Baltic Report:
Economic performance further diverges

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Executive summary

1. While Estonia is expected to contract this year again following a 3% slump in 2023, Latvia and Lithuania are rebounding from milder recessions. The driver of their recovery will be private consumption and RRF.
2. The Baltic region is returning to price stability after high inflation rates in 2022 and 2023. Service prices, supported by rising wages, pose the most substantial upward risk to the inflation outlook.
3. Lithuania's industrial sector is witnessing a recovery, while Latvia and Estonia's industrial output continues to contract.
4. The retail sector's performance varies, with Estonia reporting subdued performance and Lithuania significantly outperforming the EU average. Consumer confidence is improving in Latvia and Lithuania.
5. Defense spending has increased significantly in the Baltic states due to the conflict in Ukraine, putting pressure on public finances. Estonia plans to raise defense spending to 5% of GDP in the upcoming years.
6. S&P downgraded all three Baltic countries due to the impacts of the conflict in Ukraine. Defense spending will damage public finances and the uncertain security situation might discourage potential future FDI.

BALTIC REPORT

Main economic developments

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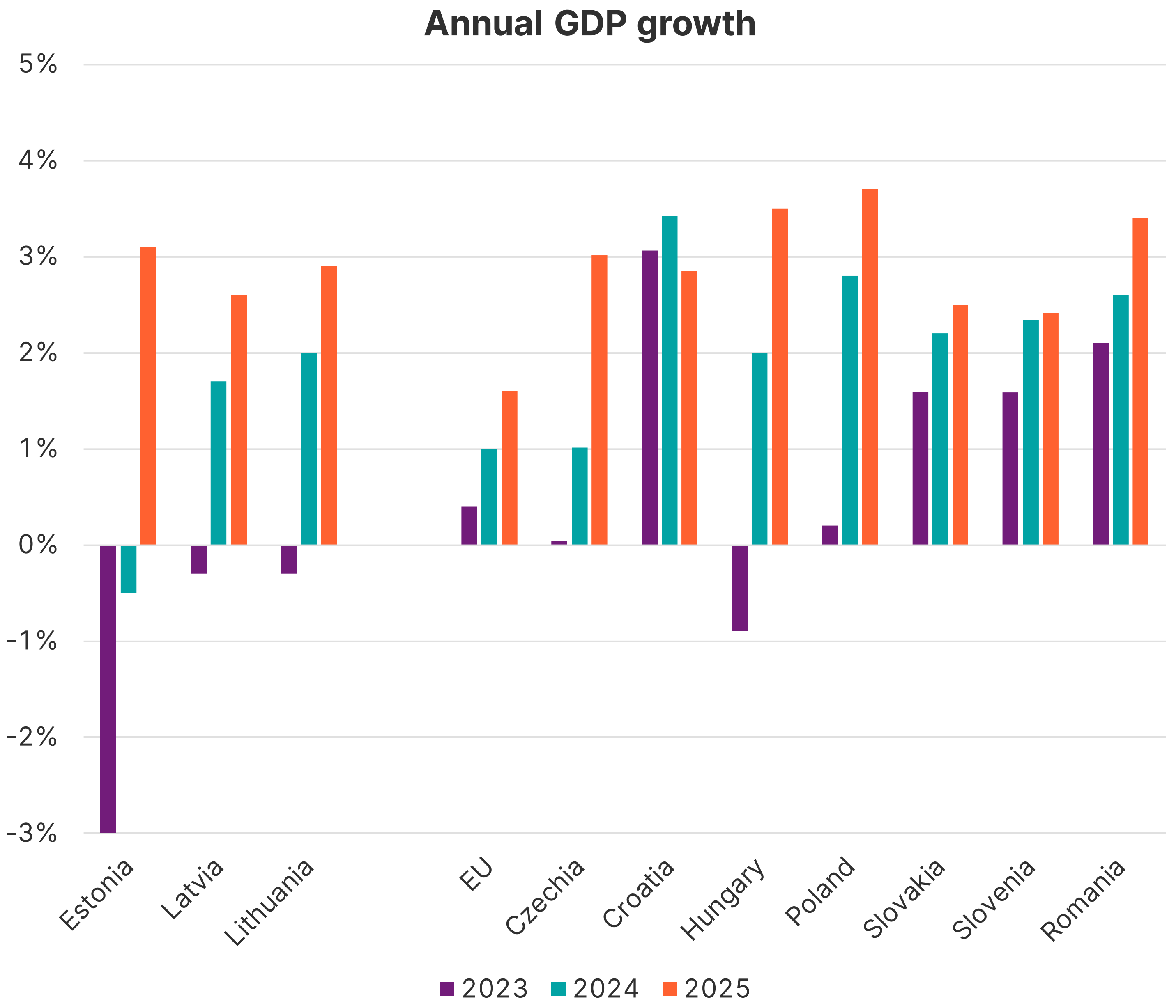
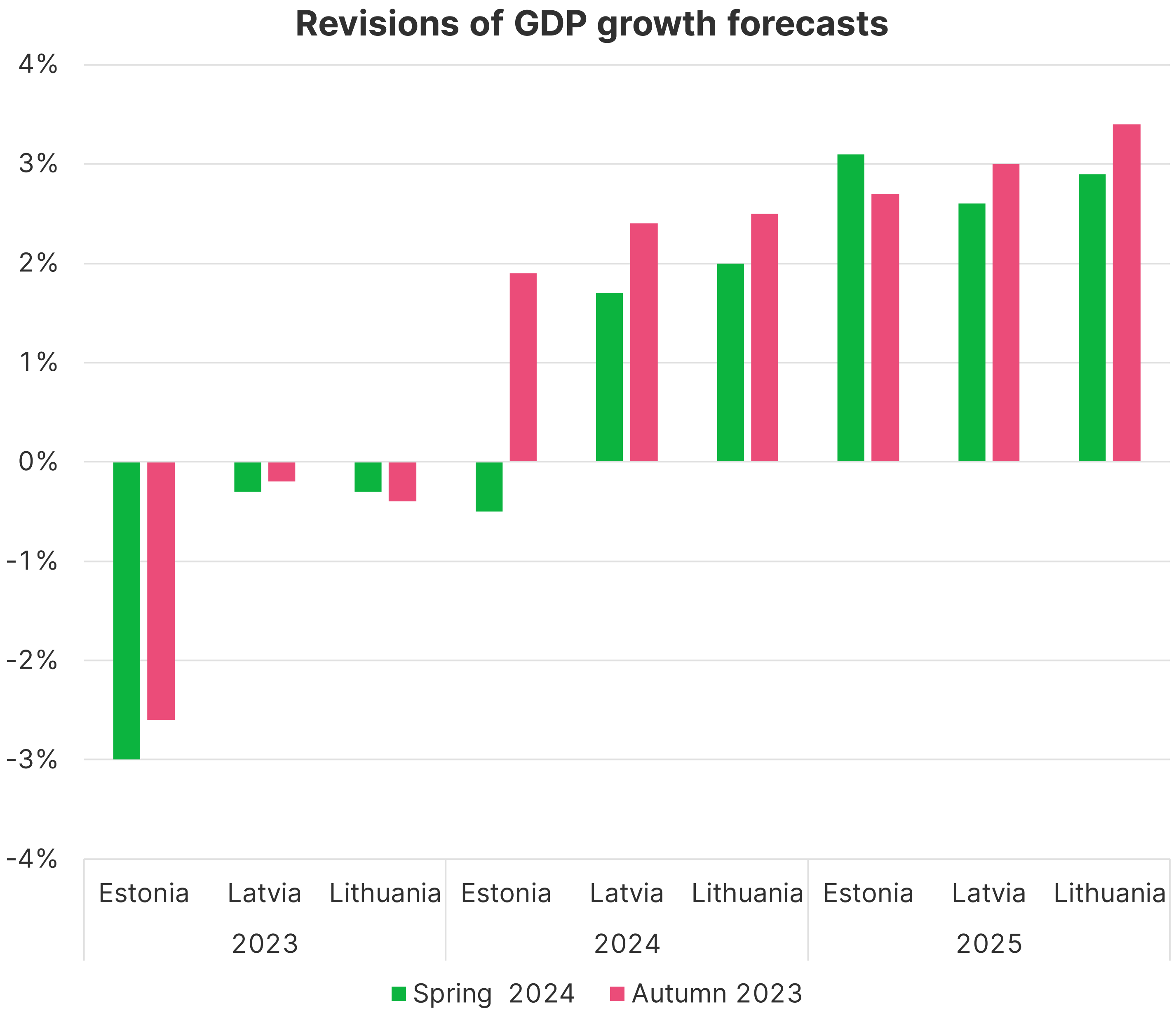


Source: European Commission, Erste Group

Estonia to contract also this year

Estonia's economic struggle is expected to persist this year, following a 3% contraction in 2023. The EC's current forecast indicates a slight shrinkage of 0.5%, with hopes for a 3% rebound in 2025. Challenges persist in the wood-manufacturing sector due to diminished demand from Nordic markets and supply chain disruptions, particularly from Belarusian suppliers. Moreover, the transport sector continues to grapple with interrupted eastern transit.

