Baltic Household Outlook

MAY 2015

- Employed persons are benefitting from solid nominal wage growth and low inflation as their purchasing power is increasing. In Estonia and Latvia the average net real wage has exceeded the pre-crisis level last year by 3 and 2.3 per cent respectively. Lithuania is lagging behind the other Baltic countries – last year the average real wage was 4.2 per cent below the level of 2008.
- Consumers in Lithuania are less optimistic regarding their financial situation over the next 12 months compared to households in Latvia and Estonia.
- In the Baltic countries the number of households who are planning to make savings over the next 12 months has reached its highest level. The share of those who are still not able to make savings is largest in Latvia.
- Household assets grew in all three countries due to increasing income, trust in the banking system, favourable situation in the financial markets, and, specifically for Lithuania, - the euro introduction.
- A large share of households remains financially vulnerable: due to relatively low liquid savings in Latvia and Lithuania and relatively low long-term savings in all the three countries.
- In the future, we expect household assets growth due to increasing income and low inflation which will not contribute to the fear of increasing prices.
- The housing credit market has recovered in Estonia and Lithuania – in 2014 the volumes of housing loans increased by 2.8 per cent and 1.8 per cent, respectively, while in Latvia the volumes declined by 6.7 per cent. The deleveraging continues in Latvia while a substantial share of households is still struggling with the payments of their current loans.
- The volumes of consumer loans and other borrowing is continuing to decline in all Baltic countries and the financing of new purchases is shifting from banks to the stores in the form of hire-purchases or other credit providers in Estonia and in Lithuania.
- It was much more favourable for households in the Baltic States to borrow in the 2000s when the inflation rate was high, than in 2015 when the inflation rate is negative. Households cannot count on the erosion of their debt due to the increasing prices and wages any more.
- Although the nominal interest rates on deposits are at record low, saving is more attractive in 2015 than it was in 2006 -2008 when the real interest rate on term deposits was negative. Due to the low-inflationary environment households do receive positive real interest rates on their term deposits.

Edmunds Rudzitis
Socioeconomics Expert
SEB Latvia
Telephone: +371 67215933
edmunds.rudzitis@seb.lv

Julita Varanauskiene
Household Economist
SEB Lithuania
Telephone: +370 52682518
julita.varanauskiene@seb.lt

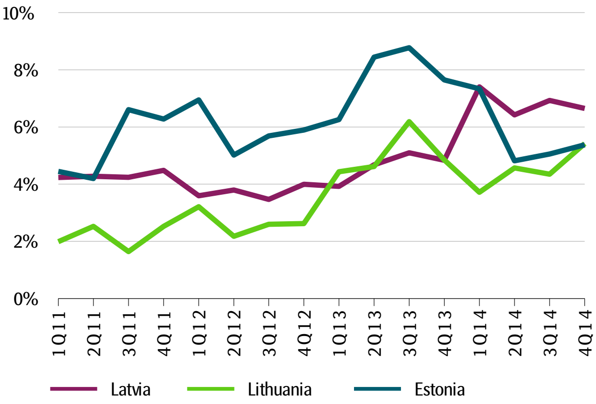
Triin Messimas
Household Expert
SEB Estonia
Telephone: +372 6656175
triin.messimas@seb.ee

Merike Kukk
Research Scientist
Tallinn University of Technology
Telephone: +372 6204069
merike.kukk@ttu.ee

Wage growth continues

Despite the economic slowdown and a slower increase in employment, the labour market situation continues to improve. In 2014 the average gross wage rose in all of the Baltic countries. In Estonia the wage growth rate decreased last year after rapid wage growth in 2013. In Latvia the average gross wages posted the highest growth rate among the Baltic countries, rising by 6.8 per cent. Last year wages in Latvia rose more quickly compared to previous years, showing the highest wage growth in the post-crisis period. In Lithuania the average gross wage rose by 4.6 per cent, at a slower rate compared to the other Baltic countries. In Lithuania the increase in the average gross wage slowed in the first quarter of 2014 (from 4.8 per cent to 3.7 per cent year-on-year) and accelerated in the next quarters. Last year in all the Baltic countries the growth of the average gross wage was affected by the increase in the minimum wage.

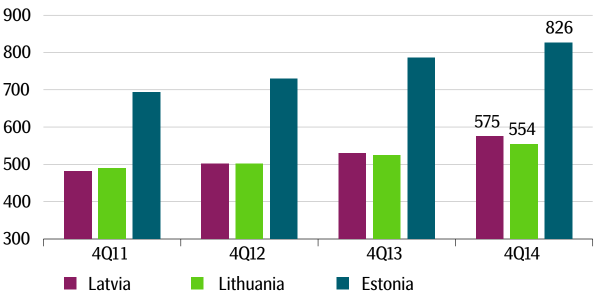
Average gross wages and salaries (%, YoY)



Source: National Statistics

Due to the reduction in tax wedge in Latvia and Lithuania the average net (after tax) wage rose at a quicker pace than the gross wage. In Estonia last year there were no reductions in labour taxes, thus the average net wage rose more slowly than the gross wage. In Latvia the growth rate of after-tax salaries was the highest among the Baltic countries, reaching 8.6 per cent year-on-year. Wage statistics show a substantial gap in the average wage between Estonia and the other Baltic countries. Estonia has a much higher average wage compared to Latvia and Lithuania. In the last quarter of 2014 the average net wage in Estonia was EUR 826. It was 44 per cent higher than in Latvia (EUR 575) and 49 per cent larger than in Lithuania (EUR 554).

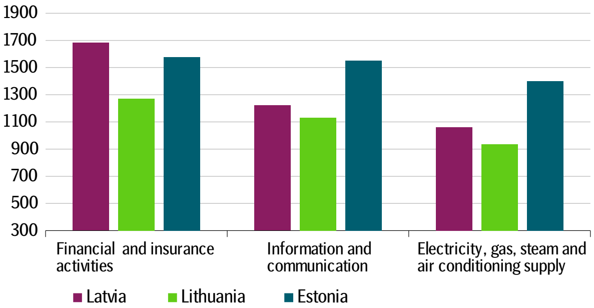
Average net wages (in euros)



Source: National Statistics

Estonia has larger wages in nominal value terms compared to its neighbours. It applies to almost all economic sectors. One exception is the financial sector where the average wage in Estonia is lower compared to Latvia. There are no differences in the list of top economic industries with the largest wages. In all the Baltic countries, industries with the largest average wage are similar – financial services, information technology companies and the utilities sector. The average wage in these economic sectors are well above the average level.

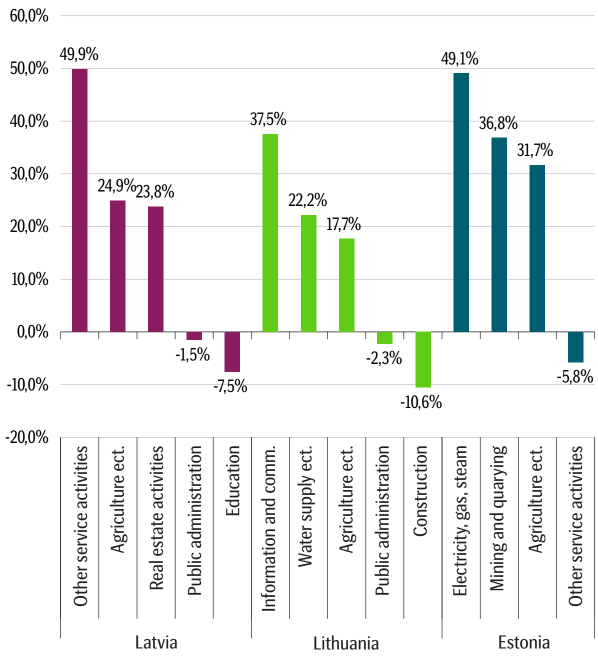
Top 3 industries with highest average gross wages (in euros)



Source: National Statistics

In previous years the average gross wage rose in most economic sectors, not only in top industries, however the wage growth was uneven in different economic sectors. Compared to the pre-crisis period some economic sectors have substantially higher nominal wages, while some sectors have lower wages. According to national statistics, during the last 6 years the best performing sectors with the highest wage growth rate in Latvia was other service activities (average wage rose by 49 per cent compared to 2008), agriculture, forestry and fishing (25 per cent) and real estate activities (24 per cent). It should be noted that wages in some sectors (including other service activities and real estate companies) rose so sharply as a result of State Revenue service activities towards a reduction of tax avoidance, particularly, "envelope wages". In some cases "envelope wages" were legalised, thus improving wage statistics. At the same time, persons who are employed in education and public administration have lower wages compared to the pre-crisis level – the average wage in these sectors is lower by 7.5 and 1.5 per cent respectively. In Lithuania the largest wage increase during the crisis and post-crisis period was in information and communication companies (37.5 per cent compared to 2008), water supply and waste management activities (22.2 per cent) and the economic sector which represents agriculture, forestry and fishing (17.7 per cent). According to wage statistics the worst performing industries are construction (average wage decreased by 10.6 per cent compared to 2008) and public administration (2.3 per cent). In Estonia electricity, gas, steam and air conditioning supply has the largest increase in wages – the average wage rose by 49.1 per cent compared to 2008. In mining and quarrying the average wage rose by 36.8 per cent, while in agriculture, forestry and fishing wages grew by 31.7 per cent. The other service activities sector demonstrated the worst wage dynamics during the last 6 years, showing a 5.8 per cent drop compared to the pre-crisis level.

