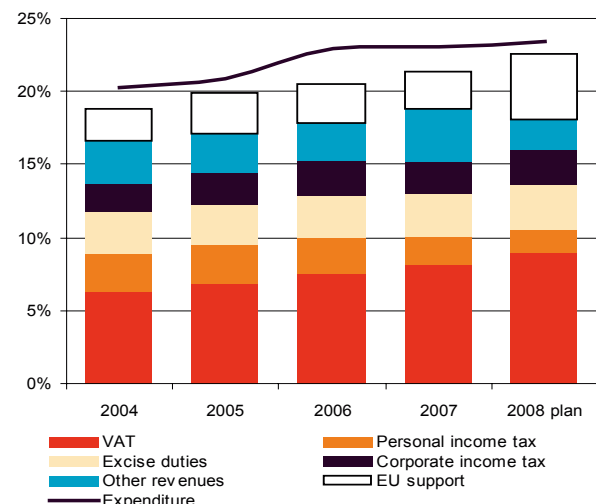
• The 3Q surprised us with government spending, which increased by only 0.9% in real terms and significantly contracted from the 5% growth in 1H. However in the whole of 2007, Lithuania's central government fiscal deficit accounted for 0.5% of the GDP despite due to exceptionally good revenue collection. Strong economic developments have been very beneficial for Lithuania's public finances, but expenditure was much higher. The national budget revenues in 2007 grew by 22.6% compared to 2006, largely due to significant, and again, surprising improvements in revenues from the value added tax, which soared by 27.2%, and excise duties (18.1% growth), i. e. from taxes, which fuelled by increasing consumption and price acceleration.

• However, according to the budget plan, Lithuania's government fiscal policy will be expansionary this year as well. The revenues in the state government's budget are projected to reach LTL 25.6bn (EUR 7.4bn, 23.7% growth) and the expenditures have been pegged at LTL 26.6bn, bringing the deficit to LTL 1bn (0.9% of our projected GDP), but we expect the general government deficit to be not more than 0.5% of the GDP.

General Government Finances, % of GDP



State Budget, % of GDP



• The government has passed a law on fiscal discipline. The law commits the general government to submit a budget with a deficit of less than 0.5% of the GDP in 2008, a balanced budget by 2009, and to maintain the budget balance at around zero over the medium-term. Spending growth should also be restricted if certain criteria pertaining to past budget balances and economic growth are met. As the actual budget balance is in a good shape already, the bill is expected to have no significant impact on fiscal policy or aggregate demand within the next two years. On the other hand, the bill may strengthen the government's attempts to keep extra spending under control especially in light of forthcoming general elections in October 2008.

• As Lithuania has a currency board, fiscal policy is the only tool remaining to influence aggregate demand. Rating agencies are concerned that fiscal policy is less tight than the headline numbers alone suggest. Revenue growth is highly correlated with GDP growth, and will slow commensurately with GDP growth. Further reduction in the personal income tax rate and the abolishment

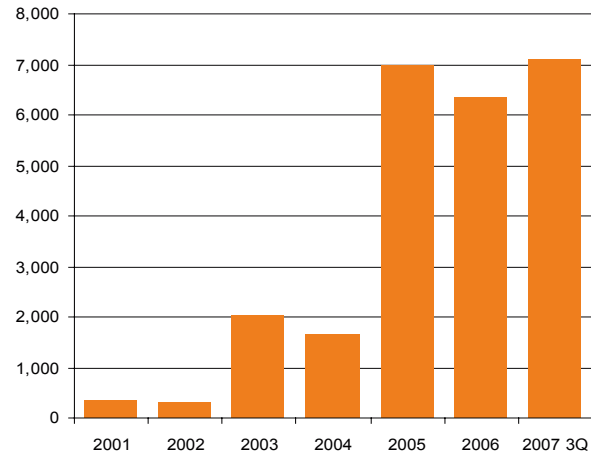
of a temporary social tax on profits raises the spectre of a revenue shortfall when the economy cools down.

