

Baltic macro outlook – Q3 2016

Rokas Grajauskas
Chief Baltic Economist
Danske Bank A/S Lithuania branch
rokas.grajauskas@danskebank.lt
+370 674 03350

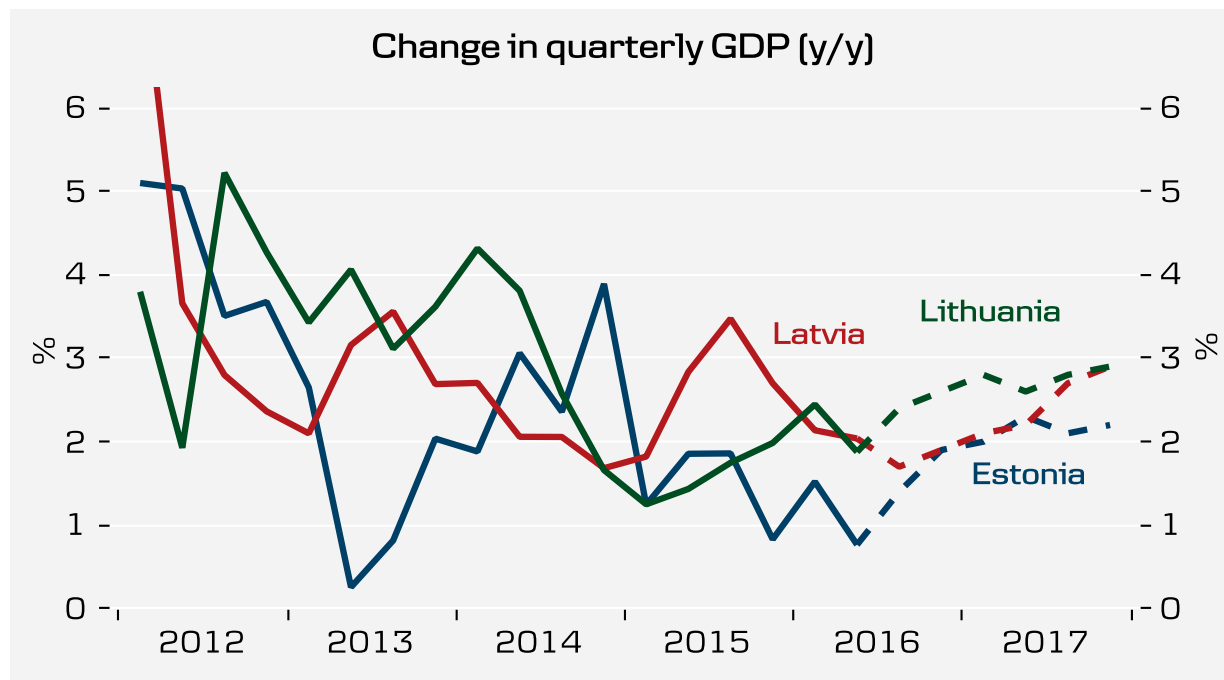
2016-09-30

Key messages

- All three Baltic economies have been **growing at a modest pace in 2016**. Lithuania maintained the highest growth rate (+2.2%) compared to 1.1% in Estonia and 2.1% in Latvia.
- Supported by rising wages and growing employment, **private consumption remains the key driver of growth**, although **exports have also recovered more strongly** in all three economies compared to weak 2015.
- Due to **lower disbursement of EU funds** from the 2014-2020 financial perspective, **fixed investment has taken a hit** in all three economies, although in Q2 2016 **investment in Estonia expanded for the first time since mid-2014**. Investment is not expected to recover more strongly before 2017.
- Falling investment is reflected in the **negative performance of the construction sector**, most notably civil engineering. The **transport sector is still trying to recover** from losses incurred in the Russian market, although **the Lithuanian transport sector is already growing**.
- **Rising labour costs are eroding corporate profits**. The share of profits to added value is now at record low levels in all three economies.
- Despite slow growth, **employment continues to expand**, thus **pushing down unemployment**. Estonia is a relative exception as stronger growth in the labour force compared to employment has kept unemployment at a higher level in 2016 compared to 2015.

Modest GDP growth in 2016

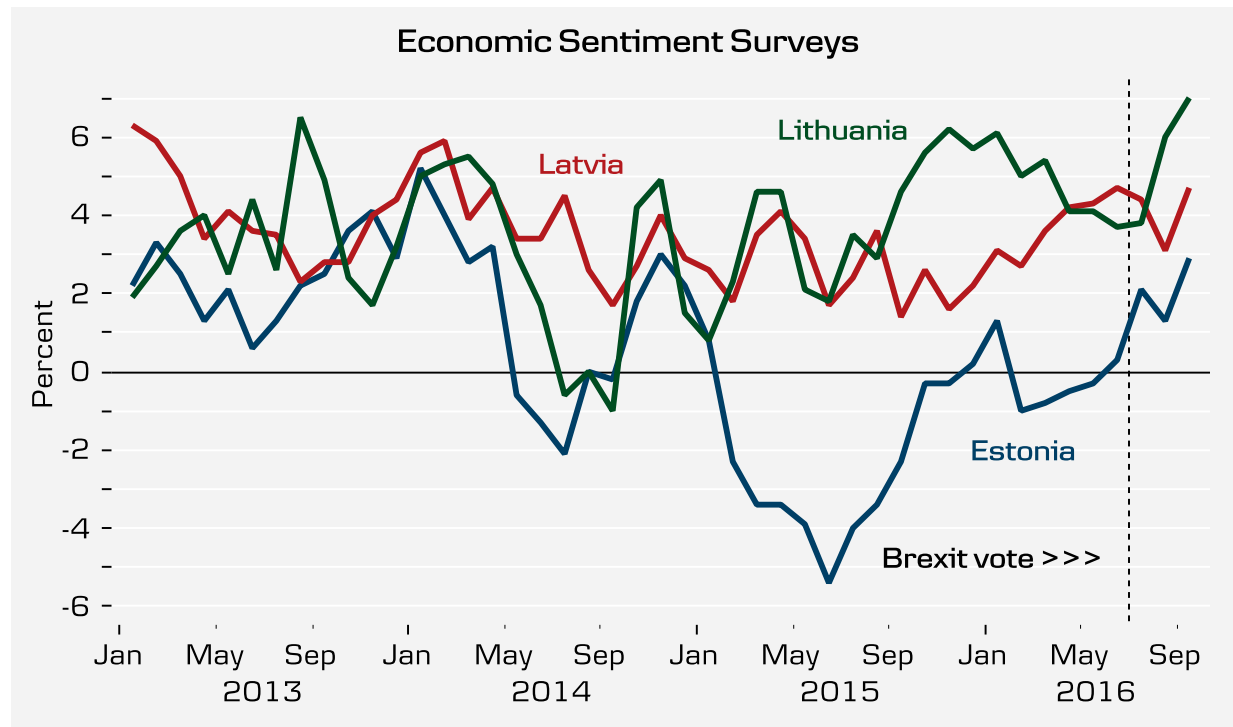
- Lithuania maintained the highest GDP growth among the Baltics in H1 2016, growing at 2.2% compared with 1.1% in Estonia and 2.1% in Latvia.
- Growth is expected to remain lacklustre throughout 2016. Estonia is set to grow at 1.5%, Latvia at 1.8% and Lithuania at 2.5%.
- In 2017 growth should reach 2.1% in Estonia, 2.7% in Latvia and 2.8% in Lithuania.



Source: Macrobond, Danske Bank Markets estimates

Economic sentiment has improved since the Brexit vote

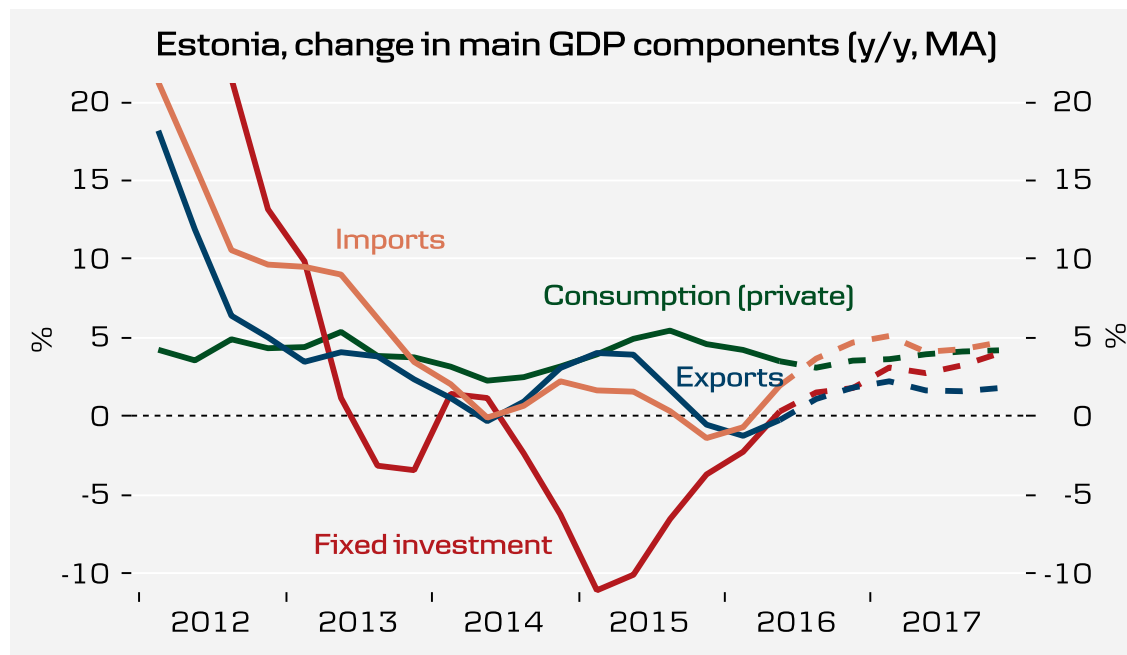
- Economic sentiment has improved in all three economies since the Brexit vote in June and is also higher on a year-on-year basis.
- This indicates that the effect of the Brexit on domestic demand will be limited. The key potential effect is from lower economic growth in main European markets. However, there still needs to be more evidence that economic growth will be slower in Europe due to Brexit.



Source: European Commission, Macrobond

Estonia – balancing out

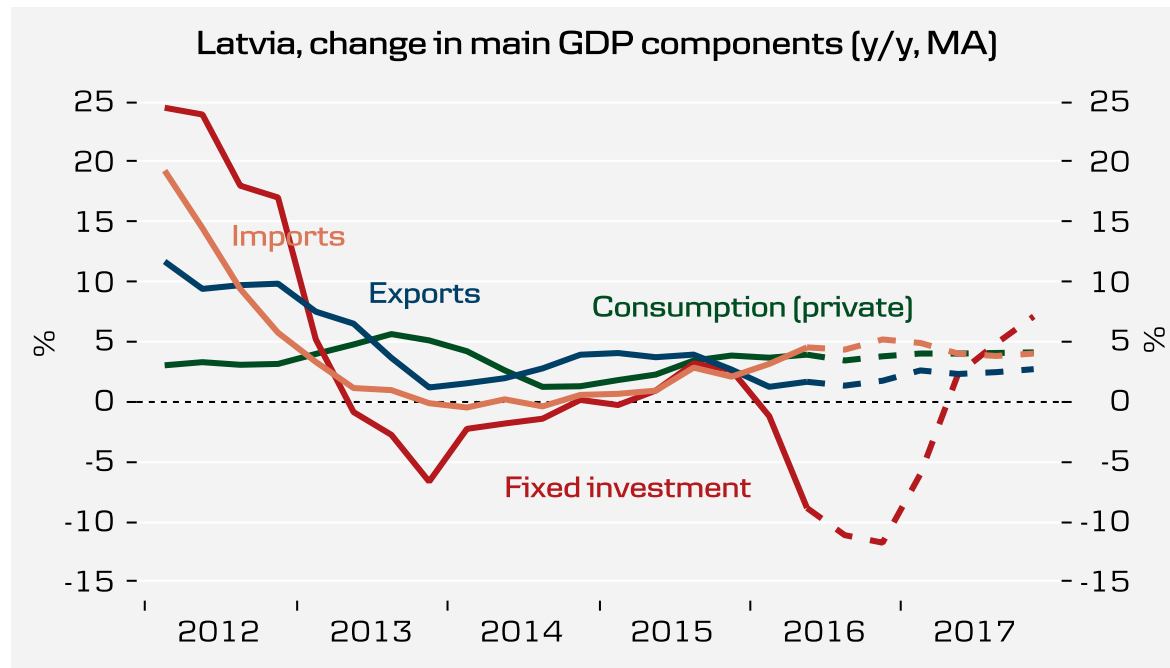
- After negative export growth in 2015, export in H1 2016 was the key driver behind economic growth (+2.2% y/y).
- Growing wages and increasing employment also increased consumption (+3.4%).
- After seven consecutive quarters of contraction, investment in Q2 2016 has finally picked up, allowing for investment growth to be positive in H1 2016 (+2.1% y/y). Investment should continue growing in the second half of 2016 and into 2017 and will be facilitated by a more rapid disbursement of EU funds from the new 2014-2020 financial perspective.