Dynamics of average gross wages in different economic sectors 2014/2008 (%)

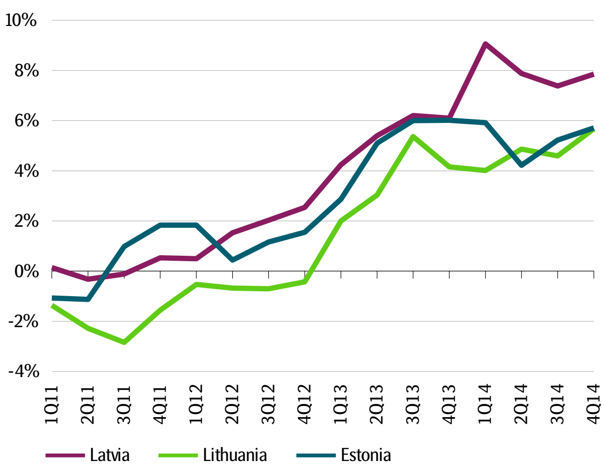


Source: National Statistics, SEB calculations

Consumers benefit from low inflation

The solid nominal wage growth and low inflation rate helped to improve consumer's purchasing power. In the low inflation environment when prices of first necessity products and services are growing slowly or even decreasing, consumers can afford more. In 2014 real wages (wages adjusted to inflation) in the Baltic countries had solid growth. In Latvia the real average wage rose by 8 per cent. In Lithuania and Estonia the real income of employed persons rose by approximately 5 per cent. In Estonia the real wage grew at a slightly slower pace compared to the previous year.

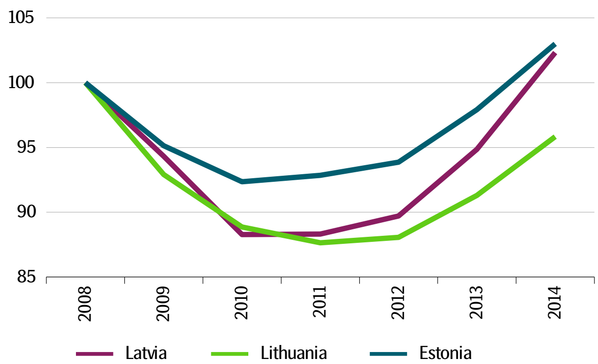
Real net wages (%, YoY)



Source: National Statistics

In Estonia real wages have now risen for the 14th consecutive quarter. In Latvia the growth of real income started in the fourth quarter of 2011 (one quarter later than in Estonia), while in Lithuania real wages have only increased since the first quarter of 2013. Since then real wages in Lithuania have grown for eight consecutive quarters. In Estonia and Latvia real wages have reached the pre-crisis level, while in Lithuania real purchasing power is lower than in 2008.

Real net wages 2008-2014 (2008=100)

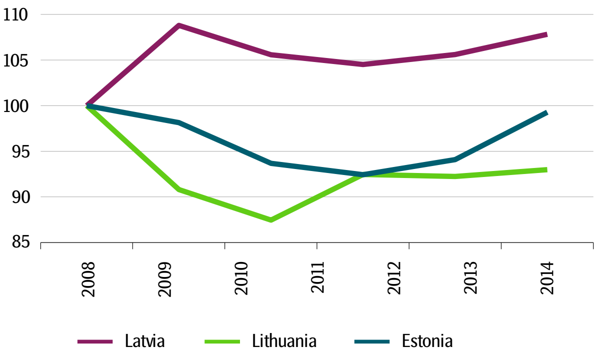


Source: National Statistics

In Estonia last year the average real net wage was 3 per cent higher compared to the previous peak. In the last quarter of 2014 real net wages were 4.3 per cent higher compared to the previous peak (second quarter of 2008). In Latvia the real purchasing power of employed persons was higher than before the crisis. In 2014 the real average wage rose 2.3 per cent above the pre-crisis level. In the last quarter of 2014 the real wage was 3.2 per cent higher than in the last quarter of 2008. Lithuania is lagging behind the other Baltic countries – last year the average real wage was 4.2 per cent below the level of 2008.
If purchasing power and the economic situation of working people is improving, growing even above the pre-

crisis level, people who are receiving pensions face a less significant increase in purchasing power. On the other hand, low inflation on first necessity products is very important for older people. In 2014 the average old-age pension increased most in Estonia. In the last quarter the average old-age pension in Estonia rose by 5.6 per cent year-on-year, reaching 349.6 euros. In Latvia and Lithuania the average old-age pension grew by 2.6 and 0.5 per cent respectively. In the last quarter of 2014 the lowest average old-age pension was in Lithuania (240.6 euros). In Latvia the average old-age pension was 271 euros – 12.6 per cent higher compared to Lithuania and 22.5 per cent lower compared to Estonia.

Average old-age pension at constant prices (2009=100)



Source: National Statistics

In Latvia and Estonia the real purchasing power of pensioners is close to the previous highest level (2009 year for Estonia and 2010 for Latvia). In Lithuania the average old-age pension is 7 per cent lower compared to the level of 2009 when the purchasing power of Lithuanian seniors was the highest.

Forecasts still positive

This year wage growth and low inflation will continue to improve the financial situation of Baltic households. Inflation will be low this year as the prices of commodities remain at low levels and a rapid increase in oil prices is not expected. In Lithuania on average consumer prices are expected to be even lower compared to the price level of last year. In 2016 consumer prices are expected to increase faster and inflation will be higher, particularly for Latvia and Estonia. The main reasons are a possible increase in the price of oil, hikes in consumption taxes, fees and administrative prices that will contribute to an increase in prices. Thus the purchasing power of working people next year is expected to improve at a slower pace compared to 2015.

In Estonia the gross wage is expected to grow by 5-6 per cent this year. Starting in 2015, the minimum wage has been increased to 390 euros. The income tax cut from 21 to 20 per cent, increase in tax allowance and allowance for families and lowered employment insurance contributions will lift up net wages. Due to the decrease in labour taxes the real net wage growth rate is expected to be higher compared to the increase in gross wages. A decrease in the labour tax wedge will increase take-home pay by approximately 2 per cent for those persons who are receiving the average wage.

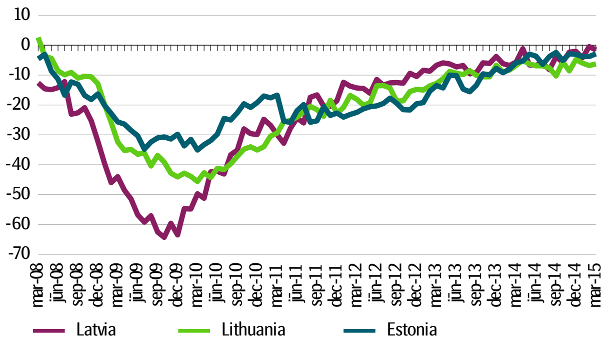
In Latvia solid wage growth will continue this year, albeit at a bit slower pace compared to last year. Changes in the minimum wage (increase by 12.5 per cent to 360 euros) will contribute to the growth of gross wages, while the personal income tax cut by one percentage point from 24 to 23 per cent will ensure that the growth rate of the average net wage will be faster. The average real wage is expected to grow by approximately 6 per cent.

In Lithuania real wage growth is expected to reach 4.5 per cent this and next year. The rate of wage growth could be even faster this year as the Government of Lithuania is planning to increase the minimum wage from 300 to 325 euros or by 8.3 per cent in July of 2015.

Improvements in sentiment

Labour market improvements and income growth helped to improve consumers' sentiment. The evaluation of the last year is similar in all the Baltic countries; almost neutral. In Latvia and Estonia the number of people who experienced improvement in their financial situation are balanced with those whose financial situation deteriorated. It's at its highest level since the crisis started. In Lithuania the financial situation indicator is more negative compared to the other Baltic countries. There are differences in different socio-economic groups. Unemployed persons and persons older than 65 years in all the Baltic countries have a negative evaluation of the financial situation. At the same time, most employed persons describe last year as neutral or positive in terms of their personal finances. Self-employed persons and office employees are the most optimistic about their financial situation in the past and in the future.

Financial situation over last 12 months

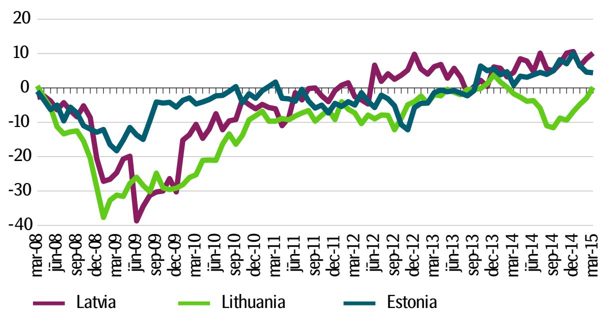


** Balances, i.e. differences between the percentages of respondents giving positive and negative replies*

Source: Eurostat

Consumers in Lithuania are also less optimistic regarding their financial situation over the next 12 months. At the same time, their outlook has improved since September of 2014 from negative to neutral. In the middle of 2014 consumer sentiment and the financial outlook of Lithuanians was negatively affected by geopolitical tension and euro adoption (people expect a high price increase due to the euro changeover, thus their financial outlook worsens). In Latvia the consumers' outlook of the financial situation is the most optimistic among the Baltic countries. Households expect their financial situation to improve this year. As wage growth continues, employed consumers are quite optimistic about their future. In Latvia the largest optimists are office employees. The largest pessimists about their financial situation in all the Baltic countries are older people.

Financial situation over next 12 months

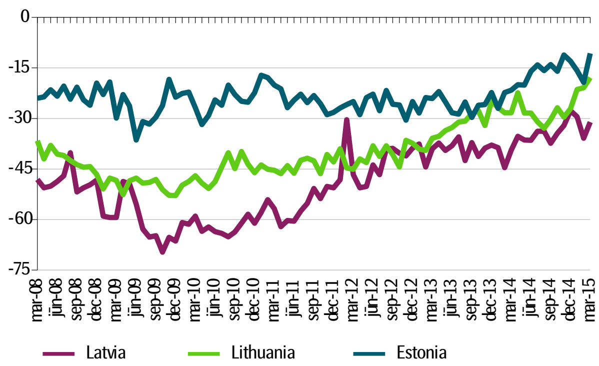


** Balances, i.e. differences between the percentages of respondents giving positive and negative replies*

Source: Eurostat

Income growth improves the financial situation of households and helps to put some money aside as savings. The sentiment survey shows that the share of households able to save has increased in all the Baltic countries. In the Baltic countries the number of households who are most probably going to save some money over the next 12 months has reached its highest level. At the same time, the share of those who are not able to make savings is still largest in Latvia.

