
- Households in Estonia are the most positive about euro
- Anxiety about inflation due to the euro adoption persists in all three countries, though not justified by official statistics
- The currency changeover brought "mattress money" into the banking sector and increased the use of non-cash in Latvia
- Lithuanian businessmen and households take early measures related to euro adoption
- Irrespective of changes in saving and borrowing conditions, the euro adoption does not affect significantly households' financial behaviour

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Three years with the euro in Estonia. What are the main learnings?

Households in Estonia are the most positive about the euro

Estonia was the first of the Baltic countries where euro was introduced. It occurred on January 1 in 2011, in the middle of the government debt crises in Europe. To recall the changeover period, the two weeks of dual circulation period were smooth. Although during the first days of the changeover period most households were carrying still kroons with them, on the 7th day only 10 per cent had kroon banknotes or coins while the proportion of those who carried euro banknotes or coins reached the 50 per cent. A week after euro introduction, around 60 per cent of cash payments in shops were done by euro only.

Three years after the euro adoption, households in Estonia are very positive towards the European and economic union with one single currency. The support is the highest not only among the Baltic countries but among all EU countries. According to the Eurobarometer survey, in EU an average 55 per cent of the population supports the euro while in Estonia, 80 per cent of the population favours the euro. The support has increased significantly in Latvia after joining the euro area, from 53 per cent in autumn 2013 to 68 per cent in spring 2014. In Lithuania, the trust in the euro is lower than in EU on average but it is relatively high compared to the other EU countries without the euro.

Support for EU with one single currency (%)

The most positive attitude of households in Estonia towards the monetary union among EU countries is surprising given that Estonia entered the eurozone in the middle of the euro crises and there has been more discussion about problems than about the benefits related to the euro. As the fiscal position in Estonia is one of the strongest in the eurozone, apparently Estonian households do not perceive the euro crisis as a common problem but rather a problem of specific countries with spill-over effect to Estonia. Households in Estonia are less outstanding in the assessment whether Estonia has benefitted from the euro. In autumn 2013 (the latest data available) 58 per cent of the population agreed that having the euro is a good thing for Estonia, the results are on the average level of EU countries. It is not possible to compare the results with Latvia and Lithuania as this survey has been implemented only among euro area countries. The assessment of the positive impact of the euro on Estonia (the home country) is comparable with the results in Slovenia which adopted the euro in 2007 and with the results in Slovakia which joined the eurozone in 2009. However, these countries show a strong decline in the positive assessment of euro on the respective home country during the last years. The results are evidently affected by the overall economic situation of a country; households perceive the euro to be more beneficial when the economy is doing well.

Euro is a good thing for the country (%)
The anxiety about higher inflation due to the euro adaption has not been justified in Estonia

The main concern related to the euro changeover was the inflation in all countries which have joined the euro. The biggest fears were seen a couple of months before the euro adoption while the strong concerns were still present after the euro changeover. The survey results from Eurobarometer Flash which was carried out shortly after adopting the euro show that 55 per cent of households in Estonia expected the prices to increase after joining the euro area. Almost as many Slovenians expected the prices to increase after the changeover and in Cyprus even 2/3 of the population thought that the euro would increase inflation. Slovaks have been the most optimistic with only 19 per cent fearing inflation caused by the euro.

When looking at the developments in Estonia, the Consumer Confidence Survey reveals that the inflation expectations started to increase in June 2010, at the same time when the euro adoption was declared. The fear about price increases declined in December, shortly before the changeover. While the real price growth was quite modest in the first half of 2010 due to the recession, the inflation increased above 5 per cent in November 2010 and declined below 5 per cent only in October 2011. The main drivers of the prices at the end of 2010 where food prices and prices under regulation (electricity and heating). The direct causality from euro changeover to price increases is not clear as the price increase followed the deep recession and there may be other explanations for the higher inflation. E.g. one can also argue that the prices were under pressure in 2009 and at the beginning of 2010 due to the recession, as it was difficult for the companies to adjust prices during unfavourable economic environment. There were more optimistic expectations about the economy towards the end of 2010 which gave the companies an opportunity to adjust the prices in order to return to earning profits. On the other side, there was very strong public attention towards any price change during that time. The dual display of prices lasted from July 2010 to June 2011.

When looking at the perceived inflation by the population, i.e. analysing assessments ex post, according to the 2013 Eurobarometer survey 93 per cent of households in Estonia believed that the euro adoption had an impact on prices. Around 70 per cent thought that all prices increased, while 23 per cent believed that prices grew only in some categories. The belief in price increases during the euro changeover has strengthened over time – for comparison, in both 2012 and 2011 about 2/3 of the population said that all prices had increased. The perceptions of households are not consistent with the actual effect of the euro on prices. The recent studies of Eesti Pank reveal that the increase of inflation during the euro changeover has been induced mainly by other factors than the euro. The study of Rõõm and Urke (2014), which uses aggregate data, estimates that the effect of the euro has been relatively modest in the range of 0 – 0.5 percentage points1. The strongest effect occurred in the second half of 2010 which is before the euro adoption. The study of Meriküll and Rõõm (2014) utilises the brand level data and estimates the effect of the euro changeover in the similar range2. They also find that the price increases related to the euro changeover were mainly focused among cheaper goods. The price increases were identified mainly in small stores while in large stores no effect of the euro changeover on prices was observed.

Now that Estonia has entered the era of low inflation environment, the inflation expectations by households are expected to remain low. And in the period of no concern for inflation, households may also reconsider the subjective assessment between the euro adoption and the price increase.