Conversely, **Latvia and Lithuania are experiencing a recovery from their mild recessions in 2023**. Their resurgence is similar the broader trend in CEE, driven primarily by domestic private consumption fueled by real income recovery, alongside the inflow of funds from the RRF.



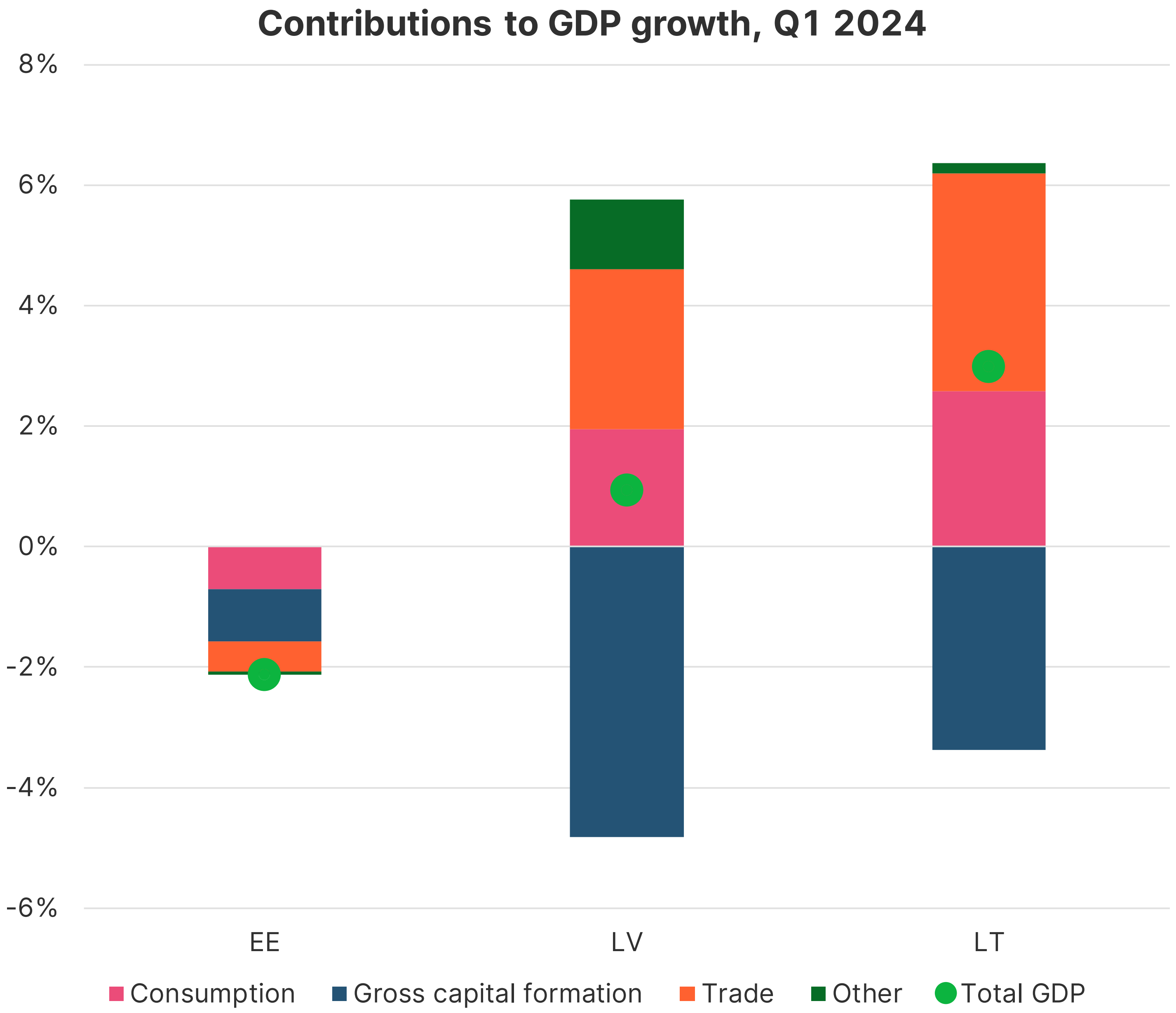
Source: European Commission, Erste Group

Downward revisions for 2024

Comparing the GDP growth forecasts between the last two rounds reveals **a downward revisions for 2024.** Estonia's economy is exhibiting a slower than anticipated recovery, characterized by firms planning to further postpone their investment activities. Household spending has not yet recovered, partly due to higher mortgage payments due to flexible interest rates.

The modest downward adjustments for Latvia and Lithuania stem primarily from a slower external recovery than previously projected. **In 2025, all three nations are expected to witness a resurgence** in their export sectors, further complemented by investment contributions from both the private and public spheres.

Consumption and trade revive

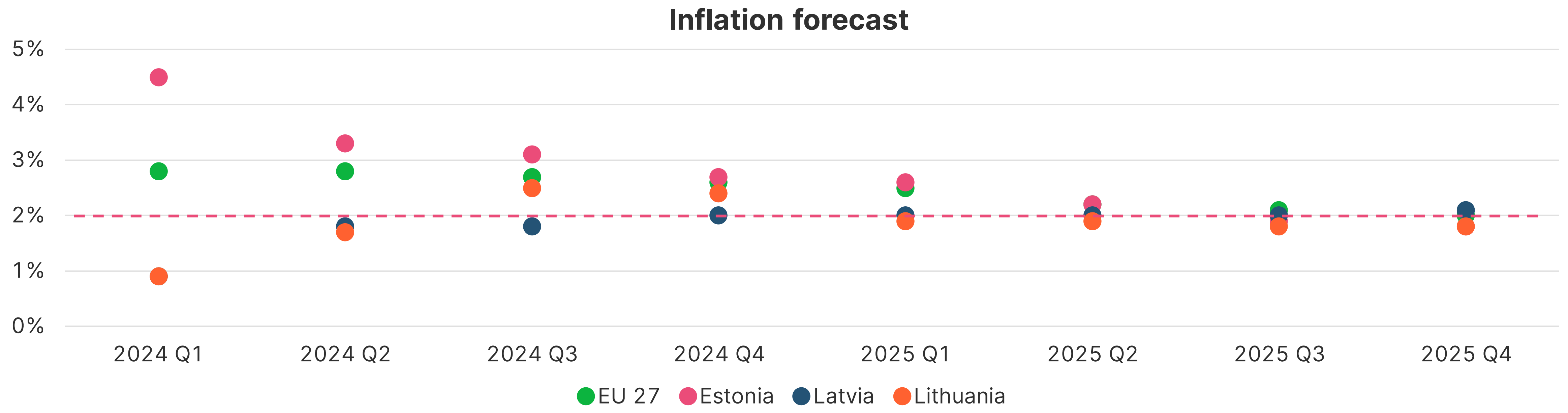


Source: Eurostat, Erste Group

The GDP data for Q1 2024 indicate that **Latvia and Lithuania are experiencing a revival in consumption and an improvement in trade balance**. The latter has particularly benefited from significantly cheaper energy imports, while exports have remained stable in Lithuania but have diminished in Latvia and Estonia.

Estonia has seen a positive impact from fixed capital formation, in contrast to Latvia and Lithuania where it has been detrimental. The most substantial drag on growth has been the depletion of inventories, marking a shift after years of positive input. In Estonia and Lithuania, government consumption has had a negligible effect, whereas in Latvia, it has contributed 1.48pp to growth.

