# Baltic Report:

# **Lithuania outperforms the region**

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January 25

# Executive summary

1. The economies in the Baltic region are expected to return to growth in 2025, although the pace will be more sluggish for Estonia and Latvia than previously anticipated. Lithuania's pace of growth this year will be around three times larger.
2. Inflation remains stable at or below target levels in Lithuania and Latvia, while Estonia is projected to converge to 2% by 2026.
3. Unemployment has increased in Estonia, whereas the job markets in Lithuania and Latvia have remained stable. Wage growth is expected to moderate this year.
4. The retail and industrial sectors are performing best in Lithuania. However, these sectors continue to face challenges in Estonia and Latvia.
5. Economic sentiment is the highest in Lithuania, being above the EU average and still trending upwards. Consumer sentiment is also most positive in Lithuania, though it remains deeply negative in Estonia.
6. Budget deficits in the Baltic countries are expected to be around 3% of GDP, heavily influenced by defense spending.
7. S&P downgraded the credit ratings of all three countries last year, with Estonia requesting the withdrawal of its rating at the end of 2024.
8. Despite poor economic performance, Estonia leads the region in Social Development Goals. The RRF funds are expected to finance further improvements in SDGs, but governments need to accelerate their efforts as the 2026 deadline approaches.

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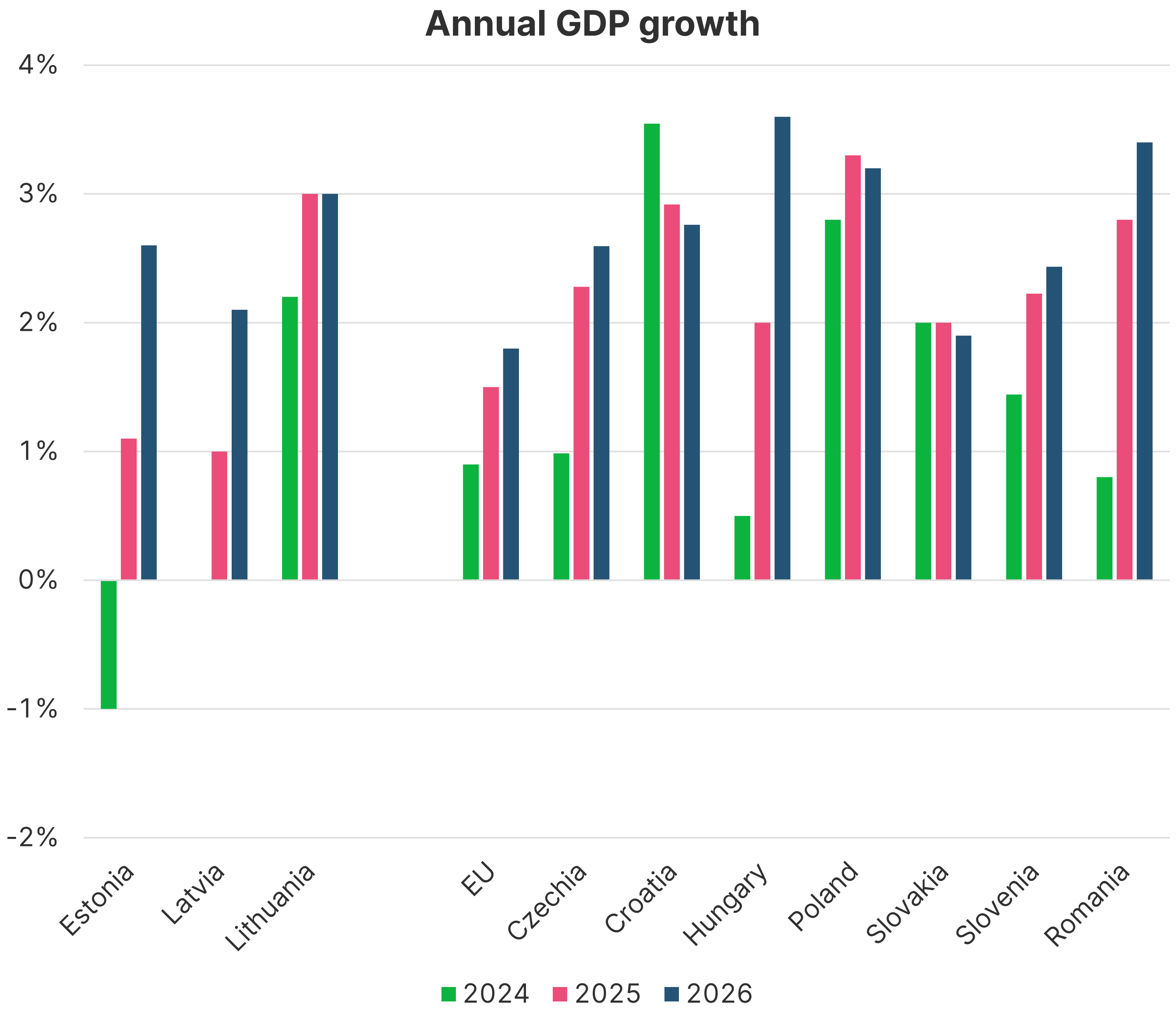
# Main economic developments

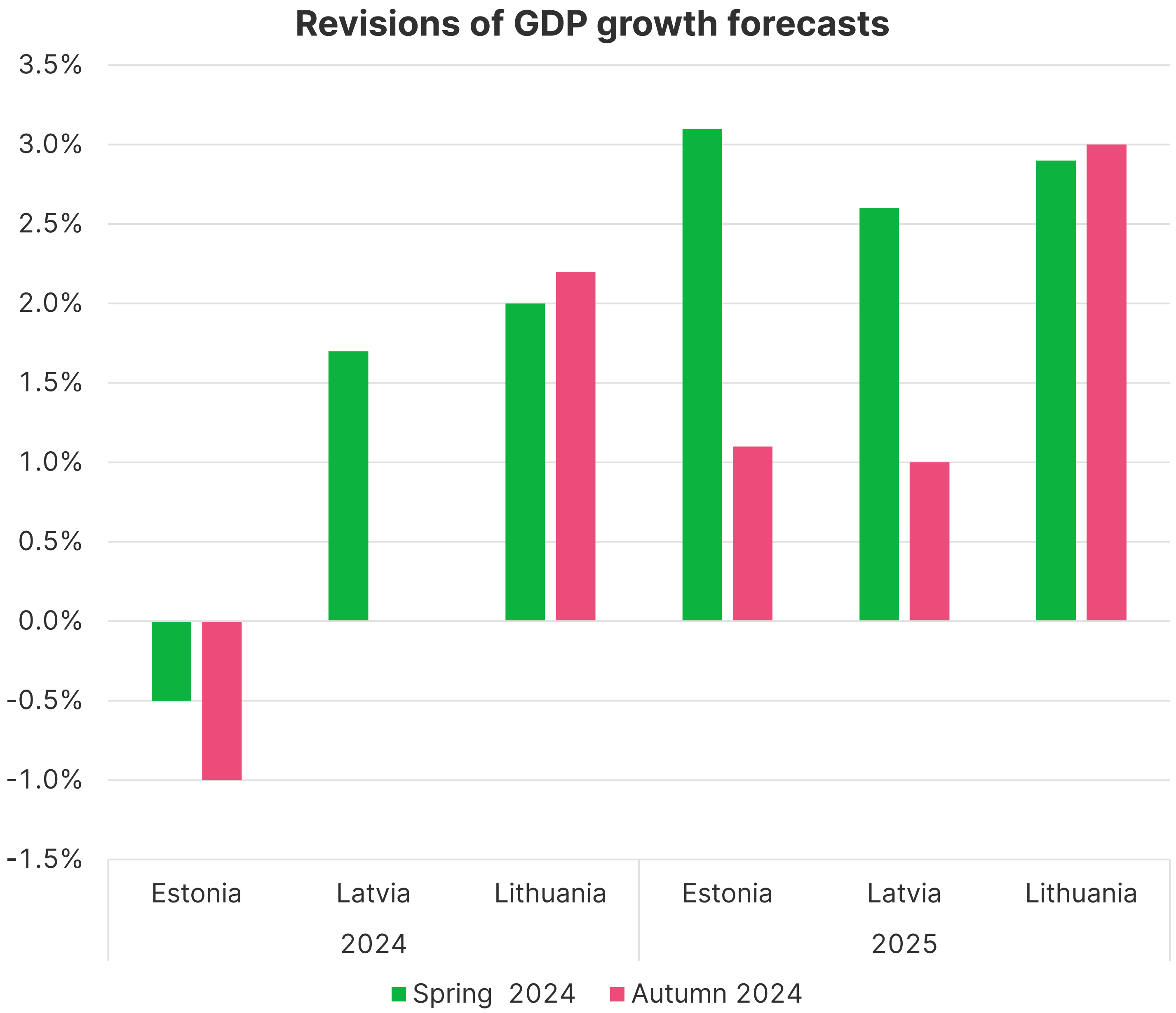
# Slow growth in Estonia and Latvia




Source: European Commission, Erste Group

According to the European Commission's Autumn forecast, **Estonia is the only country in the Baltic region with economic contraction expected in 2024**. The situation is particularly grim, with GDP having shrunk by 3% in 2023 and stagnating in 2022. Between 2022 and 2024, Estonia lost approximately 4% of its economic output, with only a modest recovery anticipated this year. A more substantial growth is expected by 2026.