Source: Macrobond, Danske Bank Markets estimates

Investment taking a deep dip in Latvia

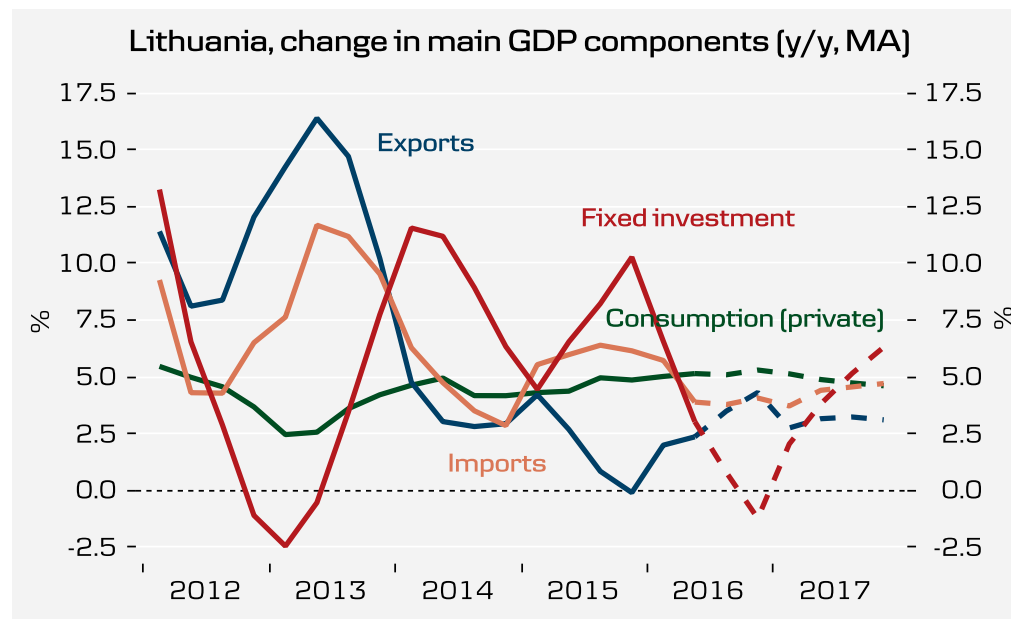
- Investment has taken a deep dip this year in Latvia (-21% y/y) largely driven by lower disbursement of EU funds from the 2014-2020 financial perspective. This brought investment-to-GDP ratio down to just above 16% - the lowest level since 1997. As EU funding picks in 2017, investment should bounce back to higher levels. We therefore expect investment growth to be more pronounced (+7.1%) in 2017.
- In H1 2016 consumption remained the key driver of growth (+3.6% y/y).
- Export of goods and services in H1 2016 expanded by 1.6% y/y.



Source: Macrobond, Danske Bank Markets estimates

Falling investment pushes down economic growth in Lithuania

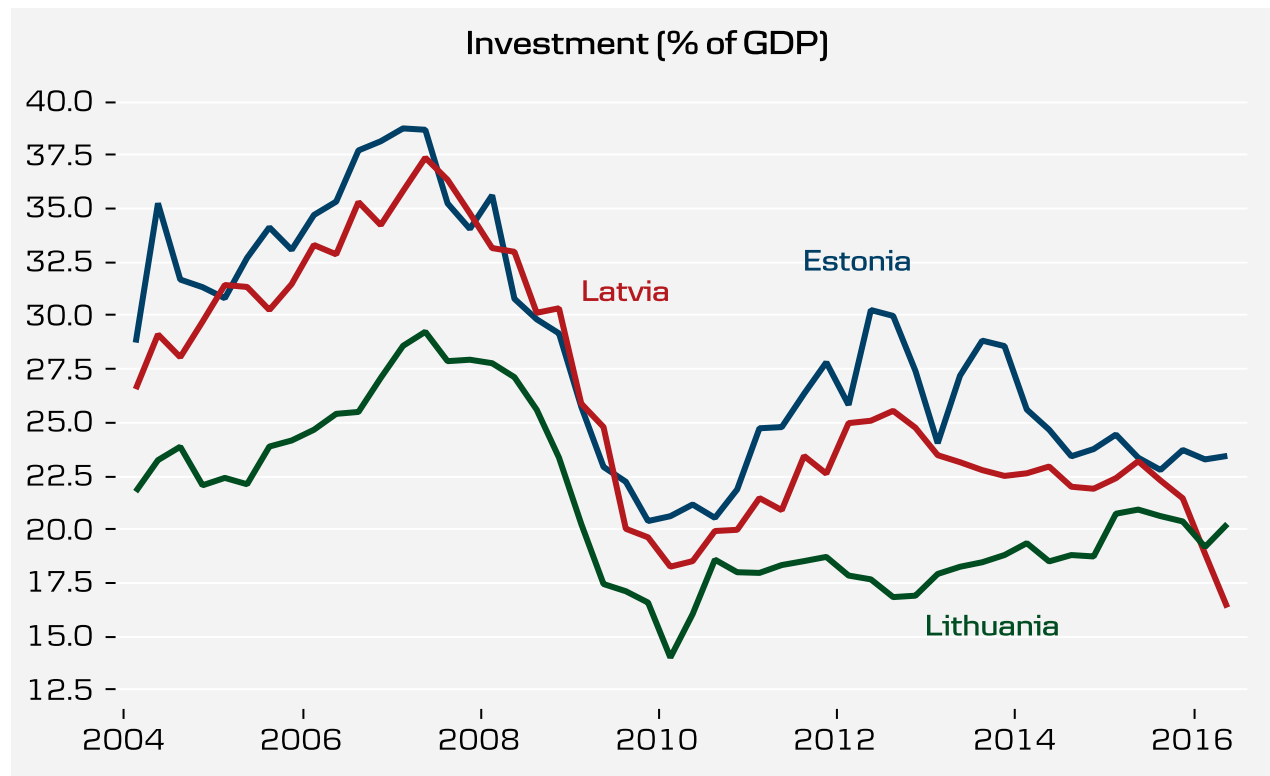
- After robust growth in investment in 2015, Lithuania did not manage to avoid a contraction in investment in H1 2016 for the same reason as in Latvia - lower disbursement of EU funds from the 2014-2020 financial perspective. Capacity utilisation is at record high levels, thus demand for investment remains strong. Investment should pick up speed in 2017 as EU money reaches the planned investment projects.
- As wage growth accelerates and employment continues growing, consumption is expanding at strong pace (+5.4% y/y in H1 2016).
- Exports in H1 2016 also grew by 5.4%. Growth was particularly robust in Q1 2016 (+9.3% y/y) but slowed down in Q2 2016 to 1.5% y/y.



Source: Macrobond, Danske Bank Markets estimates

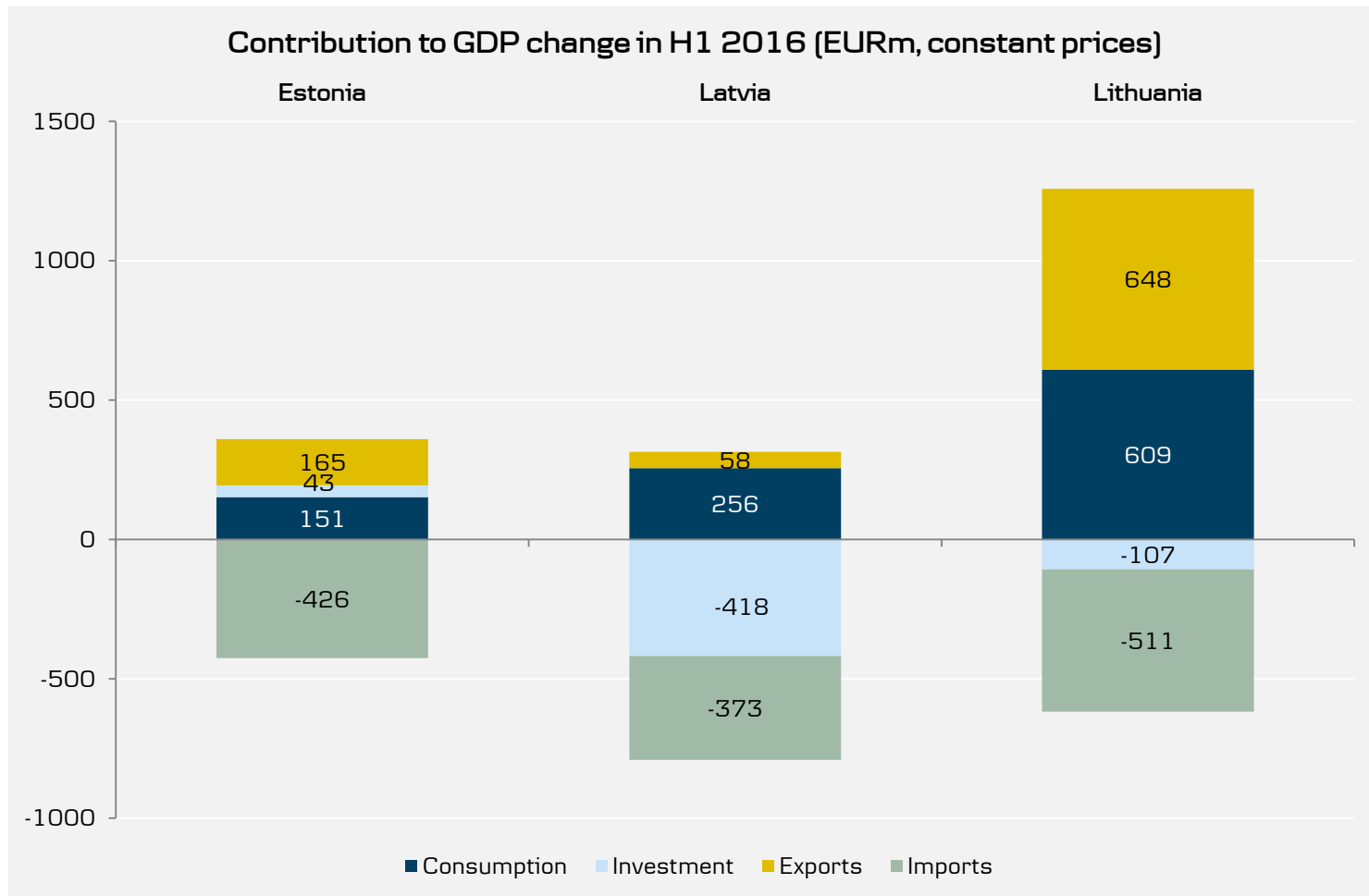
Investment still most robust in Estonia

- Despite the recent setback, Estonia still maintains the highest rate of investment among the Baltics.
- One of the key factors keeping investment rate consistently higher in Estonia is the policy of applying 0% tax on reinvested profits.



Source: Macrobond, Danske Bank Markets estimates

Factors behind GDP change in the first half of 2016

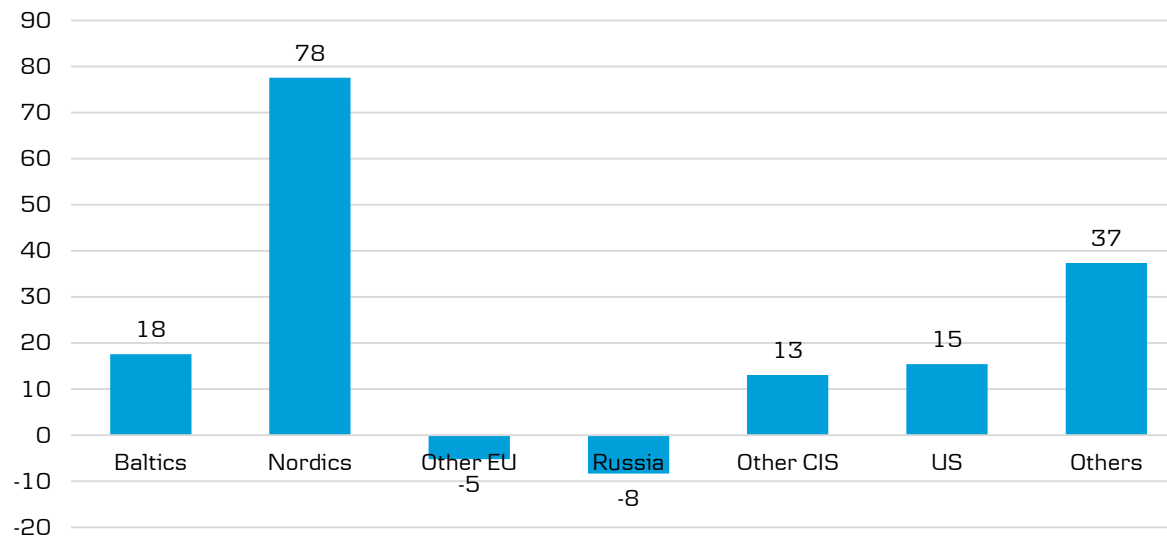


Source: National statistical offices, Danske Bank Markets

Recovery of Estonian exports after the decline in 2015

- Estonian exports of goods and services grew by 2.2% in H1 2016. Exports of goods expanded by 1.9% while exports of services grew by 2.8%.
- Nordic markets led the way in growth. Other markets where exports expanded were Mexico, Saudi Arabia, Nigeria. Key categories to have grown were machinery, furniture, electrical equipment. After a very sluggish start of the year, sales of *Ericsson Eesti* recovered in Q2 2016. Overall, exports of products produced by the company declined by just more than 1% y/y in H1 2016.