Inflation paths converge to the target



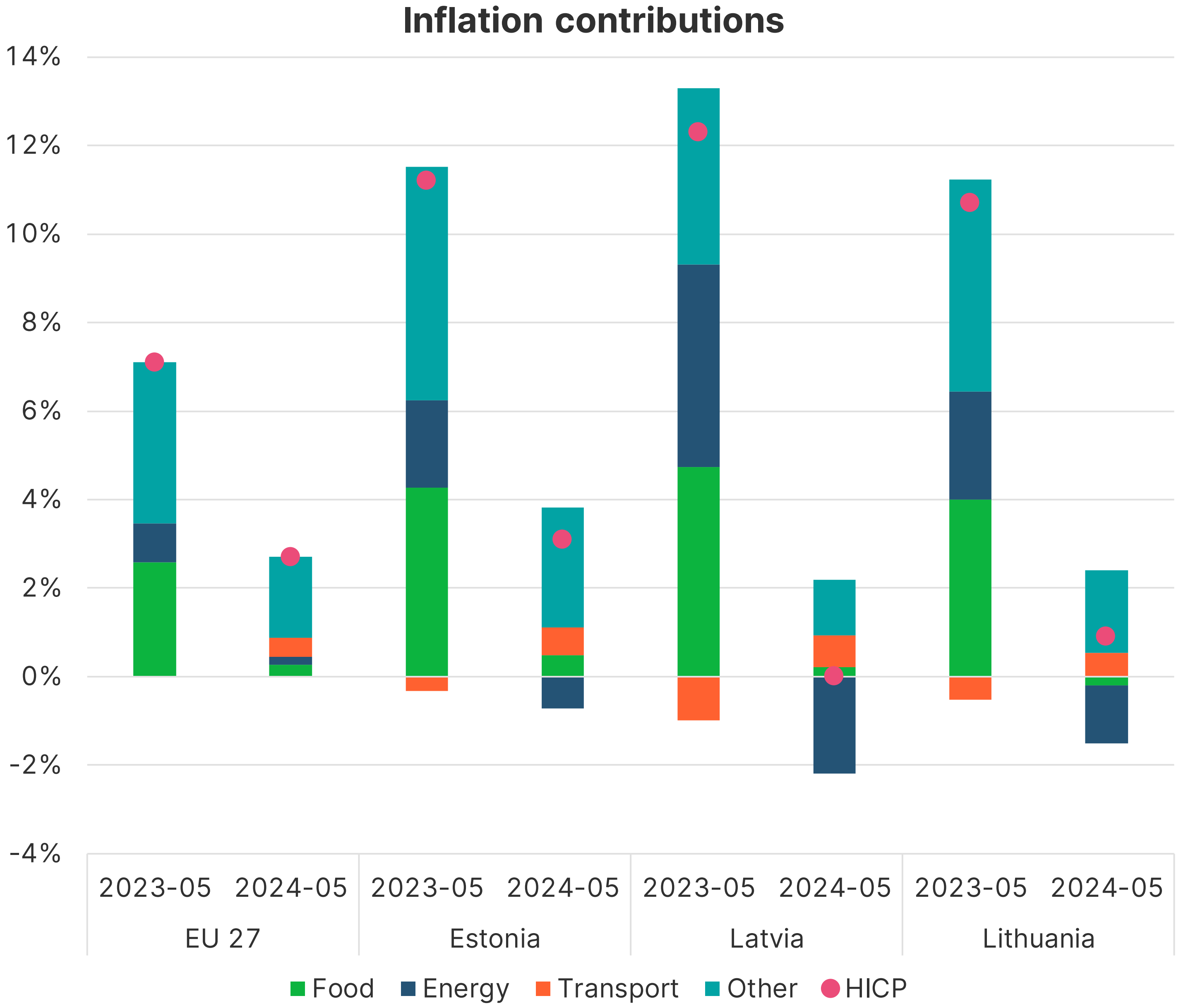
Source: European Commission, Erste Group

The Baltic region experienced some of the highest inflation rates in the EU during the price shock of 2022 and 2023. Stability returned in the latter half of 2023, with a positive **economic forecast indicating that prices are under control**. Estonia observed a minor inflation increase in Q1 2024 due to a VAT hike at the year's start, pushing January inflation to 5%. The HICP in Estonia is expected to fall to 3.4% in 2024 and further to 2.1% in 2025. Latvia and Lithuania's inflation rates are anticipated to hover around the 2% target for both years. **Inflation, excluding unprocessed food and energy, is likely to surpass headline inflation**, propelled by the costs of services and processed food.

Price pressure from services remains

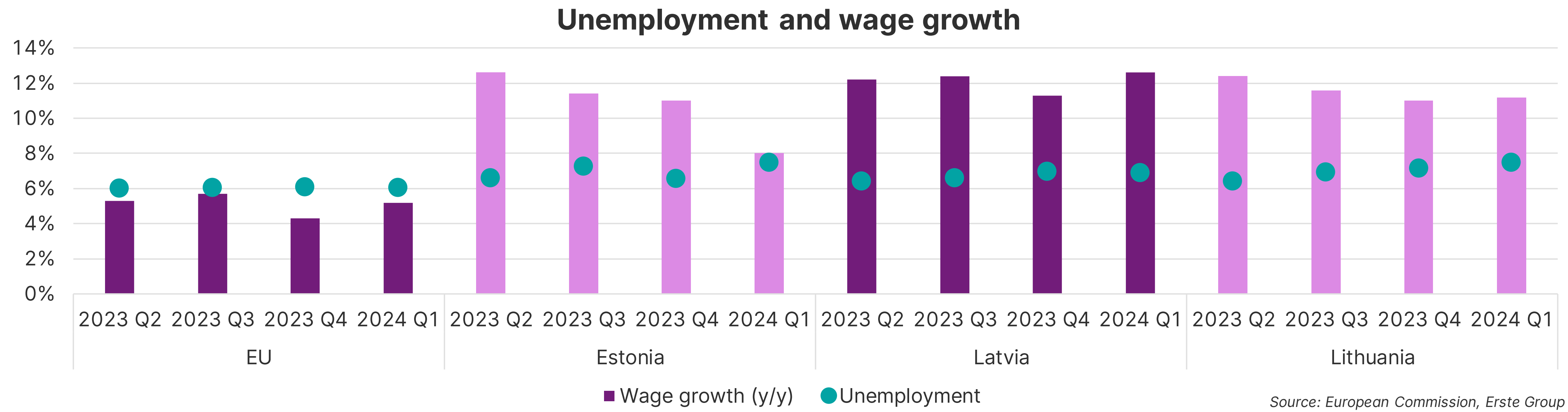
In comparison to the previous year, the costs of food, energy, and transportation have acted as counterbalancing factors in the trajectory of inflation. However, similar to trends observed in the CEE region, the **increase of service prices supported by rising wages, poses the most substantial upward risk to the inflation outlook**.

Furthermore, the disappearing favorable base effect will be another source of upward pressure. This will be particularly visible in Latvia, where a reduction in energy prices has decreased the HICP by two percentage points in May.



Source: European Commission, Erste Group

Salary growth decelerates in Estonia, unemployment rises



Source: European Commission, Erste Group

Wage growth in Latvia and Lithuania remains robust, with reported figures consistently exceeding 10% y/y. In Lithuania, the pace of wage increases is slowly decelerating, whereas Latvia has recorded its highest surge at 12.6% in Q1 2024. **Estonia has experienced a sharp deceleration in salary growth to 8%** y/y in Q1, a decline from over 10% growth observed in 2023. This slowdown may be attributed to the rise in unemployment, which currently stands at approximately 7.5%—a two percentage point increase from 2021 and three percentage points above pre-pandemic levels. A similar trend is observed in Lithuania, where the unemployment rate has risen by 2 percentage points since Q2 2022. Consequently, wage pressures are likely to diminish more rapidly as the job market cools down.

BALTIC REPORT

Retail and industrial development

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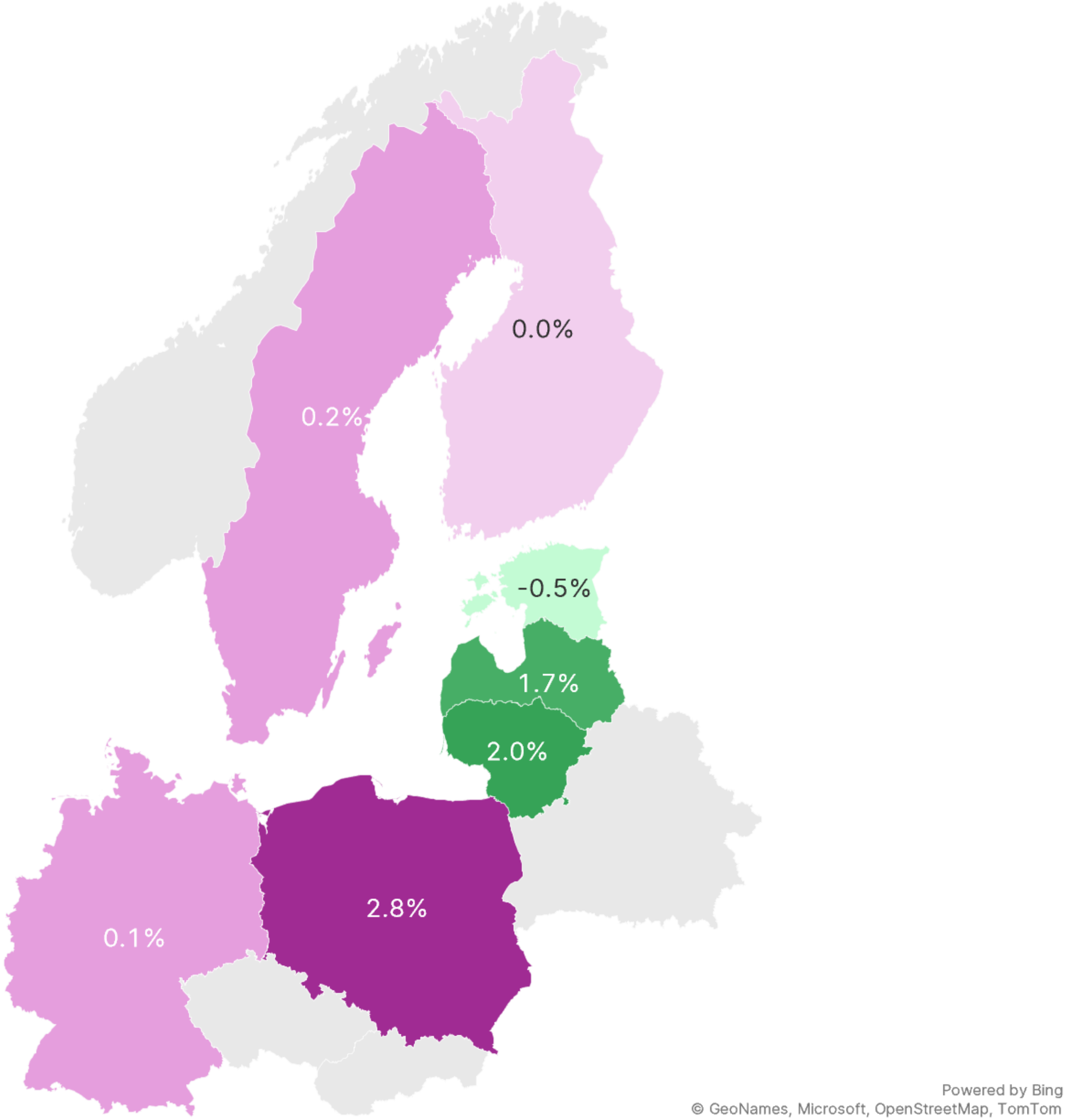
Exports recover only in Lithuania