- External deficit is expected to improve this year

- Lately, strong domestic demand growth influenced the demand for imports and resulted in a widening current account deficit. The trend of rising deficit has been observed for the last few years and stood at 13.5% of the GDP according to the preliminary data of eleven months of 2007 (10.8% of GDP in 2006). The deteriorating balance of goods and services was the main driver of the deteriorating CAD, as the growth rates of exports continued to lag behind those of imports, 9.1% and 13.4% respectively over Jan-Nov 2007 (17.9% and 23.1% in 2006). In the coming years, we expect the largest Lithuanian exporter, "Mazeikiu Nafta", to recover in exports of mineral products as the company switched on their vacuum distillation tower after more than a year of repairs. With the installation launched, the refining capacity of the plant should reach the level achieved before the fire that broke out at the refinery in October 2006. Meanwhile, the growth rates of imports should shrink due to slowing domestic demand. Therefore, our forecasts are for the CAD to contract from 14% of GDP in 2007 to 13.5% and 12.5% of GDP in 2008-2009.

(covering 73% of CAD), while other sectors received LTL 2.5bn in loans during the same period. The role of FDI was significantly lower, and unsatisfying taking into account the part of FDI that came from Poland's PKN Orlen's investment, buying out minority shareholders of the "Mazeikiu Nafta" company.

Foreign Loans to Lithuanian Commercial Banks, LTLm

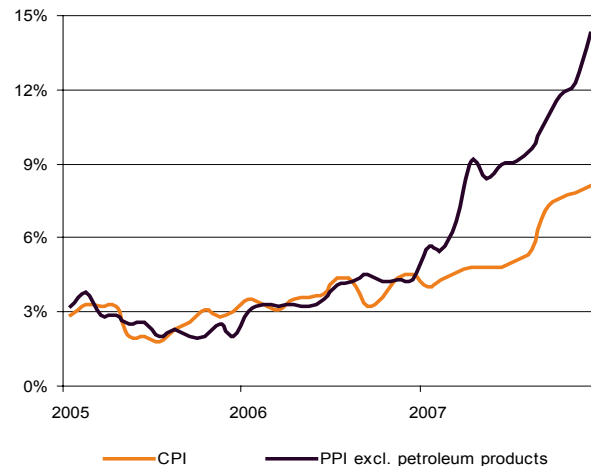


Source: LiB

4. Inflation

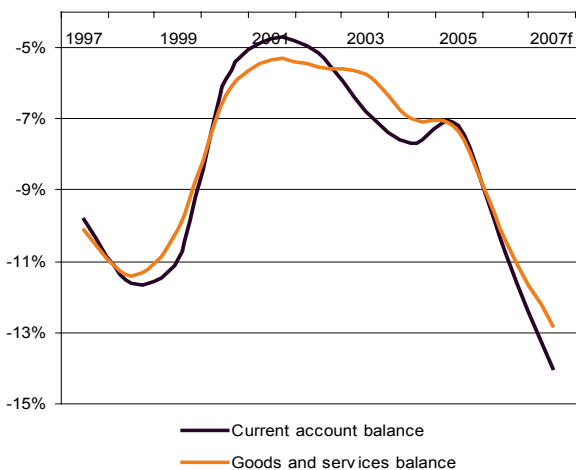
Throughout 2007, CPI inflation maintained an upward trend: the annual inflation gradually doubled from 4% in January to 8.1% in December. The average annual inflation in 2007 reached 5.7% compared to 3.7% in the previous year. A similar situation was observed in producer prices, which exclude petroleum products: the average PPI growth jumped from 3.8% in 2006 to 9.3% in 2007 with a significant upsurge over the fourth quarter of the year.

