

The Baltic Outlook

Maris Lauri	+372 6 131 202	maris.lauri@hansa.ee
Vidmantas Saferis	+370 52 684 598	vidmantas.saferis@hansa.lt
Liene Kule	+371 7 024 162	liene.kule@hansabanka.lv

Macro Outlook

The Baltic Region

15. 07. 2005



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Abbreviations

CB – central bank

CEE – Central and Eastern Europe

CSBL – Central Statistical Bureau of Latvia

ECB – European Central Bank

EIER – Estonian Institute of Economic Research

EP – Eesti Pank (central bank)

ESO – Estonian Statistical Office

EU – European Union

HBM – Hansabank Markets

LaB – Latvian Banka (central bank)

LDS – Lithuanian Department of Statistics

LIB – Lietuvos Bankas (central bank)

MoF – Ministry of Finance

NFA – net foreign assets

REER – real effective exchange rate

Summary

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Maris Lauri +372 6 131 202 maris.lauri@hansa.ee

Economic developments in the three Baltic countries are very strong and although economic growth rates are about to decline they will remain strong for several years. Due to stronger than expected developments and increased estimates of the past we have raised our forecast for Estonia from 5.9% to 6.1% with the possibility that it might be increased further to 6.4% in the next two-three months. The Latvian and Lithuanian forecasts have remained the same – 7.3% and 6.8%, though the latter seems to be on the high side of the forecast range. We have not changed our expectations regarding 2006.

The growth in all three countries is based both on fast expanding exports and domestic demand. Exports of goods and services have grown rapidly, though every country has areas where stronger growth was expected, but it has been compensated by stronger than expected growth in other areas. As a general we expect growth rates to fall in foreign trade as changes in statistics took place in May 2004 when our countries became members of the EU.

Households are rapidly increasing their spending as incomes grow and unemployment declines. Very favourable borrowing conditions are also an important factor albeit that most loans are taken for mortgage purchases or real estate renovation. That means additional support for investment growth, which is already benefiting from business investments for expansion and modernisation, as well as from increased public sector investments in road building and social projects.

Strong domestic demand has its setbacks – imports are strong though their growth is now falling behind exports growth, and inflation remains strong and threatens euro adoption in all three countries. Growing fuel costs and currency fluctuations (in Estonia and Lithuania – euro weakening vs. dollar, in Latvia – adjustment process after currency peg to euro) are additional factors behind price growth. As a result, our inflation forecast is raised for Latvia and a little for Estonia, but cut for Lithuanian consumer prices as so far local price level have well resisted to price pressures.

Current account deficits remain large, though falling, as in addition to rather strong imports the outflow of foreign

investors' earnings grows. Monetary transfers from EU funds have remained relatively small, as project handling has turned out to be a slower process than had been assumed previously and most of the big projects are in the beginning phase (EU financing usually takes place after a project is finalised). Most of the monetary transfers have been reported under capital account, not in transfers account as we expected – hence current account deficits are only little better than we forecast (exports growth has been stronger). However, the current account combined with capital account shows much better developments, which are close to our previous forecast. We expect that current account deficits combined with capital accounts will result in a deficit of less than 6.5% of GDP in Estonia, 7.3% in Latvia and 7% in Lithuania.

Two conflicting processes influence public sector fiscal situations. Although tax revenues are better than expected, as economic growth is strong, governments are looking for their electorate (especially if elections are coming). Consequently those extra revenues (or more) are spent on various social areas, which grant popularity. As a result, we do not expect budgetary situations to improve. In Estonia we forecast fiscal deterioration, as the fiscal surplus will be replaced with the deficit, which may exceed 1% of GDP if the current economic policy is followed.

Summary of Forecasts				
	2003	2004	2005f	2006f
Economic growth				
Estonia	6.7%	7.8%	6.1%	6.0%
Latvia	7.5%	8.5%	7.3%	6.8%
Lithuania	9.7%	6.7%	6.8%	6.5%
Inflation (GDP deflator)				
Estonia	2.1%	3.1%	3.3%	3.2%
Latvia	3.4%	7.3%	5.8%	4.8%
Lithuania	-0.8%	3.0%	2.9%	3.0%
Current account balance, % of GDP				
Estonia	-12.1%	-12.7%	-10.2%	-8.5%
Latvia	-8.2%	-12.3%	-12.2%	-10.1%
Lithuania	-6.6%	-7.2%	-8.0%	-8.5%

General Assumptions

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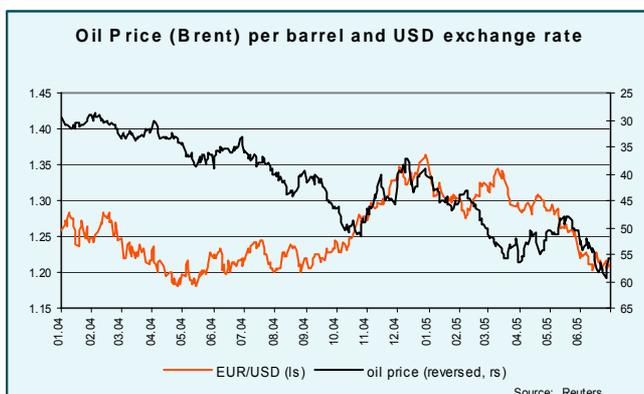
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Global economy

