# Baltics: shifting the gear

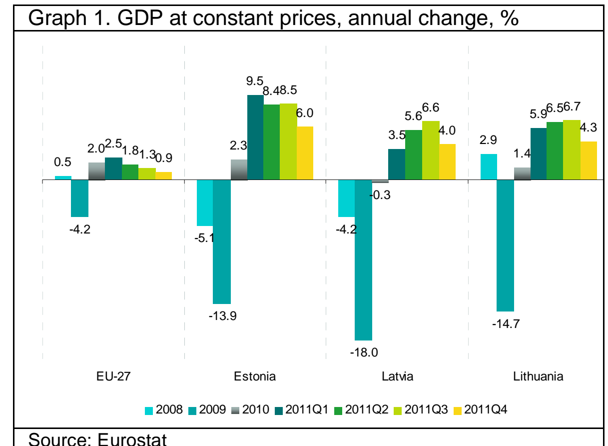
**After a major slump in 2009, the Baltics started to recover in 2010 and turned into the fastest growing region in the EU last year. Estonian economy expanded by 7.6 per cent while Lithuanian and Latvian economies grew by 5.9 and 5.5 per cent respectively (see graph 1). This compares nicely with EU average of 1.5 per cent. According to our forecasts, the Baltics will continue to be amongst the top performing economies in the EU both in 2012 and 2013 but the pace of growth will decrease.**

## Export led recovery

Strong recovery in the Baltics last year was propelled by swiftly rising sales in foreign markets. The three countries were the EU leaders in terms of growth of exports in 2011. Exports of goods and services at constant prices rose by 25 per cent in Estonia and by around 13 per cent in Latvia and Lithuania last year. Expansion was particularly strong in the first half of the year but slowed down considerably towards the end of 2011. The deceleration was affected by deteriorating external environment. In our opinion, exports will expand albeit at a much slower pace this year

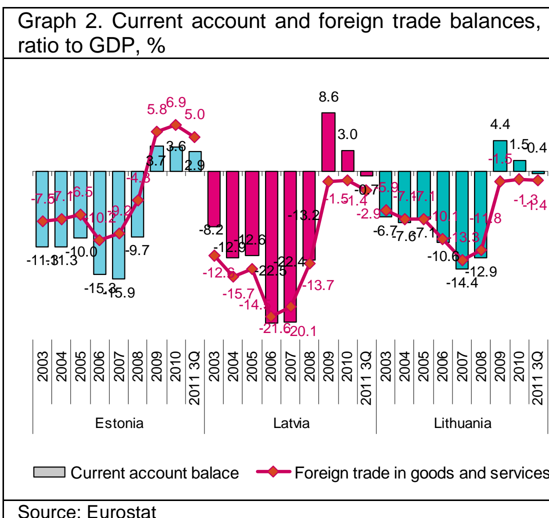
Due to a better diversified geography of trading partners Lithuania will remain among the top performers in the EU in terms of a growth rate of exports. Lithuania is less dependent on the EU market with only 57 per cent of its production being sold there which compares to Estonia's 67 per cent and Latvia's 66 per cent. Lithuania's close ties with the Commonwealth of Independent States will be an advantage as its members have much stronger growth prospects this year.

Graph 1. GDP at constant prices, annual change, %




Source: Eurostat

Graph 2. Current account and foreign trade balances, ratio to GDP, %




Source: Eurostat

The Baltics had a considerable trade deficit prior 2008 varying between 10 per cent of GDP in Estonia to 20 per cent in Latvia. During the crisis, however, trade balances have improved markedly (see chart 2). Estonia has even reported a surplus of 5 per cent of GDP in 2011. Lithuania and Latvia also had only marginally negative current account balances. However, this came as a result of positive net transfers from the EU structural funds and remittances from expatriates.

## Healthier domestic market

Domestic markets in the Baltic states have showed signs of strong recovery last year. This was especially pronounced for Lithuania. Household consumption grew by more than 4 per cent in Estonia and Latvia and by 6% in Lithuania. This had a positive impact on internally orientated sectors. Retail trade (less motor vehicles and motorcycles) grew by more than 4 per cent in Latvia, Estonia and by an impressive 8.8 per cent in Lithuania. While construction activity remains well below the peak reached in 2007 - 2008, the sector recovered strongly last year growing by around 18 per cent in Estonia and Lithuania and by 12 per cent in Latvia.