Savings over next 12 months



** Balances, i.e. differences between the percentages of respondents giving positive and negative replies*

Source: Eurostat

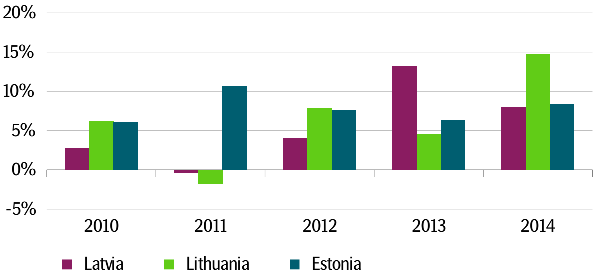
Household assets grew in all three countries

As the main factors of the growth of the financial assets held in financial institutions, we outline increasing income, trust in banking system, favourable situation in the financial markets, and – specifically for Lithuania – the euro introduction.

Due to a different data collection methodology, statistics available for the country comparison include deposits and pension-related savings, such as Pillar II and Pillar III pension funds and life insurance. During the year 2014, household deposits in Lithuania grew 14.8 per cent. Deposit growth in Latvia and Estonia was not so impressive but still significant in Latvia – by 8 per cent and Estonia – by 8.4 per cent.

A strong growth in Lithuania was mostly related to the euro adoption as the national currency. The value of household deposit accounts was raising, whereas savings kept in cash till the above date were deposited aiming to conveniently exchange the litas in the euro free of charge. The same pattern was observed in Estonia (2011) and Latvia (2013) prior the euro adoption. However the deposit growth volume in Lithuania was larger compared to the deposit growth prior euro introduction in Latvia (11.2 per cent) or in Estonia (6 per cent).

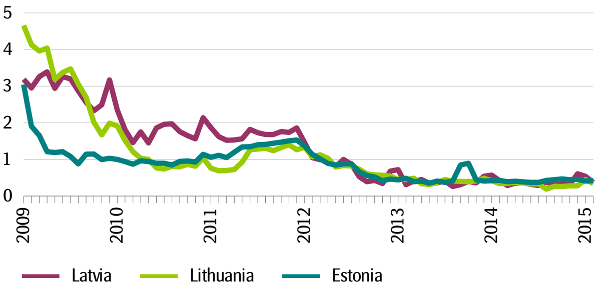
Household deposit growth (y-o-y)



Source : National Central Banks

The most recent data received from Lithuania shows that compared to the developments in other countries following the euro adoption the money deposited in accounts are not withdrawn after exchange to the euros. Other factors such as increasing income and non-decreasing trust in banks were typical to all the countries and contributed to the deposit growth. The growth rate of deposits outpaced increase in wages and pensions. Households saved a certain part of their increased income and do not spend the total amount for the consumption needs, although interest rates on deposit are at the record low levels.

Weighted average interest rate on new deposits up to 1 year (per cent)



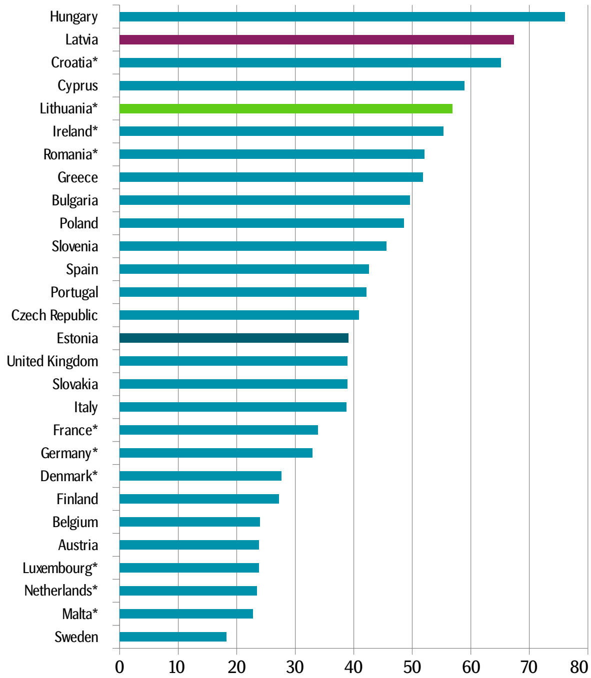
Source: National Central Banks

The weighted average interest rates on deposits up to one year in 2014 made up 0.42 per cent in Estonia, 0.38 per cent in Latvia, and 0.31 per cent in Lithuania (on deposits in euro). The interest rate was slightly lower than in the year 2013 when financial institutions paid 0.49, 0.41, and 0.41 percent respectively. The consequence of such low interest rates was the households' indifference to term deposits. Amounts of cash deposited in the demand deposit accounts are continuously growing.
On the other hand, the low deposit rates contribute to the growth of long-term savings (private pensions and life insurance). During the year 2014, private pensions and life insurance grew by 21.3 percent in Lithuania, 19.1 percent in Latvia, and 11.6 percent in Estonia. Positive investment results have also contributed to the long term savings portfolio growth. The average return of Pillar III pension funds in 2014 was 7.8 percent in Lithuania and in Estonia and 6.6 percent in Latvia. Larger contributions to long term savings indicate households' lower risk aversion – confidence in their future income, trust in financial markets, and striving for higher returns.

A large share of households remains financially vulnerable

At the end of the year 2014, the volume of deposits per capita reached EUR 4096 in Estonia, EUR 3416 in Lithuania and EUR 2618 Eur in Latvia. Liquid assets (deposits) per capita equals to 5 monthly average net salaries in Estonia, 4.6 monthly average net salaries in Latvia and 6.2 monthly average salaries in Lithuania.
On the other hand, based on the data of Eurostat, 39 per cent of population were unable to cope with unexpected expenses in Estonia in 2014. The result is slightly below EU average (39.8 per cent) and close to the richer countries, such as the UK (38.9 per cent) and Italy (38.7 per cent). While in Lithuania and Latvia the share of households unable to cope with unexpected expenses was significantly higher: 57 per cent and 67 per cent respectively in Latvia. Therefore in Latvia and Lithuania a large share of population is still financially vulnerable in terms of liquid savings.

Share of population unable to face unexpected expenses (per cent)

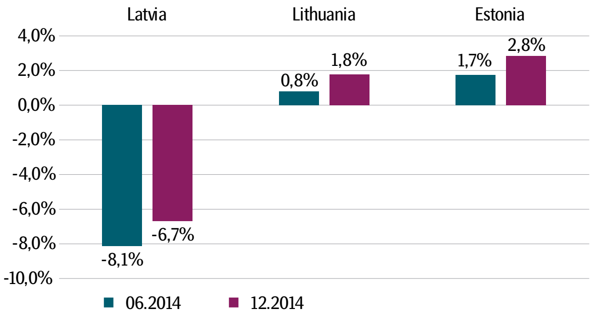


**data available for 2013 only. Source: Eurostat*

However, in terms of long-term (mostly pension-related) savings, all the three countries are vulnerable. Based on the financial asset data, private pension and life insurance savings per capita makes 258 euros in Estonia, 284 euros in Latvia, and 295 euros in Lithuania. The amount is smaller than monthly average old age pension in Estonia (EUR 350) and only slightly higher than Latvia (EUR 271) and Lithuania (EUR 241).
The statistical data is similar to the SEB Retirement Readiness Index Survey results. Percentage of population saving for pension is the highest in Lithuania (39 per cent) followed by Estonia (27 per cent) and Latvia (18 per cent). However, the regular savings amount is rather small. On average a resident of Lithuania voluntarily saving for pension, saves EUR 49 a month, a resident of Latvia – EUR 67, and Estonia – EUR 95.
The most often provided reason for not saving is the lack of money. However, based on the Pillar II results we can estimate that if people contributed a decent share of their income (2-6 per cent), they would have saved 1673 euros per capita in Estonia (in 13 years), 1010 euros per capita in Latvia (in 14 years) ad 639 euros in Lithuania (in 11 years).
In the future, we expect further household asset growth in all the three countries. The experience from the recession underlines the importance of buffer stocks and households continue to accumulate steadily their savings also during the favorable periods. As the growth factors, we outline expected wage growth which will contribute to higher Pillar II contributions and increase the ability to save by those with lower income and no buffer savings; low inflation which will not contribute to the fear of increasing prices and speeding up the consumption and which will compensate the disappointment in low interest rates on deposits. Household propensity to invest in the financial markets via the long-term saving products or other investment products will depend on the future developments in the above-mentioned markets. Longer term trend of the ageing society will also contribute to savings accumulation. While younger households will have to save for the initial mortgage installments.