- The global economic outlook is still inconsistent, although growth rates seem to be slipping to some extent. The developed world is troubled by expensive fuel and the greater competitiveness of developing economies. The European economy is still unsteady as economic reforms are at a standstill, and growth rates in developing countries have started to decline due to higher comparison base. Analysts and market players are in growing confusion trying to find answers to what is going on. There are plenty of opinions, but they often seem to lack credibility or are unconvincing in forecasting long-term developments.

	GDP				CPI			
	2003	2004	2005f	2006f	2003	2004	2005f	2006f
USA	3.0	4.4	3.6	3.3	2.3	2.7	2.8	2.7
Japan	2.1	1.9	1.0	1.8	-0.3	0.0	-0.1	0.3
Eurozone	0.7	2.0	1.3	1.8	2.1	2.1	2.1	2.0
Russia	7.3	7.1	5.4	4.5	13.7	10.8	11.5	11.0

- The price of oil has got the most attention, but the US dollar, the US economy, interest rates and the Chinese economy are important as well. Analysts of the European economy hope that the recovery will come, but their hopes also carry the disbelief and hence the few optimistic forecasts sound unconvincing. The poor situation in the biggest and wealthiest Western European countries is overshadowing developments in the smaller and more dynamic economies of the Union, although these countries can get backing from domestic demand and growing competitiveness in the markets of their western neighbours. The economic situation in Germany, Sweden and Finland, which are important for the three Baltic countries, is not good, but local producers have increased their activity in other markets, and survived and flourished.



- News of repeated new record oil prices is also pushing up future expectations; but it seems that explanations for the growth are becoming less convincing and

weaker. The shortage of production capacity, which is the result of poor investments in the past, and growing demand from China and India are stronger and frequently indicated reasons. However, reference to speculative growth is becoming more frequent. All this results in long-term forecasts being incredible pessimistic or vague. Still, the market consensus is that in the short term there will be no lower prices, though short-term fluctuations might be extensive. The positive thing is that the global economy has so far survived these high oil price levels much less pain than had been assumed. But certainly, every new price level high will affect economic developments more than the previous one.

- Inflation expectations are contradictory due to different assessments of global economic developments. It is expected that the Federal Reserve will increase interest rates in future (by 0.25-0.5%), but weak economic data, if released, will definitely slow the process. Expectations regarding interest rates in the euro zone have stabilised for now – in May several analysts and market players expected that the ECB would ease monetary policy, but now this expectation is buried. The market rates have recovered, as a sunbeam of growth has shown itself in Germany (stronger exports, and a slight recovery of retail sales) and the policymaker has been very determined about not cutting rates. However, an increase in the interest rate is far away. The generally weak economic situation and stable 2% inflation (oil prices are among the most important factors) suggest that interest rates might be increased only in the 2nd half of 2006.

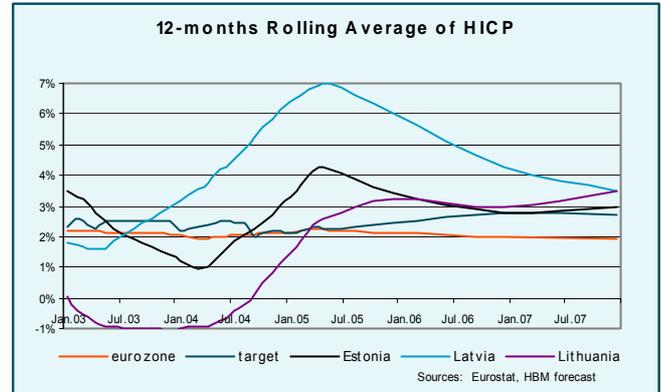


- The political failures in the EU at the time when several not very good economic figures were released, while the USA reported much better data, resulted in a rather sharp weakening of the euro and strengthening of the dollar. Immediately expectations emerged that the dollar will continue to strengthen exceedingly fast. But we are of opinion that there are several factors that still

threaten growth in USA. The slow recovery in Germany is also factor contrasting it. The weakening of dollar in the last year and a half was strongly related to the double deficit problem, but the latest data points to stronger real exports growth vs. real imports growth. If this process continues, the growth of the current account deficit might start to slow and the problem of the double deficit will lose some of its attractiveness. That in turn should support the dollar. However, we are of the opinion that competitive issues should be considered, as well as consumer spending and inflation movements in the USA and world.