**Latvia is also facing economic stagnation**. The EC forecasts 0% growth for Latvia, following a significant upward revision of the 2023 figure to 1.7%, compared to an initially estimated contraction of 0.3%. In contrast, Lithuania is the only Baltic economy expected to grow. Its economy is projected to expand by more than 2% in 2024, reaching 3% growth in both 2025 and 2026.



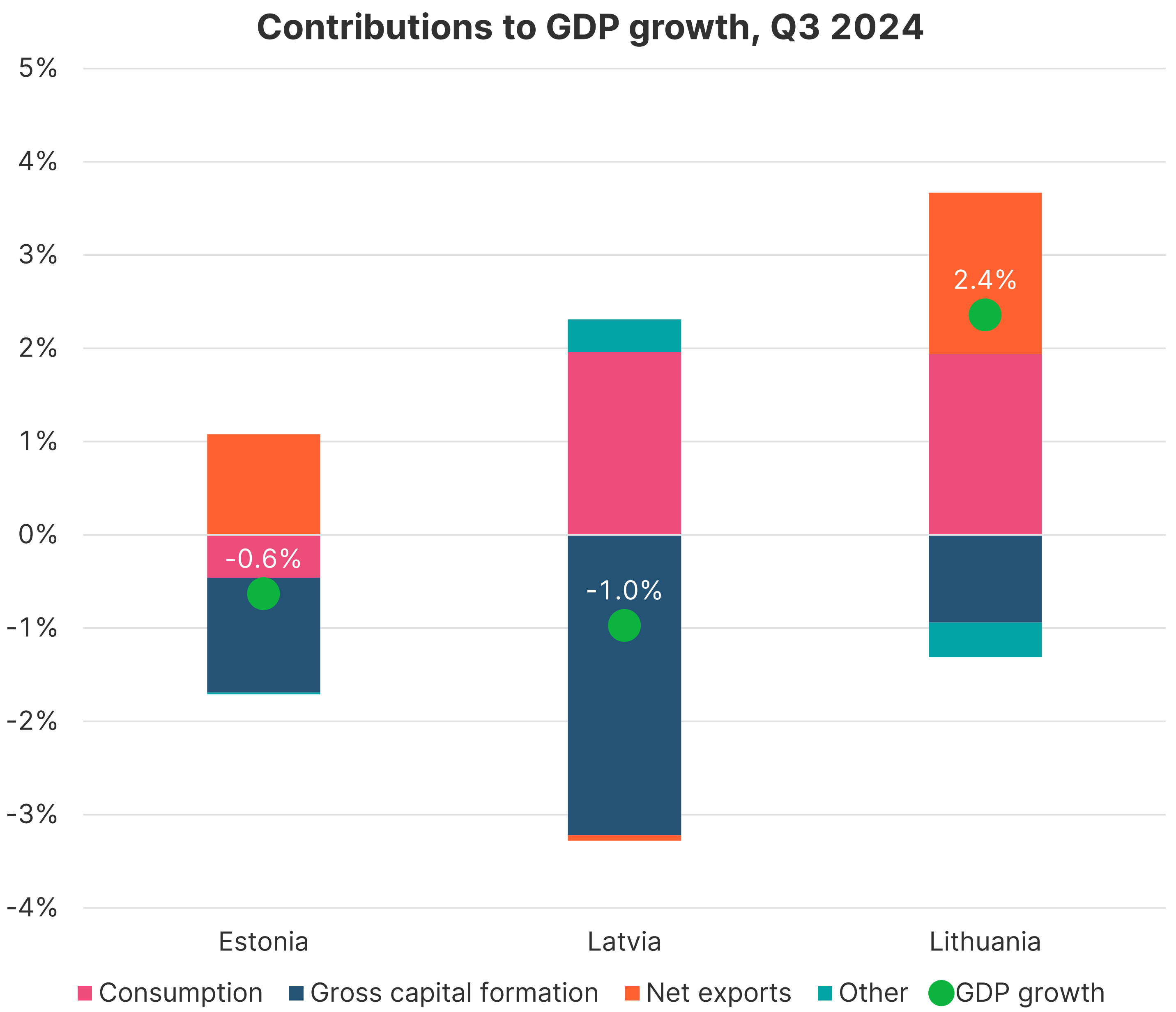

*Source: European Commission, Erste Group*



# Only Lithuania keeps its growth outlook

**Significant downward forecast revisions have been made for Estonia and Latvia.** For Latvia, this could be attributed to the previously mentioned upward revision of the 2023 output. In Estonia's case, the economic fallout from the war and the severance of ties with Russia have been more damaging than anticipated. Additionally, growth in Estonia this year and the next will be affected by fiscal consolidation and tax increases.

**Lithuania also experienced a revision of its 2023 GDP data, from -0.3% to 0.3%. However, this revision did not impact future forecasts**, as Lithuania's economy has consistently exceeded expectations. By the end of this year, Lithuania's economy is projected to be 8% larger than it was before the war in Ukraine.




Source: European Commission, Erste Group

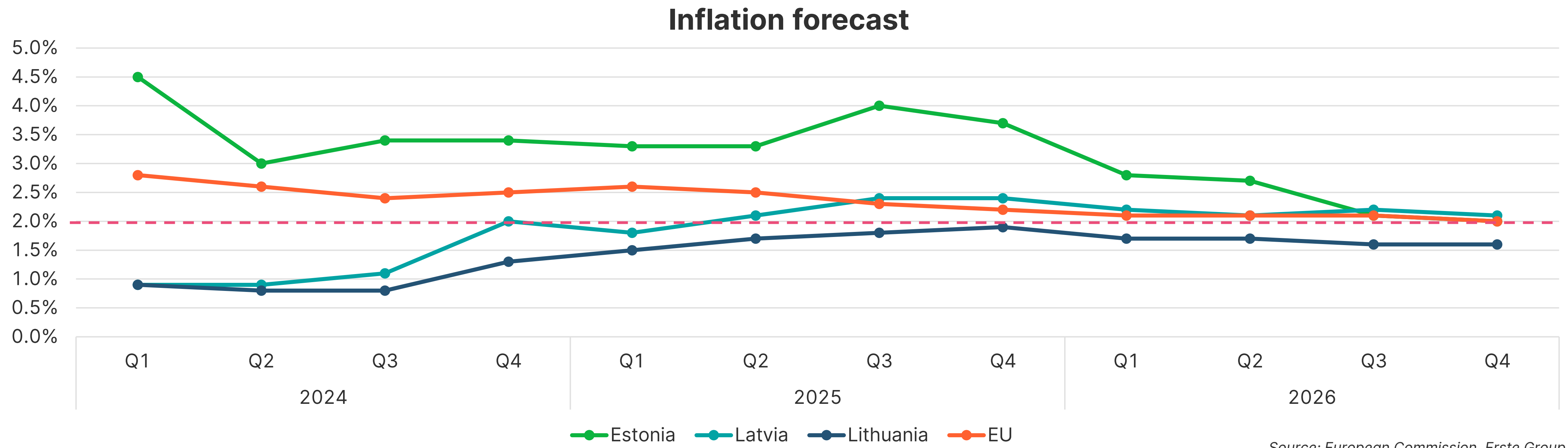


# Consumption shrinks in Estonia

**In Lithuania, most sectors of the economy have been performing well.** Manufacturing and retail trade growth have grown, household demand has increased significantly, although business investments have remained relatively weak. **Manufacturing and exports have also been more resilient in Lithuania compared to Estonia and Latvia.** It is partially due to Lithuania's more diversified export markets, including Poland, which is also in good economic condition.

**In Estonia, household confidence has kept deteriorating**, despite increases in real wages. Private consumption is expected to contract again in 2024, with only a modest recovery forecasted for 2025. Moreover, falling interest rates and improving foreign demand should contribute to a pick-up the investments next year.