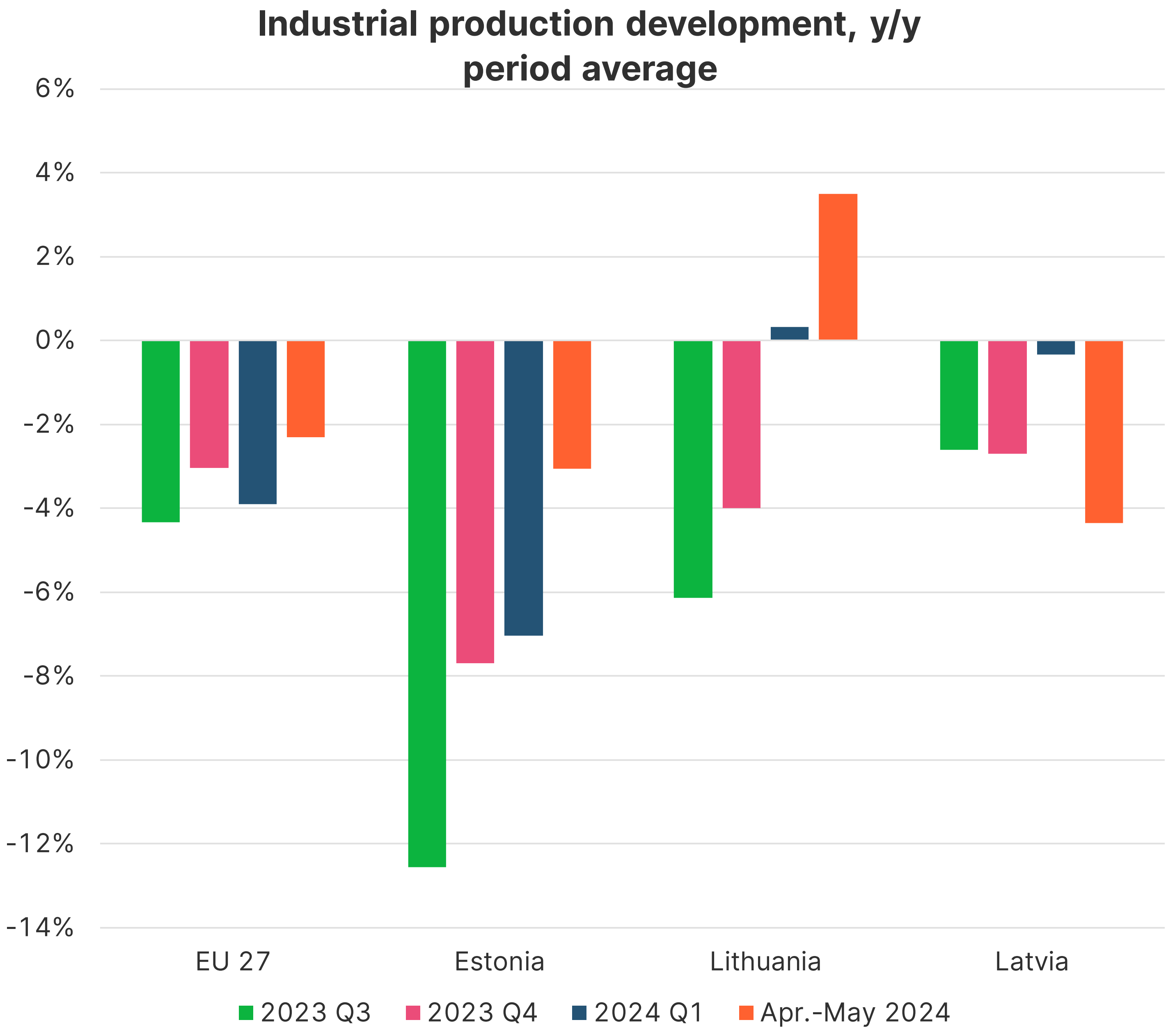
2024 GDP growth of main trading partners



Source: European Commission, Erste Group

As previously mentioned, export-driven enterprises in the Baltic region have faced challenges in recent periods. Unfortunately, among the most important trade partners of the three countries, Poland stands as the sole positive outlier.

In 2023, exports contracted across all three nations, with Estonia and Latvia projecting further downturns this year. Lithuania alone anticipates an upturn in export figures, with a forecasted increase of 2.2%, potentially supported by Poland's robust economic rebound. Nonetheless, the merchandise trade balance for all Baltic states is predicted to remain substantially negative, with projections for this year ranging between -7% to -8.8% of GDP.