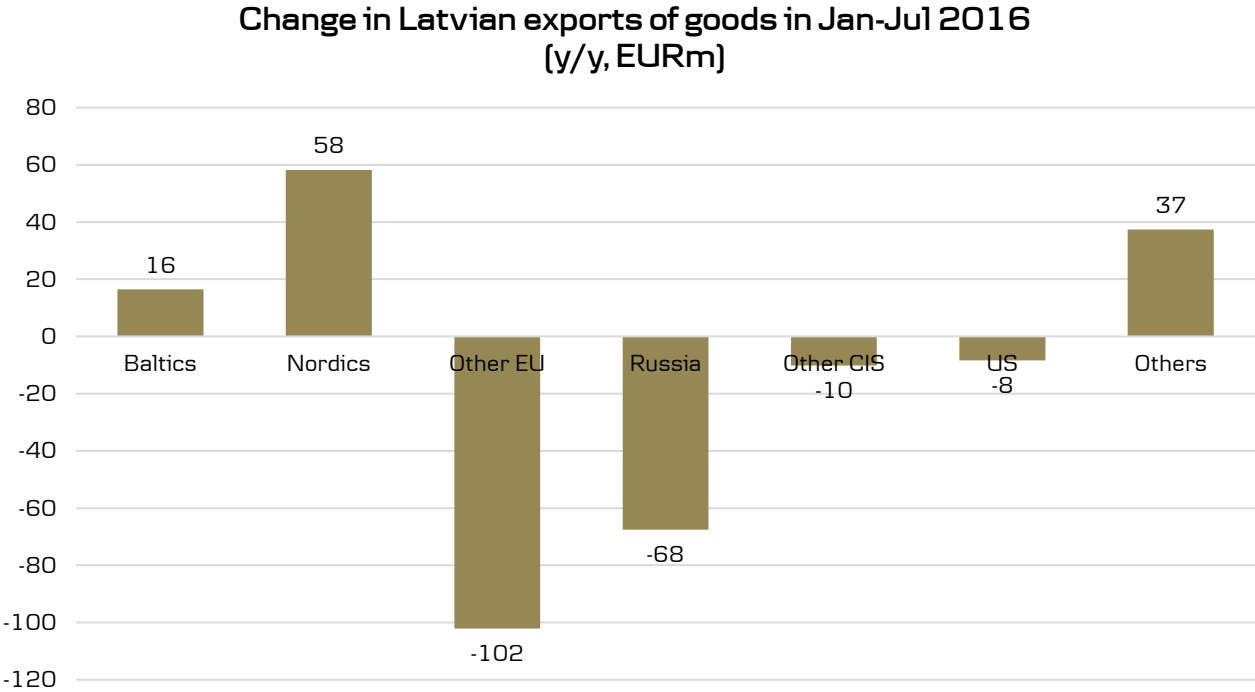
Change in Estonian exports of goods in Jan-Jul 2016
(y/y, EURm)



Source: Statistics Estonia, Danske Bank Markets
Note: Export of oil products not included

Export growth in Latvia maintained by services

- Latvian exports of goods and services in H1 2016 expanded by 1.6% y/y. While exports of services increased by 4.1%, exports of goods declined by 1.4%.
- The key category which led the decline in the export of goods was mobile phones (down 36% or EUR152m y/y). Categories that grew were pharmaceutical products, grain and transport equipment.

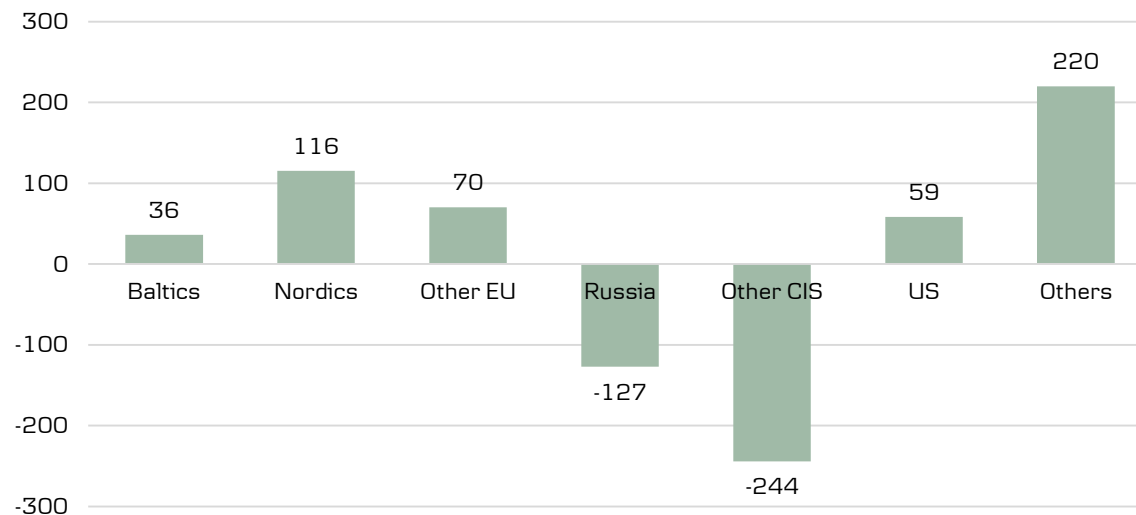


Source: Statistics Latvia, Danske Bank Markets
 Note: Export of oil products not included

Strong export performance in Lithuania in H1 2016

- Despite slowing down in Q2 compared to Q1 2016, Lithuanian exports of goods and services in the first half of 2016 expanded by 5.4% y/y. Export of goods grew by 4.3% while export of services, driven primarily by transport services, construction and business services, by 9.3%.
- As for goods, the biggest decline was recorded for exports to Russia and other CIS countries (mainly re-exported fruits and vegetables). Exports expanded to the Nordics and Other markets, such as Saudi Arabia (dairy products, grain), Japan (tobacco products) and UAE (grain and furniture). Overall, categories to have expanded most were grain, pharmaceutical products, optical and electronic products.

Change in Lithuanian exports of goods in Jan-Jul 2016
(y/y, EURm)

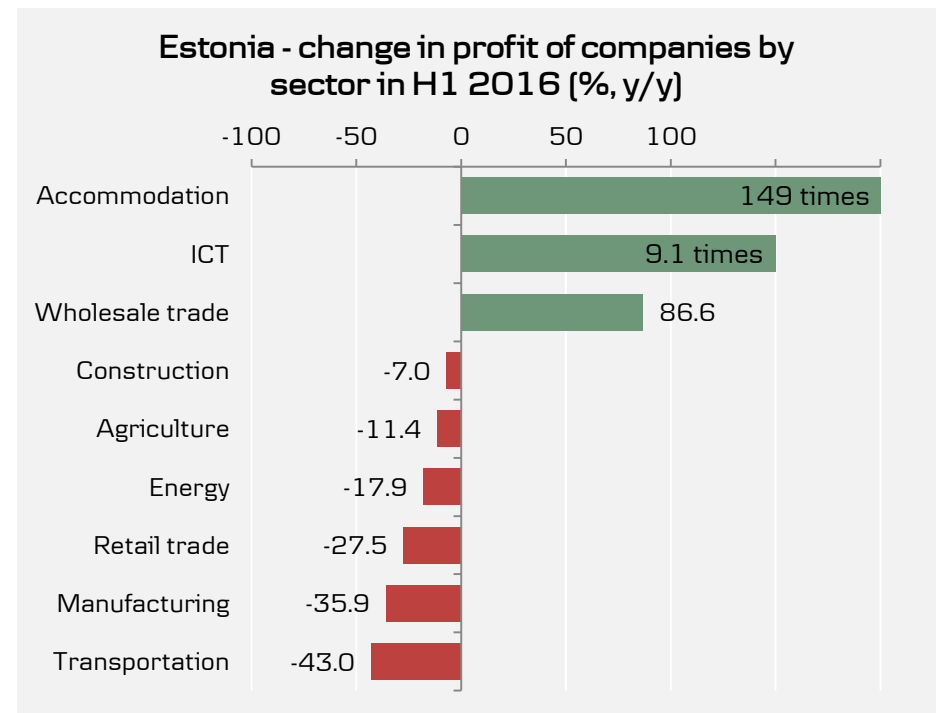
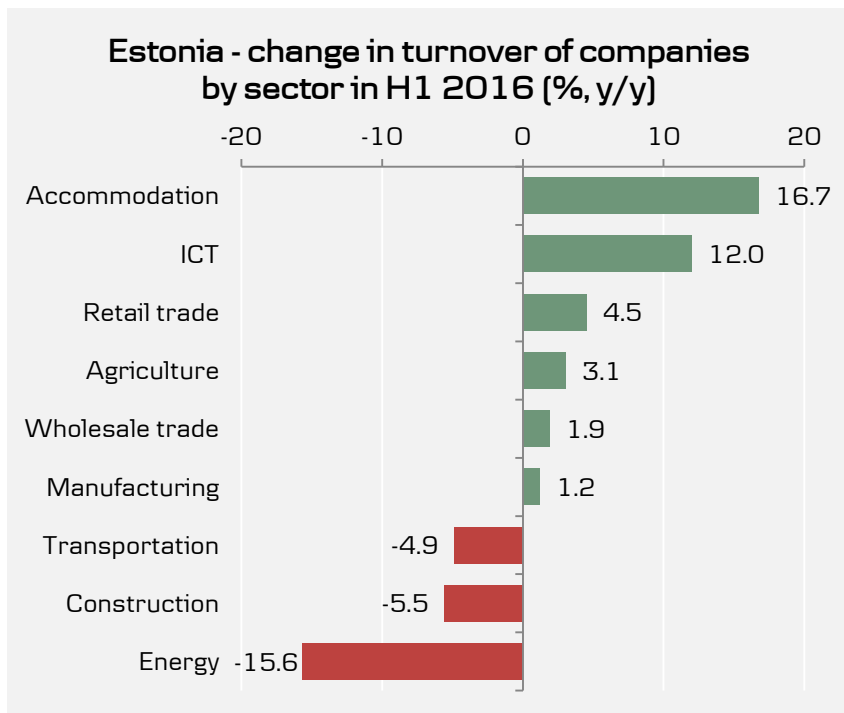


Source: Statistics Lithuania, Danske Bank Markets

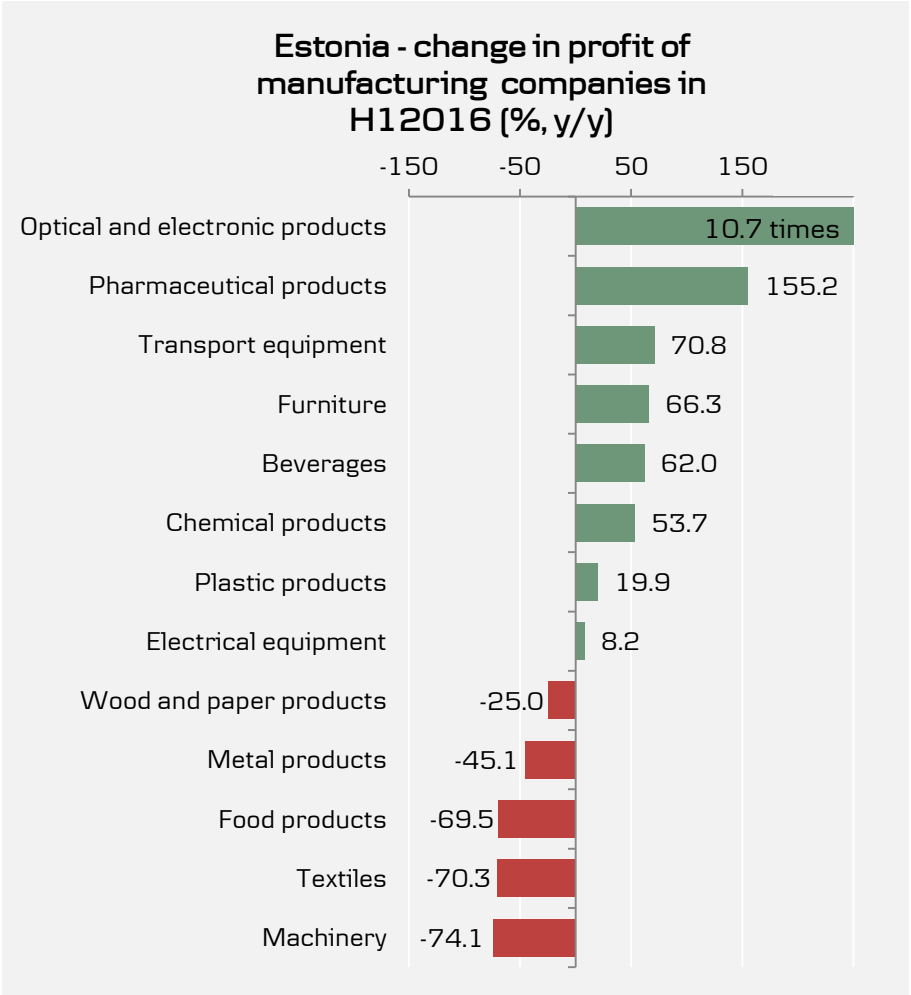
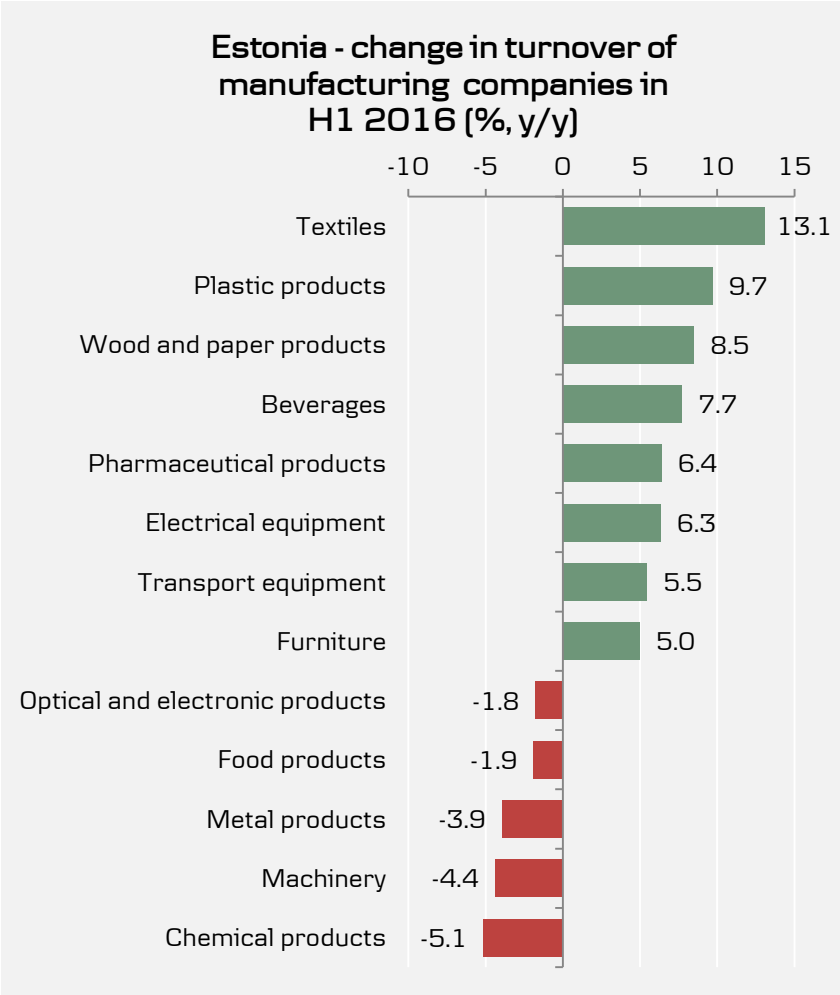
Note: Export of oil products not included