Most of the euro prices are not converted into the local currency any more

Households in Estonia have switched relatively fast from calculating the prices of goods into kroons to keep the price assessments in euro. While in 2011 around 70 per cent of the population converted the prices from euro to kroon when making big purchases, only 43 per cent of population continued doing it in 2013. This result is comparable to the eurozone average but it is quite different from Slovakia and Slovenia. For comparison, 57 per cent of households in Slovakia convert the prices to their old national currency while only 23 per cent households in Slovenia calculate the cost of exceptional purchases in their former currency. The differences between the countries are related to different factors like the former usage of euros when travelling and whether the neighbouring countries use the euro.

The shift in the mindset of households from kroons to euro in Estonia has been more prevalent when the households do their everyday shopping. There are fewer households in Estonia who convert the prices of everyday goods into their local currency than in the euro area countries on average – 19 per cent and 24 per cent, respectively.

**Big purchases - calculate in old currency (%)**

Households in Estonia have got used to the euro relatively fast and the euro does not complicate their purchasing activities. Households have become accustomed to the euro coins and banknotes relatively smoothly. Households in Estonia experience the biggest problems with euro coins, there are 32 per cent of the population who said in 2013 that it is difficult to distinguish and handle euro coins. It is the highest share of the population in the eurozone but Estonia was also the last to adopt the euro among these countries. There are fewer difficulties with distinguishing and handling euro bank notes among households in Estonia – around 6 per cent declare to have some kind of problems. In conclusion, the euro adoption has been smooth, households are used to the new currency and the euro does not affect their financial decisions or behaviour.

**Day-to-day purchases - calculate in old currency (%)**

Although there are some fears of households which have been related to the euro as explained above, households recognise some benefits from the usage of the euro. One direct benefit involves travelling, the popularity of which is increasing in all Baltic countries. According to the Eurobarometer survey, 73 per cent of households in Estonia were travelling in 2013, either in their own country or abroad. In Latvia, 65 per cent of households and in Lithuania 55 per cent of households travelled away from home for at least one night. The share of households who spend the holiday in the EU countries is increasing in all three countries. The share is the highest in Latvia, 73 per cent. In Estonia, 68 per cent, and in Lithuania, 58 per cent of households spent the holiday in the EU countries. The gain from the euro is seen when travelling to distant countries where one would like to bring along a generally accepted currency which now can be the local currency, the euro.

**Travelling with the euro is easier and less costly**

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However, the euro adoption has not demonstrably increased the incentives to travel abroad. Eesti Pank (the central bank of Estonia) provides statistics on the number of visits abroad, including personal and professional, short-term and long-term stays. The strongest increase in the number of visits abroad is seen in 2011 when the number of visits abroad increased by 8 per cent compared to 2010. However, the rise does not compensate the drop in 2009 due to the recession. The travel intensity in 2014 is still below the level of 2008.

Further data about the benefits of the euro is available only for euro area countries so we focus on Estonia with comparison to other Central and Eastern European countries, Slovakia and Slovenia. About 54 per cent of households in Estonia think that it is easier and less costly to travel with the euro. The benefit of the euro perceived by households is higher than in the eurozone on average (48 per cent) being also higher than in Slovakia and in Slovenia.

There are even more households in Estonia who perceive the gain from the possibility of comparing the prices in the euro area countries. In Estonia, 66 per cent of households say that it is easier to compare the prices in the eurozone; in euro area countries on average 74 per cent agree with it. On top of easier comparison of the price level, it is straightforward to compare the wage level for employees working abroad. As relatively many Estonians work in Finland (according to the 2011 census, officially ca 15 000, which is 2.6 per cent of the employees), it is convenient for them to compare the wage level in Finland and Estonia.

Still, the convenience of using the euro might affect the choice of destination for travel. Although the total number of visits abroad seem to be unaffected by the euro adoption, the number of visits to the eurozone increased by 7 per cent in 2011 compared to 2010. It increased further in 2012, by 15 per cent, and the number of visits to the eurozone is higher in 2014 than it was in 2008. This apparently reflects the preferences to travel to the euro area countries.
Euro has not directly affected the real estate market and household borrowing

In 2010, the volume of real estate purchases by private individuals exhibit gradual recovery after plummeting in 2009 due to the recession in Estonia. There was an expectation that households might increase their attention towards real estate purchases before the euro adoption and a slight increase in the volume of real estate purchases was observed at the end of 2010. While the volume of real estate purchases tends to decline in the last quarter of the year, in 2010 it exceptionally increased by 4 per cent compared to the third quarter of 2010. However, this might be as well induced by the recovery of the cutback during the recession rather than the impact of the euro adoption. Similarly, the real estate purchases increased in the fourth quarter of 2009 by 12 per cent. Since 2011, the seasonal pattern of the real estate purchases has followed the standard track of a slight decline at the end of a year. In the second quarter of 2014 the volumes were still only 57 per cent of the volumes of the second quarter of 2007. The interest in real estate purchases will continue to increase in relatively stable pace in the following period, partly driven by unattractive alternatives to keep the savings.

Real estate purchases by private individuals in Estonia (mEUR)

![Graph showing real estate purchases by private individuals in Estonia](image)

The borrowing has not been directly affected by the decision to introduce the euro in Estonia, as substantial share of debt was issued in the euro already before the euro adoption. During the credit expansion in 2000s, significant share of loans was granted in euros in all Baltic countries. At the point of euro changeover, in Estonia and Latvia only small share of real estate was issued in local currency, namely 14 per cent in Estonia and 13 per cent in Latvia. Hence, the changeover did not affect the majority of borrowers as their loans were already accounted for in euros. Before the euro changeover no rush for euro loans was observed; the percentage of euro loans out of total loans was stable over 2009-2010. As there is no exchange rate risk for the euro loans after the euro changeover, households may feel more secure about their borrowing as they pay back loans in the same currency as they receive their income.