# Inflation paths converged to the target, except for Estonia



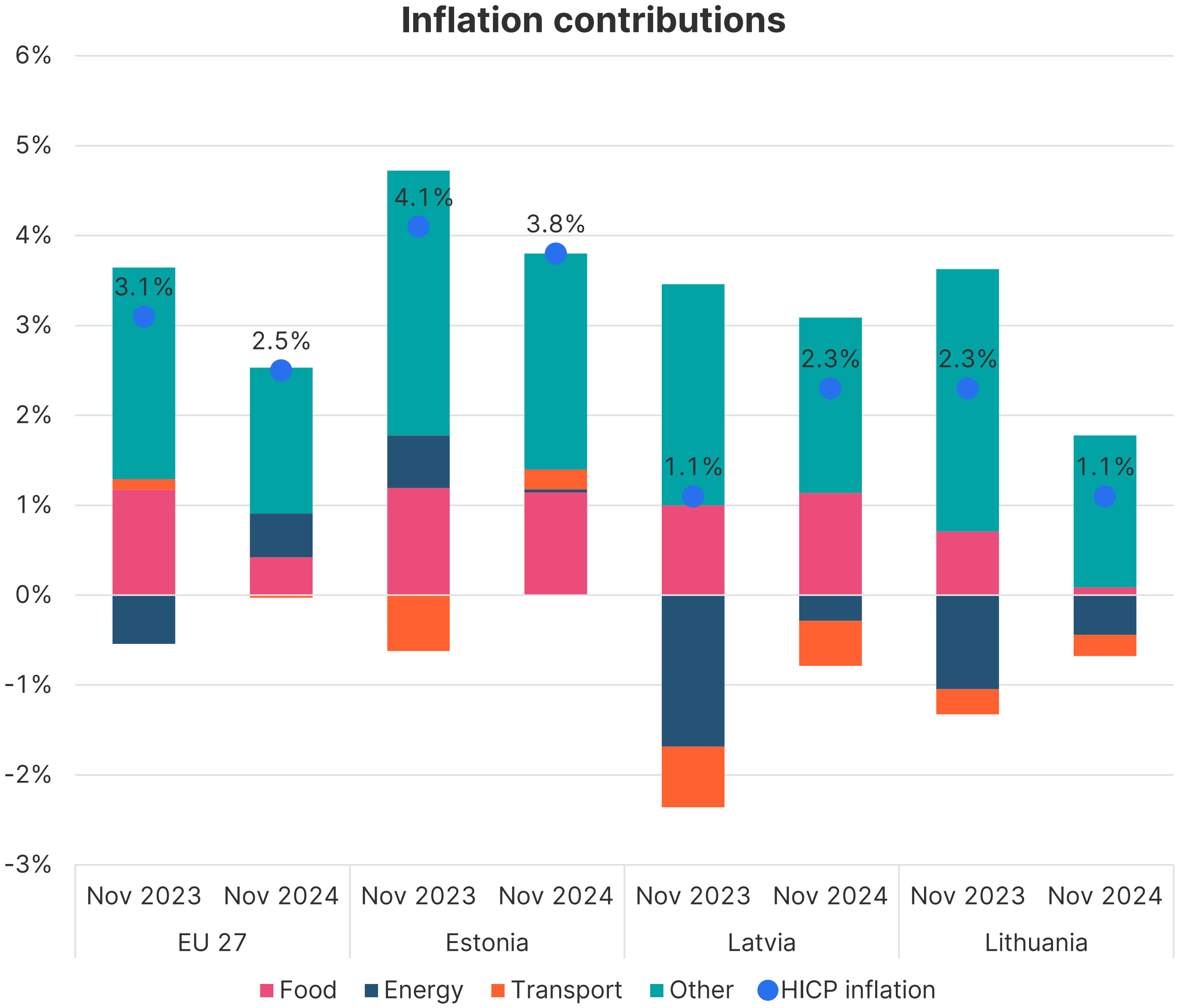

*Source: European Commission, Erste Group*

**The inflation trends in the Baltic are quite diverse.** In Estonia, the fall in inflation seen in the second quarter of last year was reversed in Q3, as prices of energy and unprocessed food dropped less, while services inflation remains persistently high, driven by healthcare costs, administered prices and wages. **The forecast for 2025 suggests inflation will remain elevated at 3.6%**, influenced by substantial tax increases in the new budget. However, a deceleration to 2.4% is expected by 2026 as the impact of these tax measures wanes and demand weakens. On the other hand, **Lithuania saw the most substantial decline in HICP inflation**, dropping to 0.9% average in 2024. This decrease is attributed to falling energy and unprocessed food prices and a slowdown in price growth across other HICP components.

# Price pressure from services remains

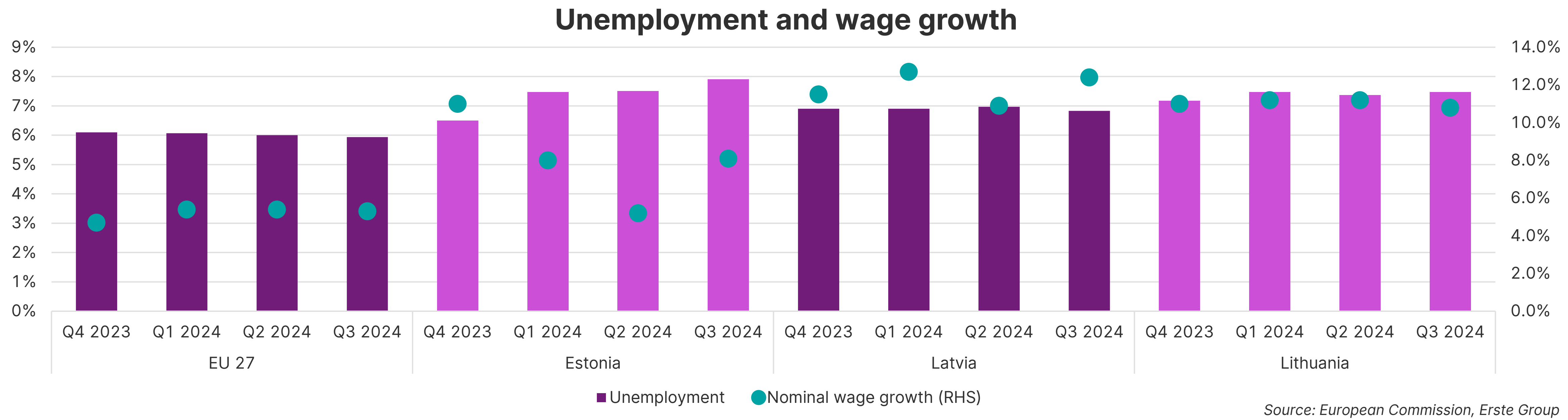
The favorable base effect in Lithuania is anticipated to disappear, with inflation projected to rise to 1.7% in 2025 before slightly decreasing to 1.6% in 2026. **These figures remain well within the monetary policy target, and overall inflationary pressures have subsided**. However, services inflation is expected to decline more slowly due to sustained wage growth.

In Latvia, the overall inflation rate for 2024 was recorded at 1.35%. As the base effects of energy prices wane, inflation is forecasted to increase to 2.2% in both 2025 and 2026. Services inflation, driven by wage developments, has peaked at 4.5% in 2024, with gradual decrease to 2.6% in 2026.




*Source: European Commission, Erste Group*

# Salary growth to decelerate in 2025




*Source: European Commission, Erste Group*

**The labor market situation remains the most challenging in Estonia**. The unemployment rate rose to nearly 8% in 2024, and employment expectations are becoming increasingly negative. The situation is not expected to improve significantly over the next two years. Despite an aging population, which limits more pronounced increases in unemployment, the jobless rate is projected to average 7.7% in 2025 and 7.2% in 2026. Wage growth in Estonia is also the smallest in Baltics due to the rising unemployment rate. In Latvia and Lithuania, unemployment remained stable throughout the recent volatile period, and this situation is not expected to change significantly. **However, wage growth rates are anticipated to naturally slow down this year**, with the European Commission forecasting 4.4% in Estonia, 6.5% in Lithuania, and 4.4% in Latvia. **Wage growth is expected to stabilize around 4-5% across the Baltic region by 2026.**

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# Retail and industrial development