Turnover and profit of Estonian companies continue to decline

- The turnover of Estonian companies in H1 2016 expanded by 1.5% while profits shrank by 8.5% y/y.
- Key sectors that led growth in turnover were accommodation and ICT. Driven by fast growth in consumption, retail trade expanded by 4.5% (5.1% in real terms). The energy sector experienced the biggest decline due to problems in the oil shale sector. Other sectors to have declined were construction and transportation.
- Manufacturing grew at a modest 1.2% (in real terms declined by 0.4%), while profit of manufacturing companies contracted by more than a third. Profit of companies producing electronic products increased by more than 10 times but from a very low base. Profitability of this sector increased to just over 2%.



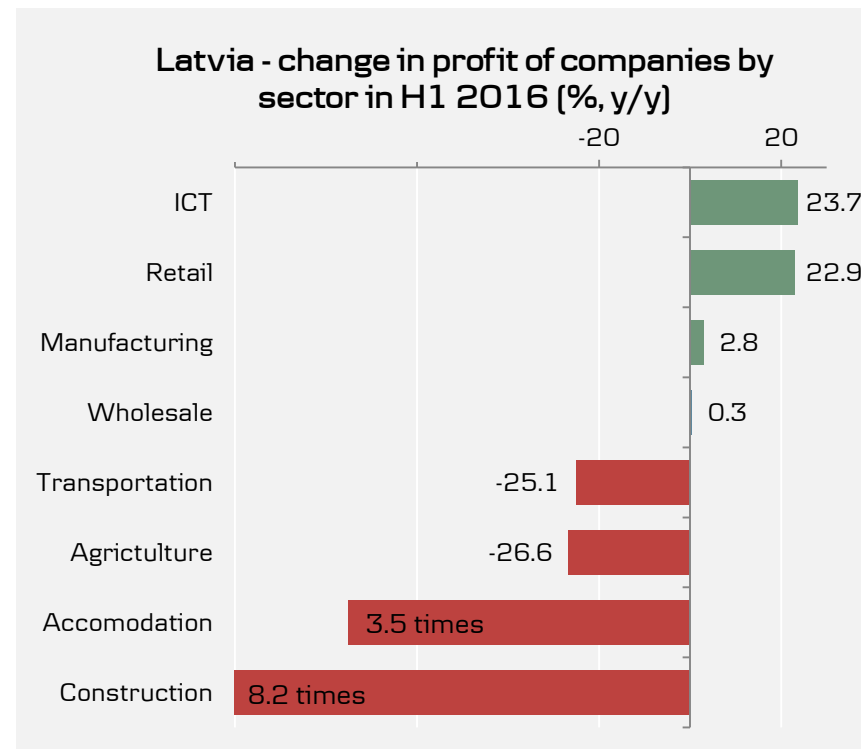
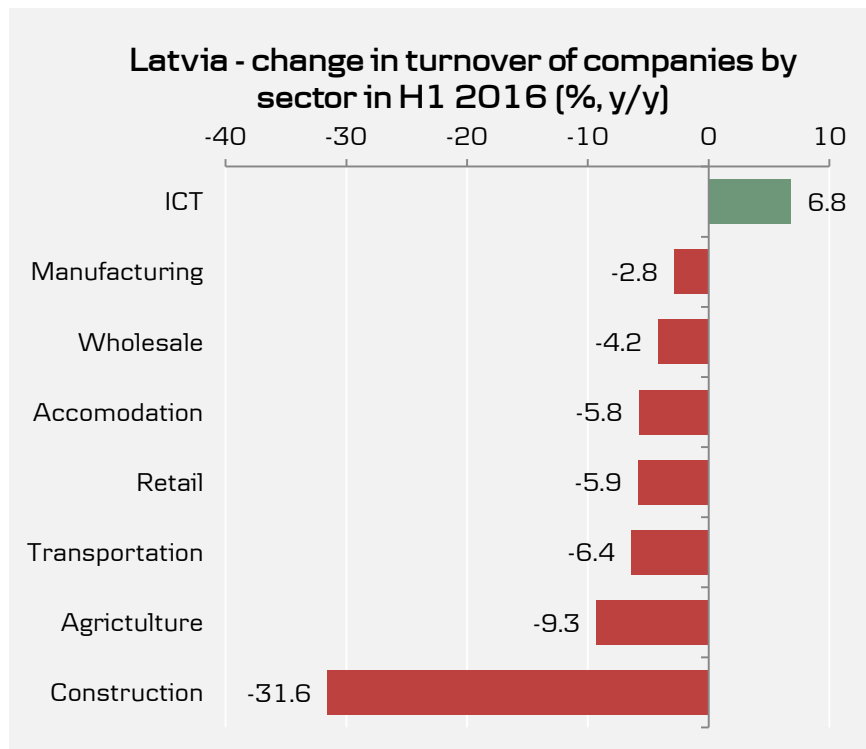
Estonian manufacturing: profits take a hit



Source: Statistics Estonia, Danske Bank Markets

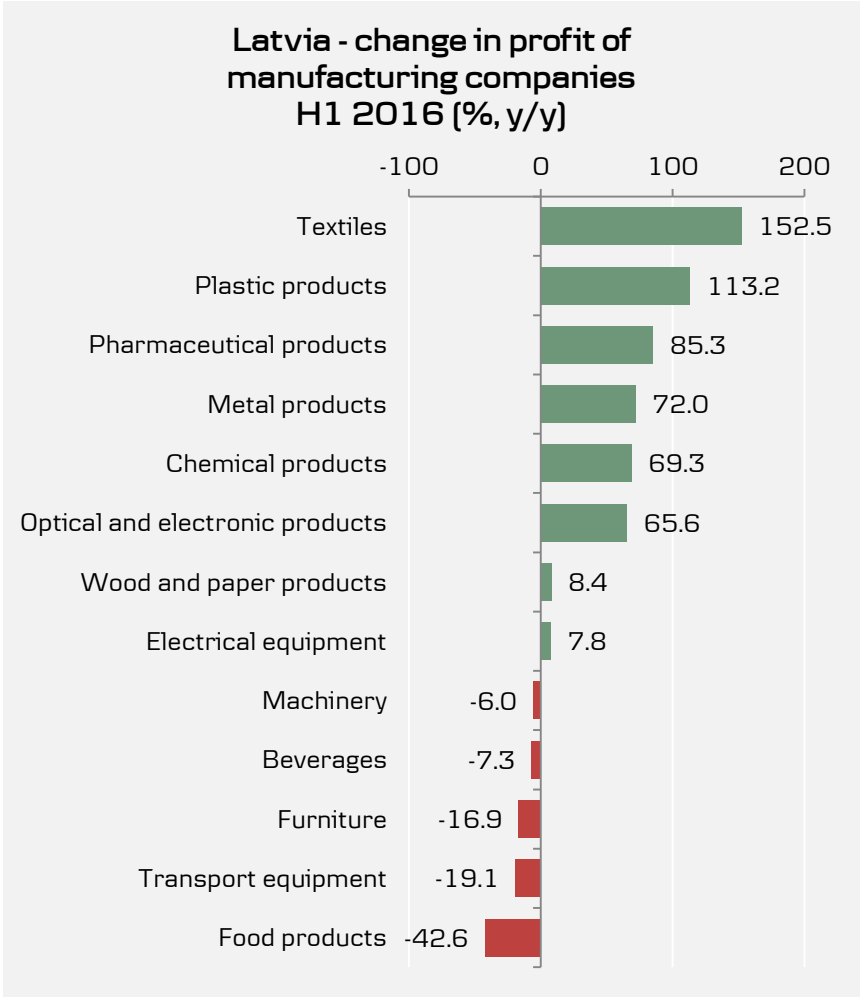
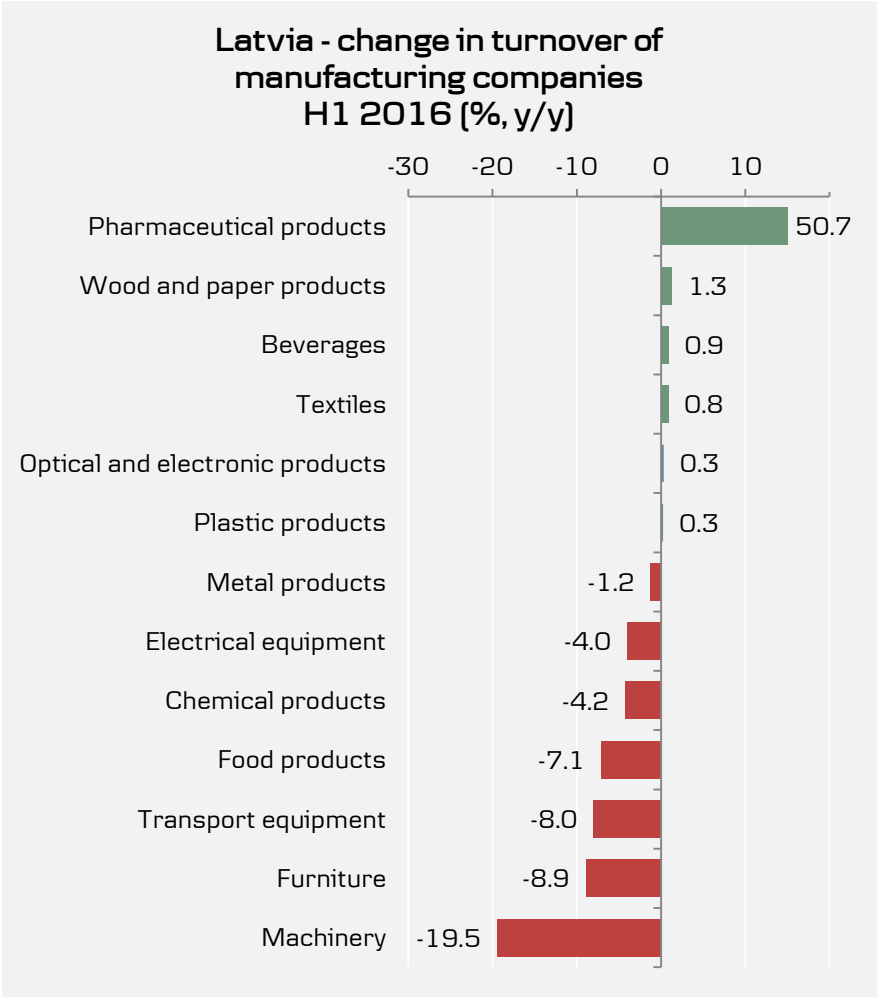
Negative results of Latvian companies persist

- The turnover of Latvian companies in H1 2016 decreased by 5.4% y/y, pre-tax profits – by 9.1%.
- ICT was the only sector which increased both its turnover (+6.8%) and profit (+23.7%). While nominal turnover of retail trade companies decreased by 5.9%, in real terms the turnover increased by 2.3%.
- Manufacturing turnover in nominal terms declined by 2.8% but in real in terms expanded by 3.3%. The biggest fall in profit was recorder for food producers, who are still recovering from the impact of the Russian embargo.



