Baltic Report: Estonia with the deepest recession

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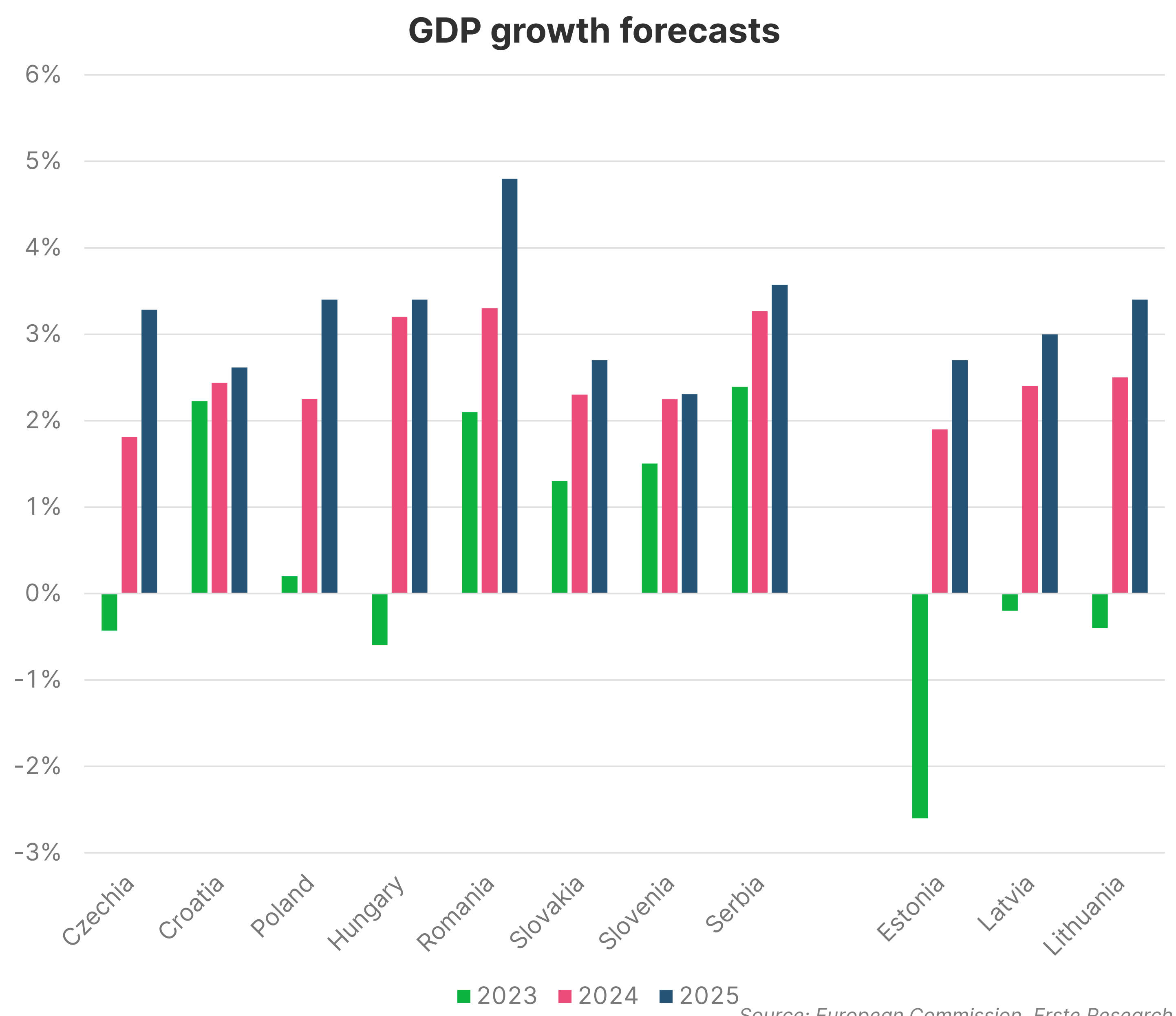
Executive summary

1. Estonia is expected to go through the deepest recession in the EU this year, while Latvia and Lithuania will stagnate. Next year, the Baltics should see growth of around 2-2.5%.
2. Inflation is getting close to the target; services are the main driving factor now.
3. Industry and retail are deteriorating significantly in Estonia, while Latvia and Lithuania see similar developments as in the rest of the EU.
4. The Baltic countries are still fiscally sound, despite Estonia's rating downgrade.
5. Only Lithuania expanded its RRF budget via a significant increase of loans under the RePowerEU chapter.
6. SDGs are generally on the right track in the Baltics.

Main economic indicators

In comparison to the spring prediction round of the European Commission, all three countries' growth figures were revised downwards. This revision comes as a consequence of adverse external conditions and weak domestic demand.



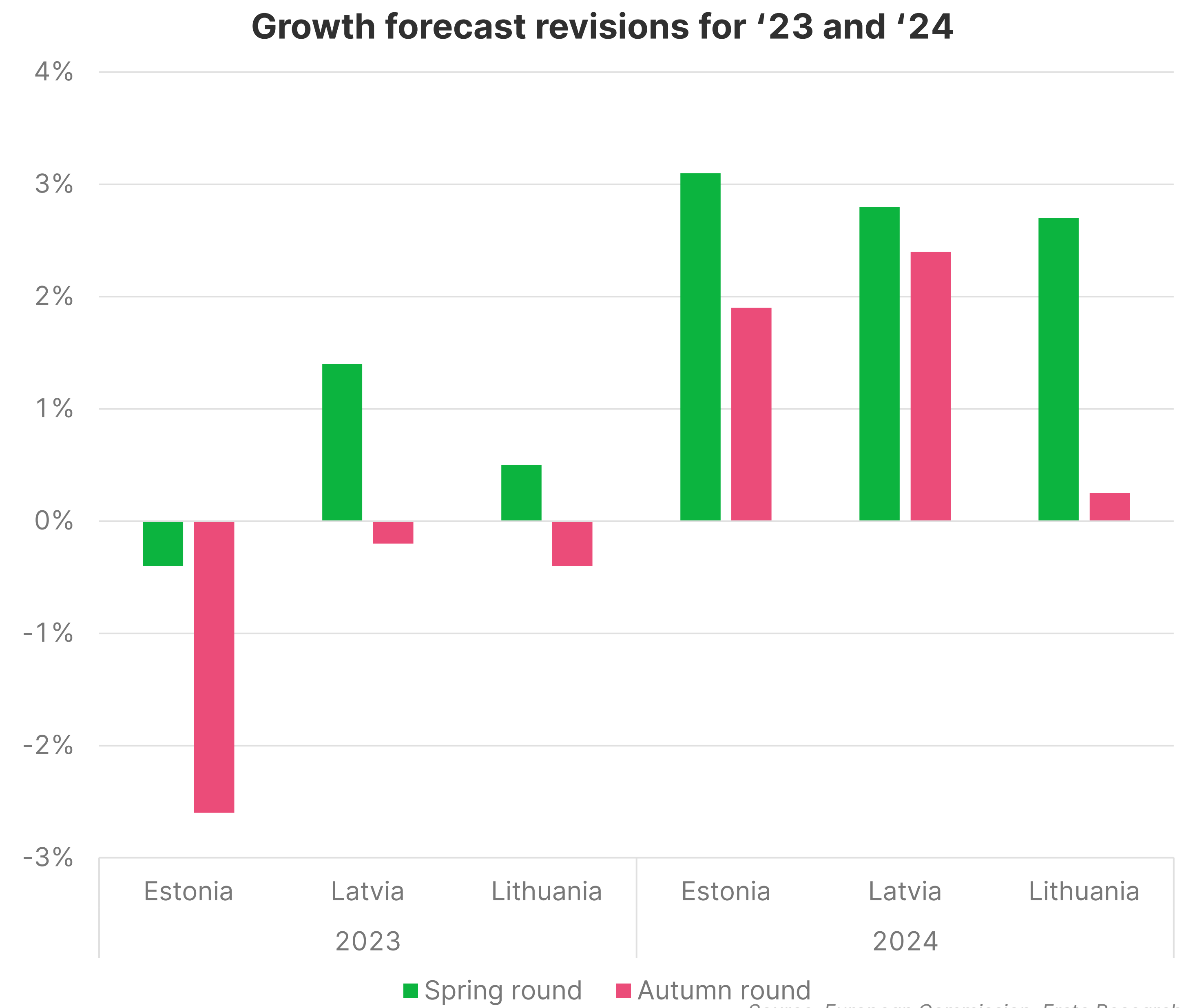
Source: European Commission, Erste Research