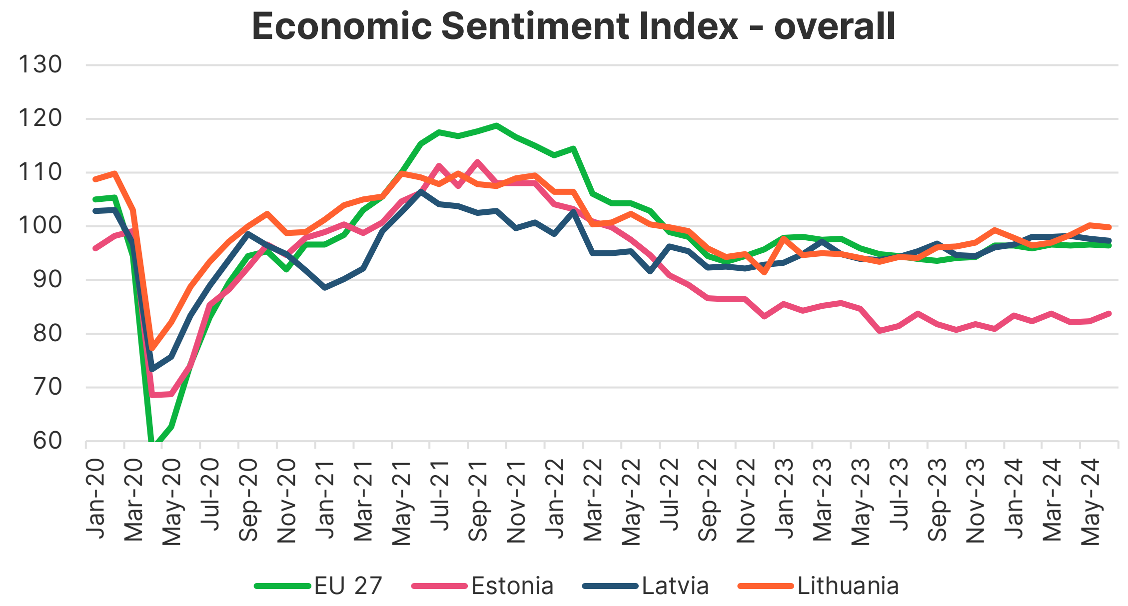
Source: Eurostat, Erste Group

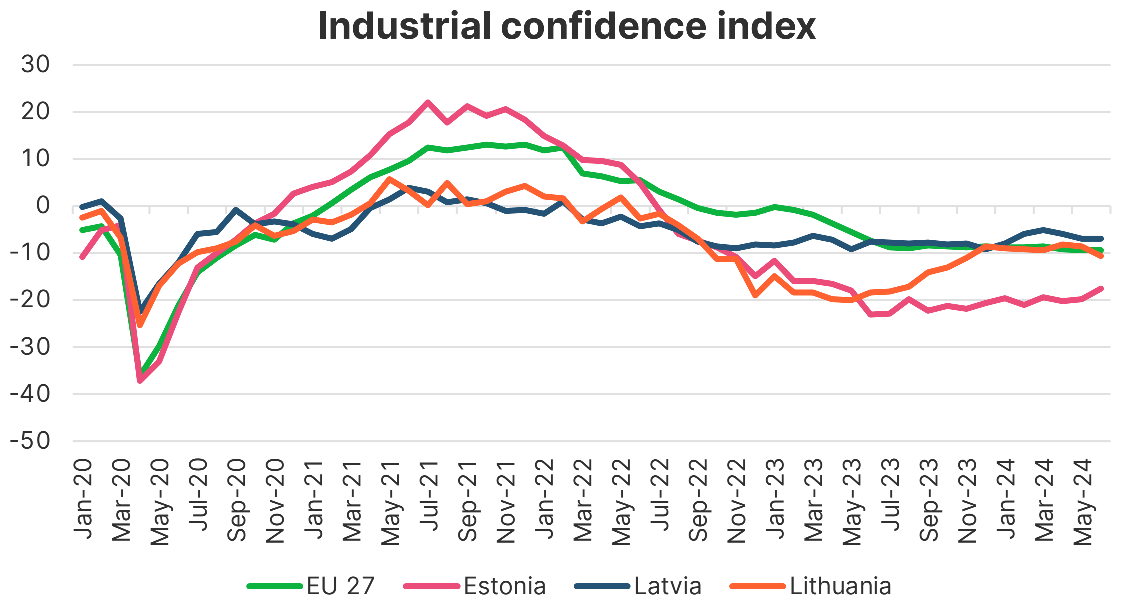
Industrial output follows exports

In tandem with the resurgence in exports, **Lithuania's industrial sector is also witnessing a robust recovery**. The primary subsectors fueling this growth are mining and manufacturing. On the other hand, energy providers are reporting a significantly lower production value.

Contrastingly, **the industrial landscape in Latvia and Estonia continues to contract**, predominantly due to weak manufacturing. The energy and mining sectors in these countries show considerable volatility. The performance of the industrial sector is set for improvement in 2025, dependent on the performance of their key trading partners.

Sentiment indicators remain static

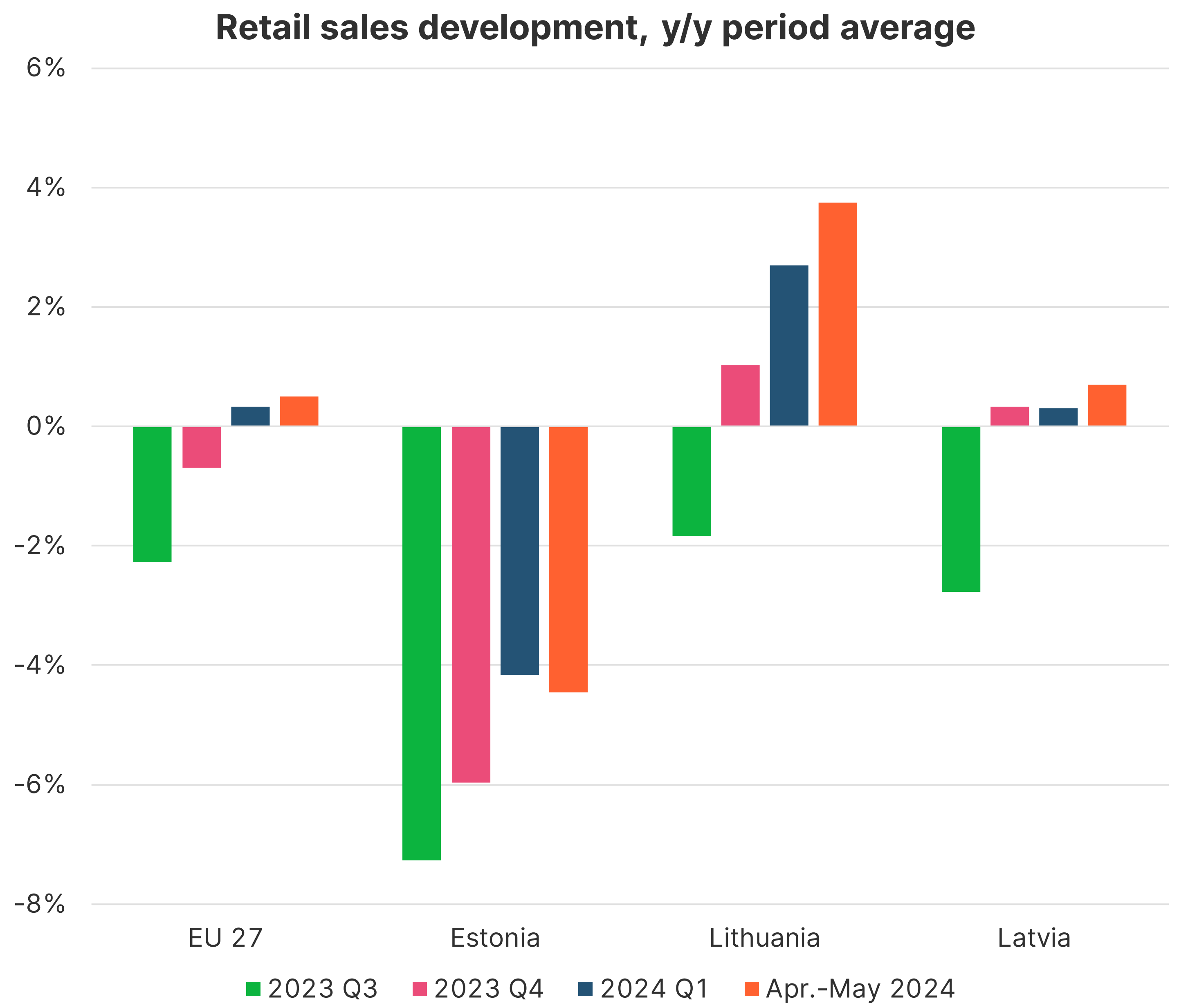




Source: European Commission, Erste Group

The **ESI in Latvia and Lithuania has been on a slow, but gradual ascent**, alongside with the EU average. **Estonia, however, lags, with the index showing reluctance to rise**. Nonetheless, it is anticipated that the bottom has been reached, and an upward trajectory for the ESI is expected soon. The index should be supported by an improved consumer climate a more favorable business outlook at a later point.

Contrary to Lithuania's recent industrial production growth, the **industry sentiment has remained relatively static**, with a decline in June. Estonia, however, has seen a slight increase, likely driven by an improving future outlook. Interestingly, Latvia registers the highest value, despite a significant downturn in industrial output in Q2 2024.