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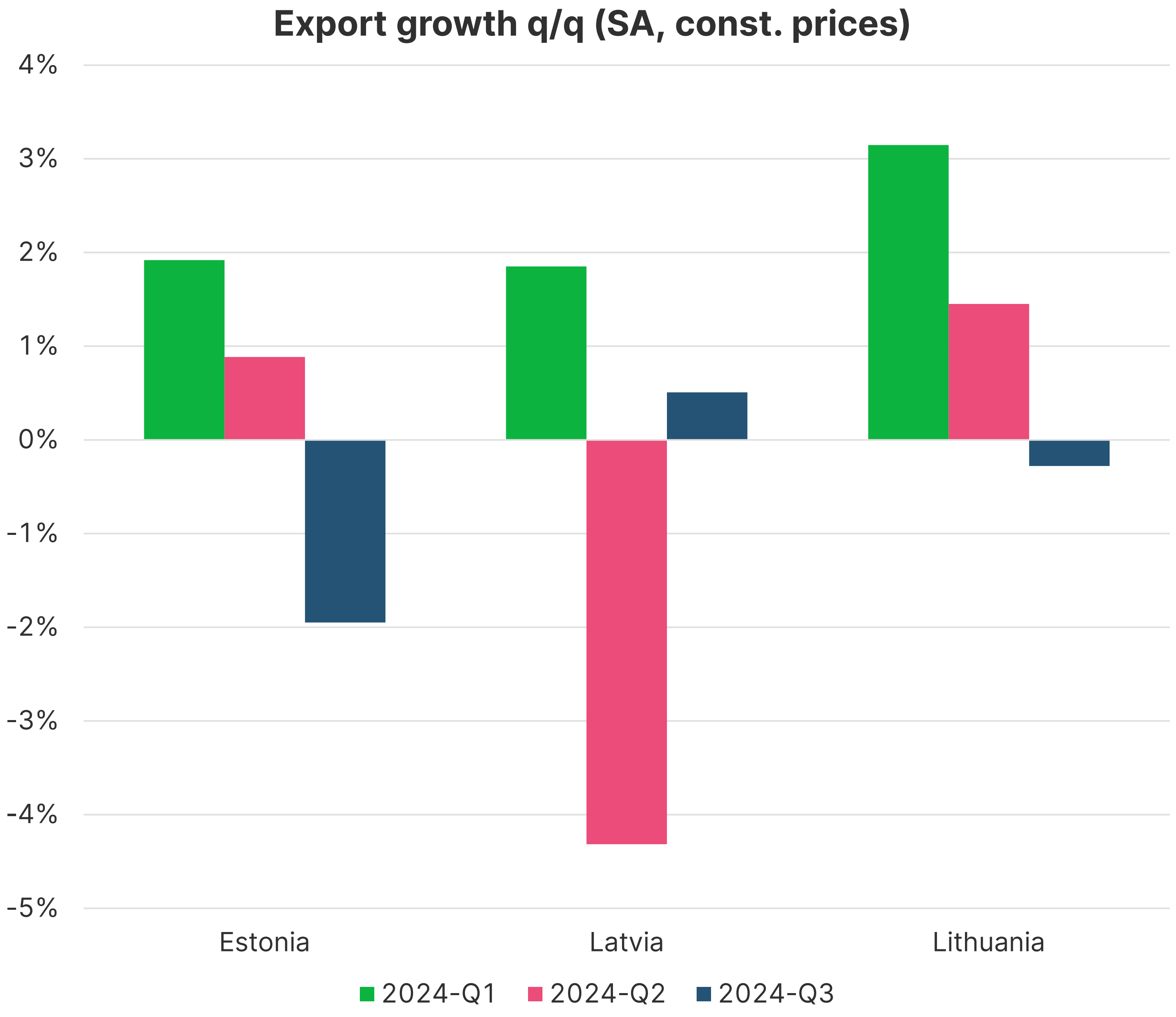



*Source: European Commission, Erste Group*



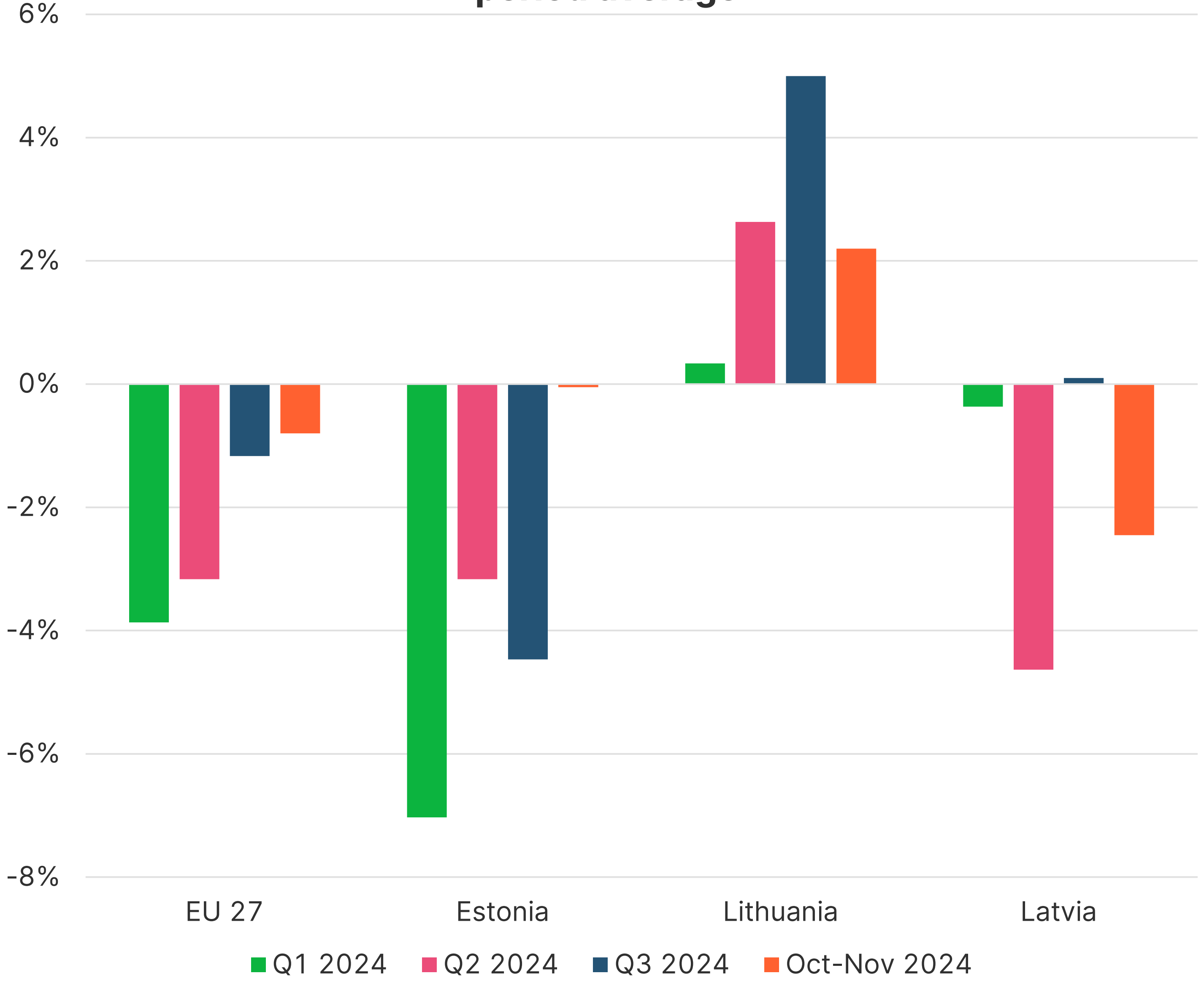
# Strongest export growth in Lithuania

While the annual change in the trade balance contributed positively to Q3 GDP growth in Estonia, **exports are currently struggling**. This is due to weak demand from key EU trading partners, particularly the Nordic countries. Over the medium term, the trade deficit is projected to keep wide, as increased domestic consumption drives imports, whose growth might even outpace exports.

This year, Sweden and Finland are expected to expand by about 1.5%, albeit with downside risks. Germany is projected to see growth below 1%, according to the European Commission. Hence, the major trading partners will not increase their demand significantly in 2025. **The only major trading partner with a robust economic growth is Poland, which primarily benefits Lithuania.**