Source: Statistics Latvia, Danske Bank Markets

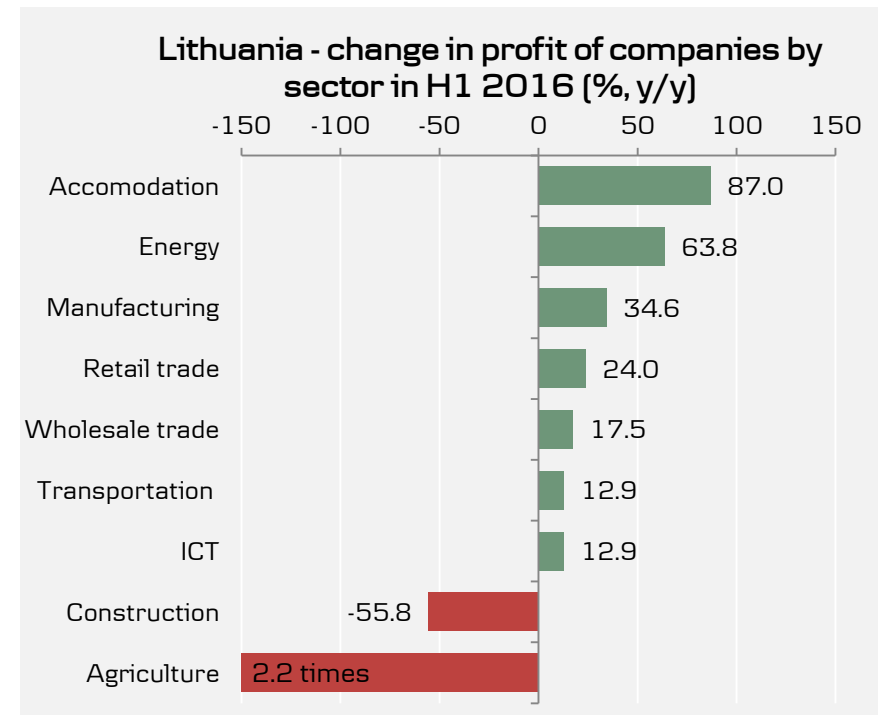
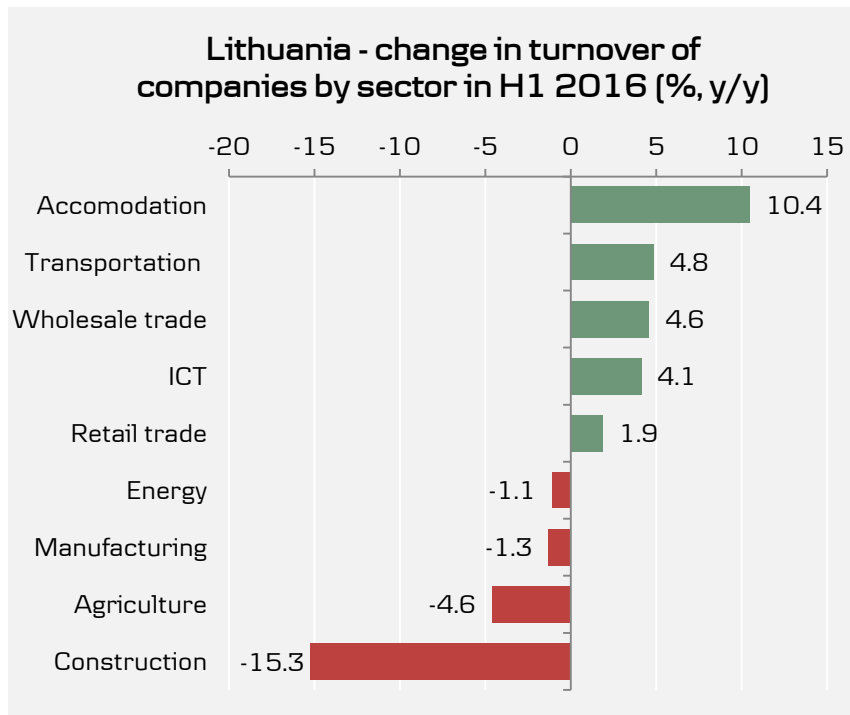
Latvian manufacturing: turnover expands in real terms



Source: Statistics Latvia, Danske Bank Markets

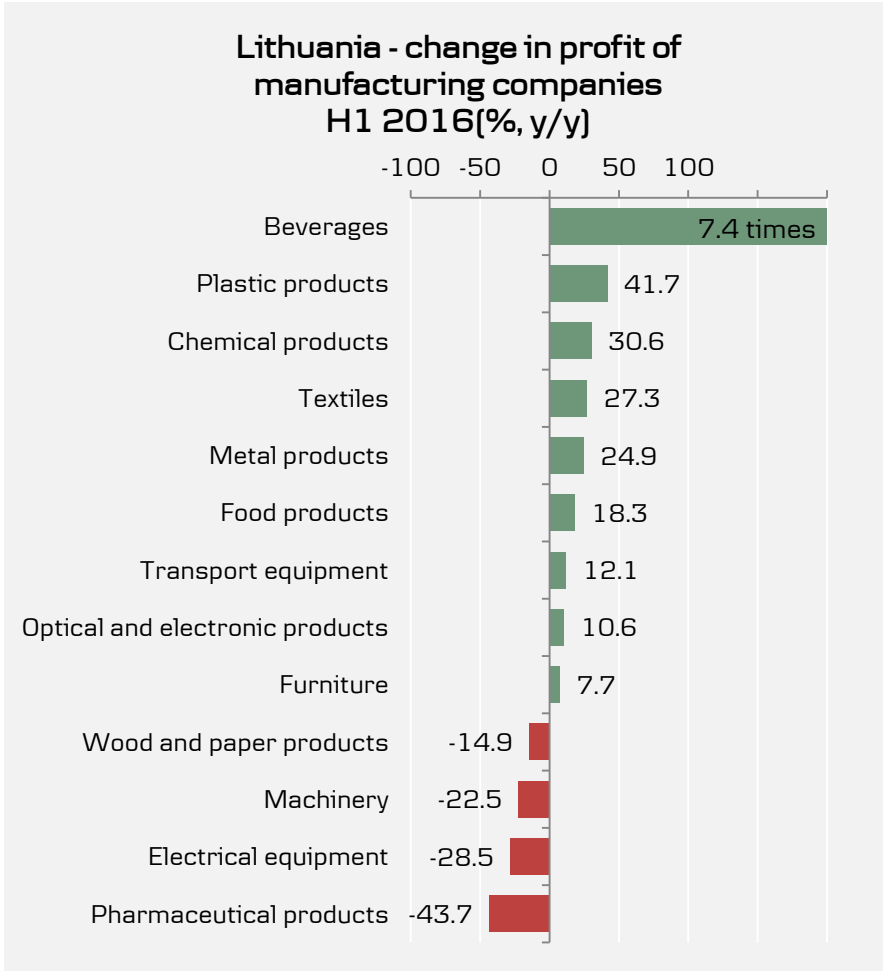
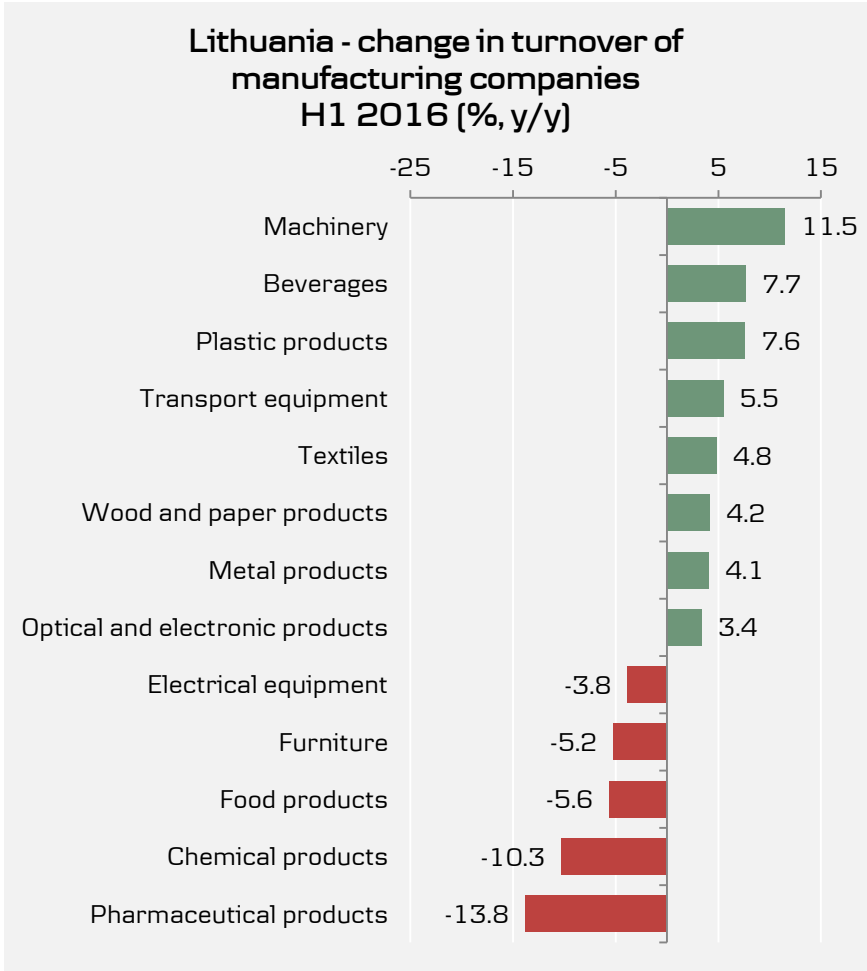
Most Lithuanian sectors show signs of growth

- The turnover of Lithuanian companies in H1 2016 expanded by 1.1%, while pre-tax profits expanded by 23.6%. Data from national accounts suggests that corporate profits have been on the decline since 2015. Therefore unusually high profit figures suggest that more profit has been brought into light from the shadow economy.
- Construction and agriculture are the only sectors suffering from both the contraction in sales and profit. Retail trade turnover in nominal terms expanded by 1.9%, in real terms - by 7.0%.
- While in nominal terms manufacturing turnover in H1 2016 declined by 1.3%, in real terms it expanded by 3.0%.



Source: Statistics Lithuania, Danske Bank Markets

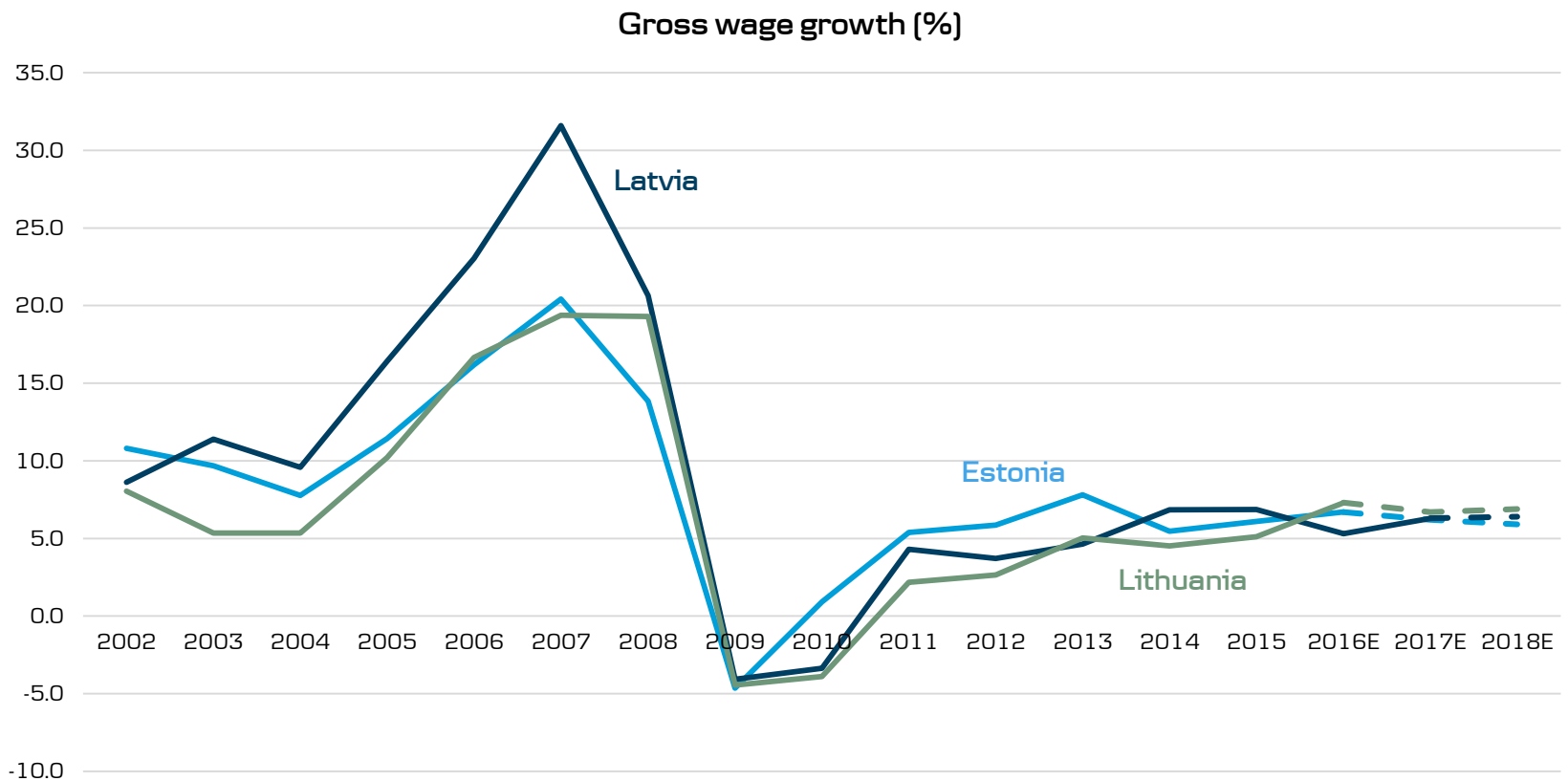
Lithuanian manufacturing: profits expand by more than a third



Source: Statistics Lithuania, Danske Bank Markets

Wage growth moving higher

- A rebound in GDP growth and lower unemployment should maintain considerable pressure on wage growth, which we expect to remain in the 5-7% range in all three Baltic states in the coming years.