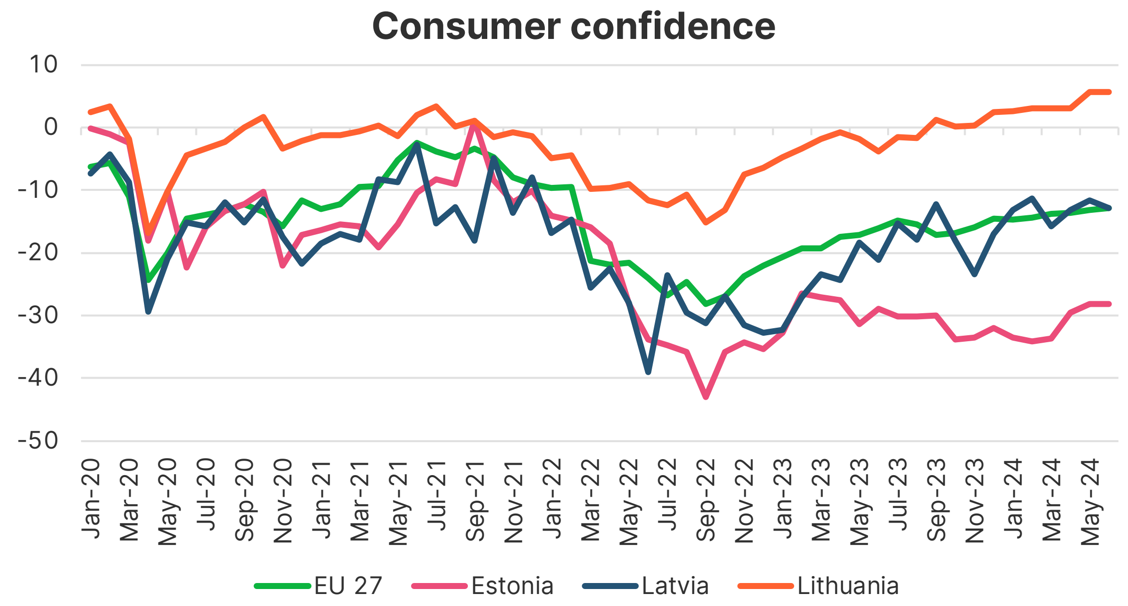
Source: Eurostat, Erste Group

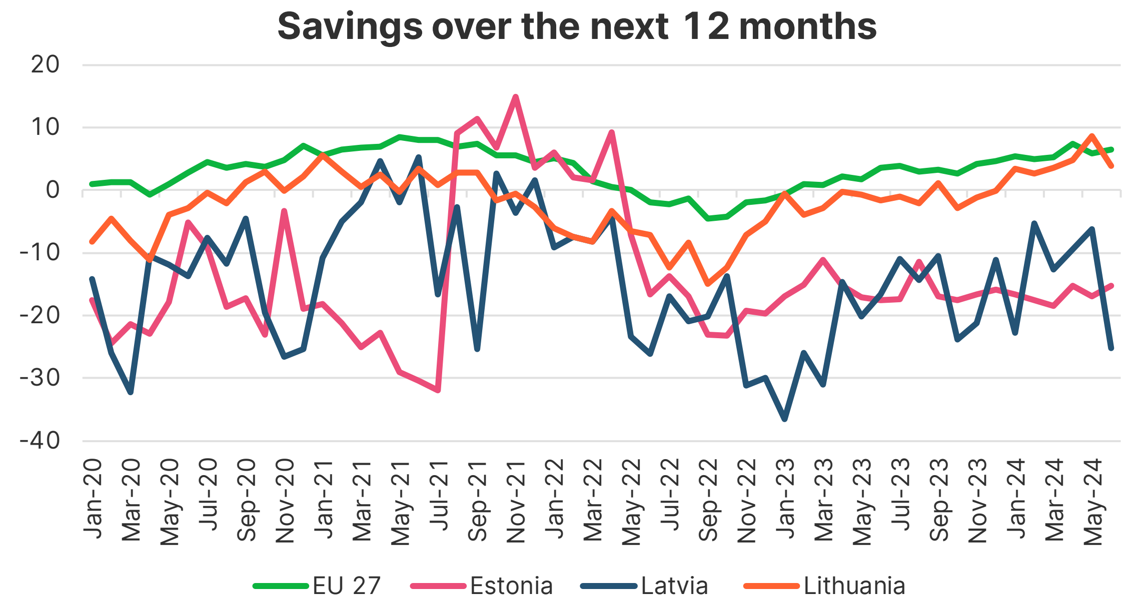
Retail sector performance varies

The retail sales in the Baltic region present a varied picture. **Estonia continues to report lackluster performance**, with no signs of improvement in Q2. **In contrast, Lithuania's retail sector is significantly outperforming the EU average**. Latvia's retail is on a recovery path as well, though at a more modest rate.

In Estonia, the downturn in retail turnover is widespread, with nearly all outlets selling manufactured goods experiencing declines. The -5% decline in May was the steepest in the EU, matched only by Belgium. The improvement will be rather sluggish, as wages are growing at a slower pace and unemployment increases.

Lithuania’s consumers the most confident





Source: European Commission, Erste Group

Consumers in Latvia and Lithuania are experiencing some relief after 2022 and 2023. The overall index is supported primarily by improvements in the current and expected financial situation and economic environment, with Lithuanian consumers also demonstrating an increased propensity to save. While similar categories show progress in Estonia, the sub-index levels remain significantly lower than its Baltic counterparts. Additionally, the unemployment and major purchases indices decrease the overall consumer confidence.

The improvement of real wages has been mentioned numerous times, but the split between consumption and savings of the additional funds remains intriguing. We investigated the topic for the CEE in one of our special reports, concluding a divergence of the savings propensity among countries. While such in-depth analysis is out of scope of the report, form the above chart we can conclude that only **consumers in Lithuania are continuously planning to save more from their income**.

BALTIC REPORT

Fiscal situation and SDG

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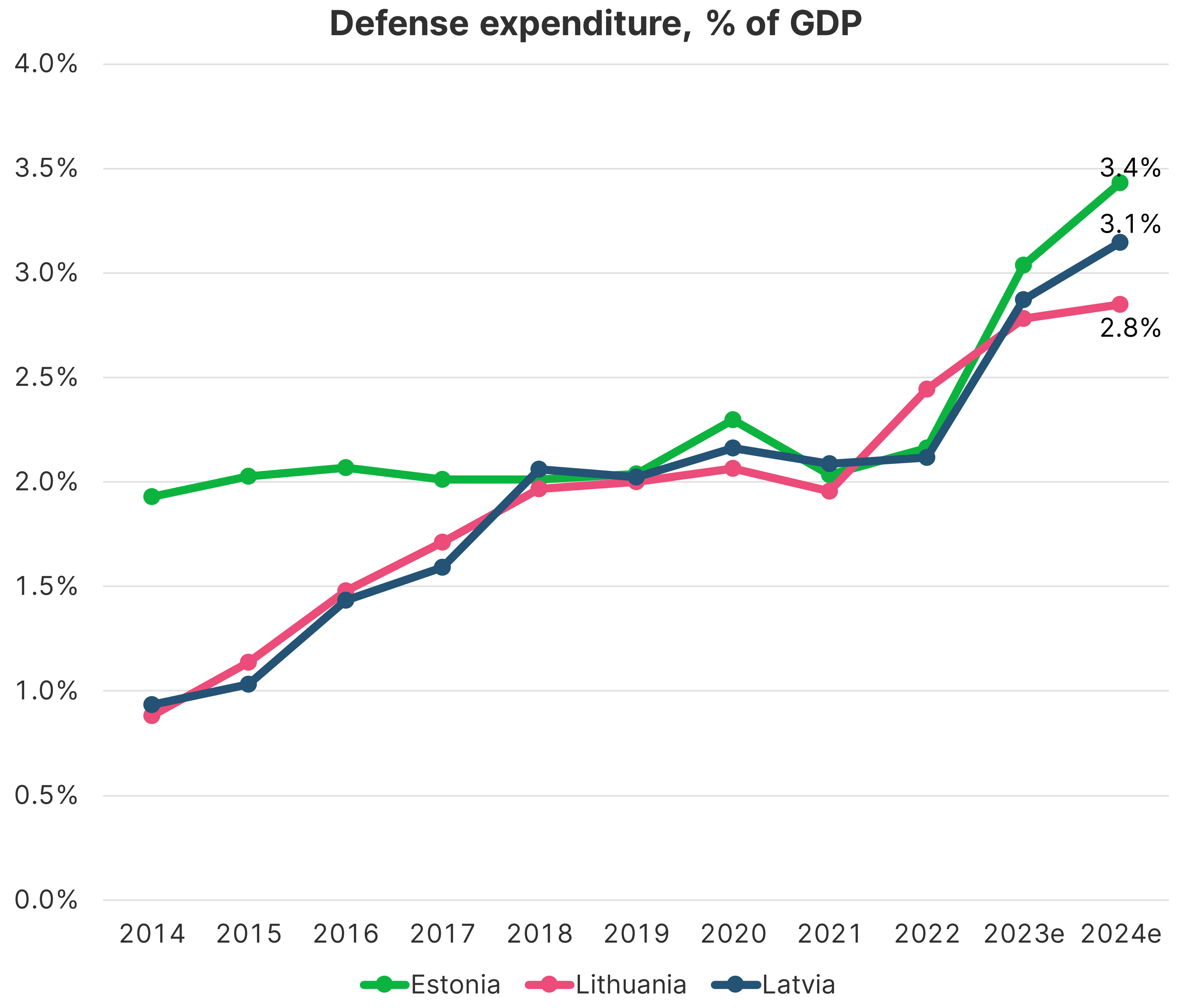