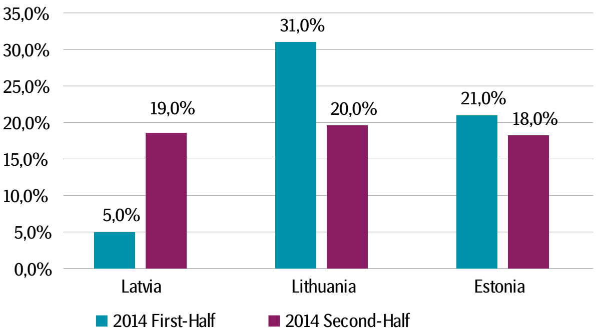
The housing loan market has awakened in Estonia and Lithuania while it is still lingering in Latvia

Housing loan portfolio, y-o-y change



Source: National Central Banks, SEB estimations

Volume of new housing loans, y-o-y change



Source: National Central Banks, UAB

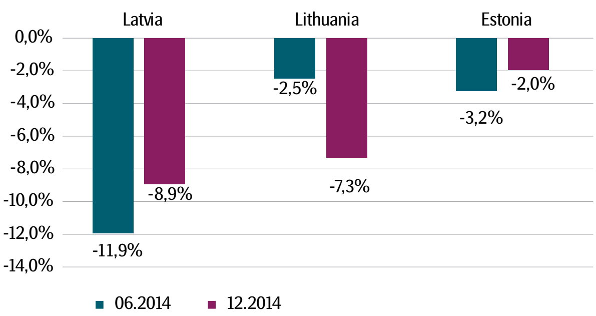
The housing loan market has recovered in Estonia and Lithuania, where the housing loan portfolios are slightly increasing. In Estonia, the volumes rose by 2.8 per cent in 2014 while in Lithuania the volumes increased by 1.8 per cent in 2014. The growth rate of housing loan portfolios has increased compared to the previous periods in both countries and the rate at which the housing loan volumes are increasing is continuing to accelerate. However, the growth rate is expected to remain below the average wage growth rate in Estonia and Lithuania and the indebtedness of households is not expected to increase.
The new volumes of housing loans issued by commercial banks are in Estonia 19.5 per cent higher and in Latvia 12.3 per cent higher in 2014 compared to 2013. The statistics from the Bank of Lithuania indicates as if the volume of new housing loans issued was 13.9 per cent lower in the first half of 2014 compared to the same period in 2013, and only in the second half of 2014 the volumes have increased by 9 per cent. However, the statistics from the Association of Lithuanian Banks and Būsto paskolų draudimas (UAB) discloses that the volume of new housing loans increased in the first half of 2014 by ca 30 per cent and the second half of 2014 by ca 20 per cent.
In Latvia, the deleveraging continues as the amortization of housing loans is higher than the volumes of new loans issued. The yearly declining rate of housing loan portfolio is still at a remarkable level– at the end of 2014 the volumes have declined by 6.7 per cent compared to the end of 2013. Households in Latvia are still struggling with the loans taken before the recession. The share of non-performing housing loans (overdue 90 days) in Latvia is still very high; at the end of 2014 it was at 8 per cent. The latest data from Lithuania also indicates a rather high level of non-performing loans; the share of housing loans overdue 60 days was 6.5 per cent in June 2014. In Estonia, the share of non-performing housing loans (overdue 60 days) was only 1 per cent at the end of 2014. The credit quality of Latvian banking sector has been worse than in other Baltic countries and the ongoing problems hinder the development of the housing credit market.
However, the interest for housing loans has increased in all three countries which can be reasoned by the continuous need for improvement of the housing conditions, being still below the EU average. According to the EU Survey on Living Conditions and Income (EU-SILC), the living conditions of households in all Baltic countries are worse than the EU

average, e.g. the average size of a dwelling is approximately 2/3 of the EU average. Therefore the need to improve the housing conditions remains high.
On the other hand, the reverse shocks experienced by households during the recession makes households more cautiaous in their borrowing decisions compared to the first half of the 2000s. The volumes of new housing loans are far from being comparable to the volumes of the boom period but are rather on the pre-boom levels. If households are not faced with additional negative shocks related to the political events in the neighbouring countries, we expect the households in all Baltic countries to further activate their borrowing for housing purchases.

Consumer credit and other borrowing continues to linger

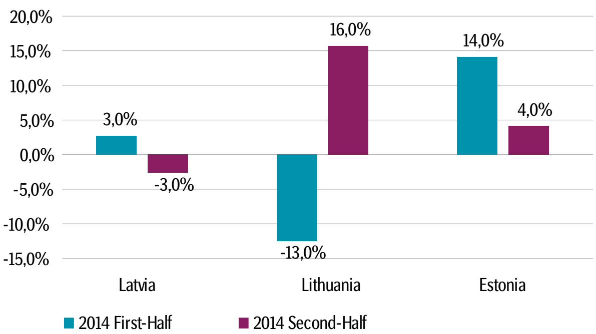
The volume of consumer credit and other borrowing fell after the onset of the crises and it is continuing to decline in all Baltic countries as the amortization and write-offs exceed the new lending. At the end of 2014, the volume of consumer credit and other borrowing decreased by -8.9 per cent in Latvia, -7.3 per cent in Lithuania and -2.0 per cent in Estonia compared to the end of 2013. For comparison, at the end of 2013 the decline in the volumes of consumer credit and other borrowing was -11.0 per cent in Latvia, -3.2 per cent in Lithuania and -4.6 per cent in Estonia.

Consumer credit and other lending portfolio, y-o-y change



Source: National Central Banks, SEB estimations

Volume of new consumer and other loans, y-o-y change



Source: National Central Banks

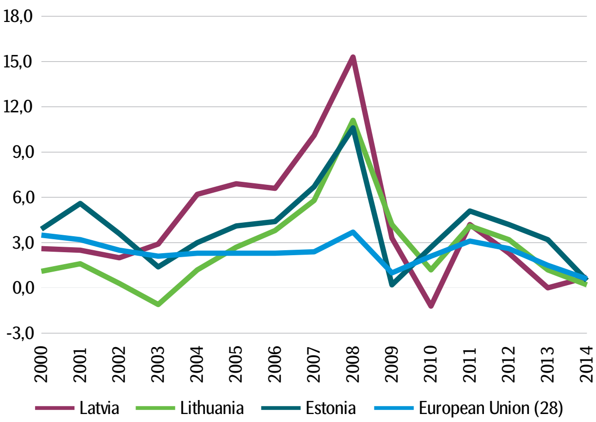
The rate of deleveraging of consumer loan volumes is the highest in Latvia where the share of non-performing consumer credit is also the highest. At the end of 2014, the share was at 14 per cent in Latvia while being at 3.6 per cent in Estonia. The latest available (June, 2014) data from Lithuania indicate 11 percent. We see the volumes declining in decelerating rates but the volumes are still expected to continue to decrease. In Estonia, at the end of 2014 the nominal loan volumes were on the same level as they were at the end of 2006, while in Lithuania on the same level as in September 2006 and in Latvia as in September 2005.

Demand for new consumer credit is increasing in Estonia and Lithuania. In the second half of 2014, 4.1 per cent more new consumer credits and other loans were granted in Estonia compared to the second half of 2013. The increase in the volume of new loans was lower compared to the rise in the volumes in the first half of 2014 but as the statistics includes the refinancing contracts, it does not give the full picture about the demand for new loans. Similarly, the volatility of new loan volumes is high in Lithuania; the statistics of the Bank of Lithuania indicates that the volumes were declining in the first half of 2014 while turned to the rise in the second half of 2014. However, the statistics from the Association of Lithuanian Banks indicates that the volumes of new consumer credits and other borrowing were increasing also in the first half of 2014 by 7 per cent compared to the same period in 2013.
In Latvia, the issuing of new consumer loans was growing rapidly in the second half of 2013 when the increase was 50.3 per cent compared to the second half of 2012. But the increase was temporary induced by the refinancing contracts. Consequently, as the interest for new loans is modest, then in the second half of 2014 the volumes of new consumer loans and other borrowing has declined slightly compared to the same period in 2013. Households are still facing problems of repaying the current consumer loans in Latvia; the share of 90 days overdue loans in consumer credit portfolio is 14 per cent. The difficulties evidently decrease from one hand the interest for consumer loans but also the availability of the consumer credit to a significant share of households.
Households continue to be reluctant to finance their consumption by borrowing from commercial banks. In Estonia, the consumer loans have been replaced by hire-purchases which are a more convenient way to finance a specific purchase. The volumes of hire-purchases are not available, therefore it is not possible to assess how much the volumes of hire-purchases have increased. The statistics from National Accounts reveal that in Estonia the volume of short-term loans (up to 1 year) issued by non-financial institutions has increased more than 30 per cent in 2014. These loans contain both hire-purchases and fast loans. According to the consumer credit market review by the Bank of Lithuania, the volume of consumer loans from non-financial institutions has increased by 17 percent compared to the end of 2013. In Latvia, the statistics from National Accounts indicates that the liabilities of the household sector for non-financial institutions are declining, suggesting that households are not shifting to other financing forms of purchases in Latvia.

Low inflationary environment – new situation for the Baltic households

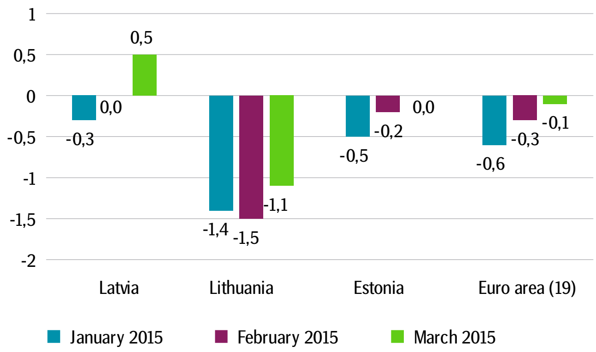
Households in the Baltic countries have faced remarkable price increases in the 2000s which continued after the recession. While the average inflation rate in the EU reached only 3.7 per cent before the outbreak of the crisis in 2008, the households in the Baltic countries did experience an inflation rate above 10 per cent (Estonia 10.6 per cent, Latvia 15.3 per cent and Lithuania 11.1 per cent). Among the Central and Eastern European countries Bulgaria is the only country besides the Baltic States which saw inflation rate in double-digit numbers (12 per cent in 2008).
Although the recession brought the inflation rate down, the prices continued to increase at a higher rate than the EU average. In 2011, the average inflation rate in the EU was 3.1 per cent while in Estonia, in Latvia and Lithuania it was 5.1 per cent, 4.2 per cent and 4.1 per cent, respectively. However, the slow recovery from the economic crisis has finally brought low inflation to the Baltic countries. Households face inflation rates close to zero or even below zero for the first time. In 2014, the average price increased in Estonia and in Lithuania less than in the EU on average – 0.5 per cent and 0.2 per cent, respectively, while on average the prices rose by 0.6 per cent in the EU.