Estonia experiences sharp recession

In terms of growth rates this year, Estonia stands as an anomaly, not just within the Baltic region, but across the entire EU. The European Commission estimates a contraction of 2.6%, driven by a decline in private consumption, exports, and investments, while government spending saw only a modest increase.

Latvia and Lithuania are also projected to experience contraction this year, albeit on a significantly smaller scale. Looking ahead to next year, the Baltic states' economic climate is expected to mirror that of CEE; a resurgence in consumption due to low inflation, full-scale initiation of RRF investments, and a marginally supportive external environment.

Growth revised downwards



Source: European Commission, Erste Research

Relative to the spring forecasting round, the EC has revised the growth outlook downwards for all countries in both comparable years*.

Estonia has been adversely affected by a contraction in both domestic and external demand. A slump in demand from Scandinavian and German markets caused a decline in goods exports, which in turn led to a downturn in private investment. Latvia and Lithuania encountered similar circumstances.

Startups in Estonia were largely impacted by costly financing, given their lack of substantial financial reserves.

*Year 2025 was not included in Spring forecasts

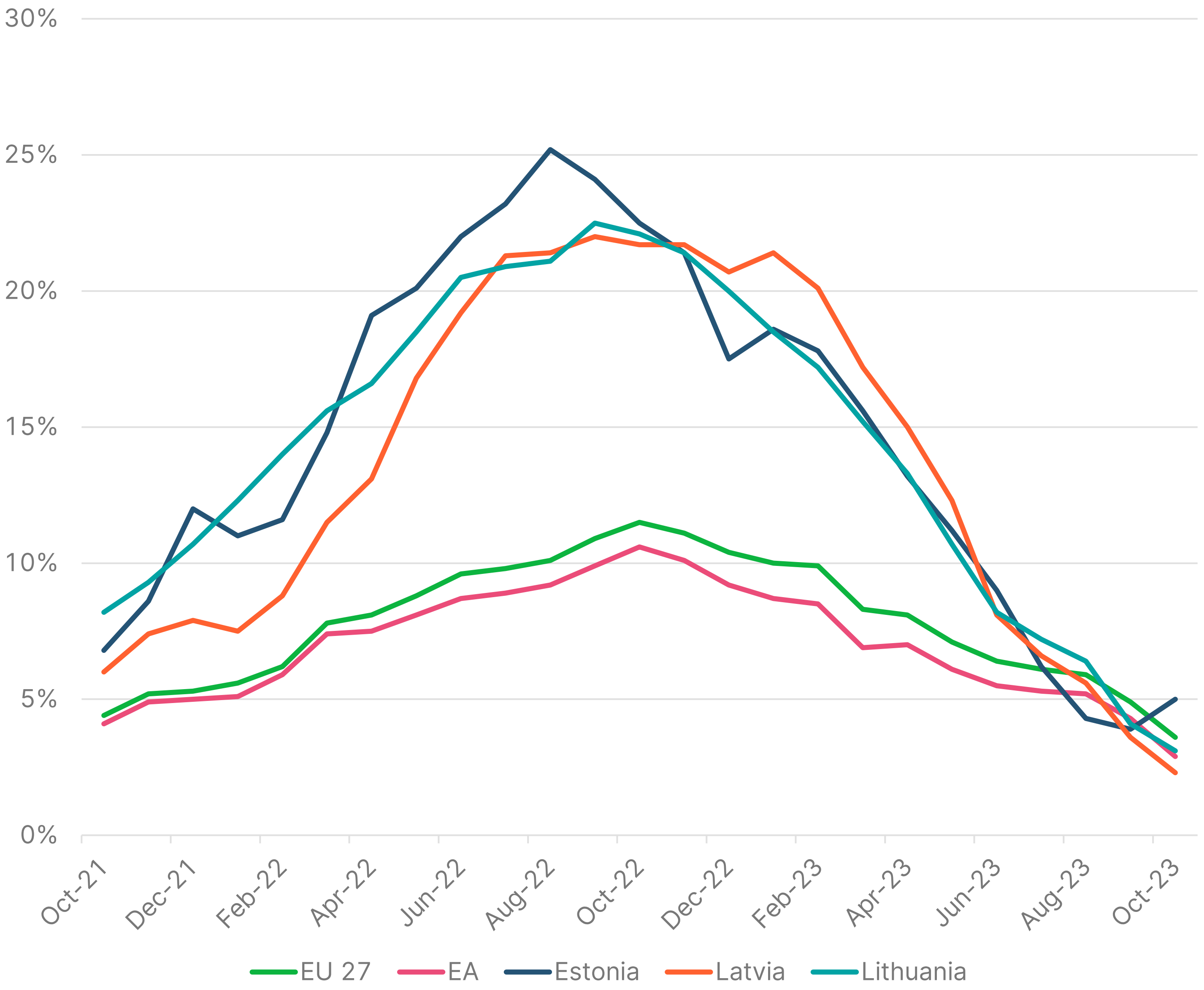
From record highs to target

The Baltics weathered the most intense inflation storm in the Eurozone. Estonia's inflation rate peaked at 25% in the summer of 2022, a figure only surpassed by Hungary a few months later.

Annual inflation is currently on a downward trajectory, largely due to the high base effect. Additionally, all three Baltic countries have experienced several monthly declines in the HICP in recent months. Lithuania, however, recorded price increases of 0.7% and 0.5% in September and October, respectively.

Forecasts from the European Commission indicate an inflation rate of 3-3.5% for the next year, and 2-2.5% in 2025.