- Domestic policies in the three Baltic countries have not eased their pressure on the economic outlook, especially in Estonia. Additionally, future membership of the euro zone and inflation are main topics. Economic policy has become more populist with less focus on long-term issues. The fulfilment of the Maastricht inflation criterion is problematic in all three countries, and this mixes with political themes, especially as price increases are highly unpopular with the electorate. The need to cut inflation and the shortage of available economic policy measures (the only practicable measure is to follow a strict fiscal policy with a budget in surplus, but this is politically unpopular) has created more or less Utopian or absurd suggestions. We are of the opinion that such suggestions, which often mirror the weak economic

background of politicians, will be not realized, but we are very certain that governments' policies will remain indirectly inflationary rather than restrictive.



Elections Time Shedule	
Estonia	
Presidential elections	September 2006
General elections	March 2007
Local elections	October 2005
Latvia	
Presidential elections	March 2007
General elections	October 2006
Local elections	March 2009
Lithuania	
Presidential elections	June 2009
General elections	October 2008
Local elections	February 2007

Estonia

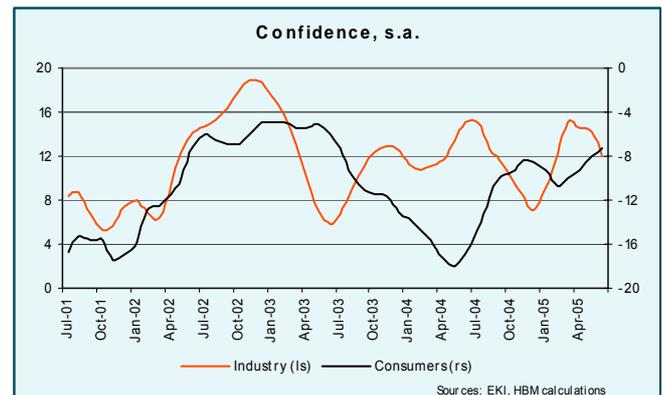
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Latest Economic Developments

Estonian economic developments in 2005 have so far been better than expected. 7.2% growth in the 1st quarter was definitely a surprise as was the growth in both domestic and external demand. The growth of investment was also slightly faster than had been assumed, but according to current data exports of services expanded less than we expected. The current account deficit was bigger than we forecast, but if taken together with capital transactions, which cover the most of transactions related to EU funds (we expected them to be reported mostly under the current account's transfer account), the deficit was as expected. Inflation has not brought any surprises, industrial production has grown faster than forecast and unemployment has until recently been falling fast. Budgetary developments have been slightly weaker than we

forecast, but the takeover of Hansabank created a very high inflow of foreign direct investments.



Highlights of the 2005-2006 Forecast

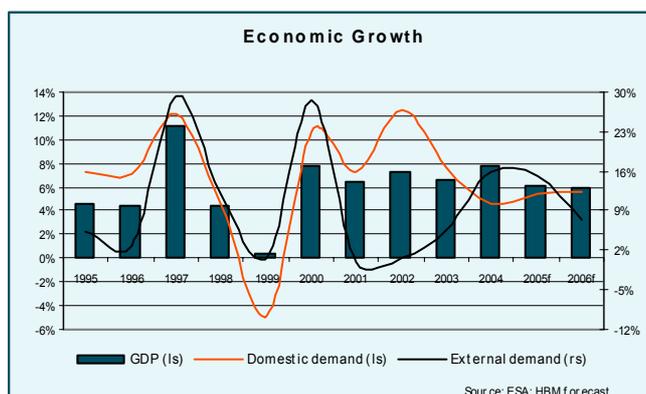
We have raised our economic growth forecast from 5.9% to 6.1% for this year, but retained the previous 6% estimate for 2006. We are also of the opinion that the risks both for weaker and stronger growth exist. In the 2nd half of the year export growth might suffer from a higher comparison base. Risks are also mounting from the high prices of oil and other raw materials, and from rather weak economic growth in Finland, Sweden and Germany, which are the most important economic partners. Additionally, rapid price growth might endanger growth in some sectors. However, as consumption is strong and investments are growing a 6.3-6.4% growth of GDP cannot be overruled. However, if developments follow the negative scenario, growth may reach only 5.6-5.7%. Currently we are more inclined towards a stronger growth outlook, and expect modest price

growth (3.4%) and a declining current account deficit (10.2% of GDP).