Additionally, the decision to introduce the euro at the same exchange rate as it was fixed before in all Baltic countries has been a clear message for households that the economic environment is relatively strong. The euro adoption supports the economic environment; hence the euro might have indirect impact on the borrowing decisions via improving the economic prospects of the countries. When looking at Estonia, there was a significant increase in borrowing in the last quarter of 2010, when new loan volumes increased by 14 per cent compared to the third quarter of 2010. Usually a decline in borrowing is observed in the last quarter of a year. The increase in the volume of new loans exceeded the increase in the volumes of real estate transactions in the same period. However, there are also other factors which might affect the exceptional increase of borrowing at the end of 2010 such as low comparison level in 2009 and the realisation of postponed borrowing after the recession.

Similarly, Latvia experienced an upsurge in new borrowing in the second half of 2013 while there is no growth in the first half of 2014. No additional boost of borrowing has been observed in Lithuania; one reason might be that as Lithuania is the last Baltic country to adopt the euro, there is no substantial adjustment of the expectations.
Adoption of the euro: a step towards a cashless society

The changeover to the Euro brings “mattress money” into the banking sector

In Latvia the first nine months with the euro confirm that the adoption of the euro has influenced the financial behavior of households, albeit not very significantly. The share of cash in the financial assets of households is declining and households’ attitude to cash payments is changing gradually as well.

Adoption of the Euro was the main reason why households brought cash to commercial banks late last year, choosing this automatic currency exchange method to convert their lats to euros. In December of last year the volume of household deposits in commercial banks rose by 286 million euros, while over the last two months of 2013 household deposits grew by 387 million euros or 8 per cent, and the lion’s share of this money flew into current accounts (demand deposits). As deposit rates remain at very low levels, the willingness of households to put their money in term deposits continues to decrease. Thus, the outstanding amount of term deposits is shrinking and the share of demand deposits in total household deposits is climbing.

Monthly changes in the outstanding volume of household deposits (in millions of euro)

Last year the annual growth rate of total household deposits raced per cent, demonstrating much faster growth than in the previous three years when the volume of household deposits rose slightly. In the first months after the adoption of the euro some of the money returned into circulation (due to a seasonal decrease in January), thus the volume of household deposits shrank slightly in the first quarter. However, this decline was temporary and the growth of deposits resumed in the second quarter. At the end of August the volume of household deposits was 4.931 billion euros, the highest deposit volume in commercial banks ever. Over the first 8 months the household deposits increased 2.3 per cent or by 110 million euros compared to December of 2013. The deposit growth rate is expected to drop again to a single digit number this year in line with economic and income growth.

The increase in non-cash money in Latvia in the last quarter of 2013 was in line with expectations and confirmed the experience of other euro newcomers prior to the changeover to the euro. The dynamics of deposits before the changeover to the euro in new eurozone member states shows a similar increasing trend, albeit with different growth rates in individual countries. This can be explained by several factors: the economic cycle, the confidence in the banking sector, the attractiveness of banking products, attitude towards cash payments, and support for the euro etc. For instance, Slovenia, Cyprus and Malta entered into the eurozone before the global financial crisis. Slovakia joined the eurozone at the beginning of the crisis, while Estonia introduced the euro in the middle of the government debt crisis in Europe.

Dynamics of household deposits a year before and after euro adoption

The most significant increase in the volume of household deposits prior to adoption of the euro was registered in Slovakia with an almost 30 per cent large annual deposit growth rate. This huge increase in household deposits was also related also with relatively high deposit interest rates (euro deposit rates were above the 4 per cent level) at the end of 2008, helping to attract cash savings of Slovakian households.

In Latvia the annual deposit growth rate was similar to the growth rate of Malta in the year prior to the changeover to the euro, exceeding the growth rate registered in Estonia where deposits before adoption of the euro grew at a slower pace compared to other new eurozone members. Thus, in Latvia household cash inflows into banking accounts last year were larger compared to the increase in deposits of Estonian households before the changeover to the euro. It can be explained by the popularity of cash payments and cash as the form of saving. Estonia is the most cashless society among the Baltic states with a larger share of non-cash payments, while in Latvia households more often use cash in payments and prefer to stash their cash “under the mattress”.

Baltic Household outlook / October, 2014
A proportion of households in Latvia is not satisfied with the transition from the lat to the euro even after the smooth changeover to the euro, and acceptance of the euro will only come with time in the case of positive developments in the economy. The attitude towards the euro could improve if the euro helps to bring more money into households’ pockets. Some people avoid using euro notes and coins in everyday life and purchases. The main reasons are unacceptance of the euro as a currency, problems with wallets as euro notes and coins are larger than lat notes and coins, and gradual changes in households’ habits and attitude towards cash as well. Instead of euro cash these households use payment cards, increasing the popularity of non-cash payments.

According to statistics published by the Association of commercial banks of Latvia, the usage of payment cards continues to increase. In the first half of 2014 the number of card payments for purchases grew by 27.2 per cent year-on-year, while the value of money spent at POS terminals increased by 21.5 per cent compared to the first half of 2013. The card usage statistics indicate that consumers use payment cards more frequently for day-to-day transactions, as the average amount per transactions is decreasing. The more popular online shopping in local and foreign internet shops also contributed to an increase in numbers of card transactions.

The ratio of purchases with payment cards to total card turnover increased to 40 per cent in the 2nd quarter of 2014. Despite the increasing popularity of non-cash payments, many households in Latvia still prefer to take out cash from an ATM and use this cash for their purchases instead of a payment card. In the first half of 2014, the number of ATM cash withdrawals and money withdrawn from ATM’s rose by 7.6 per cent and 6.5 per cent respectively.