Annual inflation rate (HICP), %



Source: Eurostat

Yearly inflation rate (HICP), %



Source: Eurostat

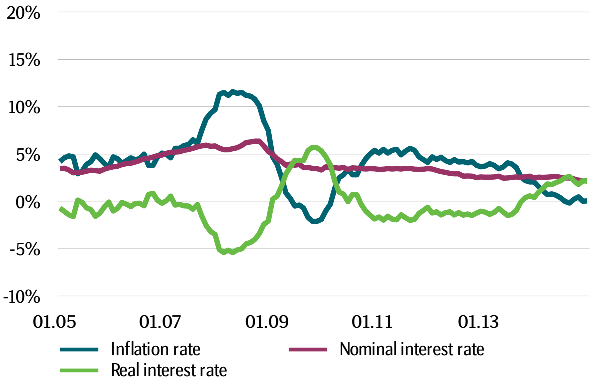
In the beginning of 2015, households in all Baltic countries have experienced a decline in the average price level. In Lithuania, the prices dropped by 1.5 per cent in February 2015 compared to February 2014 while the drop in March 2015 was 1.1 per cent. In Estonia, the average prices declined in February by 0.2 per cent compared to February 2014 while in March 2015 the prices were at the same level as a year ago. In Latvia, the prices decreased in January 2015 by 0.3 per cent but have increased by 0.5 per cent in March 2015 compared to March 2014.
High inflation in the 2000s increased households' uncertainty about the economic environment for several reasons. First, unevenly rising prices reduced the purchasing power of some consumers. Although the increase of the average nominal wage exceeded the high inflation rate before the crisis, there was disparity in the wage increases across industry sectors and different skills of workers. Some households had better opportunities to bargain wage increases compared to the others, leading to uneven wage increases. In the period 2009-2011 (in Lithuania also in 2012) the real wages were declining mainly due to relatively high inflation. There is no in-depth research done on the Baltic countries but the latest research on UK reveals that low-income households have been hit harder by high inflation as the prices of the goods, which they are consuming, increased more than other goods. [1] Apparently the findings also hold in other countries and therefore low income earners are expected to benefit the most from the current low inflationary environment.

The benefits of inflation to borrowers have disappeared

The change from the high-inflation to low-inflation economic environment will also have some implications on the households' borrowing. During the 2000s, the real interest rate of housing loans issued in euros was extremely favourable as due to high inflation the real interest rate (the nominal interest rate less the inflation rate) was negative. Usually high inflation rate increases the nominal interest rate to keep the real interest rate, which is the return to lenders, positive. But in the small Baltic countries, the nominal interest rate for euro has been determined by Euribor; hence the borrowing interest rate (in EUR, which has been the most popular currency for loans) has been detached from the inflation rate in these countries. Consequently, the average real interest rate of housing loans (in EUR) turned negative in May 2004 in Latvia, in November 2004 in Estonia and in August 2007 in Lithuania. The trough of the negative real interest rates which was induced by record high inflation rates was at -5.4 per cent in April 2008 in Estonia, at -9.5 per cent in May 2008 in Latvia and at -6.2 per cent in June 2008 in Lithuania, despite the fact that the nominal interest rates were also at the highest levels in this period.

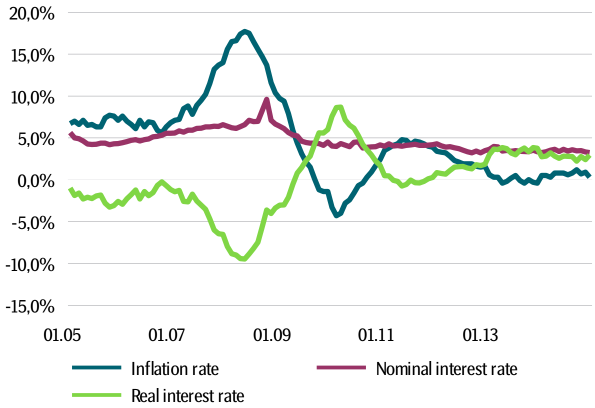
[1] *Adams, A., Hood, A., & P. Levell (2014). "The IFS Green Budget: The Squeeze on Incomes", Institute for Fiscal Studies.*

Average yearly interest rate of housing loans (in euro) Estonia



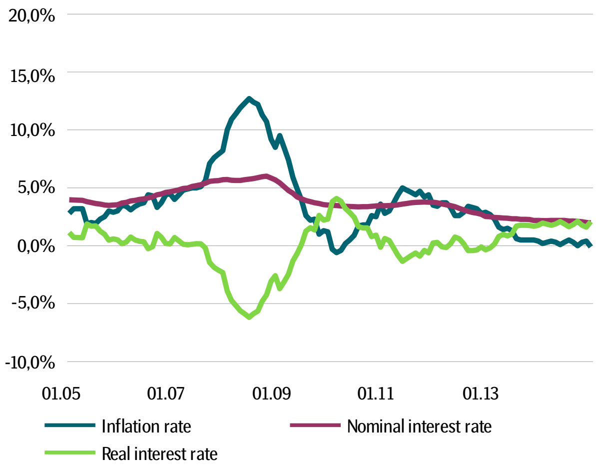
Source: Central Banks, Eurostat, SEB calculations

Average yearly interest rate of housing loans (in euro) Latvia



Source: Central Banks, Eurostat, SEB calculations

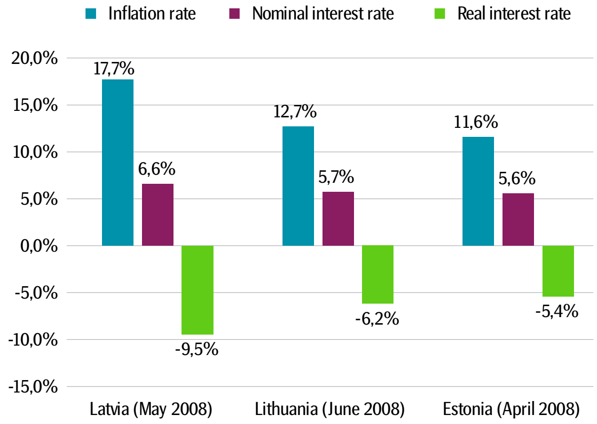
Average yearly interest rate of housing loans (in euro) Lithuania



Source: Central Banks, Eurostat, SEB calculations

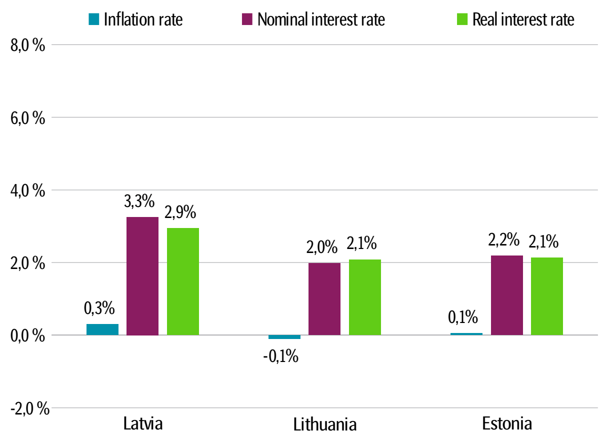
The negative interest rates prevailing since 2005 increased the attractiveness of borrowing. The negative real interest rate implied that households did not have to pay the interest in real terms (evaluated in the goods rather than in money) as the value of money was eroded by the inflation. Of course households could benefit from the negative interest rate only when the borrower's income was keeping up with inflation. Households, which faced lower income growth than the inflation rate, lost in purchasing power and the uncertainty about the economic situation due to high inflation made borrowing less attractive.

Average interest rate of housing loans (in EUR)



Source: Central Banks, Eurostat, SEB calculations

Average interest rate of housing loans (in EUR, December 2014)



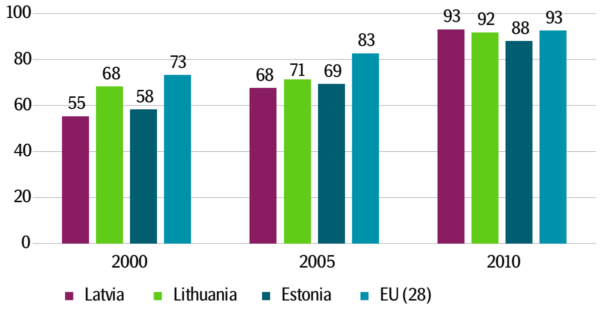
Source: Central Banks, Eurostat, SEB calculations

The situation has reversed by now. The average nominal interest rates for housing loans are at their record low levels in all Baltic countries – at the end of 2014 the average yearly interest rate for housing loan was 2 per cent in Lithuania, 2.2 per cent in Estonia and 3.3 per cent in Latvia. Nevertheless, positive real interest rates are observed due to low inflation rate. The real interest rate turned positive since November 2011 in Latvia, February 2013 in Lithuania and in October 2013 in Estonia. At the end of 2014, the average real interest rate on housing loans was 2.1 per cent in Estonia and Lithuania, while being 2.9 per cent in Latvia. In these days when the inflation rate is expected to remain low, the households cannot rely on negative interest rates but have to accept the positive real interest rates when borrowing, implying that households have to count with real costs when borrowing.