# Industry still struggles in Estonia

**Industrial production development, y/y period average**

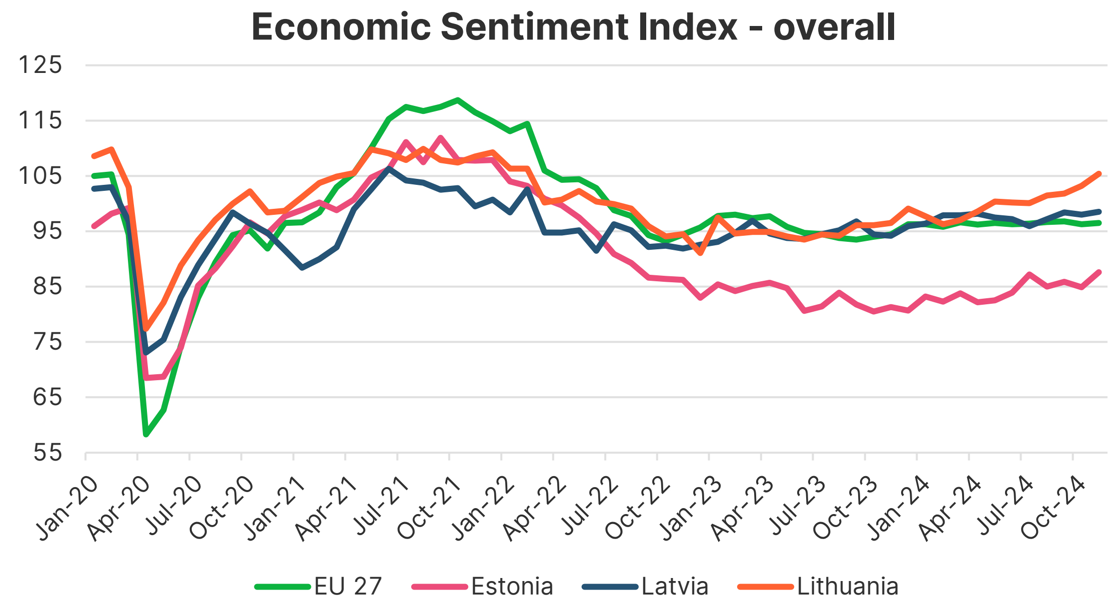


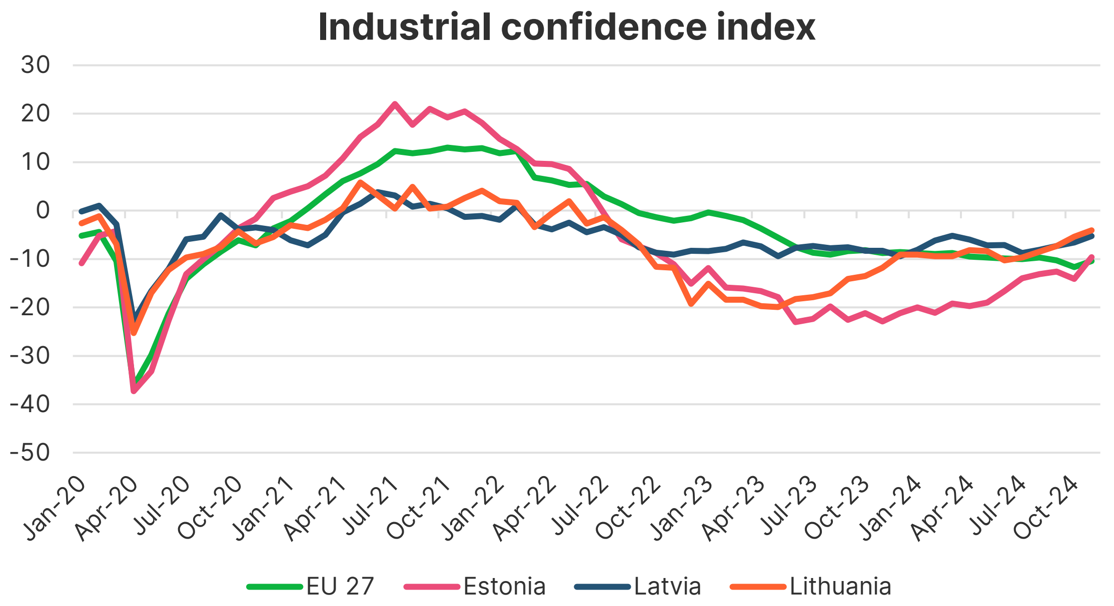

*Source: European Commission, Erste Group*

**Lithuania stands out in the Baltic region, having managed to expand its industrial complex by an average of 5%** year-over-year in the third quarter of last year, with the fourth quarter also looking favorable. Moreover, the index of industrial production is approximately 25% above pre-COVID levels and roughly 7% above pre-war figures.

Conversely, Estonia's industry has been struggling for some time, with annual growth deeply in negative territory. Several factors contribute to this trend, including a negative external environment, the cut-off from Russia, and high interest costs.

# Sentiment indicators remain static

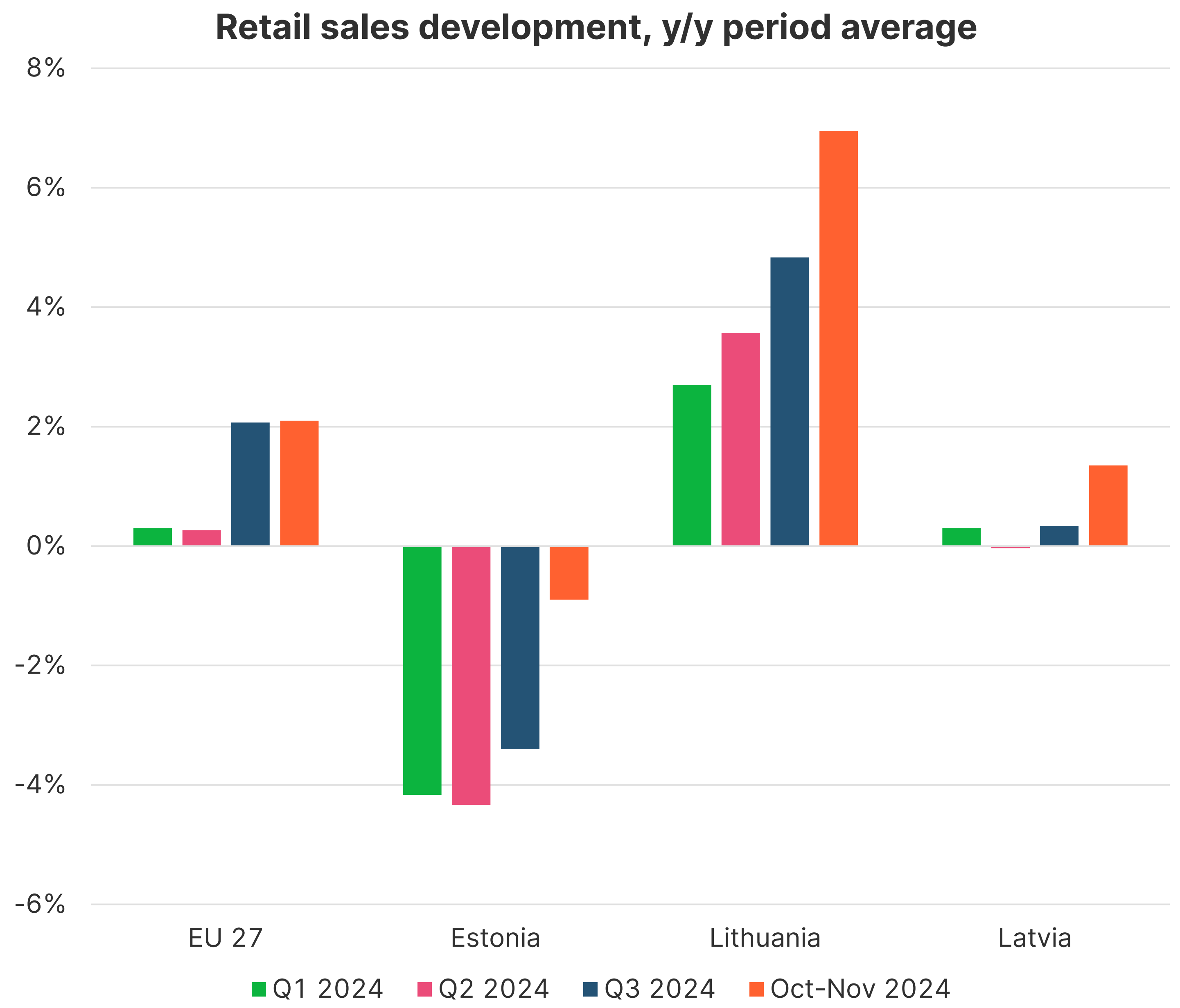



*Source: European Commission, Erste Group*

The **composite ESI has been gradually improving in Estonia**; however, its value remains well below that of its Baltic peers and the EU average. The main drivers behind this improvement are the services, industry, and partially the retail sectors, while consumer sentiment continues to put downward pressure on the index. In Latvia, the ESI has remained largely stagnant, mirroring the EU average almost identically. In contrast, **economic sentiment in Lithuania has diverged upwards from the EU**, with improvements observed across all sectors except retail.

In recent months, **industrial sentiment has been improving across the Baltic region**. In Estonia, this improvement is evident in all but one area: the assessment of stocks of finished products. Latvia is experiencing a similar trend, with all industrial sub-indices rising year-over-year. In Lithuania, respondents expressed slightly more concern than a year ago about their stocks of finished products and their expectations for selling prices in 2025.