HICP inflation trajectory

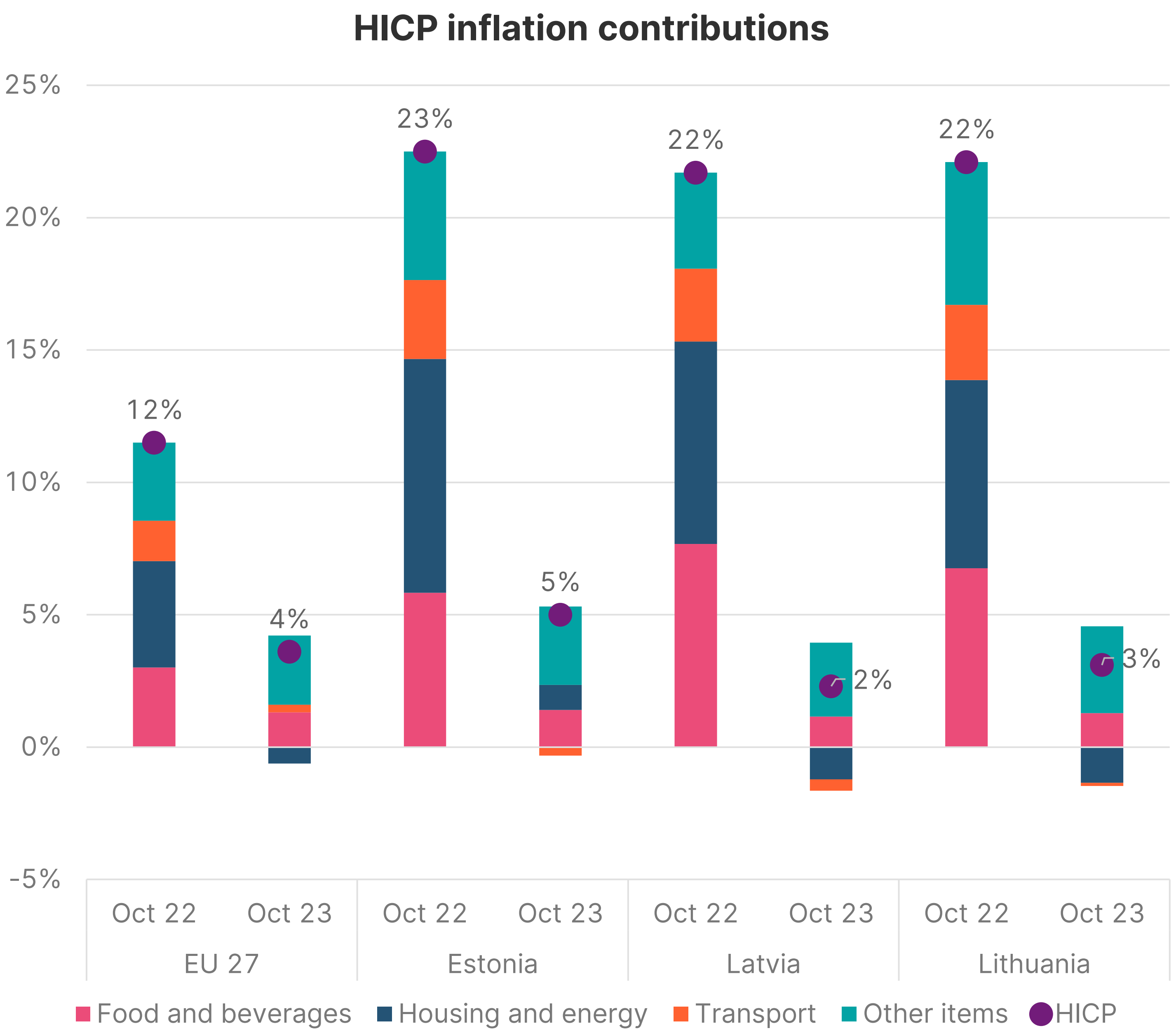


Source: Eurostat, Erste Research

Services are main driver of inflation

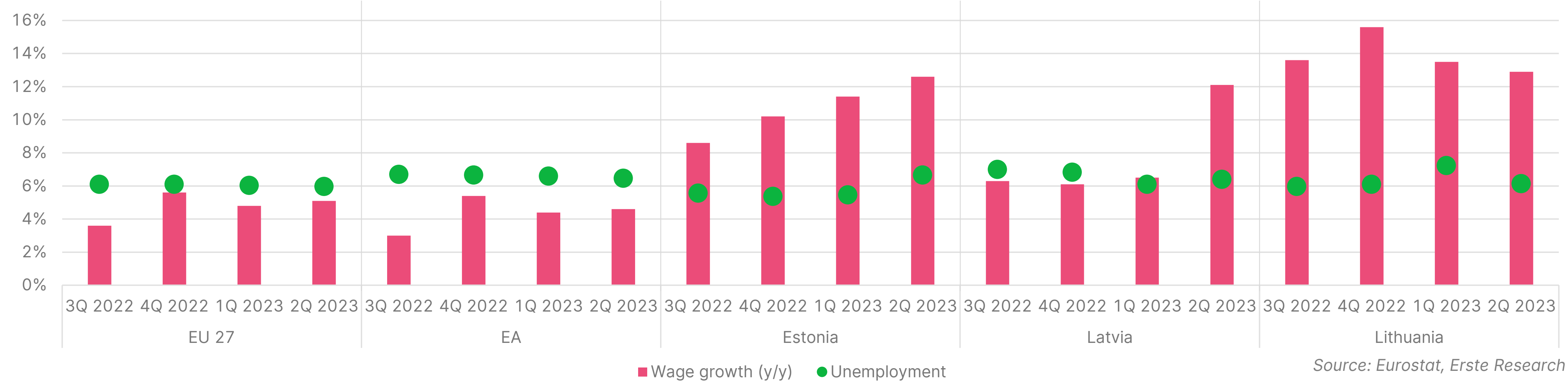
A year ago, all three Baltic nations had already surpassed their inflation peak. Similar to other regions in Europe, the primary catalysts for inflation were energy and food prices.

Currently, these categories have transitioned into a deflationary phase. Services have emerged as the main driver of inflation. Despite the HICP growth nearing its target, service inflation stands at 6.9% and 7.7% in Latvia and Lithuania, respectively. Wage pressures are expected to sustain this trend in the coming months. However, inflation in the services sector is projected to normalize by the end of 2024.



Source: Eurostat, Erste Research

Wages are growing, unemployment (almost) steady



Source: Eurostat, Erste Research

Despite this year's negative economic performance, the Baltic nations have witnessed robust wage growth. Interestingly, Latvia saw a surge in nominal wages only in the second quarter of this year, while its peers experienced double-digit wage growth as early as 2022. Despite economic challenges, unemployment rates have remained stable in Latvia and Lithuania. However, Estonia, which is in a deeper recession compared to the other two Baltic countries, has seen a gradual increase in unemployment in 2023. The proportion of job seekers rose from 5.2% in January to 7.4% in September, as per Eurostat data.

Industry and Retail

Estonia stands out as the most negatively impacted country in the Baltic region again. There are several factors for the deterioration in all three countries, mainly weak demand from the Nordics and decreased disposable income of households.