One major factor behind expanding domestic demand was growing employment. The number of employed people rose by 8 per cent in Estonia, by 3 per cent in Latvia and by 2.4 per cent in Lithuania. Improving consumer sentiment also had an impact. Consumer sentiment on average was by around 13 points higher last year than in 2010 in Lithuania. It appears that a combination of these two factors were the main forces behind the recovery of domestic demand.

On the other hand, rising prices put a downside pressure on domestic consumption. Inflation in the Baltics was largely caused by rising prices of food, fuel, electricity and heating. Energy inflation was less pronounced in Estonia because the country is less dependent on imported energy resources. However, prices of services rose more quickly in Estonia . Average annual rate of inflation was above 4 per cent in Latvia and Lithuania and reached 5 per cent in Estonia. inflation outpaced growth of nominal

wages in both Lithuania and Estonia, resulting in falling real incomes. Only in Latvia people enjoyed rising purchasing power.

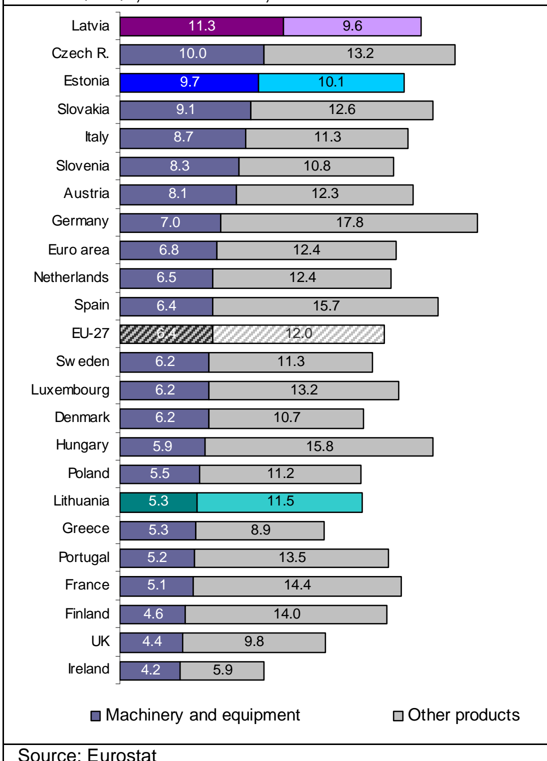
It is important to note a fact that the burden of private sector debt is much lighter in Lithuania than in its Baltic neighbors. Private debt to GDP ratio is around 80 per cent in Latvia and Estonia. It is 50 per cent in Lithuania. This bodes well for future prospects of Lithuania's economic development, as lower level of indebtiness reduces risks for internal market associated with the process of deleveraging and also means lower debt servicing costs.

Domestic consumption is expected to continue growing, albeit a little bit slower than in 2011. Eurpean Commision forecasts household consumption in the Baltics to grow by around 2.7 per cent this year and by 3.4 per cent in 2013. We expect slightly higher growth rate. Real wages should finally start growing in all three Baltic states and employment is expected to rise further.

## Lithuania lacks investments

Investment activities in the Baltics have slowed down markedly since the emergence of economic crisis. The level of fixed investments remained rather high in Latvia and Estonia compared to the EU average. However, low investment activity in Lithuania in recent years is a worrying sign (see graph 3). Lithuania’s fixed investment to GDP ratio was noticeably lower than in the most of the EU countries last year. The difference is especially pronounced in investments in metal products, machinery and transport equipment - arguably the most productive forms of fixed investment.

Graph 3. Expenditure on gross fixed capital formation, 2011 Q1-Q3, ratio to GDP, %




Source: Eurostat

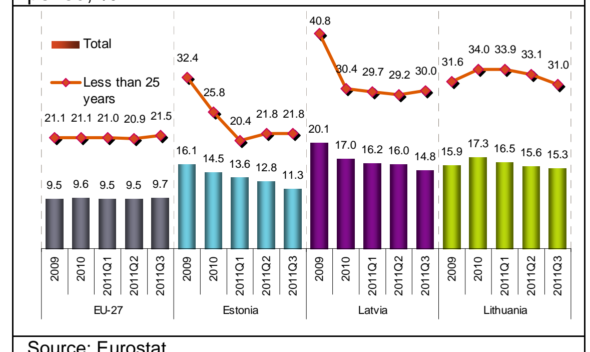
Falling level of investment in the Baltics has to do with the access to financing. Outstanding portfolio of loans granted to private sector (households and non-financial corporations) has been diminishing since the beginning of 2009 and has contracted by 15 per cent on average since then. The process appears to have stabilized only in Estonia, while Latvia and Lithuania continues to be in decline. The loan portfolio shrank by around 6 per cent in the three Baltic states last year compared to an increase of 1.5 per cent in the Eurozone. This is the problem of both demand and supply of credit. Industrial companies are not eager to expand their production capacity given the uncertain environment in export markets while banks are managing their risks as well.