*Source: European Commission, Erste Group*

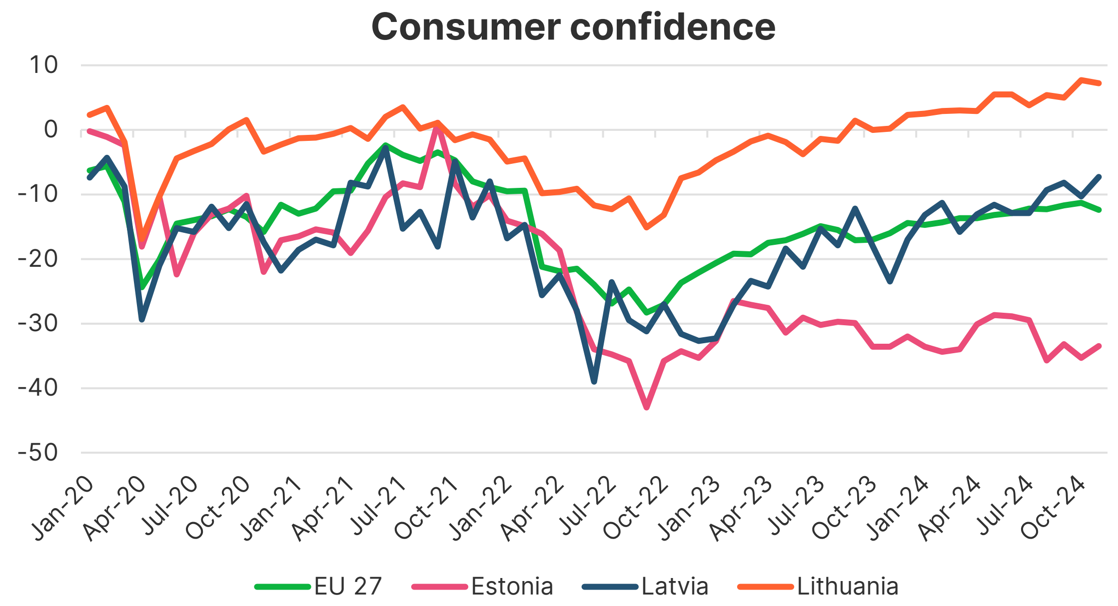


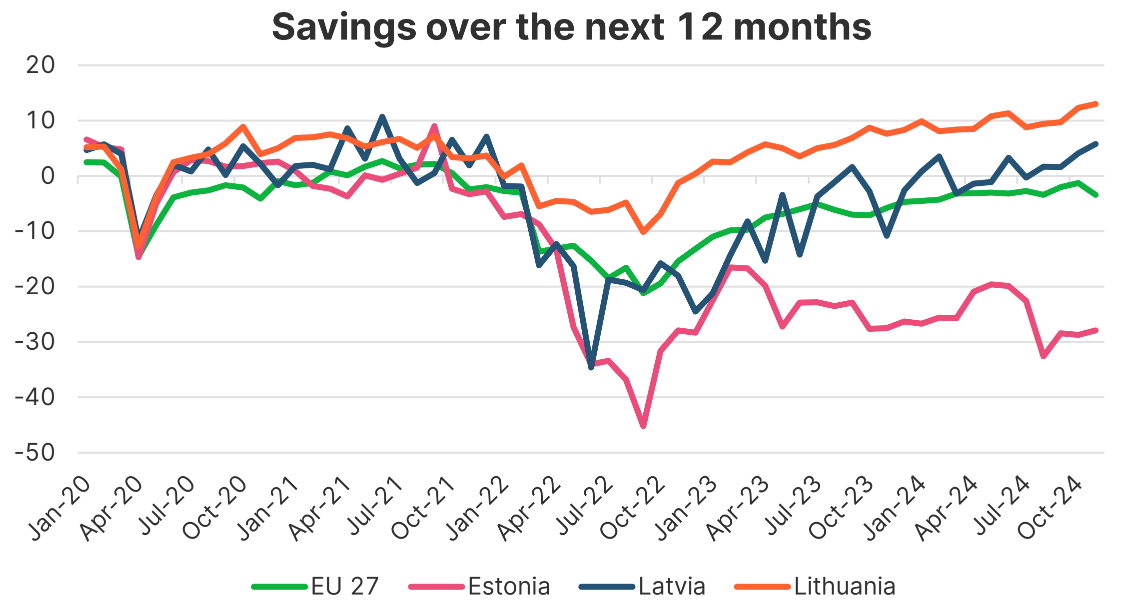
# Retail sales growth in Lithuania surges

The **retail sector in Lithuania has demonstrated robust growth over the past year**. Private consumption is projected to increase by 0.7 percentage points in 2025, rising from 3.8% to 4.5%. This forecast indicates a continued acceleration in retail sales growth.

In Estonia, the retailers appear to be emerging from its lowest point, although the annual growth for the last quarter of 2024 may still be negative. Nevertheless, a slight positive growth in retail sales is anticipated this year, as the economy is expected to return to modest expansion. A similar trend is projected for Latvia, where retail sales growth is expected to surpass that of Estonia.

# Lithuania's consumers the most confident



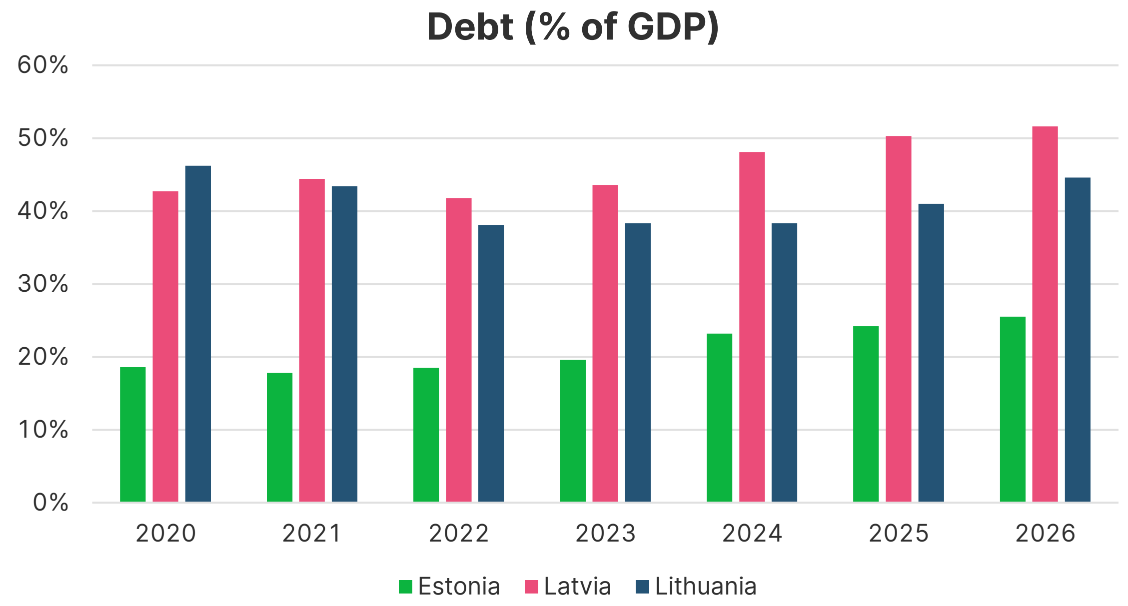

*Source: European Commission, Erste Group*

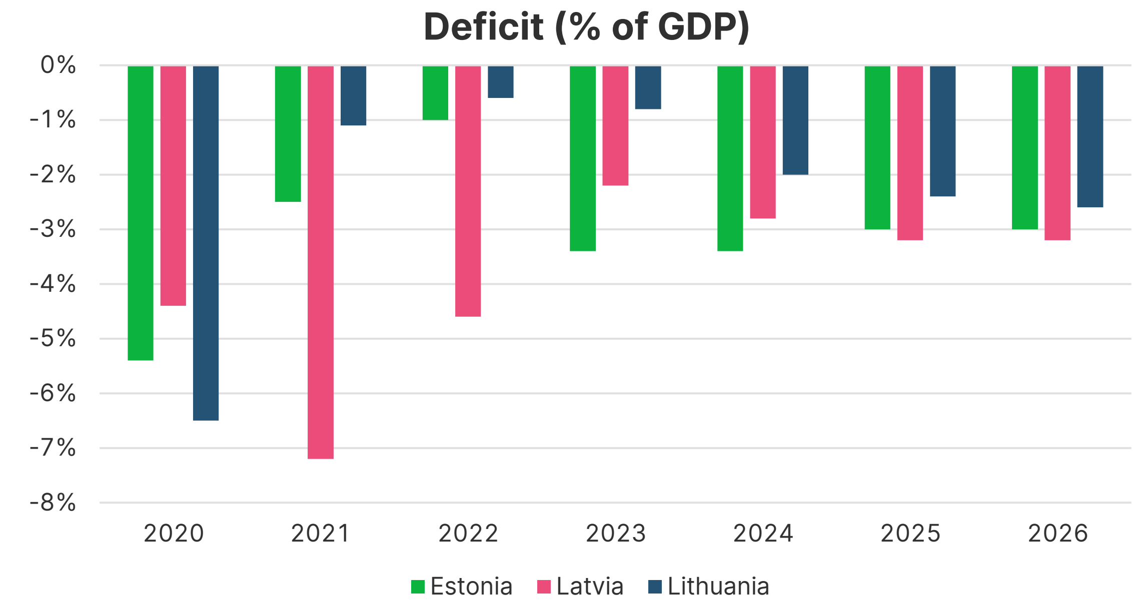
In contrast to its peers and the EU average, **consumers in Estonia are not becoming more optimistic**. They hold negative views on several aspects of consumption, including major purchases, their financial situation in the coming year, and expected future savings. On the other hand, **Latvians are increasingly concerned about unemployment**, although their outlook for the next twelve months has improved compared to a year ago. In Lithuania, annual improvements have been recorded in eight out of twelve questions in the questionnaire.

Similar to the overall consumer sentiment index, **Estonia lags in consumer expectations regarding future savings**. This may be attributed to the job market, where real wages have not been increasing significantly, and the unemployment rate has risen. In contrast, **in Latvia and Lithuania, savings expectations are supported by wage increases**, although the index values are expected to gradually stabilize.