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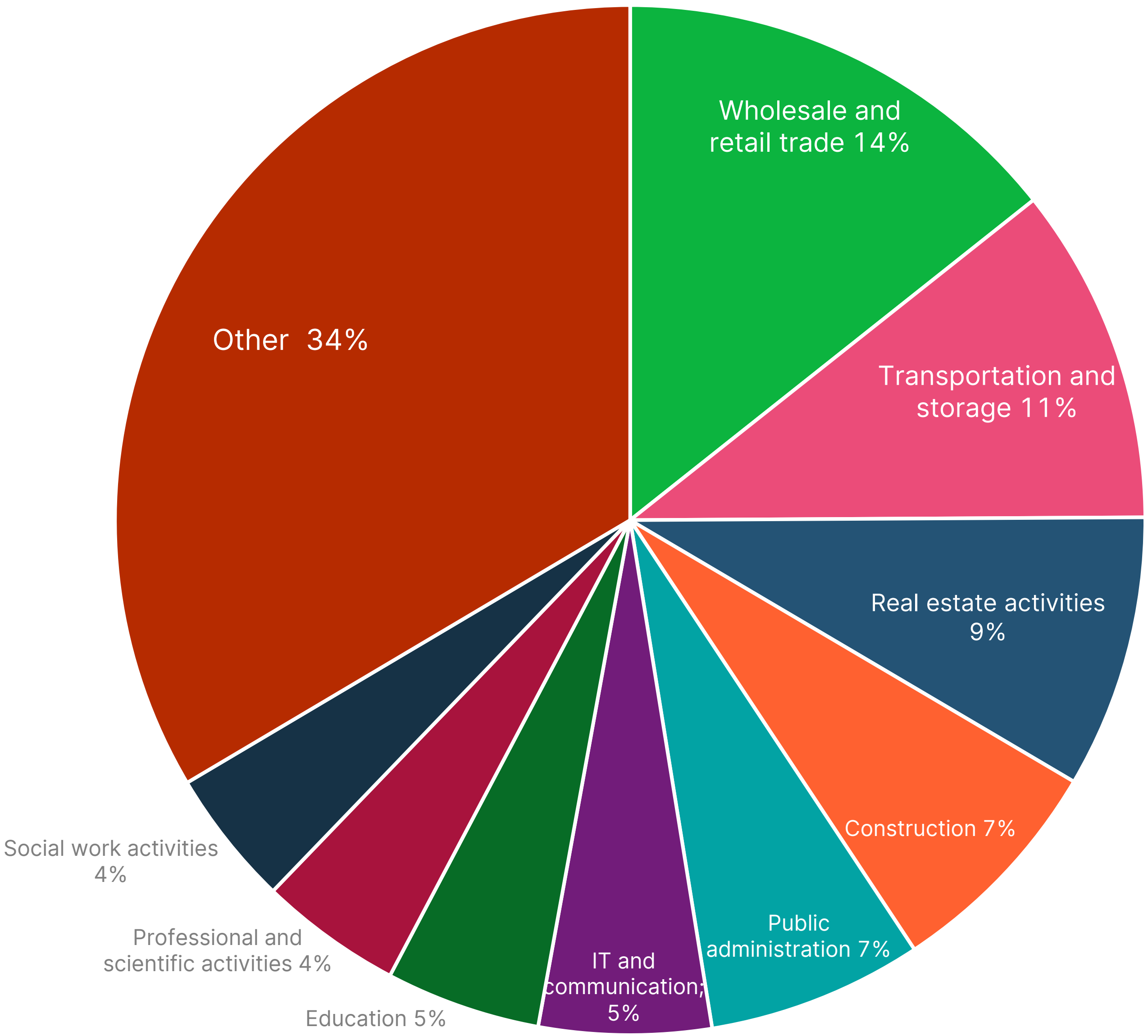
Most important sectors in Baltics by GVA



Source: OECD TiVA, Erste Research

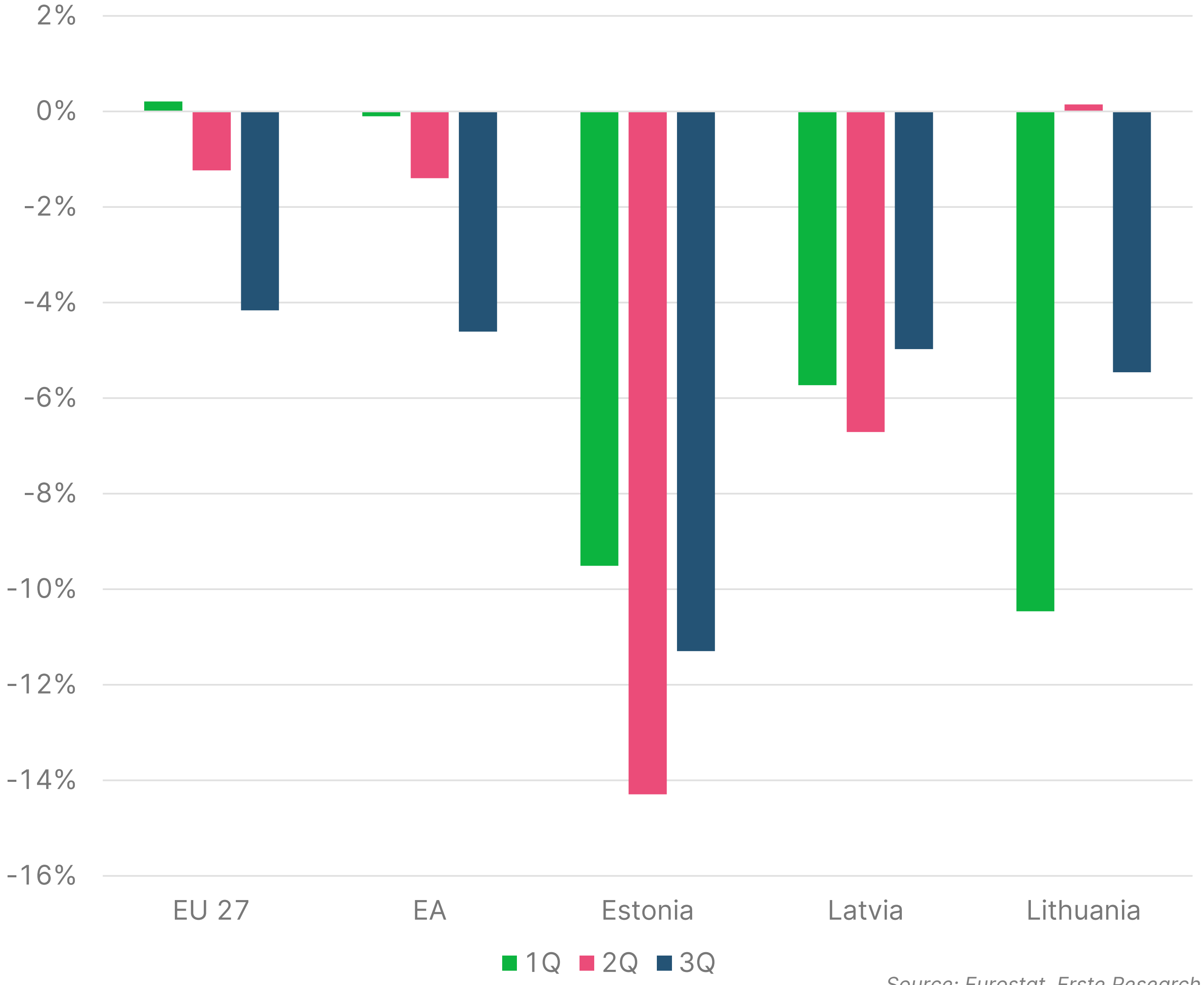
Transportation and RE are top sectors

Excluding the “Wholesale and Retail Trade” sector, which predominates in many countries, the Baltic economies are primarily driven by the Transportation, Real Estate, and Construction sectors.

Hight value-added sectors such as Information Technology and other professional activities also have a substantial impact, particularly in Estonia. However, due to external environmental slowdowns and high interest rates, these key sectors in the Baltics have experienced setbacks.