	2003	2004	2005f	2006f
Economic growth	6.7%	7.8%	6.1%	6.0%
GDP, mIn EUR	8138	9043	9900	10850
GDP per capita, EUR*	6012	6704	7370	8100
Industrial production growth	11.1%	7.9%	9.6%	8.9%
Inflation (GDP deflator)	2.1%	3.1%	3.3%	3.2%
Average growth of consumer prices	1.3%	3.0%	3.4%	2.7%
Average growth of HICP	1.4%	3.0%	3.4%	2.7%
Average growth of producer prices	0.2%	2.1%	1.9%	1.0%
Unemployment (ILO, national)	10.0%	9.6%	9.3%	8.6%
Harmonized unemployment	10.2%	9.2%	7.9%	7.2%
Average growth of real gross wage	8.2%	4.6%	6.5%	5.9%
Goods and services exports growth	9.0%	17.2%	15.5%	10.4%
Goods and services imports growth	9.7%	16.9%	12.0%	8.8%
Trade and services balance, % of GDP	-7.6%	-7.8%	-6.0%	-5.0%
Current account balance, % of GDP	-12.1%	-12.7%	-10.2%	-8.5%
FDI inflow, % of GDP	10.1%	9.3%	19.0%	8.6%
Gross foreign debt, % of GDP	68.7%	81.2%	75.0%	83.0%
Public sector budget balance, % of GDP	2.4%	1.7%	-0.4%	-1.2%
Public sector gross debt, % of GDP	4.7%	4.1%	4.0%	4.5%

*HBM estimates

Economic Growth



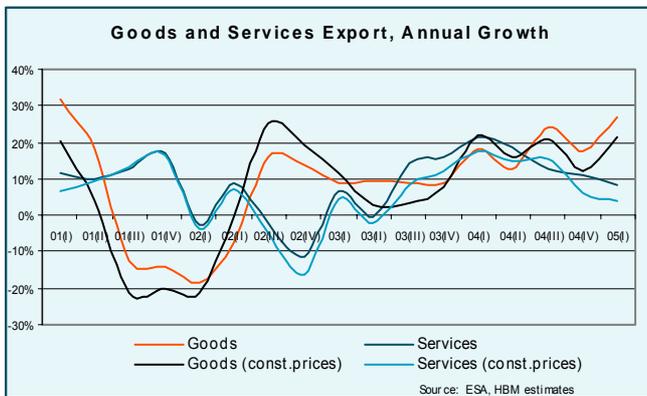
We have increased our economic growth forecast for 2005 to 6.1% due to strong consumer sentiment, which is

supported by declining unemployment and growing wages. We have, to some extent, taken into account some negative factors (stronger inflation, stabilisation of unemployment), but if they do not operate strongly (as we currently assume), growth might easily reach 6.4%.

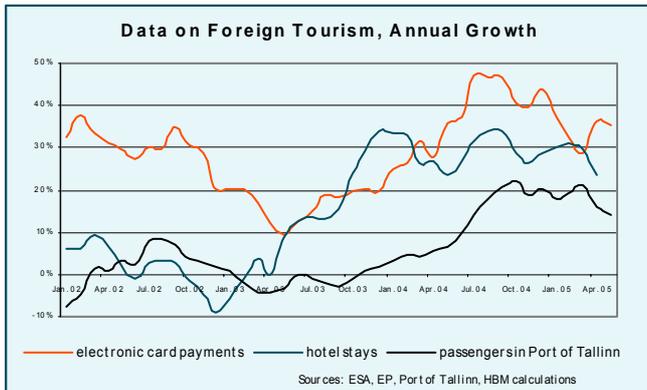
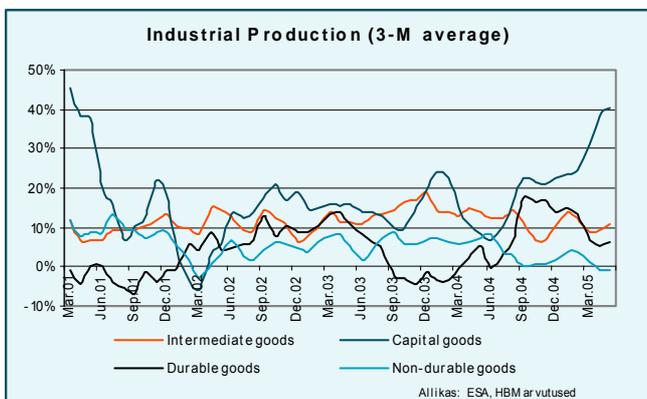
External Demand

External demand has grown fast despite the weakness of the EU economy. Estonian exports grew by 21.3% y-o-y in the 1st quarter (16.2% in constant prices) but there is a high probability that in the 2nd half of the year growth will be smaller due to the higher comparison base. However, our estimates suggest that Estonian exports might grow faster than 15% this year (17.2% in 2004). We are especially fascinated by the goods trade – in the 1st half of the year growth should exceed 20% (26.8% in the 1st quarter) but decline to ca 14% in the 2nd half. The growth will get

support from customary areas – the production of machinery and equipment, chemical and metal products will add the most, but modest growth in traditional sectors (the food industry, and production of wood, timber and paper products) give the base. However, we forecast that in the textile industry even minor growth will be a success.



It is hard to believe that service exports will grow faster than 10% due to competition. The growth of transport services exports will grow relatively strongly, but due to capacity shortages and very tight competition profits will grow only a little. Growing expenses, especially for fuel and labour, are making it difficult for companies to survive and we are of the opinion that competition for market share will soon lead to consolidation in the sector. For Estonian companies salvation might come from the high price growth of service imports, which will probably end with slower growth of imports in the 2nd or 3rd quarter.