# Fiscal situation and SDG

# Deficits in the Baltic to oscillate around 3%




*Source: European Commission, Erste Group*

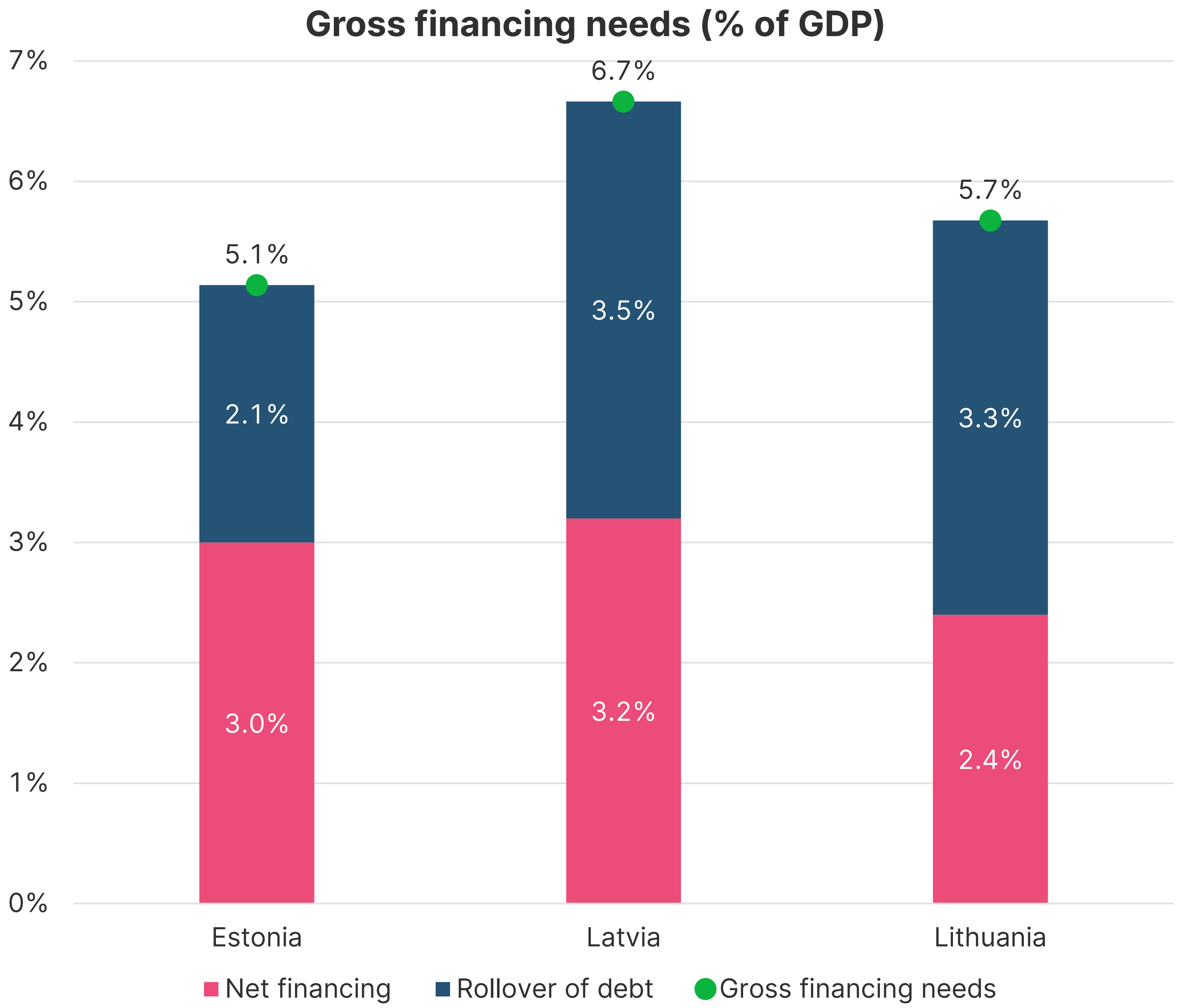
On the fiscal front, **all three countries are gradually converging towards the 3% deficit threshold.** Last year, Lithuania demonstrated the most fiscal prudence, achieving a budget balance of -2%. However, the deficit is projected to widen to 2.6% by 2026. There remains room for improvement, as **Lithuania has the largest VAT gap in the Baltic region**, at 14.6% of potential VAT—approximately three times higher than Estonia (4.4%) and Latvia (5%). Estonia slightly exceeded the 3% deficit threshold last year, but due to consolidation reforms, the budget gap is expected to narrow to 3% this year, potentially even falling below this mark. Latvia's budget is also anticipated to have a deficit of approximately 3%. **Public finances in the Baltic region are significantly influenced by defense expenditures**, which are expected to significantly exceed 3% of GDP for all countries this year. Given the persistent eastern threat, we anticipate that similar levels of military expenditure will continue in the coming years.

*Difference between the VAT revenue if all taxpayers paid and the actual amount collected.*

# Financing needs around 5-6% of GDP

In contrast to last year, Latvia's funding needs have increased by approximately 0.7 percentage points. According to the available data, **Latvia has not yet tapped into the bond market this year**, despite needing to cover approximately €2.8 billion in 2025, based on our estimates.

Lithuania is the only country to have entered the bond market in January, with two bond tap-ins totaling only €100 million. **A new bond issuance in Lithuania is expected in early February.** Estonia typically rolls over short-term debt, with new issuances occurring around April and September each year. However, we anticipate that **Estonia will need to enter the market with a new, long-term issuance**, similar to last year.



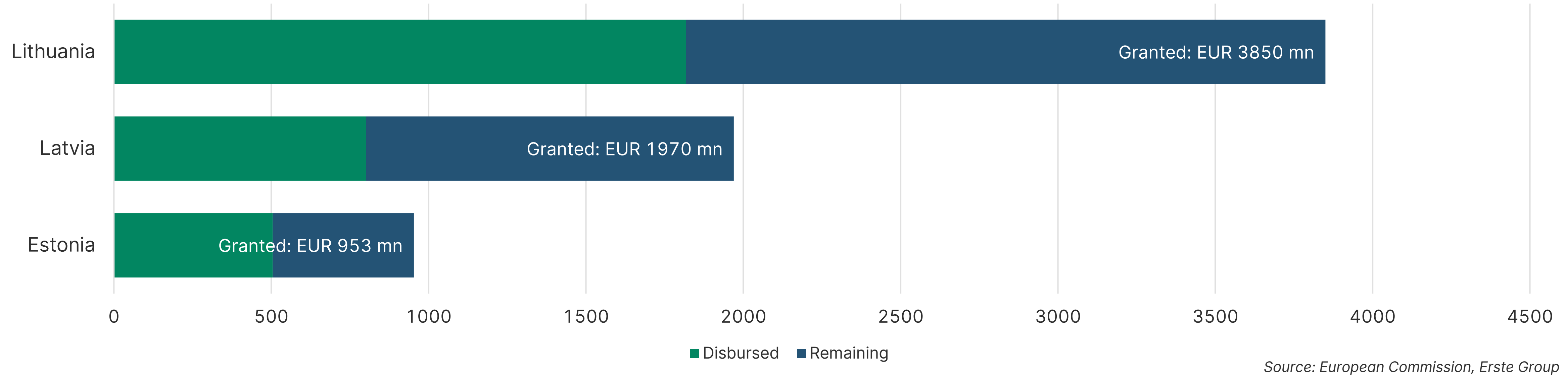

*Source: European Commission, Erste Group*

# Estonia withdraws its sovereign rating from S&P

**The most significant event concerning sovereign ratings last year in the Baltic region was the triple downgrade by S&P** in May. Estonia's rating was lowered from AA- (negative) to A+ (stable), while Latvia and Lithuania were both downgraded from A+ (negative) to A (stable). These downgrades were attributed to the impacts of the conflict in Ukraine, which is seen as the primary factor influencing these decisions**. An interesting development was the withdrawal of Estonia's long-term debt rating by S&P at the end of 2024, after the issuer's request to withdraw the ratings.** However, the new rating should be made public again on May 30th, according to S&P's Rating Review Calendar for 2025. Fitch will reassess Estonia on January 17th, and Moody's will do so in early March. Latvia will have a rating review by Moody's on January 24th with Fitch and S&P following in Q2. Lithuania will be rated in Q2 by all three major agencies. As the ratings for all three countries are relatively aligned across agencies and the situation has not changed significantly in the past six months, we do not anticipate any rating changes during the first round of reviews this year.

| | Estonia | | Latvia | | Lithuania | |
|---|---|---|---|---|---|---|
| | Rating | Outlook | Rating | Outlook | Rating | Outlook |
| S&P | **NR** | **-** | **A** | **Stable** | **A** | **Stable** |
| Moody's | A1 | Stable | A3 | Stable | A2 | Stable |
| Fitch | A+ | Stable | A- | Positive | A | Stable |