Additionally to the outcome that households did not pay the interest for borrowing in real terms, in the 2000s, the value of debt eroded due to the increasing consumer prices. As the repayment period for a housing loan can be over 30 years, the real value of the constant payments agreed in the beginning of the repayment period declines in tact with the inflation rate. For example, 100 EUR which households borrowed at the end 2000 were worth

(assessing the value in consumer goods) only 55 EUR in Latvia, 58 EUR in Estonia and 68 EUR in Lithuania by the end of 2014. Hence, households which borrowed in the beginning of the 2000s are paying back substantially less than they borrowed.
In the 2000s, the erosion of loans due to the inflation was making borrowing attractive; household also counted on the lowering debt burdens in the future due to the wage upsurge which was accompanied by the price growth. In 2015, households cannot rely on the lowering real value of their loans; in an environment with declining consumer prices households have to pay back the full amounts (in real term) they have borrowed. As households do have to assess their ability to repay the loan, low inflation makes them more careful about taking new loans. However, as low inflation reduces the uncertainty about the economic situation, the current low nominal interest rates may be more appealing than the high nominal interest rates with high inflation rate.

In 2014, the real value of 100 EUR borrowed in...

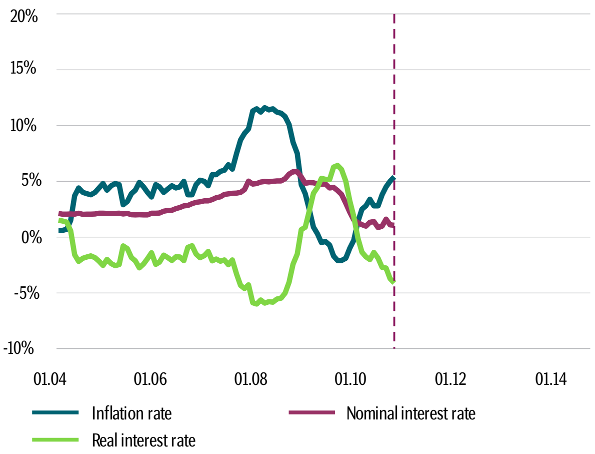


Source: Eurostat, SEB calculations

Low inflation makes saving attractive even with low nominal interest rate

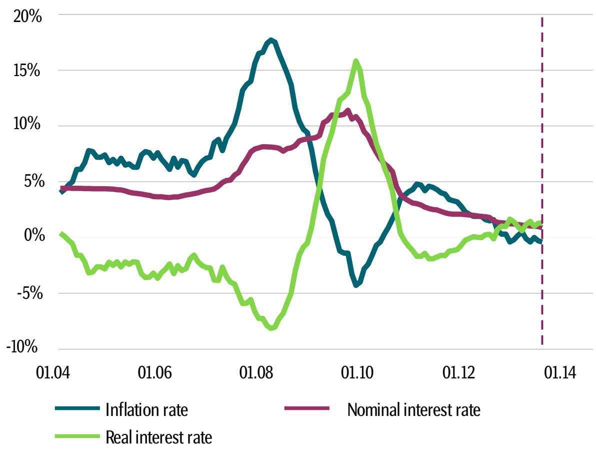
Households do need precautionary saving in any time period, even when saving seems to be irrational during a period of high inflation when the value of money diminishes. Households in all Baltic countries have experienced negative deposit rates during 2000s when the inflation rate exceeded the nominal interest rates on deposits, not only for deposits in EUR but also for deposits in local currency. Similarly to the interest rates on loans in EUR, the interest rates for deposits in EUR were hardly affected by the local inflation rate and the deposit rates in local currency did not rise as rapidly as the inflation rate. Therefore, households had to accept negative interest rates on deposits even when the nominal interest rates were relatively high.

Average yearly interest rate of term deposits (outstanding, in EEK) Estonia



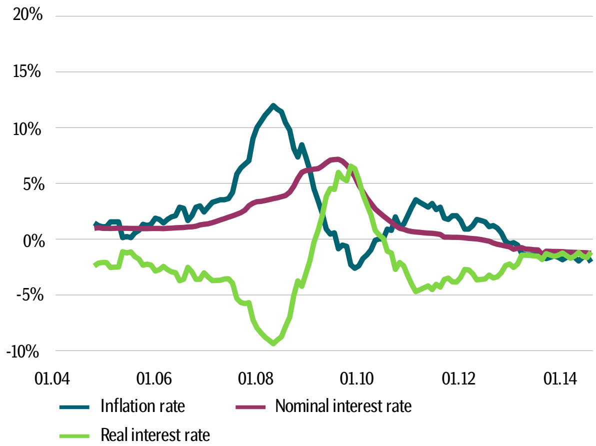
Source: Central Banks, Eurostat, SEB calculations

Average yearly interest rate of term deposits (outstanding, in LAT) Latvia



Source: Central Banks, Eurostat, SEB calculations

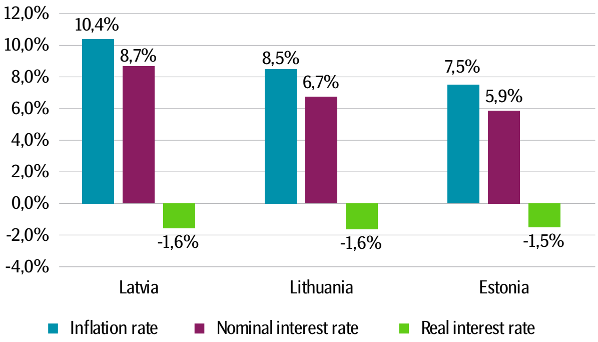
Average yearly interest rate of term deposits (outstanding, in LIT) Lithuania



Source: Central Banks, Eurostat, SEB calculations

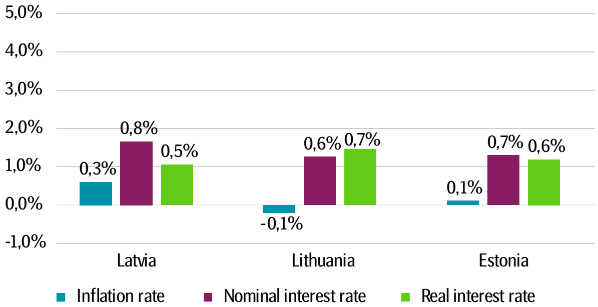
The nominal deposit interest rate (in EEK) was the highest in December 2008 in Estonia when the average annual deposit rate (in EEK) was 5.9 per cent. But as the inflation rate was 7.5 per cent, the average real interest rate was -1.5 per cent. In Latvia, the average annual nominal interest rate for deposits (in LAT, with maturity up to 2 years) was even higher, at 8.7 per cent and as the inflation rate was also higher, the real interest rate for deposits (in LAT) was - 1.6 per cent. The lowest average real deposit interest rate which households have received in Latvia was at -8.6 per cent (in May 2008, term deposits in LAT with maturity up to 2 years), in Lithuania at -6.8 per cent (in June 2008, all term deposits in LIT) and in Estonia at -6.0 per cent (in February 2008, all term deposits in EEK).

Average interest rate of term deposits (outstanding, in local currency, Dec 2008)



Source: Central Banks, Eurostat, SEB calculations

Average interest rate of term deposits (in EUR, December 2014)



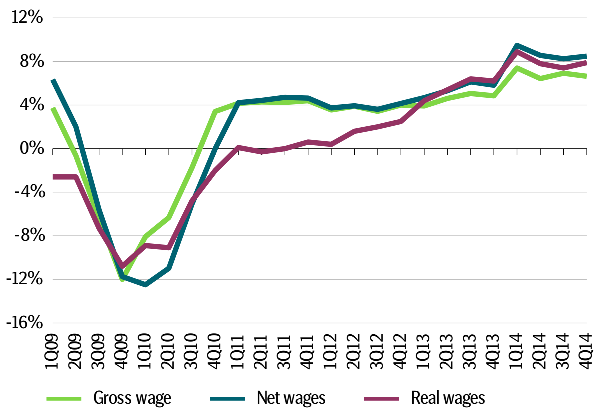
Source: Central Banks, Eurostat, SEB calculations

The upshot is that the average deposit interest rates have constantly been negative in all three countries until 2009, when the real interest rate turned to the positive side due to the sharp decline in the inflation rate while the nominal interest rates continued to rise. But the positive deposit rates did not last long as the inflation started to increase and the nominal interest rates to decline. Estonia faced negative interest rates in 2010 followed by Lithuania and Latvia in 2011.
A lowering inflation rate since 2012 has offered positive real interest rates again. In Latvia, the average annual real interest rate on deposits (in LAT with maturity up to 2 years) turned positive in July 2012. In Lithuania, the positive real interest rate on deposits (in LIT) is seen since July 2013 and in Estonia the average deposit interest rate (in EUR) is positive since June 2014. At the end of 2014, the average real interest rate on deposits was positive at 0.5 – 0.7 per cent in all Baltic countries. The low inflationary environment provides positive interest rate on deposits even when the nominal deposit rates are at very low level. This should encourage households to save. However, when households do not take into account the real interest rates but consider only the nominal interest rate –they perceive the deposit interest rates to be unattractive.