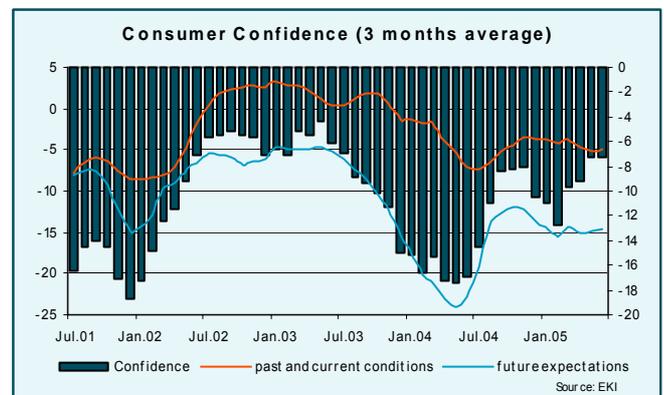
Regarding exports of tourism services we maintain a different opinion from the official one. We are of the opinion that part of non-residents' spending is still

accounted among residents' consumption (hence household spending volumes and growth is slightly overestimated). It is hard to believe that 20-25% growth in tourist numbers and ca 35% growth of the turnover of card payments (the use of cash has not increased much by non-residents) will result in 7.7% growth in the export of services. So we expect that the current figures will be upgraded. We forecast that exports of tourism services will grow less in the 2nd half of the year (base effect), and although it will remain strong, the slowdown of growth rates is inevitable. There might be positive impacts, if new air or ferry lines are opened but we see this as unlikely in 2005.

Household Incomes and Consumption

Household Incomes

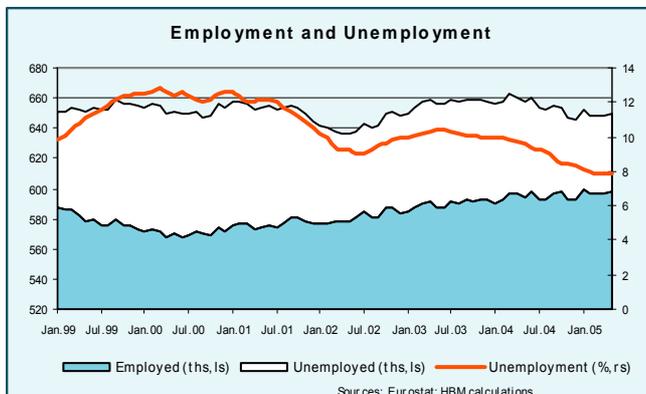
Estonian consumer confidence is very strong: growing employment and wages and favourable monetary conditions have supported growth in both consumption and savings. The relative calmness of domestic policy in recent months and receding fears regarding EU accession have raised consumers' moods and led to positive developments in the economy. However, households are significantly concerned about the relatively long period of high inflation and even though the price level has not yet undermined consumption, some services and goods are already exceeding or are about to exceed the sensitive limit of prices.



The level of unemployment in Estonia is more dependent on labour supply than on employment and as the labour supply is about to decline in the long-term, the decline in unemployment is written into every long-term forecast. Still, the short-term baby boom in the late 80ies and early 90ies is now started to supply more new blood to the labour market. The birth rate is growing so is the outflow of labour to other EU countries (so far small). Younger pensioners and early-retired persons are the only source to increase the labour supply and activity rate in the short and medium term.

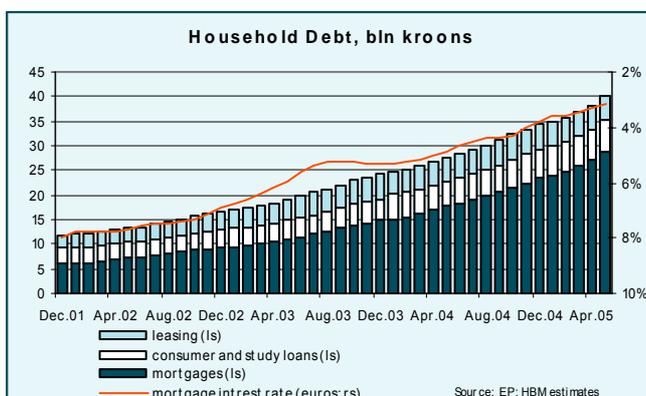
Growing employment assists the decline in labour supply, but it has recently receded. The shortage of labour and the related wage growth are to blame. Employment figures are also affected by structural changes in the economy – though the re-education process has considerably improved, the time lag between demand and supply still exists. We expect that in industries where employment has recently grown faster than productivity and turnover, a short-term

correction will occur (i.e. employment growth slows). Employment is expected to grow most of all in the services sector and construction, and probably also in budgetary sectors, while in manufacturing it will decline as production structure changes and productivity grows.