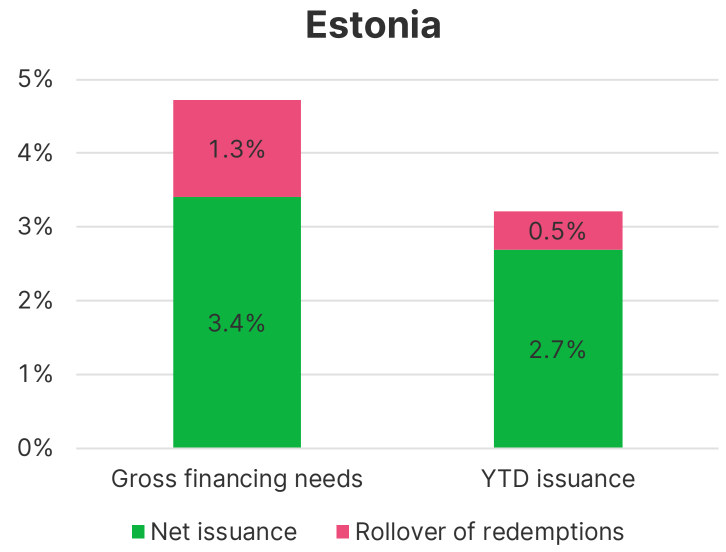
Source: NATO, Erste Group

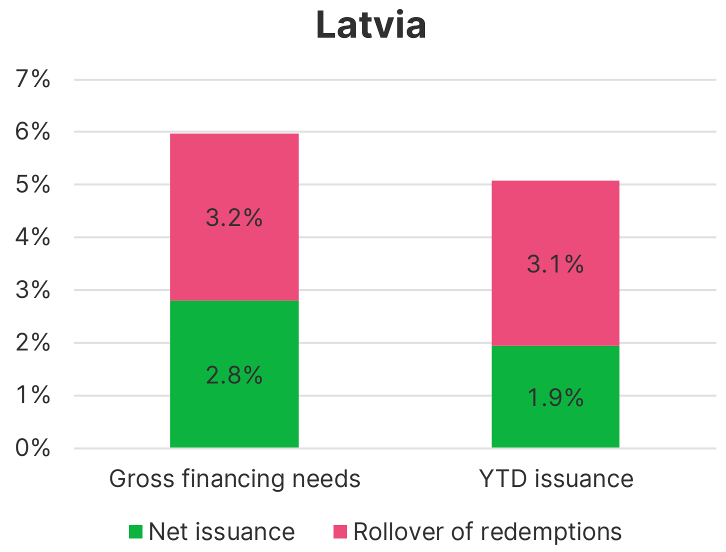
Defense expenditure grows

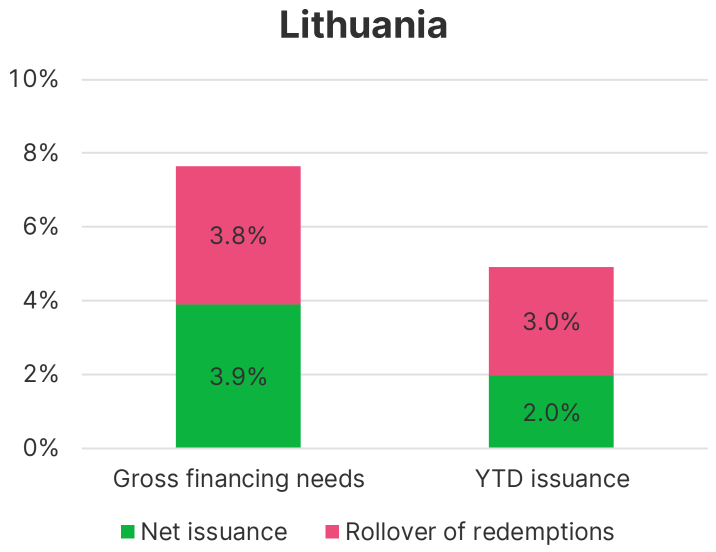
The ongoing conflict in Ukraine has placed the **Baltic states in a position of the highest exposure among EU and NATO members**, with economic and security uncertainties being significant.

Therefore, **defense spending has seen a significant increase**, with Latvia and Lithuania allocating around 3% of their GDP and Estonia 3.4% for this year. This level of expenditure puts considerable pressure on public finances, resulting in higher deficits or optimization of revenue and expenditures. Lithuania's cabinet, for instance, is actively seeking to generate an additional €400 million through tax increases this year. The commitment to maintaining a high military budget is evident, particularly with Estonia's officials planning to raise defense spending to 5% of GDP in the upcoming years.

Financing needs on track







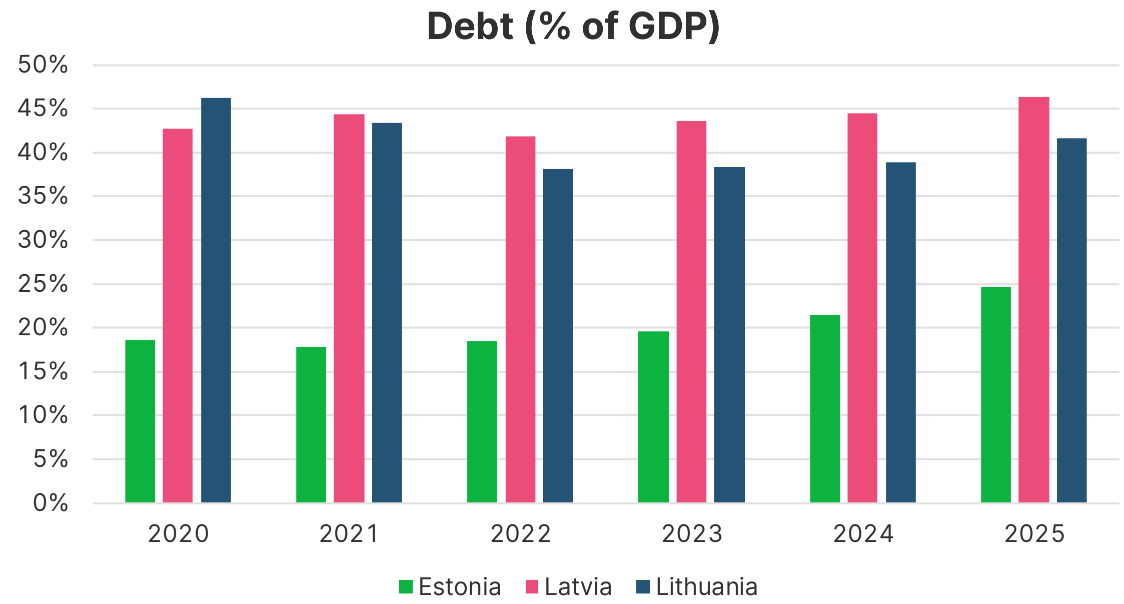
Source: European Commission, Erste Group, own calculations

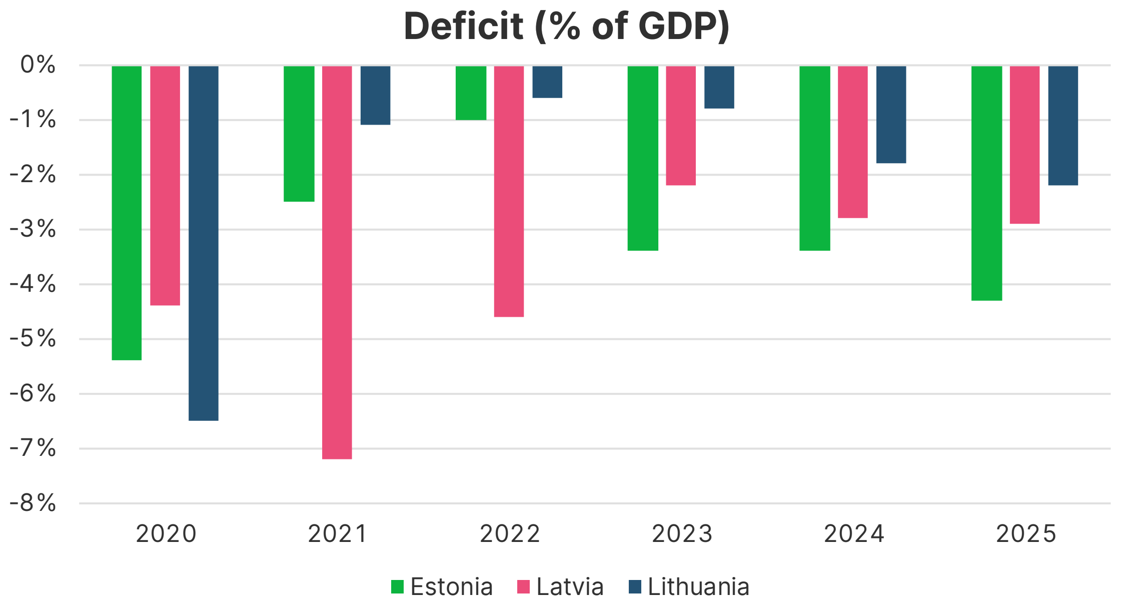
In January, **the Ministry of Finance conducted a 10-year bond issue worth 1 billion**, meeting about 50% of Estonia's gross financing needs for 2024. As the treasury issues also short-term T-bills, the refinancing of expiring ones is always needed. We expect some more issuance of short-term bills in the second half of the year.

The gross financing needs of Latvia are summing up to ca. 2.5 billion euro. The first half of the year was busy for Latvia's treasury, as it needed to roll-over most of its expiring debt. **Currently, around 1.34 out of 1.36 billion has been rolled over, with the remaining issuance focusing on covering the deficit.**

Lithuania faces the highest funding needs among its Baltic peers, both in nominal (€5.7bln) and relative terms (7.7% of GDP). Financing process is approximately on schedule, with some new significant issuance still needed. **According to the ministry of finance, €3bln will come from Eurobonds, €2.2bln from the domestic market** and the rest from IFIs.