Industry suffers in Estonia

Industrial production index in 2023, annual change

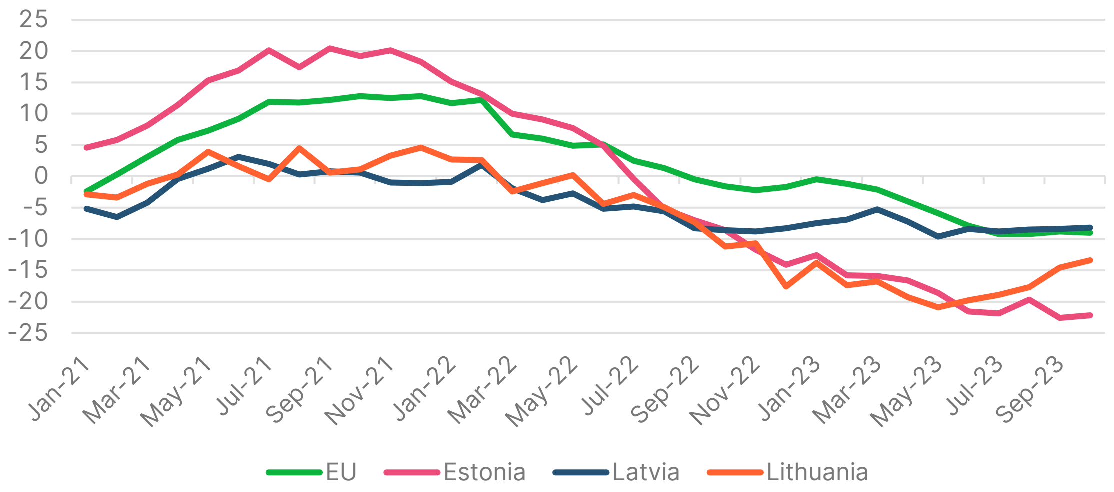


Source: Eurostat, Erste Research

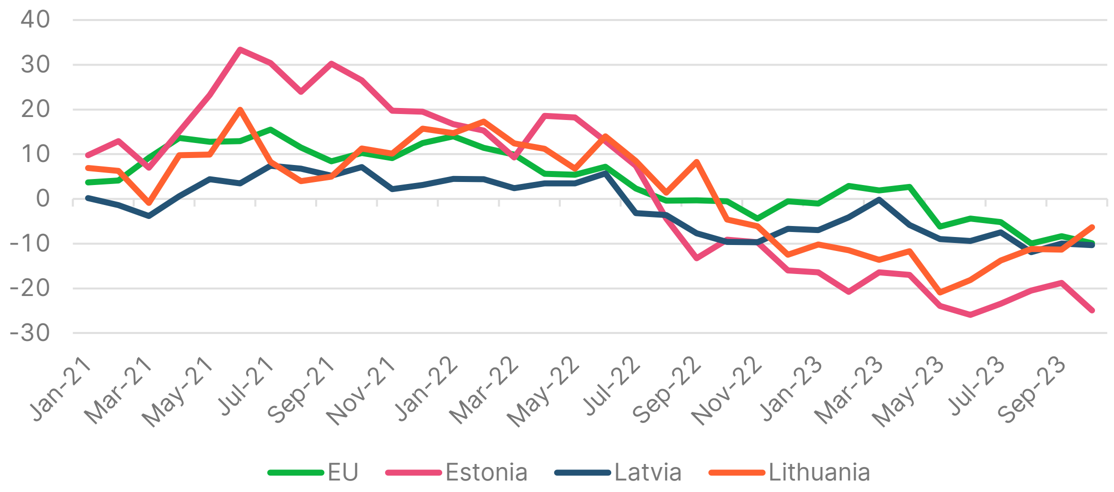
Since the start of 2023, the industrial sector has been damaged by a decline in manufacturing orders. The second quarter was particularly challenging for Estonia and Latvia, with contractions of 14% and 7%, respectively. Lithuania, however, showed an interesting development, as industry only stagnated in 2Q, but experienced the steepest decline in 1Q. This can be attributed to the base effect, as the nominal value of the index in 2Q was significantly lower than the values of 1Q and 3Q in 2022. Nevertheless, the recovery of industry depends on increased demand from main trading partners, which appears to be a distant prospect.

Confidence indicators are still subdued, but Lithuania shows recovery

Industrial confidence indicator



Industrial production trend



Source: European Commission, Erste Research

The aggregate confidence indicator for industry is still well below its long-term average. Interestingly, Lithuania's index has been rising since reaching bottom in May, while Estonia continued its declines and Latvia stabilized at values seen already last year. Moreover, Latvia is the only country in the Baltics that is close to the EU average.

The production trend observed in recent months confirms the general sentiment; Lithuania has seen a rebound and Estonia is struggling the most. The decoupling between Estonia and Lithuania could be due to poor growth in Sweden and Finland as major partners for Estonia, while Poland's economy, which is important for Lithuania, is already experiencing a slight rebound.

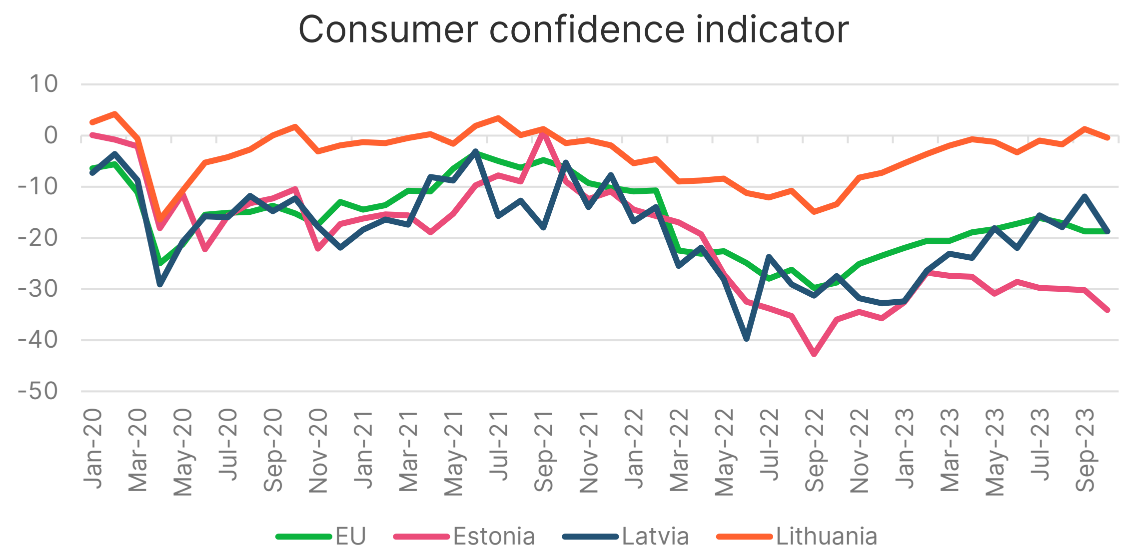
Source: Eurostat, Erste Research

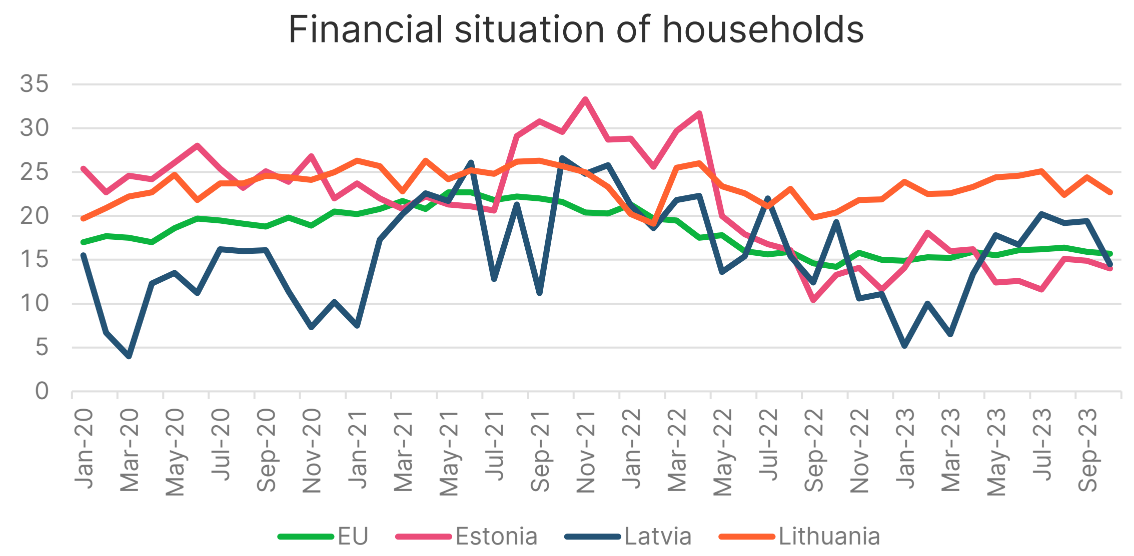
Estonia's retail is most damaged

Once again, Estonia emerges as a negative outlier in terms of economic developments. Retail sales have fallen significantly short of the previous year's figures, primarily due to reduced disposable income caused by inflation.