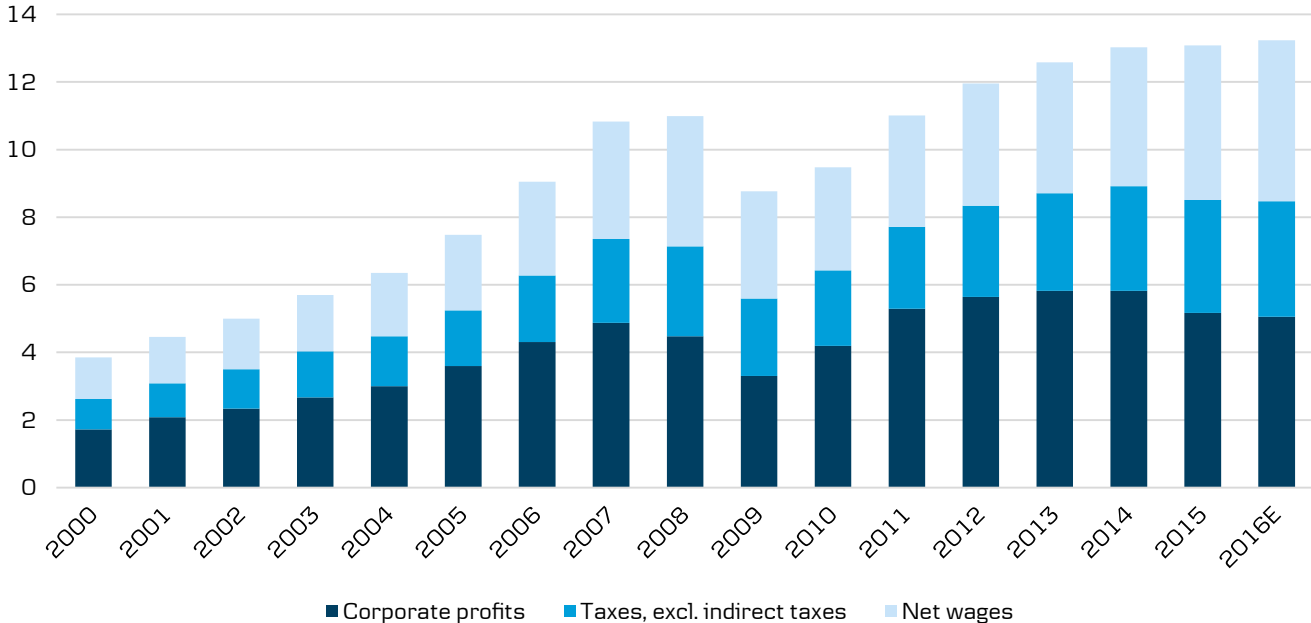


Source: National statistical offices, Danske Bank Markets estimates

Corporate profits on decline in Estonia

- In the context of fast growing labour costs and modest growth in added value, corporate profits are increasingly being squeezed in all three Baltic economies.
- The share of corporate profits in the added value created by Estonian companies is projected to fall to 38% this year – the lowest since 2009, when corporate profits took a hit due to the financial crisis. The share of net wages, on the other hand, is projected to reach 36% in 2016.

Break down of added value of Estonian companies (EURbn)



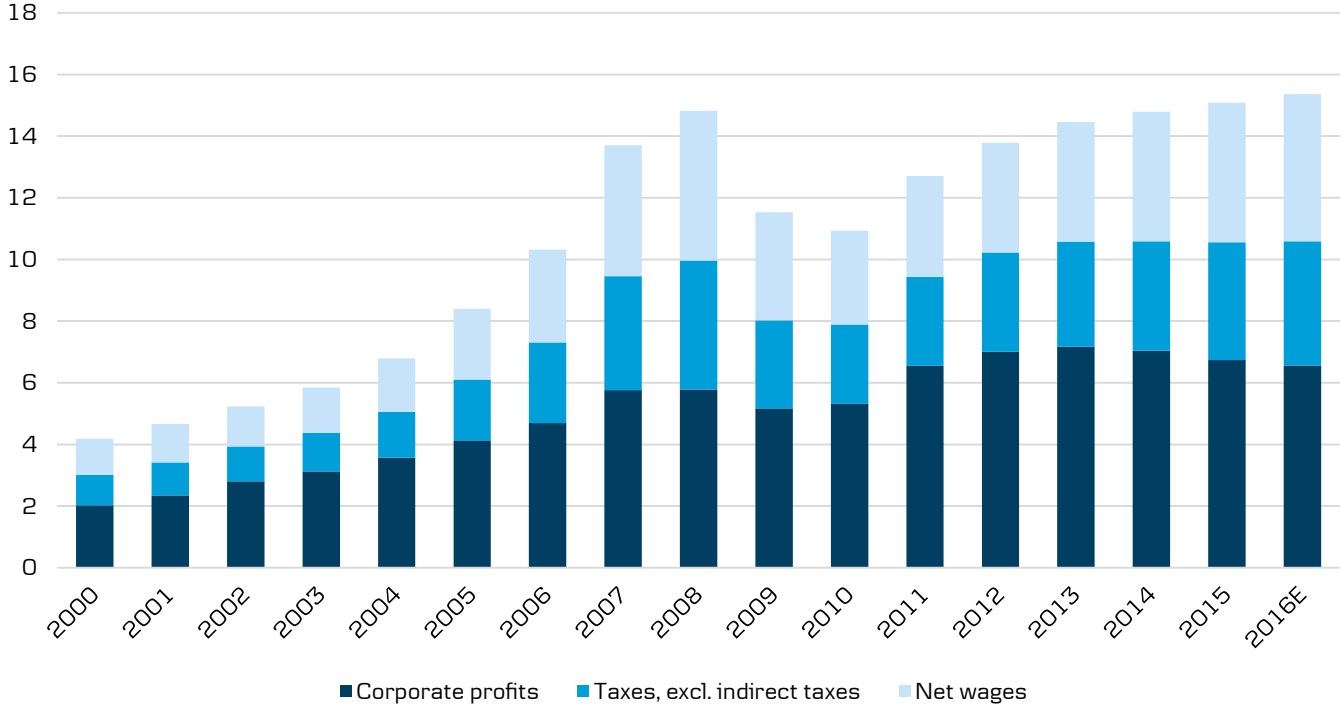
Source: European Commission, Danske Bank Markets

Note: Profit is gross operating surplus, as calculated in the framework of national accounts (which roughly corresponds to EBITDA), minus direct taxes. This figure also includes profits accrued in the shadow economy.

Similar trend observed in Latvia

- Corporate profits have been declining in Latvia since 2013. The share of profits to added value is expected to fall down to 43% in 2016, while the share of net wages to increase to 31%.

Break down of added value of Latvian companies (EURbn)



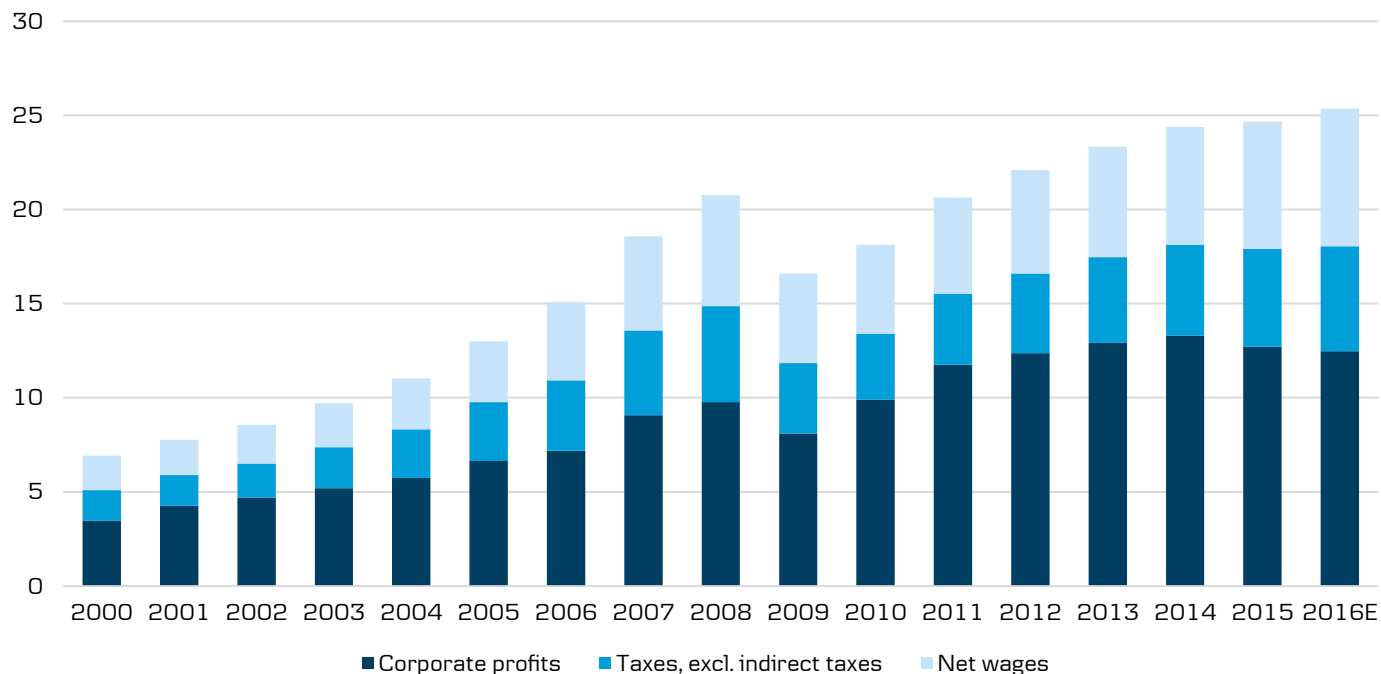
Source: European Commission, Danske Bank Markets

Note: Profit is gross operating surplus, as calculated in the framework of national accounts (which roughly corresponds to EBITDA), minus taxes. This figure also includes profits accrued in the shadow economy.

Profits most resilient in Lithuania

- Despite the recent trend downwards, Lithuanian companies still maintain one of the highest shares of profits to added value among developed economies (in 2015 only Romania and Ireland had a higher share). In 2016 the share is projected to fall to 49%, while the share of net wages in added value to increase to 29%.