According to the Bank of Latvia, 37 per cent of lat coins worth 26.8 million lats (38.1 million euros) and 94 per cent of lat notes worth 924.4 million lats (1.315 billion euros) were exchanged for euros by the beginning of September 2014. However, households still have a large number of lat coins unexchanged in terms of total weight, but not value. At the end of August 2014 347.7 million coins or approximately 799 tonnes of coins were left unexchanged. During 8 months approximately 100 million coins or 300 tonnes of lat coins were exchanged.

Based on the experience of other eurozone countries, it’s expected that quite a large amount of all the lat coins that were in circulation before the adoption of the euro will never be exchanged. Some lat coins have been damaged or have left the country in the pockets of tourists, and many households in Latvia want to keep some lat coins as a memento of the national currency as well. The national currency lat was a symbol of independence and national identity for many households, thus many Latvians won’t be planning to exchange their currency in the near future.

The experience of Estonia shows that the largest amount of cash was exchanged in the first year after the changeover to the euro, while amounts of exchanged old currency are small in the next years. According to the bank of Estonia, in 2011 318 million euros worth of kroons were exchanged. In 2012 exchanged amounts dropped to 3.5 million euros’ worth, while in 2013 only about 2 million euros’ worth of kroons were returned to the bank of Estonia. Three years after adoption of the euro Estonian kroons worth almost 50 million euros remain unexchanged.
Price increase was one of the reasons why many households in Latvia didn’t want the adoption of the euro. Although the effects of the changeover were small and inflation remained at a low level, the perception of inflation remained quite high. The survey results from SKDS show that 87 per cent of all respondents noticed a price increase due to the changeover to the euro. 39 per cent of respondents said that prices were increased significantly, 8 per cent didn’t notice changes in the price level, while a little more than 1 per cent of respondents said that prices declined during the euro changeover process.

When comparing Consumer confidence data and actual inflation data, the differences between perceived and actual inflation can be seen. Consumers’ perception of inflation was higher during the period of 2003-2008. It can be explained by the significant price increase of food, housing and other first necessity goods and services during this time period. According to the study of Dziuda and Mastrobuoni, the perception of a higher level of inflation compared to an actual increase in consumer prices is explainable in that people tend to mostly base their perceptions on cheap, frequently purchased goods. 1 The changes in perceptions and expectations of inflation were in line with the actual inflation dynamics during the period of disinflation and the economic crisis (2008-2010) when prices of first necessity goods and services declined. Since 2011 the perceptions and expectations of inflation have been much higher than actual inflation. It should be noted that the patterns of perceptions and expectations of inflation were similar until late 2012. From January of 2013 until March of 2014 the gap between perceptions and expectations of inflation can be seen. The rise in expectations of inflation was mostly related to the changeover to the euro.

In the period before and after adoption of the euro overall inflation was low; however for the service sector inflation was higher than overall inflation. In August the largest price increase year-on-year was in hairdressing (7 per cent), tourism (5.9 per cent) and catering services (5.2 per cent). Quite a rapid increase was registered in housing rent. The increase in prices of services can partly be explained by round-ups before and during the changeover to the euro. The experience of other countries that had introduced the euro before Latvia also confirms that the prices of non-tradable goods (services falls under this category) and relatively cheaper goods increased more during the changeover to the euro.

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Is Lithuania going to use the privilege of being the last one – to learn from the lessons of others?

Lithuania will be the last country in the Baltic region to introduce the euro from 1 January 2015: four years later than in Estonia and one year later than in Latvia. Anyway sometimes it is worth being the last one: we are more aware of what lies ahead of us, we can learn from the mistakes of others, and have more chances to identify potential opportunities and to use them.

People are of the opinion that prices will rise after the euro introduction

A concern that the prices will rise after the euro adoption is typical of all countries preparing for the euro introduction. As compared with other countries such concern is the most widespread in Lithuania. The Eurobarometer survey results show that in Lithuania, in September of the current year, or three months prior to the euro introduction, 84 per cent of its population was of the opinion that prices in Lithuania will rise after the euro adoption. While four months prior to the euro introduction date, 81 per cent of residents in Estonia were of the opinion that prices will increase, and eight months prior to the euro introduction date, 75 per cent of residents in Latvia were of the same opinion. However such concern related to increase in prices actually had no grounds in Estonia or in Latvia.

It is now a well-established fact that the euro changeover has been accompanied by perceptions of strong price increases, while the official inflation indices at the same time reflected only moderate price developments. Such phenomenon has been explained by various reasons: the difference between the consumers’ perception of inflation and the way official indices reflect price changes; the difficult conversion calculations; the presence of money illusion; the reality that a sizeable fraction of the population still compares the euro prices with old national currencies prices which, in the meantime, are several years old; the widespread existence of expectations of price increases prior to the cash changeover; the importance of media coverage and the effect of an unexpected deterioration of the income situation of some socio-demographic groups.

A big concern related to higher prices in Lithuania may continue to rise taking into consideration the recent months’ trends. Irrespective of the fact that the majority of trade and service companies in Lithuania have assumed an obligation not to use the euro introduction as the reason for increase in prices, a number of enterprises (and especially the service sector representatives) have increased the prices prior to accepting such obligation and prior to the period of showing the prices in two currencies. The consumer goods and service price statistical data shows, that for instance in Latvia, a more significant rise in service prices has started four months prior to the euro adoption date, while in Lithuania such rise was noticed since April, i.e., nine months to the euro adoption date.

Price changes prior to the euro introduction (y-o-y, %)

Source: National statistics
Inflation in Estonia after the euro introduction was higher than Latvia. However, the recent survey shows that rise in prices in Estonia in the year 2011 was mainly induced by other factors than the euro. The impact of the euro adoption is rather modest. Assessment in absolute terms reflects insignificant increase in prices of such products, which compared to other countries of the Eurozone, were much cheaper than in Estonia. Inflationary effects were stronger in small shops than in larger supermarkets, whereas the menu costs related to the euro adoption for such small shops are more significant.