This trend, however, is consistent across all three Baltic countries. Estonia's situation is further exacerbated by rising unemployment, a relatively moderate fiscal policy response to support households, and the lowest consumer confidence. A resurgence in consumption is anticipated for the coming year, as both Baltic and European countries are expected to witness an increase in real wages.

Consumers in Lithuania in the best situation





Source: European Commission, Erste Research

Lithuania's consumer confidence is hovering above the EU average and the peers' indexes. One of the reasons behind this is the strong wage growth, which has been well above 12% in the last four quarters. As a result of this, Lithuania's households have seen the smallest contraction of their real income.

Wage growth also supports the index of the financial situation among households in Lithuania. The remaining two countries are seeing a situation similar to the EU average; however, Latvia's index is particularly volatile. The financial situation among households in Estonia stabilized in the last year, after a sharp drop in 2Q22.

Fiscal situation

The outlook for the fiscal position of the Baltic countries has slightly worsened, yet they are still in a good shape. Financing need are covered in Latvia and Lithuania, while Estonia has extremely low interest costs.

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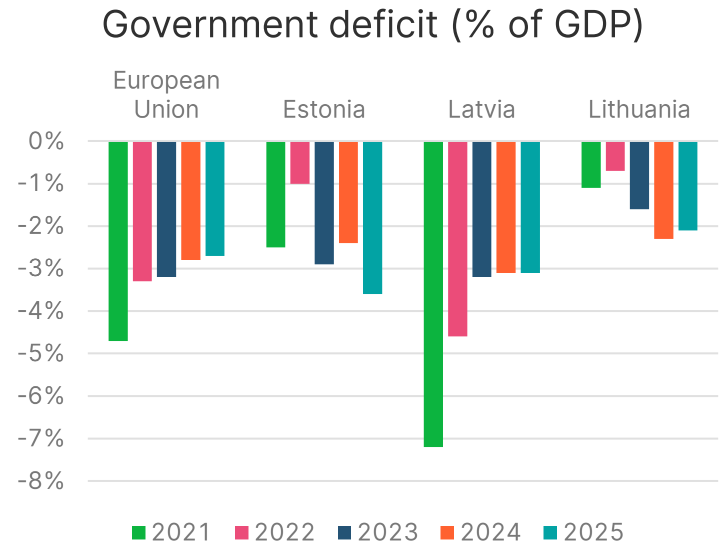
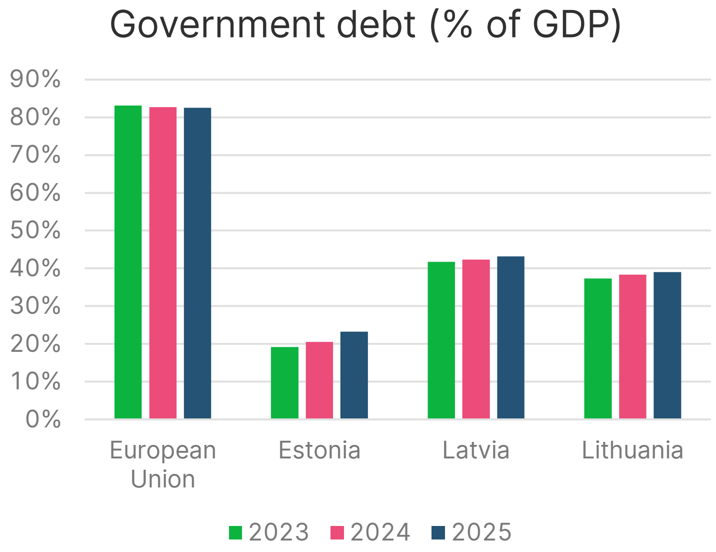
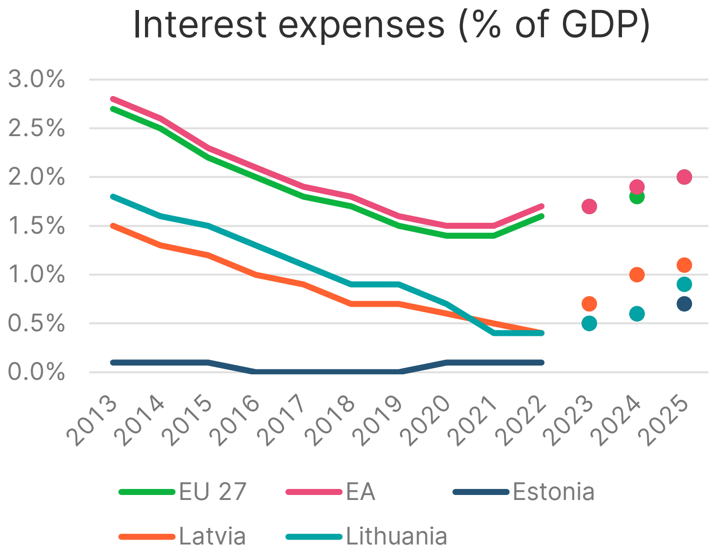
Prudent fiscal policy and low debt levels in Baltics