Latvia

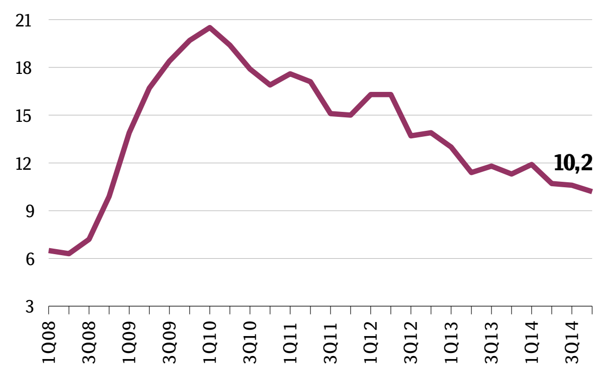
- Last year the unemployment rate continued its downward trend to an average of 10.8 per cent. In the last quarter of 2014 the unemployment rate fell to 10.2 per cent, 1.1 percentage points lower compared to the last quarter of 2013. At the same time, the share of long-term unemployed persons who have been seeking a job for 12 or more months declined to 43 per cent (48.4 per cent in 2013). Due to slower economic growth and uncertainty about future developments, job creation was slower compared to the previous year. This year job creation is expected to be very sluggish. Unemployment will continue to decline, partly due to emigration and a reduction of working-age population as well.
- Average gross wage and salary rose by 6.8 per cent compared to 2013, demonstrating the fastest growth in the post-crisis period. Wage growth rate was positively influenced by an increase in the minimum monthly wage. Due to the decrease in the labour tax burden the after-tax wages demonstrated an even more rapid growth rate. The average net salary grew by 8.6 per cent year-on-year, reaching 560 euros in 2014. Strong net wage growth and low inflation helped to improve the purchasing power of employed persons. In 2014 the average real wage (net wages adjusted to inflation) rose by 8 per cent, reaching the pre-crisis level. In 2015 wages are expected to show solid growth, albeit at a bit slower pace. The wage statistics are going to be influenced by the same factors (changes in the minimum wage and labour tax burden). Starting from 1 January , the minimum monthly wage was increased further from 320 to 360 euros or by 12.5 per cent, while the personal income tax rate was cut from 24 to 23 per cent.
- The increase in disposable income was divided between consumption and savings. Consumption rose moderately, while savings, despite a low interest rate environment, continued to increase. In 2014 household deposits increased by approximately 8 per cent, exceeding the level of 5 billion euros. Due to the record low deposit rates, households continue to shift their term deposits to demand deposits. Demand deposits rose by 10 per cent, while the total volume of term deposits contracted by 9 per cent. The share of demand deposits has reached 67 per cent of the total volume of household deposits.
- The low deposit rates and tax allowances stimulate the growth of long-term savings (private pensions and life insurance). In 2014 the number of persons having savings in private pension plans rose by 7 per cent or 15.4 thousand, which is the fastest increase in the last five years. Last year the total contributions to private pensions plans rose by 51.6 million euros, which is a 25 per cent increase compared to the previous year. Contributions of individuals rose by one third, while contributions by employers stayed unchanged compared to 2013. Due to larger cash inflows and a positive investment result the total amount accumulated in private pension funds rose by 19.1 per cent.
- The financial vulnerability of households continued to decrease. Household assets rose significantly (by 11 per cent y-o-y), while the debt level of households decreased by approximately 6 per cent. At the end of 2014 the total financial assets, also including 2nd pillar pension capital, were 8.3 billion euros. Household financial liabilities decreased by 351 million euros to 5.8 billion euros, thus the net assets reached 2.5 billion euros.
- Despite low interest rates and higher income, households are cautious towards long-term liabilities. Although demand for new loans is rising, the amounts of newly granted loans are still low compared with the amortisation of previously issued loans and loan write-offs. In 2014 commercial banks granted households EUR 360 million in new loans, up by 7 per cent compared to 2013. Newly granted mortgage loans were EUR 248 million, rising by 12 per cent y-o-y. Consumer loans were more popular – the amount of newly granted consumer loans rose by 23 per cent. Due to planned changes in the Insolvency law, demand for housing loans declined in the first months of 2015. Demand for housing loans is expected to pick up in the next quarters. The government support programme for new families could help to increase demand for mortgage loans, at the same time the total amount of state guarantees are too small to boost demand significantly. Therefore, the total household loan portfolio will continue a downward trend in this year as well.

Changes in average wages (%, YoY)



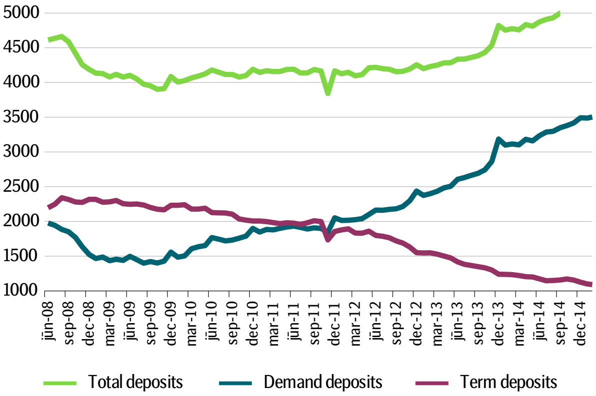
Source: CSB

Unemployment (job-seekers) rate, (%)



Source: national Statistics

Household deposits (mEUR)



Source: Central Bank

Household's financial assets, liabilities and net asset value (EUR million)

	2008	2009	2010	2011	2012	2013	2Q 2014	4Q2014
Financial assets	**5421**	**5677**	**6117**	**6120**	**6702**	**7482**	**7671**	**8307**
Deposits	4109	3999	4108	4090	4257	4735	4874	5206
Securities and financial instruments	394	375	485	411	559	592	426	528
Life insurance and private pension funds	259	301	347	377	424	474	520	564
Pillar II pension funds	660	1002	1178	1247	1462	1681	1851	2009
Liabilities	**9559**	**8944**	**8400**	**7735**	**6748**	**6162**	**5964**	**5811**
Mortgage loans	7188	6866	6554	5985	5328	5055	4864	4723
Consumer loans	1121	1012	920	864	770	488	506	437
Other loans	755	736	682	679	481	453	424	463
Leasing	494	329	244	207	170	166	170	189
Net value of financial assets	**-4138**	**-3267**	**-2284**	**-1615**	**-46**	**1320**	**1708**	**2496**

Sources: Bank of Latvia, FCMC, SEB dzīvības apdrošināšana, SEB estimates

Lithuania

- **The income of the employed people increased.** The average net wage in the fourth quarter of 2014 amounted to EUR 553.9 EUR, and as compared with the second quarter, it increased by EUR 23, or by 4.4 per cent, and as compared with the fourth quarter of the year 2013, it was larger by EUR 30, or by 5.7 per cent. The average pension increased only insignificantly – a bit more than by 1 euro within the period of one year (from EUR 239.3 to EUR 240.6). In the second half-year of the 2014, the average old-age pension remained almost unchanged.
- **Household savings at financial institutions rapidly went up.** The value of household deposit accounts within the period of one year grew by EUR 1,289 billion, or by 14.8 per cent, out of which EUR 1.131 billion – within the last three months of the year. The value of household deposit accounts was raising, whereas savings kept in cash till the above date were deposited aiming to conveniently exchange the Litas in the Euro free of charge.
- **More attention was paid to long-term modern savings instruments.** The value of premiums of the unit-linked life insurance in the last quarter of 2014 was higher by 25 per cent, as compared with the equivalent period of the year 2013. The life insurance product became more popular due to several factors: higher income and better income expectations, unwillingness to keep cash (the Litas), and favourable results of the previous investment in the financial markets. In the nearest future, the latter factor will mostly determine whether the long term savings (investment) instruments remain popular.
- **Consumption was not stimulated by the euro introduction.** Higher spending of households for consumption needs was not observed. Based on the data of the National Statistics, the retail trade turnover in December 2014, as compared with December 2013, increased: foods products – by 4.3 per cent, non-food products – by 9.9 per cent. The consumption growth indicators only slightly differ from those in December of 2013, as compared with December of 2012 (3.3 per cent and 7.6 per cent, respectively). In January 2015, the turnover of food products was lower by 0.9 per cent, non-food products – higher by 3.9 per cent in comparison with the equivalent period in the year 2014. Income during the year did not shrink. Household spending was not limited by utility (heating) costs: the average heating bill in the year 2015 was lower by almost one fourth (27.2 per cent) than one year ago. It means that in the beginning of the year, when the euro was introduced, households were unwilling to spend.
- **Borrowing behaviour of households was not influenced by the euro introduction.** The total credit portfolio of households in the second half-year of 2014 did not change. Irrespective of a modest increase in the household mortgage portfolio within the period of six months by EUR 85.3 million (or by 1.4 per cent), and within one year – by EUR 104.9 million (or by 1.8 per cent), the value of other credit portfolio shrank by the identical amount – by EUR 85 million in June –December and by EUR 109 million in the year 2014.
- **Growth pace of the new mortgage loans is slowing down.** Value of the new mortgage loans in the second half-year of 2014 was larger by EUR 74 million, or by 19.6 per cent as compared with the equivalent period in the year 2013. In the first half of the year 2014 year, the annual mortgage growth was larger (31 per cent). Borrowing volume of households during the recent years was mostly stimulated by increase in income and also by positive income expectations.
- **Dropping interest rates on the mortgage loans make effect on the behaviour of those with loans already taken instead of the new potential borrowers.** Lower interest rates on the loans improve financial standing of households who have variable rate mortgage loans: the debt service burden decreases, households may prepay loans earlier or increase their consumption by additional borrowing. Data of the Bank of Lithuania shows that quality of the household mortgage portfolio started to improve since the end of the year 2011. Loans repayment prior to the established maturity was rather active in 2012 but twice as weaker in 2014. However till today it is difficult to make a conclusion that lower mortgage credit instalments encourage the households to borrow for consumption needs. Based on the recent data of the Lithuanian Banking Association, within the nine months of the year 2014, the volume of the new consumer credit were higher only by 9.7 per cent as compared with the adequate period of the year 2013.