The comparison of experience of the euro introduction in other countries and current situation in Lithuania enables to make such conclusions: 1) some features are observed that enterprises in Lithuania have learned the lessons of the neighboring countries related to the menu costs, i.e. a number of them rushed to shift higher costs on consumers prior to the date of accepting the obligation to suspend increase in prices; 2) service prices in Lithuania started to rise earlier; therefore it is possible to expect more moderate increase in prices or price stabilization in later period; 3) based on official statistics, the euro introduction impact on prices is rather insignificant, however the opinion of residents is different.

Cash changeover will help to move towards a cashless society

Prior to the euro introduction date, a large share of cash will be handled by banks. Other countries’ experience shows that households bring their savings in cash to banks and open deposit accounts to ensure automated exchange of the litas to the euro. Historically, the ratio of cash-to-deposits in Latvia was one of the largest in the Baltic countries, and one of the largest in the European Union. However at the moment of the euro adoption the situation has changed in general. After the euro adoption (in the beginning of the year), the ratio of cash-to-deposits of households in Latvia was lower than the average in the euro zone countries.

Cash-to-deposit ratio (%)

The dynamics of deposit in Latvia shows that during the first months some amount of cash returned to the market; however the trend of decrease in deposit volume was temporary and more related with seasonal factor. In Latvia, the euro introduction helped to reach the euro zone average in terms of ratio of cash-to-deposits mostly due to such reason that previously savings kept in cash were deposited at banks. In future the ratio of cash-to-deposits will mostly depend on the choice of handling methods of income in cash.

The ratio of cash-to-deposits of households in Estonia was extremely low at the moment of the euro introduction, but within the period of three years it has increased again. In the first quarter of 2014, this ratio made up 12 per cent – similar to the euro zone average. Analysis of the statistical data in Estonia showed that the ratio change was not determined by shrinking deposits but by growing volume of cash necessary to ensure daily monetary transactions resulting from undeclared work, salaries earned abroad and brought home in cash. On the other hand, interest on deposit is very low; therefore the Estonian households have no stimulus to deposit cash at banks.

Currently, the ratio of cash-to-deposits is the largest in Lithuania among all three Baltic states. However it is expected that until the end of the year such large difference will decrease. At present, the deposit growth pace in Lithuania is faster, compared to the situation in Latvia and in Estonia prior to the euro adoption date. A significant increase in the deposit volume at the end of the year is inevitable as more and more people will select the automated cash exchange method. Mean amount of household cash per capita in the first quarter of this year in Lithuania amounted to LTL 2,190 (or EUR 634). This ratio in Estonia and in Latvia in the first quarter of the last
Based on the experience of other countries, it may be expected that in Lithuania certain number of coins and banknotes will remain unchanged. The value may reach several hundreds of million litas. Some number of the Lithuanian money is simply lost (destroyed), some is dug under the ground and forgotten. People will also decide to keep the Lithuanian banknotes and coins for retaining memories. Some number of people will not exchange all money without any reason. Nevertheless in Lithuania we may expect that the euro introduction will help to make one step closer to the euro zone countries by keeping cash and using cash for payments. It is expected that this effect will be a long-term effect. Our forecast of change in this indicator in future, i.e. whether the Latvian households will choose to deposit their new income, should take into consideration the economic situation, attractiveness of savings instruments being offered by financial institutions, point of view on cash and payments in cash, the euro support, etc.

Experience of the euro introduction in other countries and comparison of the current situation in Lithuania enables us to make the below conclusions: 1) some features exist that people in Lithuanian are preparing for the euro introduction– they started to bring cash to banks a bit earlier than their neighbors; 2) nevertheless by the end of the year, the volume of cash deposited at banks should considerably increase; 3) several hundreds of millions may remain unchanged until the end of coming year; 4) the euro introduction will bring Lithuania closer to West Europe in terms of the cash to non-cash ratio.

Currency change over involves much more aspects than only adaption to the new banknotes and coins. People, as consumers, intuitively know a reasonable price (numerical quantity) of the majority of products and also substantiate their spending decisions on such perceptions. When the former currency is converted to a new currency that corresponds to lower quantitative values, it makes effect on price evaluation (acceptance of prices), price estimates, and job attractiveness (wage offered). It was identified that the price estimates are more accurate if individuals calculate in the new currency, than in such cases when prices are rescaled (people keep calculating prices in former currency). Experience of other countries shows that it takes a reasonable period of time until people start evaluating expenses in the new currency, especially if they plan higher value purchases. The results of the Eurobarometer survey show, that after two years since the date of the euro introduction in Estonia, prices in the euro are recalculated in the kroons by two out of five Estonians (43 per cent) planning to buy big expensive purchases. But if people plan daily purchases, only one out of five consumers (19 per cent) recalculates price from the euro to the kroons. While in Portugal, i.e. the country, which introduced the euro more than ten years ago, every second person (51 per cent) still recalculates prices from the euro to the Portuguese escudos, willing to buy more expensive exceptional goods, and every third person (31 per cent) when buying daily goods and services. In each country it takes different period of time for customer to become accustomed to the new currency. Different duration may be explained by various different political and sociological factors, individual and group differences, former experience to use the new currency, and whether recalculation from the new currency to the former currency and vice versa is difficult or not, i.e. whether it requires more efforts to recalculate, or to remember the prices in the new currency. It is rather difficult to recalculate the Estonian kroons to the euro (1 EUR = 15.6466 EEK), and not easier to the Latvian lats – (1 EUR = 0.702804 LVL). While it is easy to recalculate the above-mentioned former currency of Portugal to the euro (1 EUR=200.482 PES). It is also not an easy task to recalculate precisely by heart from the litas to the euro and vice versa (1 EUR=3.45280 LTL). Based on the level of inconvenience of the exchange rate for calculation, we expect that the period necessary for the Lithuanian consumers to become accustomed to the euro and to evaluate prices in the new currency will be more similar to that in Estonia than in Portugal, but it will take longer than 12 months since date when the prices are specified in two currencies.