CPI and PPI excl. Petroleum Products, Annual Growth



Source: LDS

Current Account and Goods and Services Balance, % of GDP

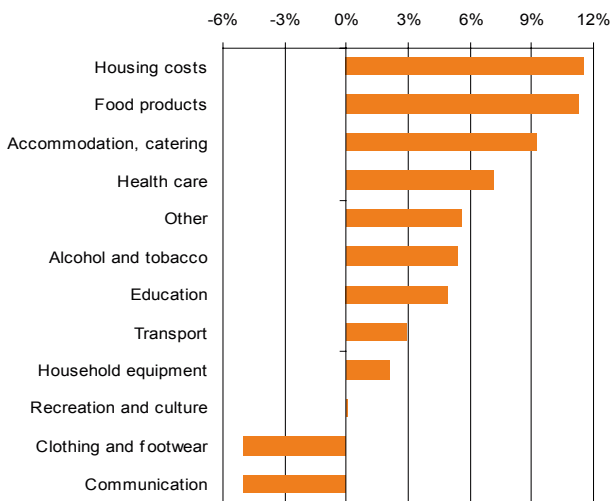


Source: LiB, HBM calculations

- As expected, foreign loans, mainly coming to the Lithuanian banking sector, remained the key source of CAD financing. Loans to the banking sector reached LTL 7.1bn in the first three quarters of 2007

The key contributors to consumer price growth in 2007 were housing costs and the prices of food products, which rose by 11.5% and 11.3% respectively. As they are primary and essential goods and services, the public understanding of the inflation level significantly exceeds the official statistics. However, some price groups have decreased over the year, namely communication services, clothing and footwear (-5%); the prices for recreation and culture climbed by a mere 0.1%.

CPI Component Growth in 2007



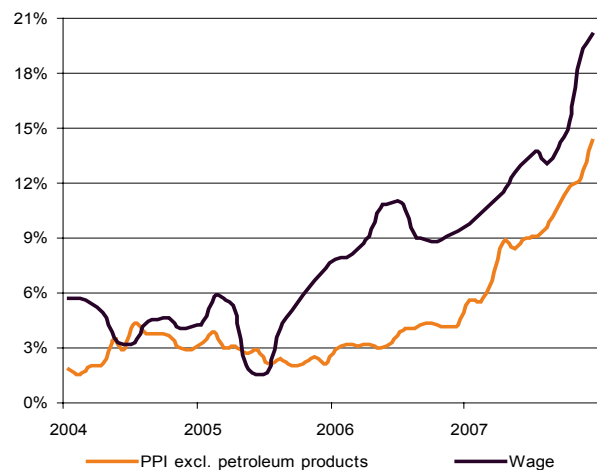
Source: LDS

In December alone, the prices soared by 8.1% yoy, the largest rise over the last decade. The main causes of peaking inflation were food, housing and transport prices - these price groups accounted for 83% of the total annual inflation. Another surge in prices is expected to register in January and March of 2008, largely due to administrative measures. The excise duties on fuel and alcohol were raised at the beginning of January. In addition, the Russian company "Gazprom" increased the price of natural gas imported to Lithuania, and the prices for consumers grew by about 62-67%. The total direct impact of administrative decisions on annual inflation in January is expected to add up to 1 p.p. However, these administrative price changes will drive inflation further through heating energy (i.e. hot water and central heating), electricity and producer prices. March will be another month with spiking inflation, related to the continuing tax harmonization in accordance with EU directives: the excise duties for cigarettes will be 17% higher. Only the price of electricity was not raised in 2008 as had been expected: the Lithuanian government, having in mind the upcoming Parliament elections in October 2008, induced the main companies in the national electricity market to retain the same electricity prices for residents. However, we are sceptical about the success of this attempt to curb inflation, especially because the prices are likely

to be raised more in 2009. Besides which, the electricity price freeze this year was not applied to other consumers (business, public institutions, etc.); hence the effect from producer prices will still be felt.

External factors that will stimulate inflation in 2008 are global food and oil prices (see General Assumptions for more detailed discussion). Internal factors that put pressure on inflation are domestic demand (the price growth in services have outpaced the growth of goods' prices since 2005) and rapid wage growth. The wage and price spiral is becoming an increasingly serious concern in the economy: higher labour costs push producer prices, which in turn will lead to consumer price inflation as well.

PPI excl. oil products and wage annual growth, lagged by 16 months



Source: LDS

Considering the strong pressures on inflation from both internal and external factors, we raised our inflation forecast from 6.8% to 8% in 2008, which should ease to 4.8% in 2009. However, the coming elections in autumn 2008, which are related to a relatively loose fiscal policy, and uncertainty in world price developments may determine upward inflation forecast revisions throughout the year.

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