Attracting foreign capital also proves to be a difficult task for Lithuanian and Latvian governments. This is yet another area where the two countries lag behind not only Estonia but the most of the EU countries as well. Accrued FDI per capita was at around EUR3800 in Latvia and Lithuania and more than EUR9000 in Estonia at the beginning of 2011.
This comes as a result of many different factors. More than anything else, this indicates rigid business environment and complicated tax system in Latvia and Lithuania. Drawing larger inflows of FDI is critical for the Baltic countries. It allows attracting more advanced technologies and gaining access to global distribution channels which would facilitate penetration of foreign markets.

## Labor market is improving. Estonia’s positions is the strongest

As mentioned above, unemployment rate diminished noticeably in all the Baltic countries with Estonia registering the sharpest fall. Average unemployment rate fell by a quarter to 12.5% in Estonia. Labour market activity improved in Latvia and Lithuania as well - both had an average unemployment rate of around 15.4 per cent in 2011 (see graph 4). Unfortunately, falling unemployment cannot be explained solely by rising employment with an exception of Estonia, Decreasing levels of participation in the work force and emigration also played its part in Latvia and Lithuania. The number of employed people in Estonia is rising faster than

Graph 4. Seasonally adjusted unemployment rate, end of period, %




Source: Eurostat

the fall in the number of unemployed people. This

implies a rising level of participation in the work force. Estonia also leads the way in the Baltics in terms of work compensation. Average net monthly wage was at around EUR460 in Latvia and Lithuania and at EUR636 in Estonia last year.

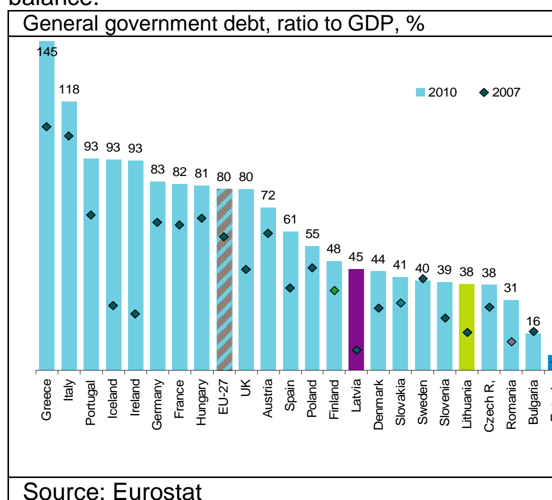
A pressing problem is youth unemployment. While Estonia managed to reduce it at least to EU average (22 per cent) the indicator remains at around 30 per cent in Latvia and Lithuania. Being a result of rigid educational systems and a mismatch between labor market demand and supply and a low demand for unqualified labor force youth unemployment is one of the main incentives to emigrate. Not surprisingly, Latvia and in particular Lithuania are amongst the leaders in the EU in terms of emigration flows. This yet again depletes the labor force making it more difficult for companies to find qualified people, expand production and to stimulate economic growth. Hence a vicious circle is created.

## Public finances improving, no imminent threat looms

All three countries have been successful in taking public finances under control since 2008. However, Latvia asked for external support from the IMF. Lithuanian government's budget deficit to GDP ratio was around 4.5 per cent according to preliminary estimates in 2011, Latvia had a bit smaller budget deficit while Estonia most likely enjoyed a budget surplus.

Latvia's and Lithuania's budget deficits are expected to continue shrinking in the coming years and Estonia will maintain a mildly negative budget balance.

General government debt, ratio to GDP, %




Source: Eurostat

Sovereign debt of all three countries remains moderate (or tiny in case of Estonia) compared to the EU average. According to latest results, Lithuania's and Latvia's government debt to GDP ratio is around 40 per cent, while Estonia's debt burden is only 6 per cent of GDP. The problem is the pace of deterioration. For instance, Lithuania's debt increased from 18 per cent in 2007 to 37 per cent in 2011 (see graph 5). However, debt level will stabilize in the coming years if countries maintain fiscal discipline. One must note that budget balances are strongly affected by factors beyond the control of their respective governments. This particularly applies to small and open economies. Further development of sovereign debt crisis may have a major impact on the Baltic economies and their fiscal performance through the export channel.