Experience in Estonia shows that prior to the euro introduction (autumn of the year 2010), less than a half of residents (47 per cent) were of the opinion that the euro will have positive impact on their country and almost similar number of residents (43 per cent) expected positive impact on them personally. Two years after the euro introduction (autumn of the year 2013), more than a half (58 per cent) of the Eurobarometer survey respondents acknowledged that the euro introduction in Estonia should be assessed positively. More than a half of Latvians prior to the euro adoption date expected positive impact on the country (54 per cent), however a smaller share of them (42 per cent) expected positive impact on them personally. Prior to the euro introduction in Lithuania, the point of view of its residents was moderate: in September of the current year, 43 per cent of
Lithuanians believed that the euro will have positive impact on their country, and 37 per cent expected positive impact on them personally. It is rather difficult to separately assess the euro impact on the local economy – stability of its public finance, inflation rate, economy growth, reduction of unemployment rate and real estate prices, as other wider economic developments make larger impact. Higher inflation rate and also expectations for housing price growth are rather often linked with the euro introduction. In Estonia, prior to the euro adoption date, only insignificant increase in the real estate purchase transactions was observed. However the price and transaction volume trends in the longer-term showed that the economic trends of wider profile, instead of the euro introduction, more clearly explain changes in prices and transactions. In Latvia, prior to the euro introduction date, the housing price expectations were raising. However in the beginning of the year (2014) such enthusiasm stopped increasing. Analysis of the housing price expectations in Lithuania shows that expectations related to an increase in the real estate prices after the euro introduction started weakening when less than half a year remained prior to the euro adoption date.

In Lithuania, in the beginning of the year, an impressive number of the real estate purchase transactions and a slight increase in housing prices were interpreted as willingness of people to decrease their financial assets (savings) through purchase of the residential property. However, they invested for the long term seeking to retain value in the longer period (instead of selling it after half a year or one year period at a significantly higher price. The number of mortgage loans also increased. Besides, the volume of new mortgage loans is growing since the year 2012. The value of the new loans in the year 2013 was higher by 37 per cent, compared with the year 2012, and in the first half of 2014 – by 30 per cent higher than within the relevant period of the previous year. Such persons, who have accumulated the required initial instalment and expected stable incoming future, make decisions to obtain loans.

The euro introduction by itself does not increase the real estate prices, and it seems that the number of Lithuanians, who believe in it, is growing. Effect on the housing prices is made by wider economic developments, which may be slightly influenced by the country’s accession to the eurozone.

**SEB Housing Price Expectations’ Indicator**

<table>
<thead>
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<td>Dec</td>
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</table>

Source: SEB

**Euro introduction will provide more opportunities**

After the euro introduction, the personal finance handling for some people will become more convenient. It is obvious, that common currency gives an opportunity to reduce expenses of those who travel to other eurozone member states, or buy goods from such states – as they no longer incur currency exchange costs. It will be easier to compare prices. Anyway, the experience of Estonia shows that after the euro adoption, Estonians did not start traveling more.

After the euro introduction, some number of households will no longer have to accept currency risk for their assets and liabilities in euros. Prior taking loans or depositing their money households had to choose: to enjoy higher (for deposits) or lower (for loans) interest rates or to be insured against currency risk.

The largest share of Lithuanians compared to other Baltic countries chose to borrow in national currency. Whereas interest rates on the euro loans usually were lower than on the litas loans, and also interest rates on the euro loans were less volatile, the choice of households to obtain loans in the litas may be best explained by unwillingness of households to accept currency risk, irrespective of the fact that since the date when the litas was pegged to the euro, the currency exchange rate never changed. It means that from the date of the euro adoption one unknown quantity will be eliminated.
The euro introduction will make no direct impact on those who have savings. Deposits with financial institutions represent the greatest share of the household assets. The largest share of savings (77 per cent) is kept in the litas. After the euro introduction, such savings will be automatically exchanged to the euro. Interest rates are equally low – on deposits in the litas and on deposits in the euro. Any features that in the nearest future the finance institutions may increase interest rates are not observed. The euro introduction may offer more investment alternatives and especially for those, who considered such instruments to be not attractive due to the additional currency exchange costs, when it was necessary to buy the euro for the litas, and when selling investment – to exchange currency once more but in different direction.

The euro introduction will have versatile effect on the level of interest rates. Interest on the litas loans started to drop, when it became clear that the country will be allowed to introduce the euro. The euro introduction will make no influence on the interest on the euro loans. Comparison of today’s interest rates in three Baltic countries, when the euro is already introduced in Estonia and Latvia but still not adopted in Lithuania, shows that the average interest rate on mortgage loans (when interest rate is approved for the period shorter than one year) is the lowest.

Adoption of the euro only, as experience in Estonia and Latvia showed, does not make a significant impact on the financial standing of households and the personal finance management. Seeking to change the needs and behaviour of households, i.e. to stimulate people to accumulate savings, to invest or to obtain loans, many other conditions in addition to the currency replacement are necessary.
Leasing and other loans

The average nominal wage has exceeded the threshold of 1000 EUR and reached 1023 EUR by the second quarter of 2014. The nominal wage increased by 4.8 per cent on yearly basis which indicates a decline in the growth rate. For comparison, in the second quarter of 2013 the annual nominal wage growth was 8.4 per cent. The real wage growth in the second quarter of 2014 was on the same level at 4.8 per cent as the prices did not change within the time period. It is expected that the purchasing power of households is continuing to rise at a slightly lower speed.