Wage growth will intensify as long as the gap between labour demand and supply exists, and it is impossible to increase productivity or investments quickly. Wage growth is also supported by other factors – the higher minimum wage, increased inflation, stronger trade unions, and EU membership, as this has encouraged employees to compare wages in Estonia with those in other EU countries.

In addition to growing wages other household incomes are growing too. The situation in internal policy encourages politicians to offer different favours to the electorate – e.g. cuts in tax rates and increase in tax incentives, and the increase of maternity leave payment and pensions. As more Estonians are working abroad the monetary transfers from the rest of the world have increased. So far the outflow of labour has been smaller than expected and mostly seasonal, but it will definitely increase and become long-term and permanent. We do not expect an inflow of labour in coming years except in some very specific professions (e.g. highly qualified welders from Ukraine).



Borrowing and Saving

Household consumption also gets support from higher leverage. Although most borrowed money is used for investments (purchase and renovation of real estate), some of the money will eventually run into consumption. The forecasting of household borrowing has turned out to be thankless business in the past as interest rates have continued to fall and very aggressive competition for

market share has cut interest margins to minimal levels. Still, the decline of interest rates is becoming more and more difficult to maintain and lending growth should start to decline eventually. One reason could be the higher comparison level. Also, we can assume that families who have only recently purchased a new house will not immediately run for a new and more expensive house if they get an income increase. The chances are bigger for owners of new apartments that they might look for better living conditions and higher leverage. But we also can count several reasons, why the lending activity might remain strong.

- Analysts and economists have been talking two years about the declining number of families who can qualify for a mortgage, but fast growing incomes and good economic outlook urge families with so far relatively low incomes to take loans (they assess future risks as low).
- There has been very aggressive wage growth in budgetary sectors in recent years and that is set to continue. But wages in those sectors have only recently reached levels which allow those employed there to take loans.
- Loans are also growing because of the fast growth of real estate prices – families will not give up their real estate purchase if they have decided to purchase a property and the price has grown during the hunting time but prefer to take higher loan instead.

The bigger incomes have not only been used for consumption – savings are also growing rapidly. The pension reform with its 2nd and 3rd pillar (compulsory and voluntary insurance) is an important contributor. Lower inflation and growing debt burden – ownership of real estate increases life insurance premiums – are also factors, which allow savings to grow.



Consumption

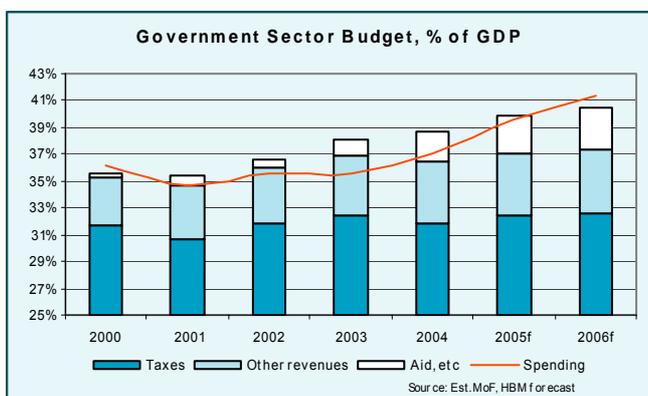
The structure of household consumption continues to change – while services are growing very fast, spending on goods slower. As has happened with mortgages the consumption of goods and services seems to grow by itself – as expectations for strong economic and income growth are long-term (10 or more years) companies are not hesitating to expand their businesses and new-comers are entering in the market. This has created the situation where

supply grows faster than demand and due to strong competition prices grow slowly. That encourages spending and attracts more new-comers. Development, however, is not uniform – in some areas where supply is more dependent on the local labour supply or where in addition to domestic demand there is significant external demand (e.g. in form of tourism), supply often falls behind demand and prices are growing very fast thus cutting fast growth of the domestic demand. We are of the opinion that the “knife edge” businesses (in the sense of domestic demand) are now construction, renovation and various maintenance works, but also some real estate services and some leisure services.

The fact also is that some food and consumer goods have higher prices in Estonia than the EU average (e.g. clothing), especially if purchasing power is taken into account. A surprise is that Chinese cheap imports have not had any impact on supply or prices in the Estonian domestic market as has happened elsewhere in Europe. If the situation remains, consumption growth in this sector will be very modest.

Government Spending and Policy

We have not changed our opinion regarding the Government’s economic policy – it is very populist and lacks any clear targets besides an election win. We are of the opinion that several steps taken or planned are destroying the economic policy path created in the last decade or more. However, we do not expect changes to appear, at least not before local elections in October. So our forecast includes growth in spending supported by one-off revenues (selling state property, increased dividend payments from state companies). Such a policy may end in a chronic budget deficit after several years (if it continues till to general elections in March 2007). The only way to overcome this problem then is to trim spending, which however will mean cuts in investments and social spending. As the latter is very unpopular with electorate, politicians will avoid such a decision for as long as possible and Estonia might find itself in the same position as Germany and France today. So we have to hope that Estonian parties will understand that to increase spending you must have stable and growing revenues at first.