Financial assets and liabilities of households (EUR million)

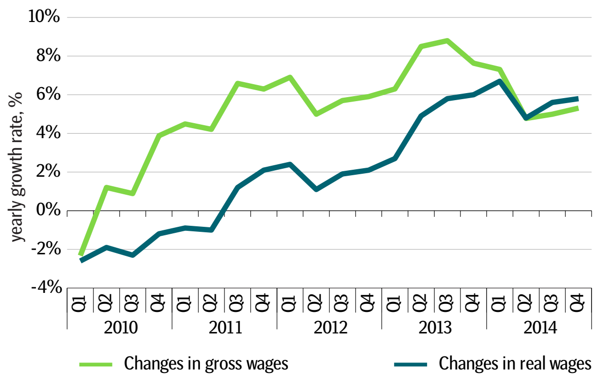
	2008	2009	2010	2011	2012	2013	2Q2014	4Q2014
Financial assets	**8830**	**9614**	**10096**	**10027**	**10900**	**11472**	**11797**	**13311**
Deposits	7152	7392	7856	7720	8322	8694	8744	9981
Securities	493	580	241	322	332	333	374*	374*
Units of investment funds offered by the banks	121	183	264	207	201	164	206	229**
Savings under life insurance agreements	420	514	618	599	653	710	755	861
Pillar II pension funds	**644**	**945**	**1117**	**1180**	**1392**	**1571**	**1718**	**1866**
Liabilities	8740	8362	7917	7561	7420	7391	7381	7382
Mortgage loans	6055	6027	5983	5934	5873	5897	5911	5997
Consumer loans	1265	1026	932	691	656	661	653	632
Other loans	1420	1309	1002	935	887	834	817	753
Net financial assets	**90**	**1252**	**2179**	**2466**	**3480**	**4081**	**4416**	**5929**

Source: Bank of Lithuania, Lithuanian Bankers' Association

Estonia

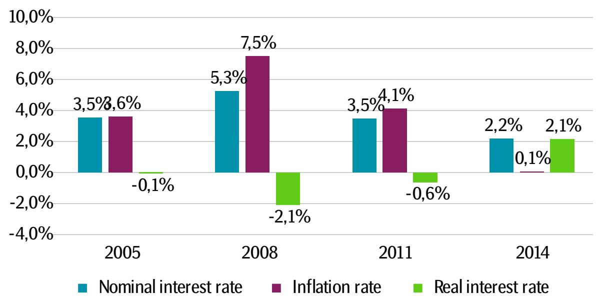
- Although nominal wages increased less in 2014 compared to 2013, the average real wage which determines the purchasing power of households continued to increase at high levels. The annual growth rate of nominal wage in Q4 2014 was 5.3 per cent while the real wage grew by 5.8 per cent. Low inflationary environment supports the growth of real wages in 2015 improving the economic situation of working households. The unemployment rate is expected to decline in 2015 only marginally from the level of 6.3 per cent, which it had reached by the end of 2014. On the average, households in Estonia have experienced together with Latvian households the highest income increases in the EU.
- The growth rate of housing loan volumes is picking up gradually. In 2014, the housing loan volumes increased by 2.85 per cent compared to 2013. However, the growth rate is below the wage growth rate and therefore the overall indebtedness of households has not increased. The volume of new housing loans increased by 19.5 per cent in 2014 compared to 2013, which is a slightly lower growth rate than was seen in 2013 (21.5 per cent). Households continue to be careful about borrowing and a substantial share of real estate purchases are not financed by borrowing.
- The balance of consumer credit and other borrowings decreased by 2 per cent in 2014. The decline is smaller than it was in 2013 when the volumes dropped by 4.6 per cent. The demand for consumer credit continues to be modest; the volume of new loans issued was 8.8 per cent higher in 2014 compared to 2013. Hence, the volumes of new consumer credit and other borrowing increased in 2014 only slightly more than in 2013 when the growth rate was 8.1 per cent. The amortisation of the current loans is continuing to be faster than the growth rate of new loans granted, resulting in decreasing volumes of consumer credit. Households prefer to finance the consumption from their income or with hire-purchase rather than borrowing from banks.
- The volumes of deposits increased in 2014 by 8.4 per cent, being a higher rate than in 2013 (6.4 per cent). The growth rate of deposits outpaced wage increases, indicating that households do not channel all their additional income to consumption but also save a fraction of their earnings. As stock markets with uncertain returns are not attractive to a substantial number of households, the savings accumulate mainly on demand deposit. The volumes of term deposits are shrinking because of the low interest rates of term deposits.

Changes in gross and real wages



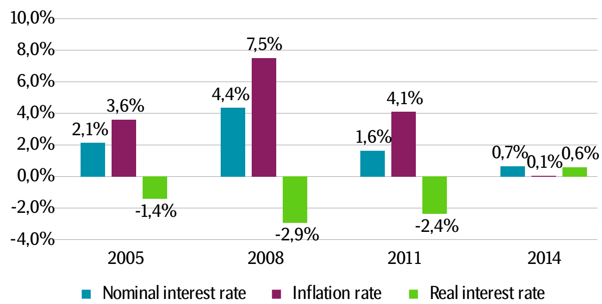
Source: Estonia Statistics

Annual interest rate of housing loans (in EUR, at the end of the year)



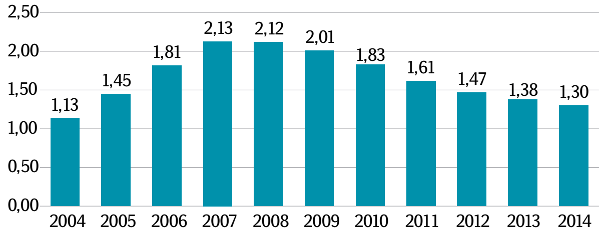
Source: Central Banks, Eurostat, SEB calculations

Average annual interest rates on term deposits (in EUR, at the end of the year)



Source: Central Banks, Eurostat, SEB calculations

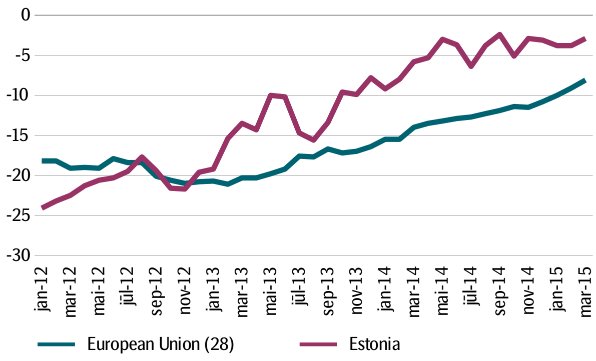
Loan-to-deposit ratio



Source: Bank of Estonia

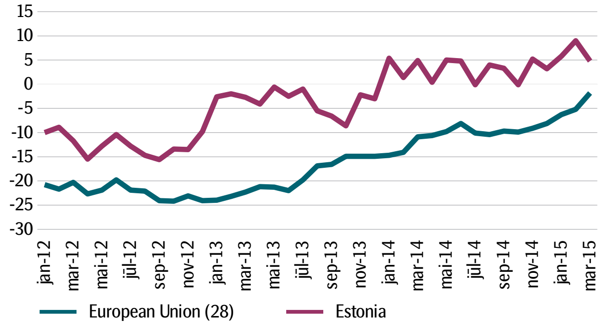
- Estonia is experiencing low inflation which it has not seen before; in January and February the average prices declined compared to the same period a year ago while the harmonised consumer prices in March 2015 remained at the same level than in March 2014. The main concern of households in Estonia has been the increasing prices and therefore the low inflation is a new situation for families. It might take some time for households to understand the implications of low inflation on their financial situation. Although the housing loans interest rates are at record low levels, the real interest rate is positive for the first time since 2004. Likewise, despite the marginal interest rates on deposits, the real interest rate is positive which is different from the 2005-2008 period, when the nominal interest rates were relatively high, still due to high inflation, the real value of the money on deposits diminished.
- The overall financial situation of households has improved; the increase of financial assets surpasses substantially the rise of liabilities. In 2014, the financial assets showed an increase of 11.8 per cent while liabilities increased by 2.3 per cent. At the end of 2014, the share of loans to assets was 1.3, meaning that the total loan volumes exceeded the liquid financial assets by 30 per cent. Households continue to accumulate their financial assets at a higher rate than will rise the debt volumes.
- The increasing real wages are accompanied by improved assessment of the financial situation by households. According to the consumer sentiment survey, the share of households who are able to save has increased steadily in the last years, although there are still more households who are not able to save compared to those who can (the balance was at -2.9 in March 2015). However, the households' assessments about their financial situation are higher in Estonia than in the EU on average, the average balance in the EU was -8.1 in March 2015. Similarly, the share of households who think that now it is a good time for durable purchases is increasing steadily, the balance reached to 9.0 in February 2015 and dropped slightly to 4.8 in March 2015. For comparison, the average balance in the EU was at -1.8 in March 2015. The assessments are consistent with the retail sales statistics in Estonia which indicate stable yearly real growth rate at 5-6 per cent while in February 2015 it was even higher, at 8 per cent.

Financial situation in the last 12 months



Source: Eurostat

Now it is a good time for major purchases



Source: Eurostat

Household's financial assets, liabilities and net asset value (EUR million)

mln EUR	2008	2009	2010	2011	2012	2013	2014
Financial assets	**5047**	**5554**	**6014**	**6410**	**7110**	**7783**	**8704**
Demand and overnight deposits	1635	1616	2054	2219	2649	3061	3554
Term and other deposits with maturity	1966	2076	1860	2110	2012	1897	1821
II pillar pension funds	707	917	1030	1090	1416	1709	2196
III pillar pension (Funds + insurance)	179	214	254	255	281	303	338
Other investment via financial institutions*	121	281	307	256	332	365	395
Other securities**	439	451	508	480	420	449	400
Liabilities	**8252**	**7940**	**7614**	**7402**	**7253**	**7287**	**7452**
Housing loans	6209	6111	5973	5882	5846	5896	6064
Consumer loans	856	765	671	599	608	591	603
Other loans	647	618	600	582	451	419	388
Leasing	539	446	370	338	348	380	398
Net value of financial assets	**-3204**	**-2386**	**-1600**	**-992**	**-142**	**496**	**1251**

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*