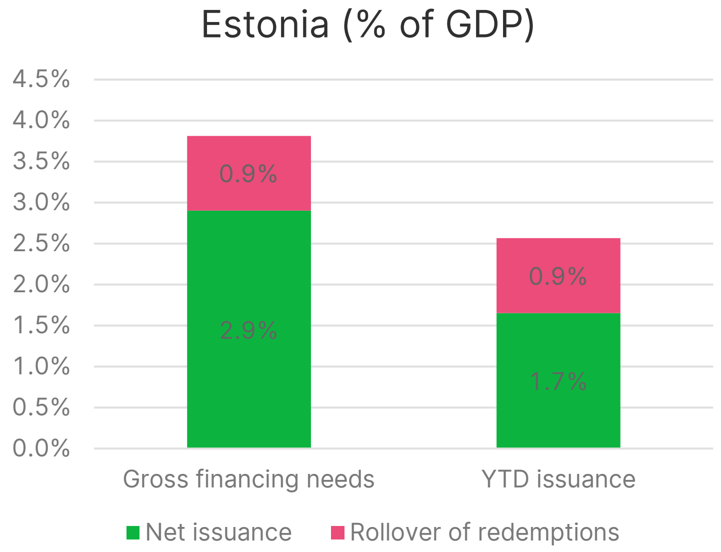


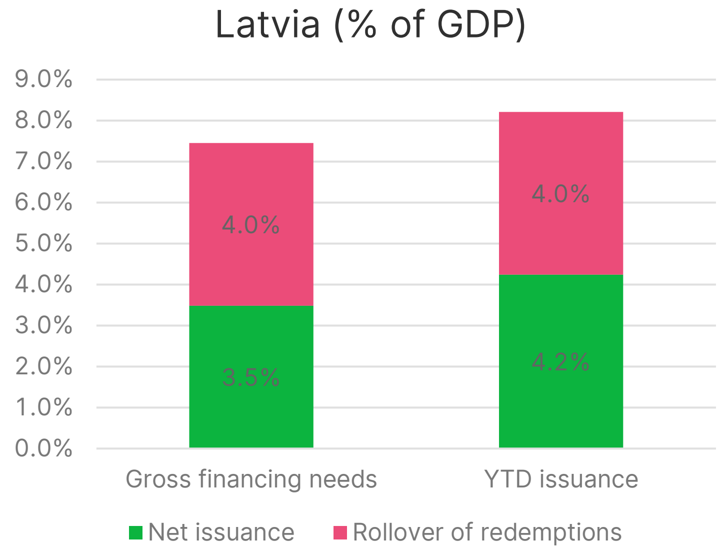


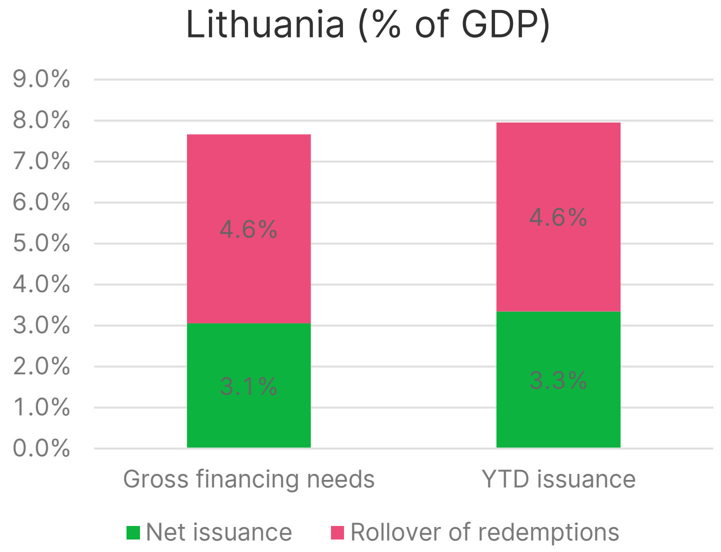
Source: European Commission, Eurostat, Erste Research

The fiscal policy in the Baltic countries has been prudent, especially in Estonia and Lithuania. However, in the medium term, the current Estonian government still anticipates fiscal deficits to widen to more than 4% of GDP as expenditure rises will outpace revenue growth. Latvia exhibits the most relaxed fiscal policy in the Baltics, especially thanks to considerable responses to the events since 2020. The EC forecasts deficit stabilization at around 3%, while the Latvian government sees the budget shortfall at 2.5% in 2024 and 2.2% in 2025. All three countries have been borrowing very cheaply on international markets, especially Estonia, as the interest costs of its debt are only slightly above 0% of GDP. The costs are likely to increase in the coming years, but they should not burden treasuries significantly.

Two out of three countries financed their needs







Source: Erste Research

So far, Estonia issued approx. 50% of the total issuance (~EUR 1bn) in short-term debt, the majority of which was used to roll over expiring T-bills. According to the data, Estonia has 67% of gross issuance covered this year, with sufficient liquid assets to fill the rest.

Latvia is done with this year's financing, as it had fulfilled its gross financing needs at 110%. The remaining 10% will probably be allocated to their cash reserves. The split between international and domestic issuance had a 2:1 ratio.

Lithuania has also covered more than 100% of its gross financing needs for this year. The auctions received sufficient interest, with the average bid-to-cover ratio at 2.5.

Estonia sees rating downgrade, Latvia with better outlook

The good fiscal situation and prudential debt management have been reflected in the sovereign ratings of the Baltic countries. However, Fitch has recently downgraded Estonia, based on a deterioration in public finances and loosening of the historically tight fiscal stance. Moreover, the weak growth outlook dampens the risk profile. On the other hand, Latvia received an outlook improvement, thanks to Fitch's expectations of a tighter fiscal policy and solid GDP growth. Both of the rating changes occurred in July, several months before the European Commission's recent forecast round. The spreads against German 10Y yield have decreased by ~40-50bps in the last 6 months for all three countries, as their yields remained stable, but German interest rate went continuously up.

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

Other developments

The Sustainable Development Goals of the EU are developing relatively well in all three countries. When it comes to the RRF, only Lithuania took advantage of the RePowerEU chapter and expanded its program significantly.

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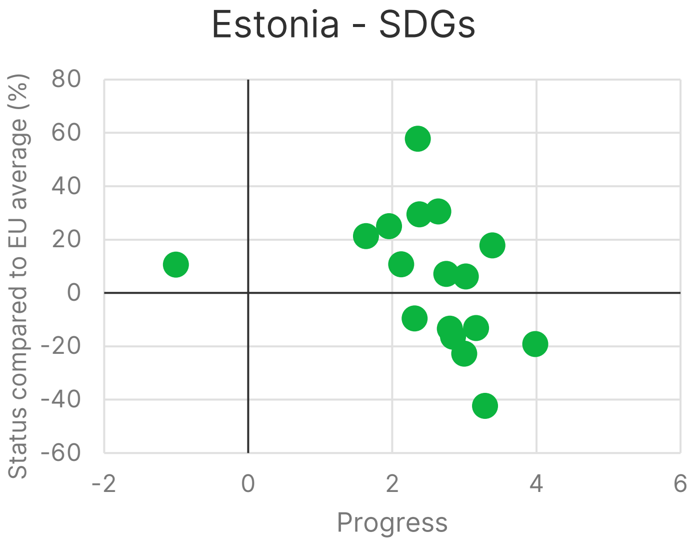
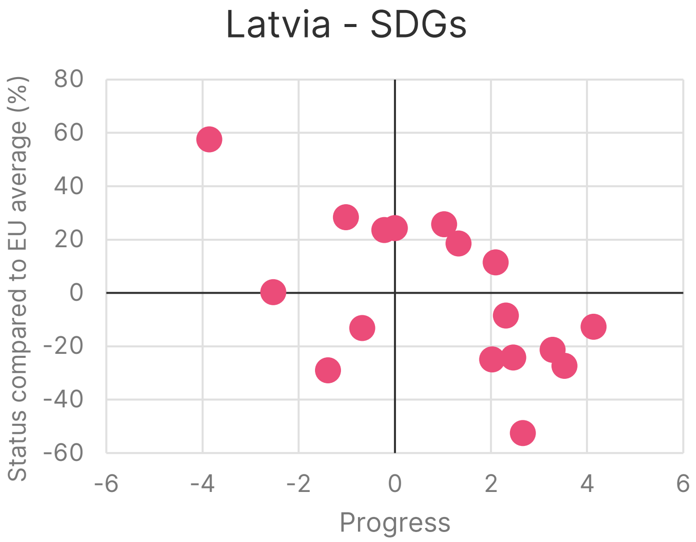
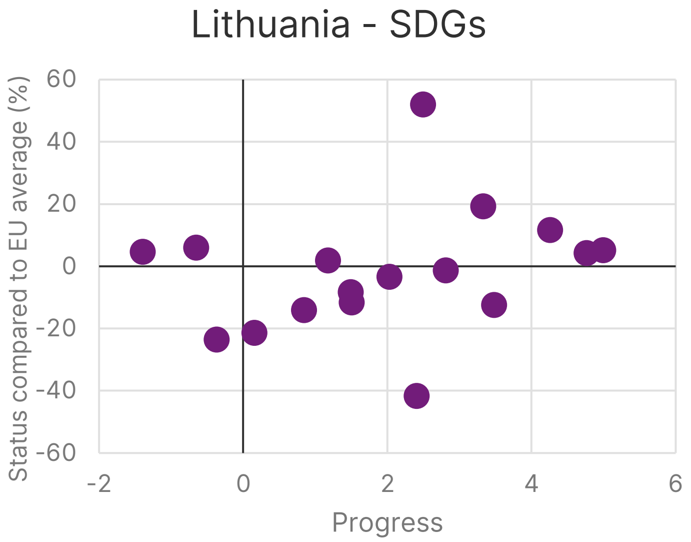
Relatively satisfactory development of SDGs in Baltics