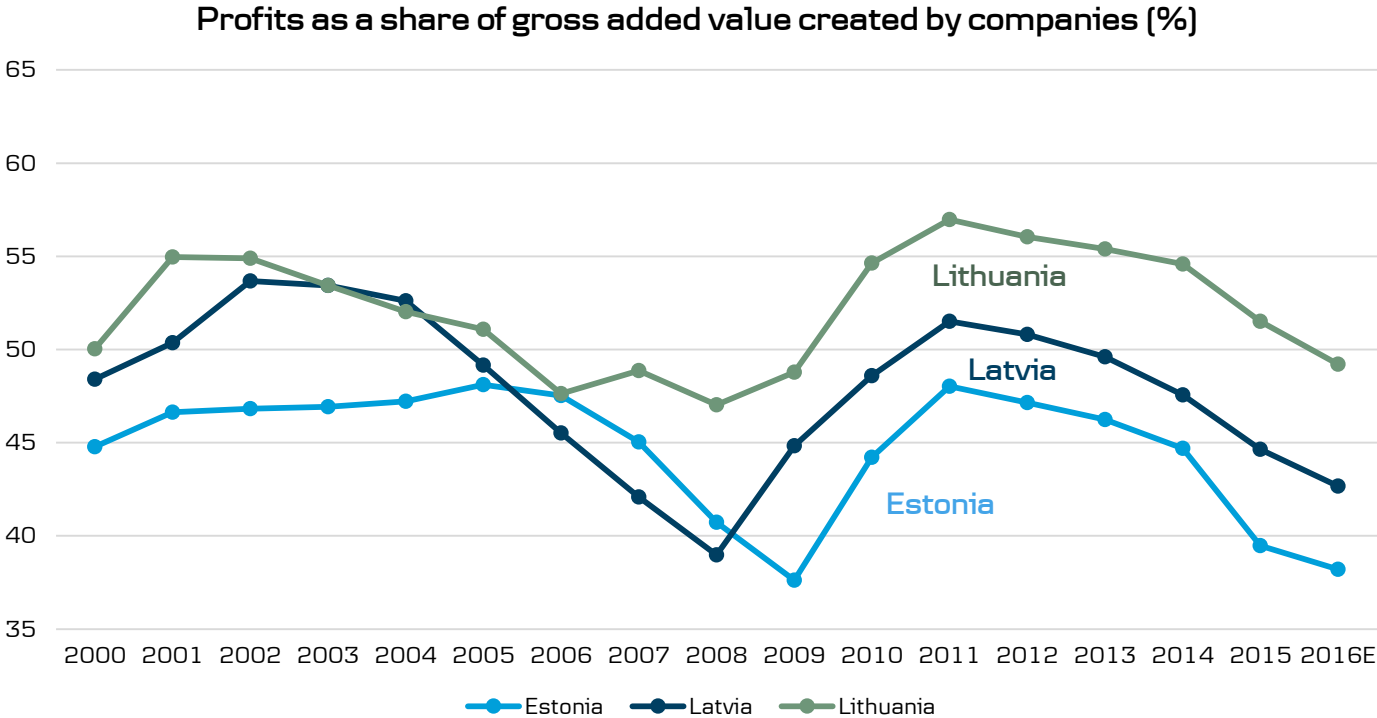
Break down of added value of Lithuanian companies (EURbn)



Source: European Commission, Danske Bank Markets

Note: Profit is gross operating surplus, as calculated in the framework of national accounts (which roughly corresponds to EBITDA), minus taxes. This figure also includes profits accrued in the shadow economy.

Profits on the decline in all three Baltic states

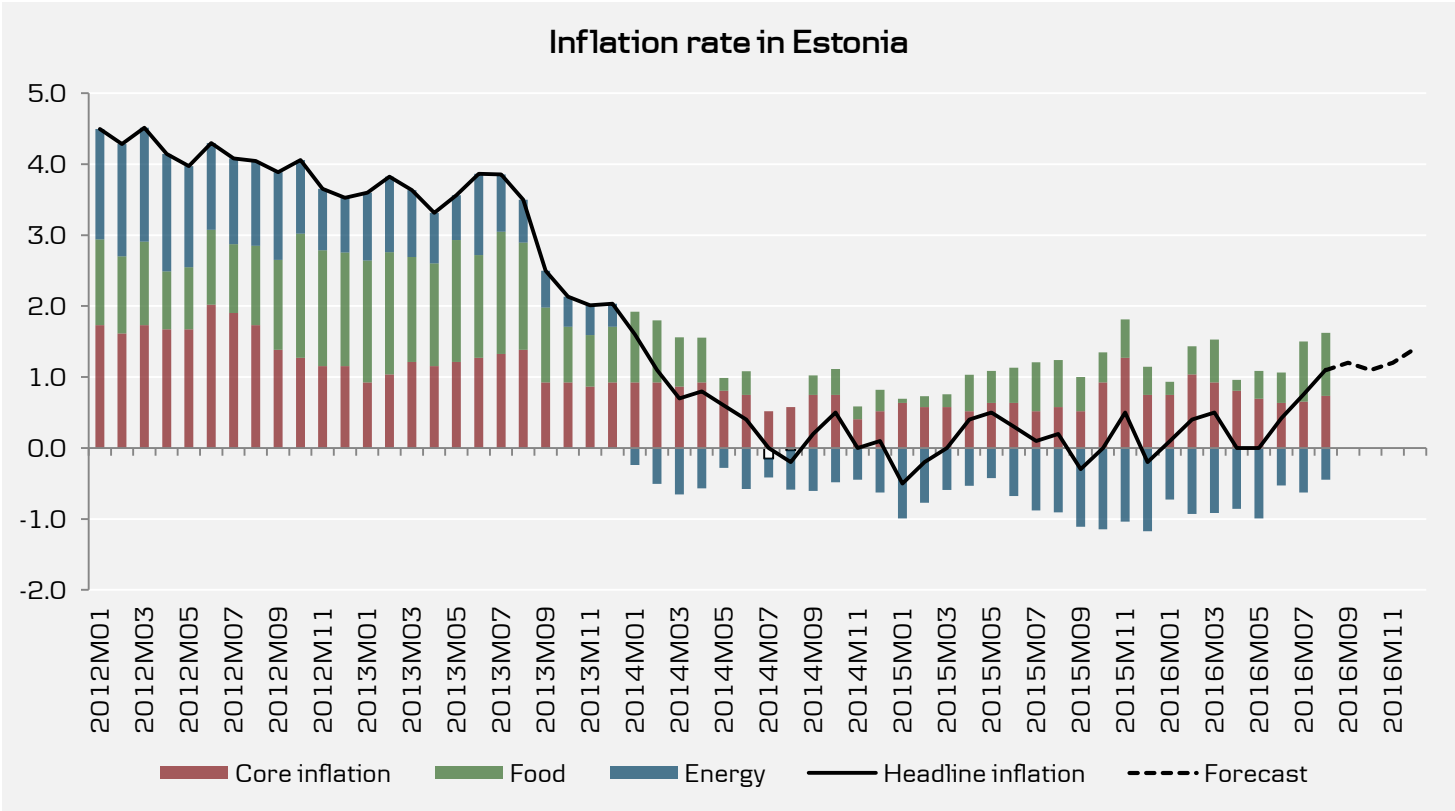


Source: European Commission, Danske Bank Markets

Note: Profit is gross operating surplus, as calculated in the framework of national accounts (which roughly corresponds to EBITDA), minus taxes. This figure also includes profits accrued in the shadow economy.

Inflation to move higher in Estonia

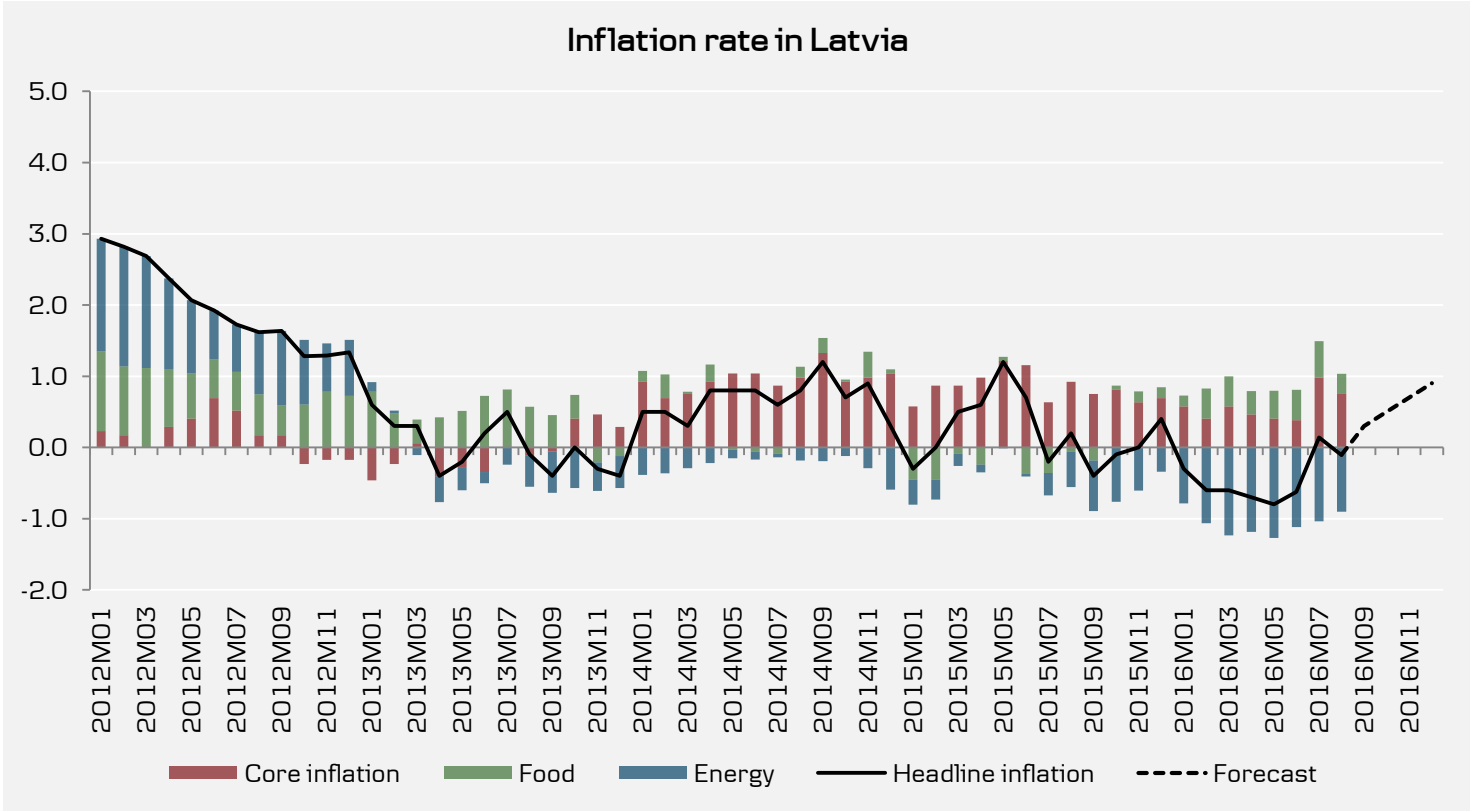
- Inflation has so far averaged 0.4% in Estonia in 2016 but is expected to edge higher towards the end of the year due to a stronger rise in energy prices.
- We expect average inflation in Estonia to reach 0.7% in 2016 and 1.9% in 2017.



Source: Statistics Estonia, Danske Bank Markets

Deflation in Latvia due to energy prices

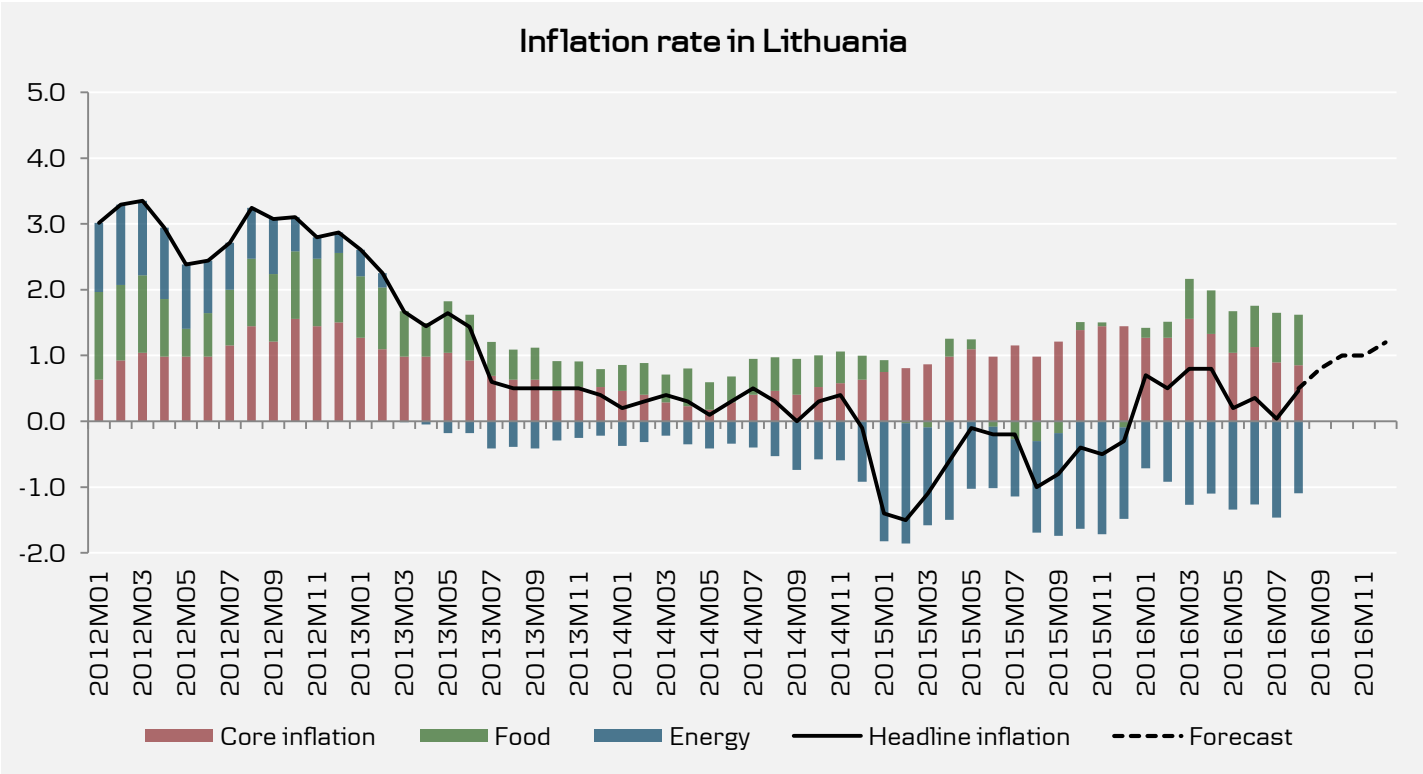
- Inflation in Latvia has so far this year been in a negative territory for all except one month. However, higher energy prices should lift inflation out into positive territory in the coming months.
- We expect inflation in Latvia to average -0.1% in 2016 and 2.0% in 2017.