As our April analysis suggested the government has to take loans, increase taxes, privatise or cut spending to its promises. Talks about increasing taxes have been several

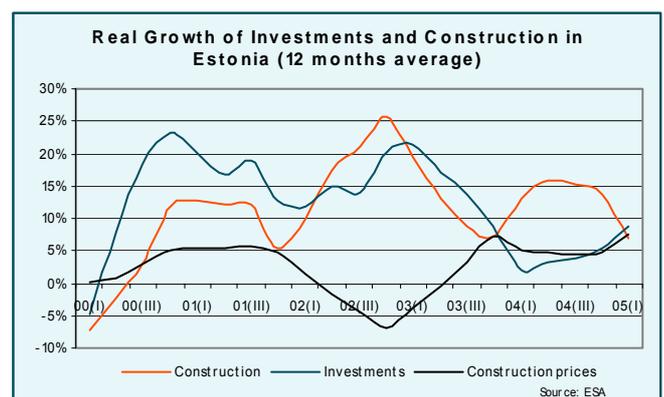
times on the agenda in the last two months and besides fuel excise increase, which have been dropped, and social tax where minimum payments will be increased, the so called environmental tax reform still hangs in the air. Probably some kind of compromise will be found and environmental taxes (natural resources’ tax) will be increased somewhat faster than was planned a year ago. While large-scale privatisation has been over for some years, the government plans to sell property (real estate, incl. land) rather extensively.

There is no information regarding cuts as the budgeting process is still at a very early stage and the discussion of such a sensitive theme might undermine the government’s popularity ahead of the elections. However, political discussions suggest that the growth of some spending is frozen or will be smaller than needed, which means that the shortfall will be paid by consumers and enterprises (e.g. some health services). This means higher prices and lower consumption.

The government has not talked about loans much, but our calculations point to the need to borrow in the next year, or at the best case in 2007. The financing of the pension reform is one reason, but with the existing growth in spending the need for extra money will emerge in the areas of health care, education and road building, and there is also the need to refinance the Eurobond in the summer of 2007. So while this year public sector debt will fall rather fast, in 2006 it will start to grow.

Investments

Cheap loans, good profits, growing incomes and demand are the main supporters of quite rapid investment growth. The money from various EU funds has so far been important only for some companies and sectors, but their importance will increase as early as this summer.



- Households continue to invest in real estate mostly supported by cheap loans and growing incomes, while growing prices are working against the growth. We are of the opinion, that due to high and growing prices real estate development might face a setback in volumes in 2006, but probably not in turnover and profits. The increasing number of foreign investors entering the Estonian real estate market might ease the situation, but at the same time, with every new foreign player,

the risk is increasing that they will not earn the fast profit they were looking for.

- Enterprises are investing in machinery and equipment and in buildings and engineering. Reasons to invest are growing demand and good future expectations together with the labour market situation and forecast. Enterprises are clearly placing the emphasis on more intensive production and employing highly qualified labour.



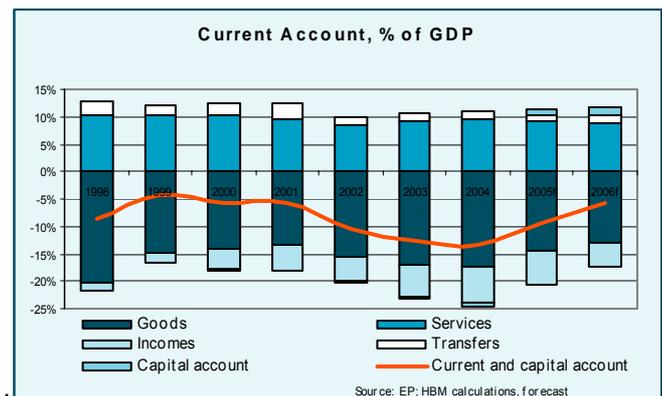
- The public sector will invest mostly in road building and social projects (schools, health facilities). Of the state companies the Port of Tallinn is about to start significant investment – building a new deep-sea port on the island of Saaremaa (mostly for tourism business). Estonian Energy (Eesti Energia) is planning to continue its renovation works in the Narva Power Station.