High deficits forecasted for Estonia





Source: European Commission, Erste Group

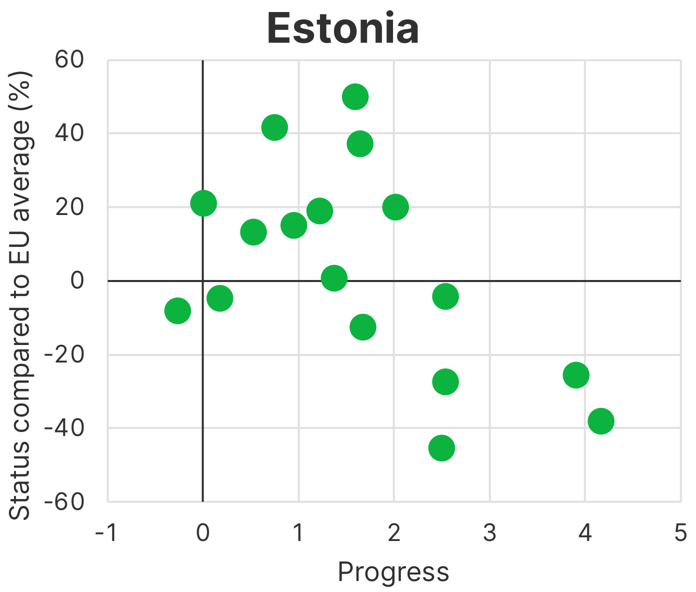
The Baltic countries, previously recognized for their fiscal prudence and low deficits, have seen a shift since the onset of the decade, with deficits remaining elevated, albeit still visibly below the 3% threshold for Lithuania. **Estonia's outlook is particularly concerning, with a projected deficit increase to 4.3% of GDP**. The primary factor is the rise in the tax-free income threshold, accounting for approximately 1.35% of GDP of lost revenue. This increase in the basic non-taxable income is expected to outweigh the anticipated hike in the basic tax rate from 20% to 22%, which represents just 0.4% of GDP. Despite being evaluated for the EDP, Estonia has not yet been recommended for the procedure, thanks to its low debt levels. Defense spending will undoubtedly impact the budgets of all three countries, while other government expenditures, such as social transfers, have aligned with inflation and their growth is currently surpassing the growth of revenues. On top of that, interest expenses are also posed to increase significantly.

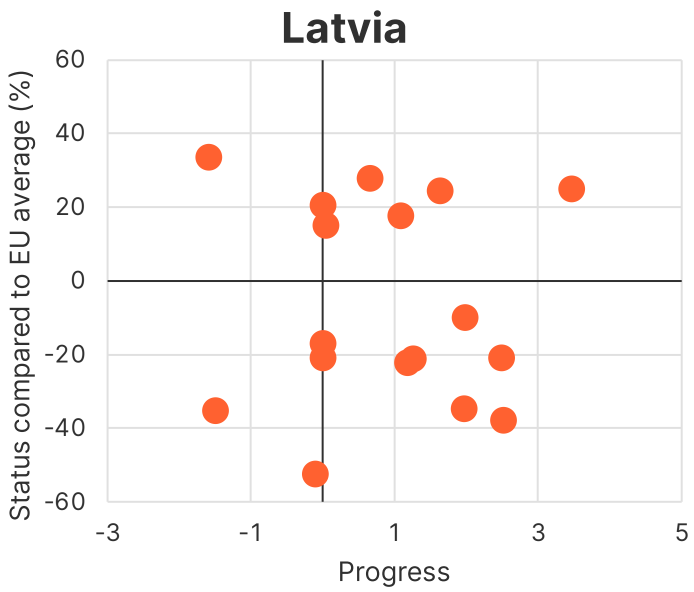
S&P downgrades all three countries

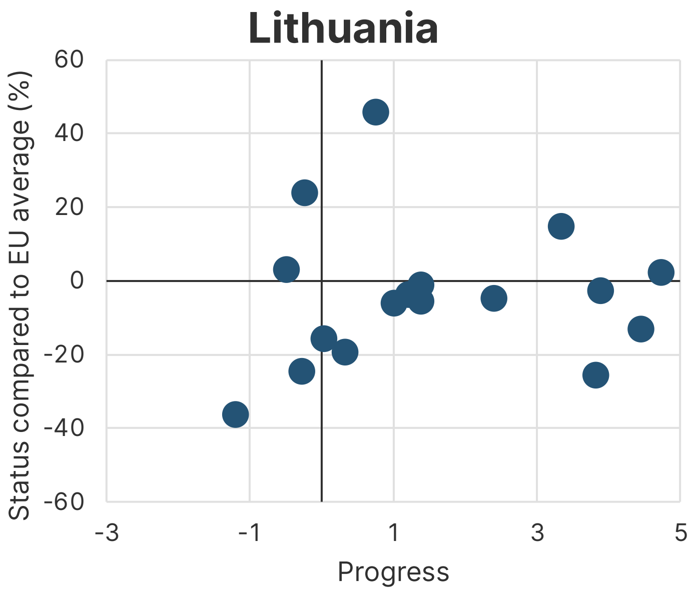
The most significant event concerning the sovereign ratings in the Baltic region was **the triple downgrade by S&P in May**. Estonia's rating was lowered from AA- (negative) to A+ (stable), while Latvia and Lithuania were both downgraded from A+ (negative) to A (stable). **The downgrades were attributed to the impacts of the conflict in Ukraine**, which is seen as the primary factor influencing these decisions. The increased defense spending is expected to exert additional pressure on the budgets, and the geographical proximity to the conflict zone could potentially discourage future foreign direct investment. Consequently, **the growth potential and external competitiveness of these countries will deteriorate.**

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

Baltics improve their SDGs, but fall behind EU







Source: European Commission, Erste Group

Estonia has made progress in 15 out of 17 SDG categories, with achievements particularly in education, where it ranks fourth in the EU. However, the category of "No Poverty" has seen a regression. Despite facing challenges in gender equality, where it is currently the second lowest in the EU, Estonia continues to make progress in this area.

Latvia's progress in SDGs is slower compared to its counterparts, advancing in only 10 out of 17 categories. The country has experienced setbacks in reducing inequalities and life on land. While Latvia does not stand out in any specific category within the EU context, it has **made considerable advancement in enhancing the accessibility of clean and affordable energy**.

Lithuania has witnessed swift progress in four categories: no poverty, climate, rule of law, and reduced inequalities, with the latter showing the fastest progress in the EU. Conversely, well-being, economic prospects, and life on land have seen declines.

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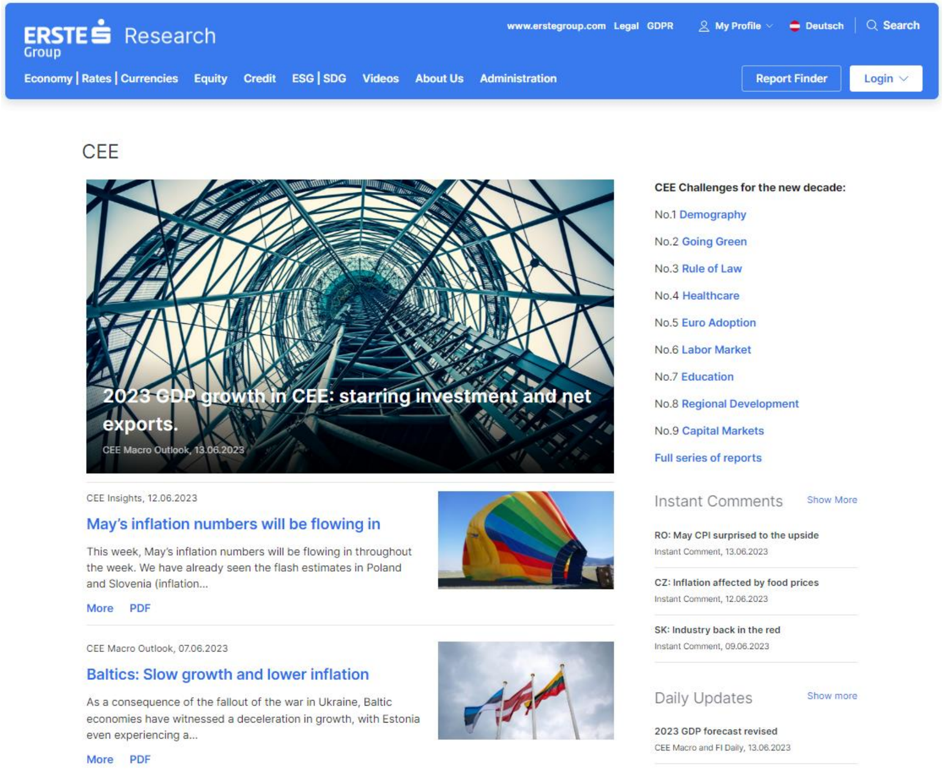

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