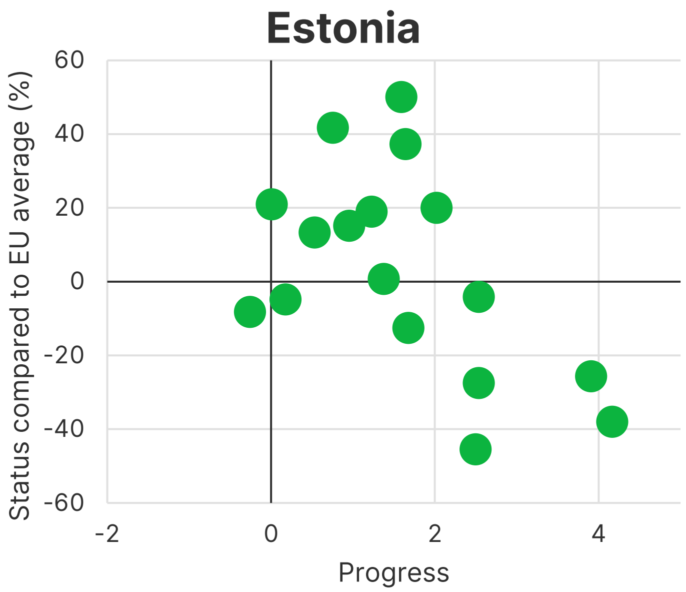
# RRF utilization around 50%, but more acceleration needed

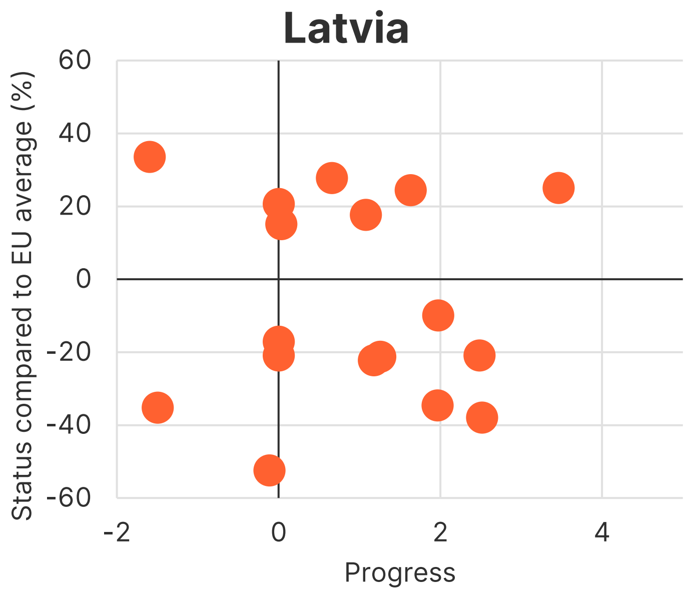


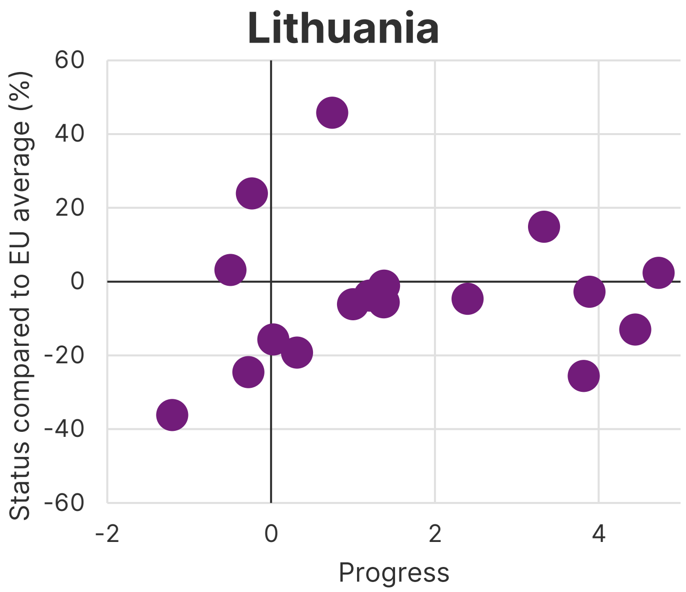

*Source: European Commission, Erste Group*

**The Baltic countries are making progress in accessing the RRF funds.** Estonia has surpassed the 50% utilization mark, with its allocation consisting solely of grants. To date, the Estonian government has received €503 million, with an additional payment of €122 million currently under assessment. Latvia is slightly behind, having withdrawn approximately €800 million from its grant allocation of nearly €2 billion. There is also a request for €275 million under assessment, which, if approved, would bring Latvia above the halfway mark. Lithuania has access to both grants and loans, with €2.3 billion in grants and €1.5 billion in loans available. Out of the total €3.8 billion allocation, Lithuania has managed to receive about half (€1.8 billion). **However, it is necessary that these governments speed up their efforts, as the grants must be drawn by the end of 2026.** We may see slight concessions from the European Commission, given that the majority of EU countries are behind schedule.

# Estonia with a large SDG lead over Latvia and Lithuania




*Source: European Commission, Erste Group*

**Estonia is the leader of the region in terms of SDGs.** Only eight topics are below the EU average, with "gender equality" and "climate action" lacking the most. However, all but two SDGs have progressed as opposed to 2023. "No poverty" category deteriorated probably due to poo economic growth, while "Zero hunger" remained stagnant.

Latvia, on the other hand, has **performed rather mediocrely in last year's evaluation**. Four SDGs stagnated, while two, namely "Life on Land" and "Reduced Inequalities" deteriorated significantly. Only four SDGs are in the favorable quadrant of the chart, while the rest needs more improvement in the coming years.

As opposed to the favorable economic situation, **Lithuania performs the worst on the SDG front**. Four SDGs have regressed, with the most negative progress noted for the "Good heath" category. Only three SDGs are progressing and above the EU average, two of which concern equality.

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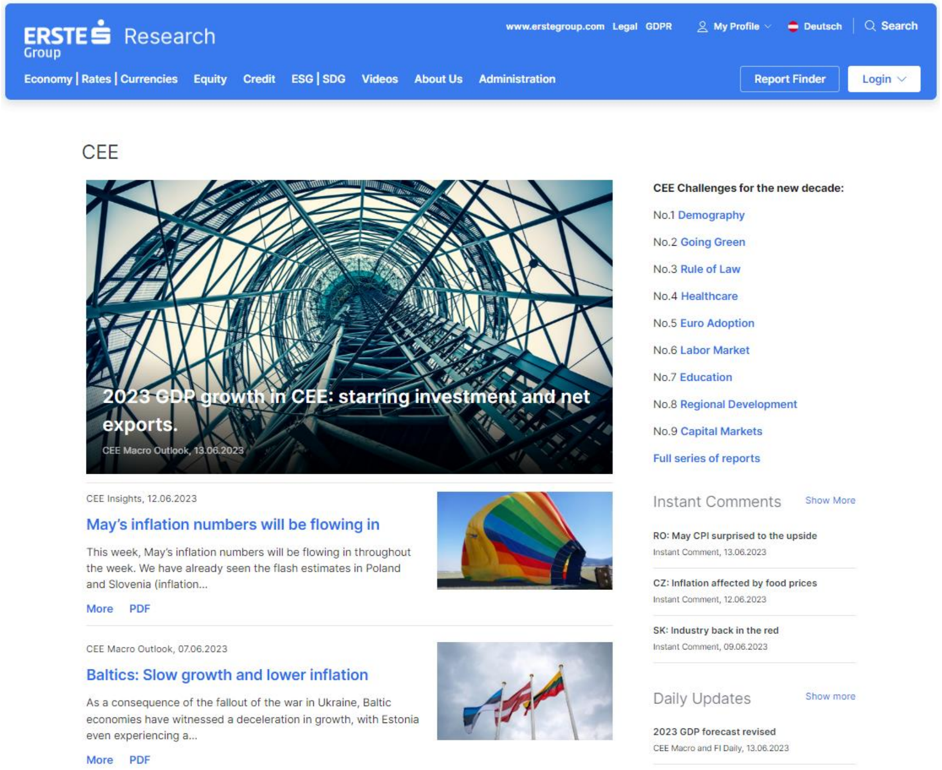


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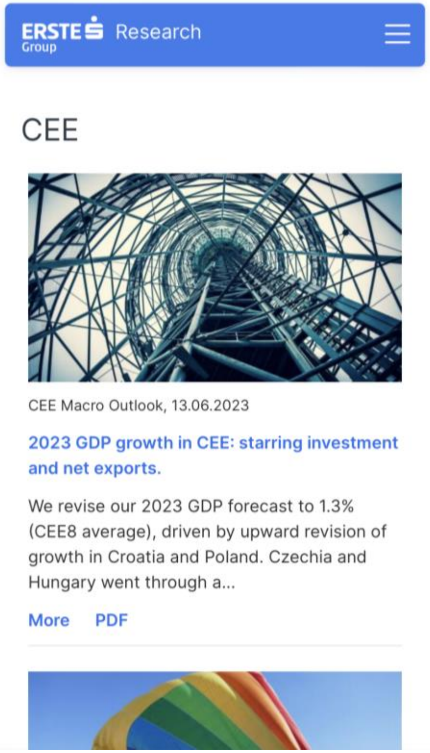


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