Access to international debt markets might be another major issue for Lithuania and Latvia. Fortunately, Latvia and Lithuania find themselves in a rather favorable situation at the moment regarding financing needs. Lithuania's remaining debt refinancing needs for 2012 amount to EUR1.6bn. Covering budget shortfall will require another EUR1bn. Lithuanian government already has 45 per cent of funds needed to meet remaining financing needs for 2012. Moreover, it already has enough foreign currency to redeem EUR1bn euro denominated bond issue maturing in May.

Latvia has yet to refinance EUR208mm of debt this year and will start repaying the IMF bailout loan (the sum will amount to EUR343mm this year). Additional EUR634mn will be needed to cover budget shortfall. This puts Latvia's total remaining refinancing needs for 2012 at EUR1.3bn. Country's government has already issued enough debt to cover half of the amount and has sufficient foreign currency for upcoming maturities. Bearing in mind healthy demand for treasury bills in local market Latvia should find it easy to raise the required funds.

Estonia has the healthiest public finances in the EU with virtually no sovereign debt and positive budget balance.

## Slowdown materializing

Despite strong growth in 2011 indicators of looming slowdown is becoming more apparent as the Euro zone's problems are starting to take their toll on the Baltic economies. Seasonally adjusted qoq GDP growth has been slowing down in all three countries since the second quarter of 2011. GDP growth fell below zero in Estonia in the final quarter of 2011.

Yearly growth of exports has been slowing down since the beginning of 2011. This had a major affect on export orientated manufacturers – its growth rate in Estonia and Lithuania have diminished markedly towards the beginning of 2012 and the sector is likely to expand at a current rate of around 3 per cent throughout the 2012. Latvia's manufacturing showed some resilience but this is unlikely to last. Construction sector will also presumably expand at a much slower pace than in the previous year.

Domestic demand has shown surprising resilience in the Baltics so far but with two major sectors (manufacturing and construction) likely limiting new employment retail trade will soon start to feel the effect. This all points to an end of a speedy recovery in the Baltics. Nevertheless, we still expect the economies to expand at around 3 per cent in 2012. This will continue to be one of the best growth rates in the EU.

## Our key macroeconomic forecasts

**Lithuania**

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Real GDP, annual change, % | 5.9 | 3.0 | 3.0 | 3.0 |
| Current account balance, ratio to GDP, % | -1.7 | -2.5 | -3.0 | -3.0 |
| Annual inflation, % 1) | 3.4 | 3.2 | 2.7 | 2.5 |
| Average gross monthly earnings, annual change, %1) | 2.5 | 4.0 | 4.0 | 4.0 |
| Unemployment rate, % 1) | 13.9 | 12.0 | 10.0 | 8.0 |
| Government budget balance, ratio to GDP, % 2) | -5.3 | -3.5 | -3.0 | -3.0 |

**Latvia**

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Real GDP, annual change, % | 5.7 | 3.0 | 3.0 | 3.0 |
| Current account balance, ratio to GDP, % | 1.2 | -2.0 | -3.0 | -3.0 |
| Annual inflation, % 1) | 4.4 | 2.5 | 2.5 | 2.5 |
| Average gross monthly earnings, annual change, %1) | 4.4 | 4.0 | 4.0 | 4.0 |
| Unemployment rate, % 1) | 14.6 | 12.5 | 11.0 | 9.0 |
| Government budget balance, ratio to GDP, % 2) | -4.0 | -3.0 | -3.0 | -2.0 |

**Estonia**

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| Real GDP, annual change, % | 7.6 | 3.0 | 5.0 | 5.0 |
| Current account balance, ratio to GDP, % | 3.2 | 1.0 | 1.0 | -4.0 |
| Annual inflation, % 1) | 5.0 | 3.5 | 3.0 | 2.5 |
| Average gross monthly earnings, annual change, %1) | 6.3 | 4.0 | 4.5 | 5.0 |
| Unemployment rate, % 1) | 11.4 | 9.0 | 7.0 | 6.0 |
| Government budget balance, ratio to GDP, % 2) | 0.5 | -2.0 | -1.0 | 1.0 |

1) end of period
2) Forecast

*Key assumptions*
- central bank rates in the major economies will largely remain at today’s levels until the 201
- oil price rises to $150/barrel in 2015

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