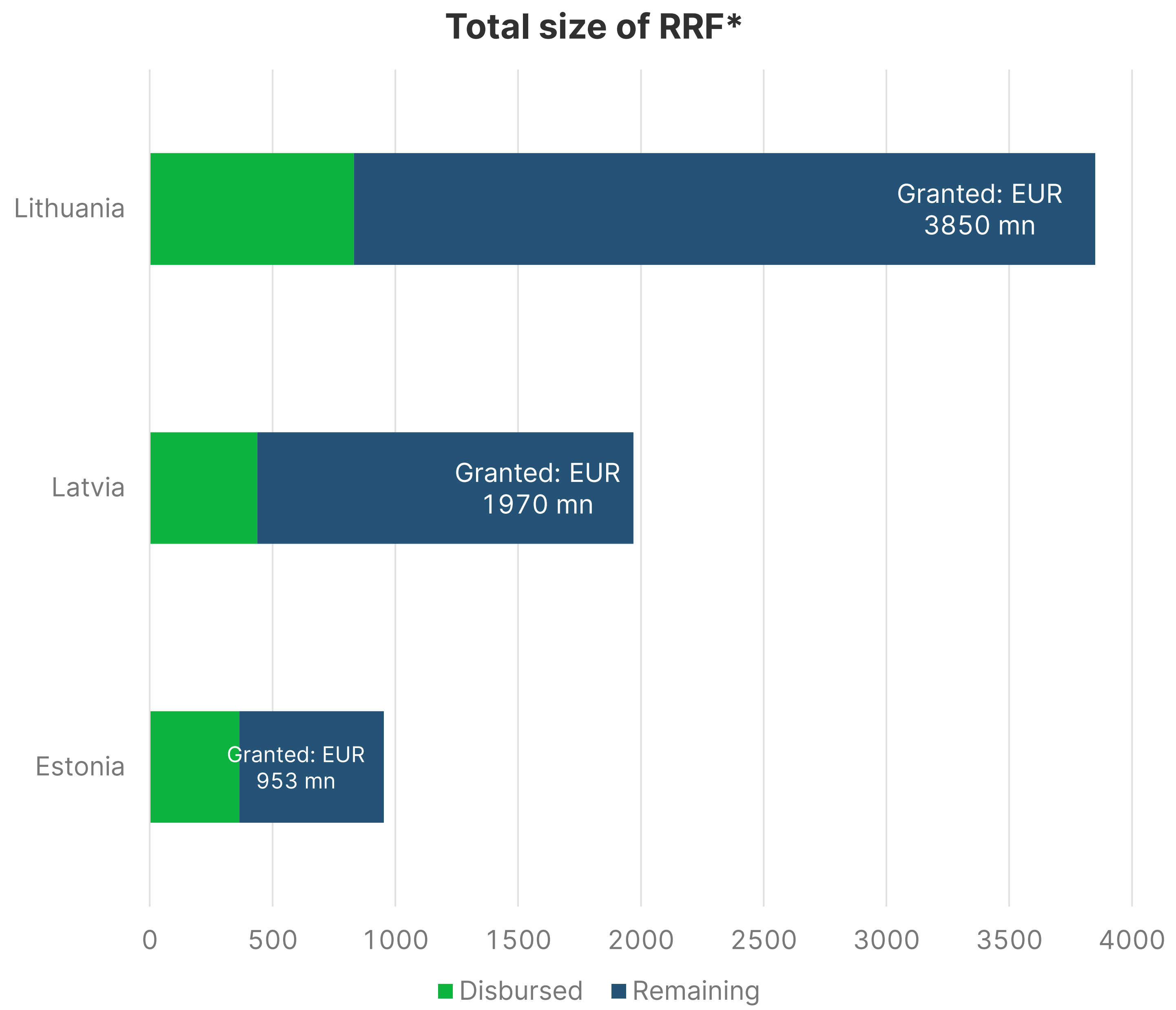
Source: Eurostat, Erste Research

Estonia sees the most promising development among the Baltic countries. All SDGs*, apart from one, have seen progress in recent years. The only one regressing is SDG 17, focused on global cooperation. Ten out of seventeen SDGs are better than the EU average.

Latvia is unfortunately the least successful in the region. Only three SDGs are in the “best” quadrant, while eight of them are above the EU average. The worst performing goal is number ten, concerned with equality of opportunities.

Lithuania, like Estonia, is making progress with a vast majority of SDGs. However, nine of them are still below the EU average. Only one SDG is in the “unfavorable” quadrant, as “Responsible production and consumption” is regressing and below the EU average.

**Sustainable Development Goals - set of targets to improve inequalities, environment and overall prosperity of humankind*



** Including the RePowerEU chapter, as of Nov. 2023*

Source: European Commission, Erste Research

New chapter increases RRP

In recent months, the majority of countries have modified their Recovery and Resilience plans to include the RePowerEU chapter, which brings additional funds to help the EU's green transition.

As the RRF changes were approved for all three Baltic countries, we saw little change in the case of Estonia, which did not request any additional loans or grants. Latvia also passed on loans but increased its grant budget from EUR 1.83bn to EUR 1.97bn. The biggest increase in the RRF occurred in Lithuania, where the total budget expanded from EUR 2.22bn in grants to EUR 2.3bn in grants and EUR 1.55bn in loans.

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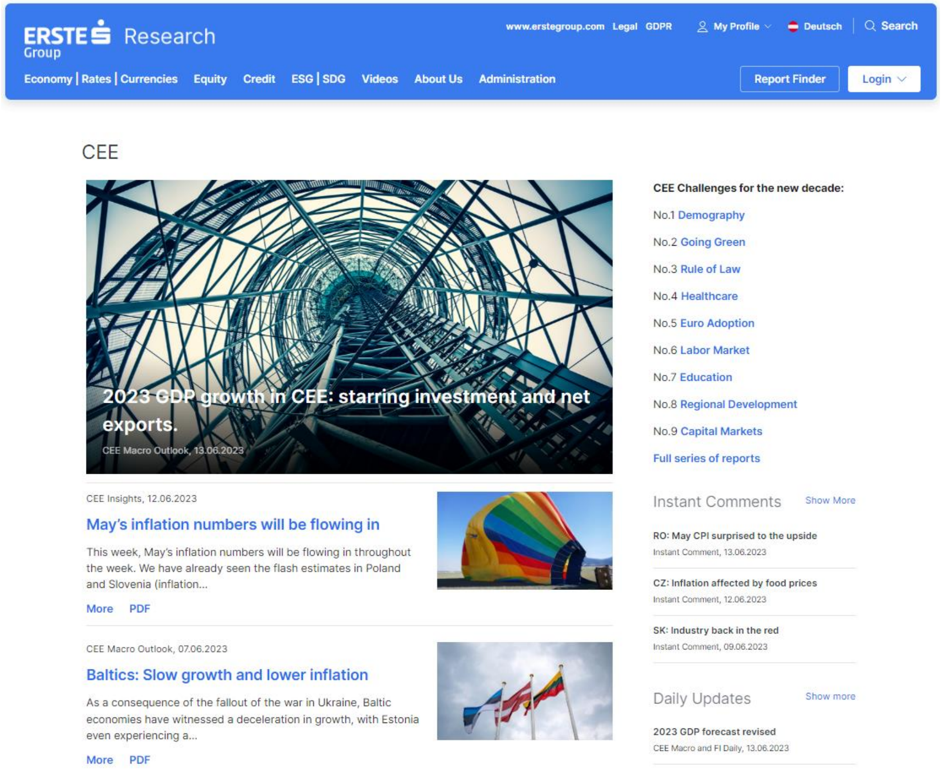

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