The unemployment rate has declined to 6.9 per cent by the second quarter of 2014, from 8.7 per cent at the end of 2013. The participation rate is 63 per cent which is the same level as a year ago. In general, the employees have more bargaining power as the number of labour force, i.e. the population who is working or looking for work, has started to decrease in Estonia since the beginning of 2013. The labour force declined by 2.4 per cent in the second quarter of 2014 on yearly basis.

The semi-durable and durable consumption (i.e. goods that are not consumed instantly but over a period of time) contributed most to the growth of household consumption in 2011 and 2012, exhibiting double-digit growth numbers, but the consumption slowed down in 2013. In the first half of 2014, the semi-durable and durable consumption has shown an increase again rising by 7.9 per cent on yearly basis. The non-durable consumption has shown strong and stable yearly growth rate of 4-5 per cent since the second half of 2012 but it has slowed down in 2014. The consumption of services has been stable but modest increasing by 1-2 per cent y-o-y since 2013. The relatively low growth rate of services and non-durable consumption in 2014 indicates that households are waiting for more certain economic and political environment in order to change their consumption habits.

The stock of housing loans has risen by 1.7 per cent on yearly basis at the end of the second quarter of 2014. The balance of consumer and other loans decreased by 3.2 per cent during the same period while the balance of leasing increased by 5.3 per cent. When looking at the households’ appetite for new loans, the volume of new housing loans increased by 21 per cent in the first half of 2014 compared to the first half of 2013 which is a comparable growth rate compared to the previous periods. In the first half of 2014, about 14 per cent more consumer credit and other loans were granted compared to the first half of 2013, while 19 per cent less leasing was issued during the same period. The decline in the new leasing volumes is the result of the adjustment to the vigorous rise in new leasing volumes last year.

The trend where financial assets exceed households’ financial liabilities is continuing at a significant pace. The turning point to the financial strengthening of households occurred in the first quarter of 2013 when the volume of financial assets surpassed the volume of financial liabilities of the household sector. At the end of the second quarter of 2014, households own billion EUR more financial assets than liabilities. The assets are accumulating at the yearly rate of 10-11 per cent while the balance of liabilities shows only marginal changes. Due to the uncertainties on the stock markets the assets held in shares decreased by 11 per cent in the second quarter of 2014 compared to the same period a year ago. The highest increase of assets is present in pension funds which have increased by 23 per cent in a year.

Although pension assets are growing at the most rapid pace, in absolute terms the most money is still accumulated in the deposits. Households increased the value of total deposits by 271M EUR within the first half of 2014. It is 5.5 per cent more than at the end of 2013 while the yearly growth rate is 7.9 per cent. As already observed in previous periods, households prefer to keep their money on current accounts, which is a passive way of saving. Similarly, the accumulation of pension assets is due to regular payments rather a passive than active saving decision, so households are hardly involved in active saving decisions. As households do not put away money from their current accounts, it is also more easily accessible by households for consumption compared to other saving instruments. Under these circumstances it is difficult for households to develop the saving habits.

Consumption change of household sector (y-o-y, %)

Quarterly volume of new loans and leasing (mEUR)
Household’s financial assets, liabilities and net asset value (EUR million)

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<td>255</td>
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Source: Bank of Estonia, Estonian Central Register of Securities, Financial Supervision Authority, SEB calculations

* Private portfolios, foreign investment funds and unit-link insurance
** Registered at Estonian Central Register of Securities
Latvia

- In the first half of 2014 the financial situation of households continued to improve. The unemployment rate dropped to 10.7 per cent in the second quarter, while the number of employed persons continued to rise, albeit at a slower pace compared to 2013. In July of 2014 the number of employed persons who are paying social tax reached 805 thousand, the highest level since June of 2009. Compared to July of 2013, the number of employed persons rose by 5.7 thousand. As economic growth slows and uncertainty about future developments increases, companies are cautious about hiring new employees. In 2014 job creation is expected to be very sluggish.
- Average gross wages increased to 762 euros in the second quarter, showing a 6.4 per cent growth rate year-on-year. In the first quarter the average gross wage increased even faster -- by 7.5 per cent. The acceleration in the wage growth rate in the first quarter of 2014 was connected to an increase in the minimum monthly wage. In January the minimum wage was raised to 320 euros (an increase by 12.5 per cent compared to December of 2013), contributing more than one per cent growth of the average wage in the first quarter. The average net wage reached 557 euros in the second quarter, showing an 8.4 per cent increase y-o-y. In the first half of this year average net wages grew approximately two percentage points faster than average gross wages. The reason for this was the reduction in the tax burden on labour. As of January, the personal income tax allowance and the allowance for dependent persons were increased and social insurance contributions were cut as well. Due to these changes in labour taxation the tax wedge for lower income employers and families with children has decreased.
- As wage growth continues to outpace inflation, the purchasing power of households improves. In the first half of 2014 the purchasing power of employed persons rose at a quicker pace compared to the previous years. Average real wages (net wages adjusted to inflation) rose by 9 per cent (the highest growth rate since the first quarter of 2008) in the first quarter and by 7.6 per cent in the second quarter. The average real wage has increased for eleven consecutive quarters, approaching the pre-crisis level.
- Despite slower economic growth, households are expecting that their financial situation will continue to improve. In August consumers' assessment of their financial situation over the next 12 months remained positive for a twelfth consecutive month. In addition, in July the indicator of consumer expectations about their finances in the next 12 months reached the highest level since June of 2007.
- The volume of deposits, which grew sharply during the last year, showed only a slight increase in the first quarter of 2014. Since December of 2013 the total volume of household deposits has risen by approximately EUR 54 million to EUR 4.87 billion, reaching the historically highest volume. Due to the record low deposit rates, households continue to shift their term deposits to demand deposits. The share of demand deposits has reached 66 per cent of the total volume of household deposits. In late 2008 the share of demand deposits was only 36 per cent.
- The financial vulnerability of households is decreasing as households continue to increase their savings, while the debt level of households is decreasing. In the first half of 2014 the total household loan portfolio continued a downward trend, decreasing by 6 per cent year-on-year. Housing loans portfolio shrank by 6.4 per cent, while the stock of consumer loans was down by 2.1 per cent.