Source: Statistics Latvia, Danske Bank Markets

Higher inflation in Lithuania after the fall in prices in 2015

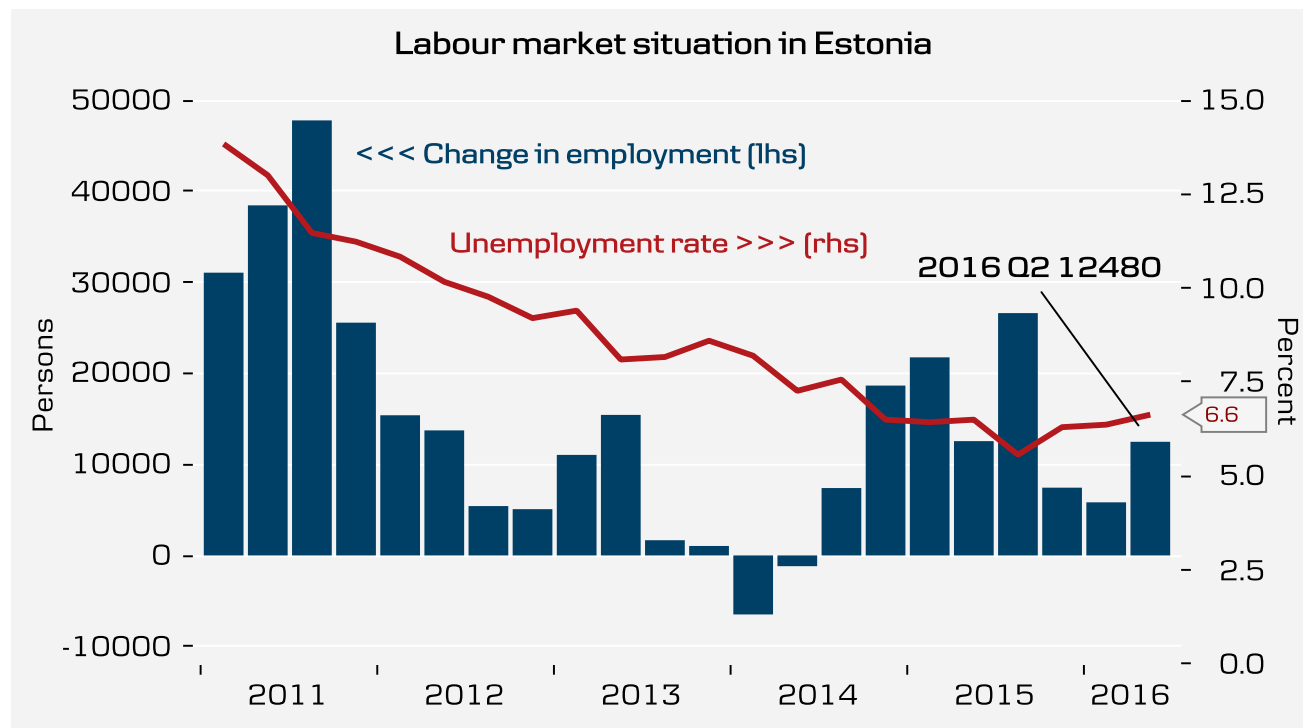
- After deep deflation in 2015 (-0.7%) inflation is already higher in Lithuania this year (+0.5% in January-August). Due to fastest growth in consumption, Lithuania has also so far had the highest core inflation rate among the Baltics in 2016: +2.0% compared to +1.4% in Estonia and +1.0%.
- We expect inflation in Lithuania to average 0.7% in 2016 and climb to 2.2% in 2017.



Source: Statistics Lithuania, Danske Bank Markets

Labour force grows faster than employment in Estonia

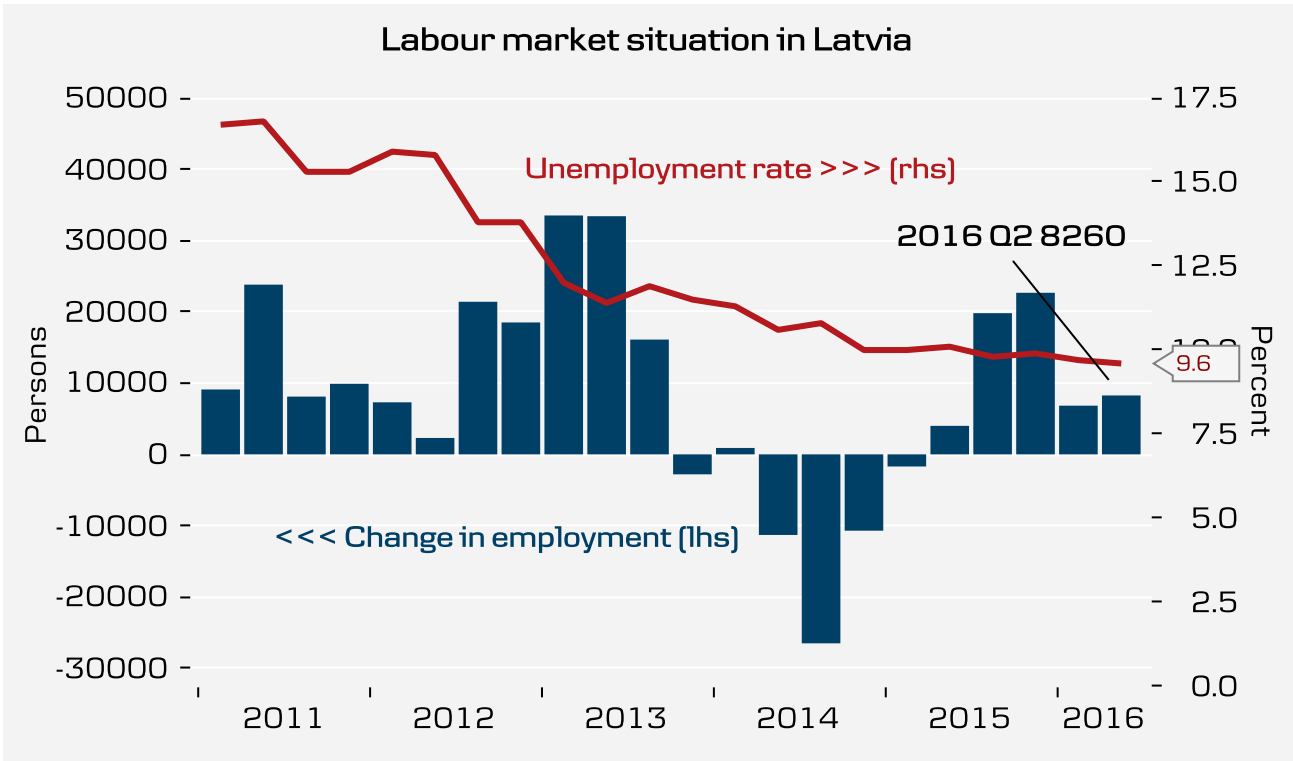
- Employment in Estonia continues growing at a healthy rate (0.9% in Q1 and 2.0% y/y in Q2 2016). Sectors where employment grew most were human health, professional activities and ICT. Sectors where employment contracted were manufacturing and construction.
- Unemployment in Q2 2016 increased marginally from 6.4% in Q1 to 6.6% due to stronger growth in labour force (+2.6% y/y) in relation to employment. Labour force increased due to the Work Capacity Reform, which aims to increase employment of disabled people, and greater immigration.



Source: Macrobond, Danske Bank Markets

Unemployment still highest in Latvia

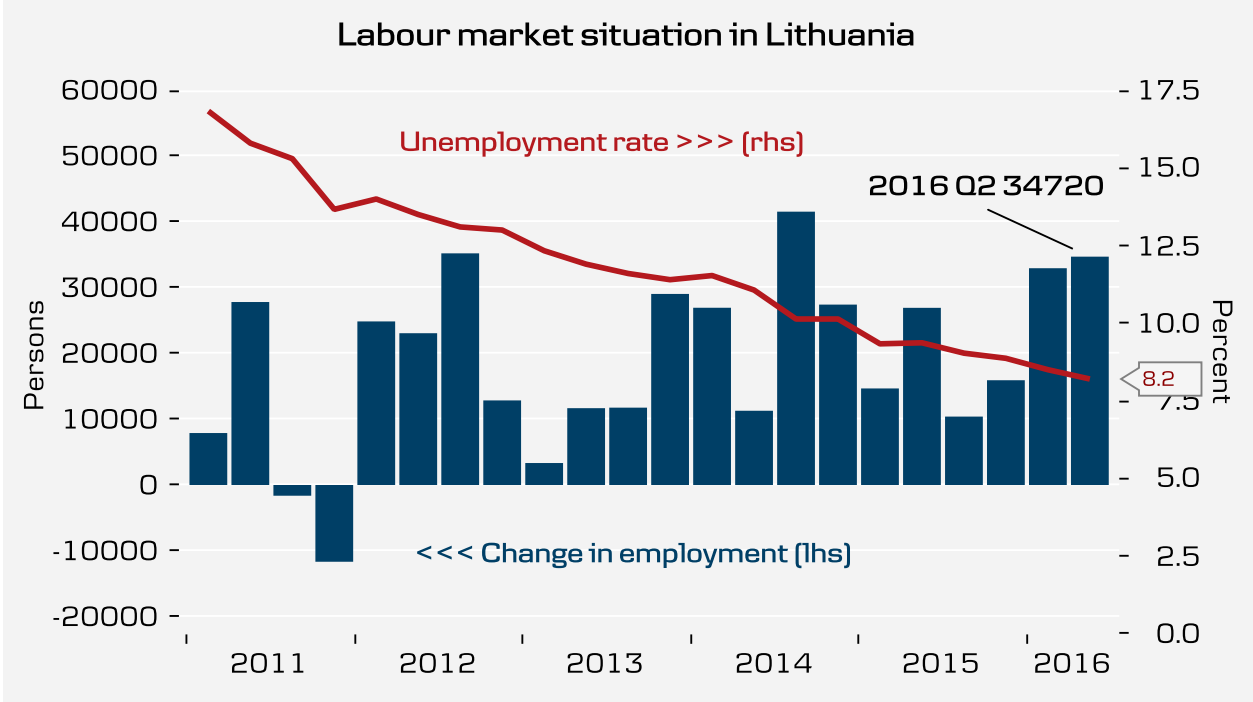
- At 9.6% unemployment rate in Latvia is still the highest among the Baltics. That is a result of slowest rate of job creation – employment expanded by 0.8% and 0.9% y/y in Q1 and Q2 2016 respectively.
- Sectors where most jobs were created in Q2 were agriculture and forestry, manufacturing, other service activities. Sectors with the biggest decline in employment were construction, human health and wholesale and retail trade.



Source: Macrobond, Danske Bank Markets

Lithuania enjoys fastest employment growth in the Baltics

- Employment in Lithuania is still growing at the fastest rate among the Baltics (by 2.5% and 2.6% respectively in Q1 and Q2 2016). In Q2 2016 34.7 thousand new jobs were created compared to the same period in 2015.
- Sectors with the biggest increase in employment in Q2 2016 were wholesale and retail trade, education and manufacturing.
- The only sectors to have reduced employment in Q2 2016 were transport (although at a lower rate than in Q1), construction and agriculture.



Source: Macrobond, Danske Bank Markets

Macroeconomic forecasts

	Year	GDP (% y/y)	HICP inflation (% y/y)	Private consumption (% y/y)	Fixed investment (% y/y)	Export, goods & services (% y/y)	Gross wage growth (% y/y)	Unemployment (%)
Estonia	2015	1.1	0.1	4.8	-5.8	-1.5	6.1	6.1
	2016	1.5	0.7	3.9	1.8	1.9	6.7	6.6
	2017	2.1	1.9	4.2	3.1	2.1	6.2	6.4
	2018	2.4	2.3	3.9	4.2	2.4	5.9	6.3
Latvia	2015	2.7	0.2	3.4	2.1	1.8	6.9	9.9
	2016	1.8	-0.1	3.9	-12.8	1.6	5.3	9.6
	2017	2.7	2.0	4.1	7.1	2.7	6.3	9.1
	2018	2.9	2.4	3.9	4.9	2.9	6.4	8.5
Lithuania	2015	1.6	-0.7	5.2	10.3	1.2	5.1	9.1
	2016	2.5	0.7	5.3	-1.6	3.7	7.3	8.4
	2017	2.8	2.2	4.6	6.7	3.1	6.7	7.7
	2018	3.0	2.5	4.4	5.5	3.4	6.9	7.1

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