Changes in average wages (% YOY)

The number of SSIMC payers (in thousands)

Financial situation

Household deposits (mEUR)
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<td>375</td>
<td>485</td>
<td>411</td>
<td>559</td>
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<td>Pillar II pension funds</td>
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Sources: Bank of Latvia, FCMC, LIA, SEB dzīvības apdrošināšana, SEB estimates
Lithuania

• In the first half of the year 2014, the household income statistics improved. The average net wage in the second quarter of 2014, made up EUR 531 (LTL 1,832) and was higher by 1.3 per cent, compared to the last quarter of 2013, and by 5 per cent higher than one year ago. The number of unemployed decreased: in the first half-year – by 1.7 thousand (1 per cent), and within a one-year period – by 6.3 thousand (3.7 per cent). The average retirement pension in June 2014 amounted to EUR 240 (LTL 830). Income of the retired persons grew at a slower pace than income of the employed individuals. Within the first half of the year 2014, the average retirement pension increased by 0.3 per cent during a one-year period – by 0.9 per cent. On average, income was growing faster than prices. Annual inflation in June 2014 made up 0.2 per cent.
• Nevertheless, the Consumer Sentiment Survey data is less optimistic. In June, almost two thirds of the respondents (64 per cent) noted that their financial standing within the period of twelve months remained unchanged, one fifth (22 per cent) declared that it has deteriorated, and one out of seven respondents (14 per cent) mentioned that the household financial situation has improved.
• A mismatch between the household financial statistics and assessment made by households is observed due to several reasons: the firstly, due to still low growth of income (wage, as especially pension); secondly, due to income (wage) growth of an insignificant number of the employed; thirdly, individually observed price changes differ from the aggregate statistical data: prices of non-seasonal goods (heating) are dropping, while the prices of daily necessities (milk, bread, meat) are rising.
• The value of all types of financial assets was growing. Financial assets of households during the first half of the year grew by EUR 325 million (LTL 1.1 billion), or by 2.8 per cent, and during the year – by EUR 889 million (LTL 3.07 billion), or by 8.2 per cent. The largest increase in the household deposit volume was observed: within a half-year – by EUR 50 million (LTL 171 million), within one year – by LTL 1,668 million (EUR 483 million). There are several reasons of such deposit growth: firstly, growth of income was faster than of consumption; secondly, the households decreased their savings in cash, as the date of the euro adoption is approaching. Funds accumulated with the Pillar II Pension Funds also grew considerably: by EUR 147 million (LTL 506 million) within a half of the year and by EUR 269 million (LTL 929 million) – during one year. Such growth of this type asset value was determined by increase in the average wage and prevailing favourable trends in the securities market.
• Total value of the loan portfolios in the first half of the year decreased by EUR 4 million (LTL 11 million), and during the year it remained unchanged. Mortgage portfolio grew: during the first six months of the year, the value of mortgage credits increased by EUR 19 million (LTL 68 million), during one year – by EUR 39 million (LTL 135 million). Based on the data of the Association of Lithuanian Banks, the value of mortgage credits granted during this year was higher by nearly one third (31 per cent), as compared with the previous year. The value of other loans such as consumer loans, loans for other needs secured by the real estate pledge shrunk within half-year and within one year.

Annual mortgage credit dynamics (y-o-y)

• Within the latter several years, the local economy situation in general has improved. The adoption of the final decision on Lithuania’s participation in the Economic and Monetary Union (EMU) from January 2015 means a positive assessment of the economy potential and its stability. Nevertheless, this year households are more concerned about their future financial situation, as compared with the current. Based on the data of the Statistics Department, the expectations of consumers that within the next twelve months, the financial standing of household may change since the start of the year is becoming more pessimistic.

Consumer expectations about changes in financial position of households in the next 12 months (balance)

• Such deteriorating expectations may be explained by several reasons. Firstly, concerns related to the approaching euro adoption date. It was expected that after determination of an irrevocable conversion rate of the Litas against the euro in July, said concern may drop however it caused quite opposite reaction. Secondly, geopolitical unrest influences or will influence households’ labour market expectations. Thirdly, after a dynamic recovery of economy its growth pace usually slows down. However deteriorating expectations do not make impact on the financial habits of households.
• In the nearest future, the trends of financial habits of households should remain unchanged: financial assets will continue to grow – and mostly due to larger real income and savings previously kept in cash but recently deposited with financial institutions; if lending volume drops, it may be caused by seasonality factor. We do not forecast any specific changes in consumption.
### Household's financial assets, liabilities and net asset value (EUR million)

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<tr>
<td>Other loans</td>
<td>1420</td>
<td>1309</td>
<td>1002</td>
<td>935</td>
<td>888</td>
<td>885</td>
<td>833</td>
<td>817</td>
</tr>
<tr>
<td><strong>Net value of financial assets</strong></td>
<td>90</td>
<td>1252</td>
<td>2179</td>
<td>2468</td>
<td>3482</td>
<td>3527</td>
<td>4087</td>
<td>4416</td>
</tr>
</tbody>
</table>

Source: Central bank, Central Securities Depository, Lithuanian Bankers’ Association