External Balance

The current account deficit should continue to fall – especially due to better trade balance. The developments in

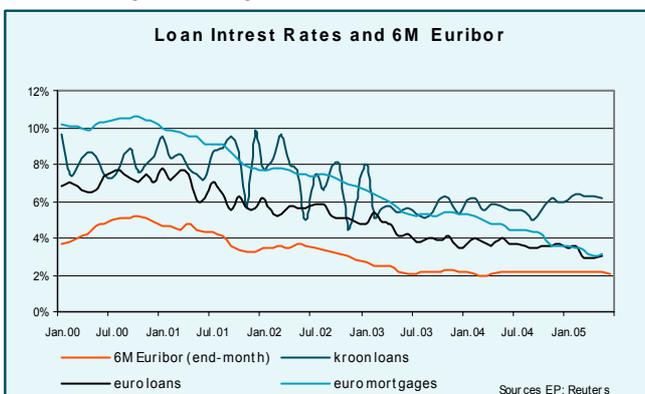
the services account have been unfavourable – imports have grown faster than exports, but we expect that the next 12 months will bring a change. Firstly, we are of the opinion that the export of tourism services is underestimated (see above). Secondly, import prices have grown very fast and consequently imports will lose at least one of its advantages.

The improvement in the income account has been faster than we anticipated, as foreigners' earnings in Estonia have grown less than we feared and Estonians' earnings abroad have grown faster than expected. The current account transfers balance was much smaller than expected as most of the EU funds were reported under the capital account (we expected the proportion to be the opposite). Due to the above-mentioned reasons we have slightly upgraded our current account forecast, and we see chances that in 2006 the outcome might be better than our current forecast expects. The positive effect of the capital account is ca 1% of GDP in this year and 1.2-1.5% in the next year. So the combined deficit of the current and capital accounts might fall below 6.5% in 2006 (11.9% in 2004).



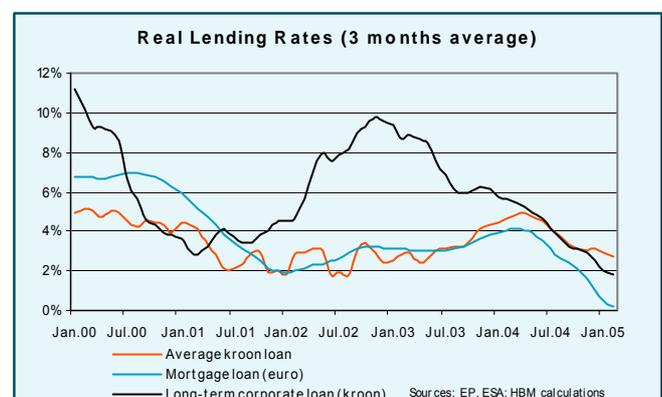
Monetary Issues

Monetary Policy and Interest Rates



We have not changed our opinion regarding monetary policy and interest rates in the last two-three months. We expect that Eesti Pank (the central bank) will start with a gradual easing of monetary policy to reach the 2% compulsory reserve requirement for the beginning of 2007 (if Estonia joins the euro zone, and current plans hold). We also expect that interest rates will stabilise, as there is no

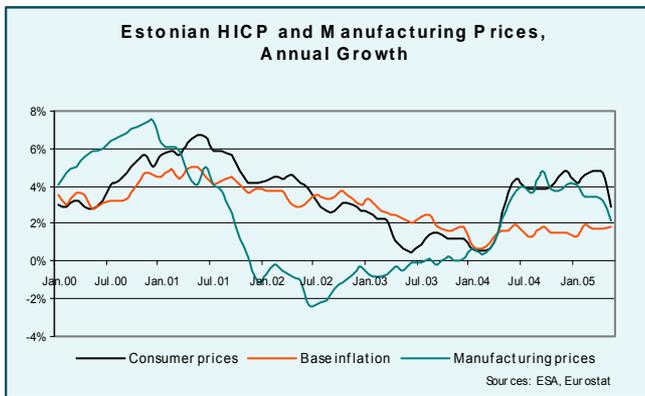
reasons to expect the ECB to cut interest rates and there is very limited room to cut interest rate margins. Real interest rates are growing as inflation slows, and we expect that in 2006 nominal interest rates will start to grow as will happen in the euro zone.



Inflation

Growing oil prices and the stronger dollar indicate that our previous 3.3% inflation forecast was slightly too optimistic. If we consider stable oil price and US dollar, and also

neutrality of domestic demand, then inflation might be only marginally stronger than had been assumed, i.e. 3.4%. However, there are some demand sided factors which will probably push inflation up to 3.5%, which means that if external factors are stronger than assumed (not stable but growing), inflation might reach 3.6%-3.7%. There are also chances that inflation in 2006 might be stronger than 2.7% (up to 2.9%). We have not included in our forecast the effects of possible increases of consumer taxes (excises, VAT) and additional social burdens (e.g. higher health costs). The growth of the harmonized index of consumer prices might be 0.1-0.2% bigger than domestic CPI as prices of goods and services meant for tourists tend to grow faster than domestically oriented prices (administrative increases of prices of utilities' and public transport services are rare ahead of elections).



Base inflation (inflation excl. food and energy) points to a slight quickening of price growth or demand effect. We are of opinion that in 2005 base inflation will remain below 2% and it will be slightly less in 2006, although currently demand sided factors are working in favour of higher price growth. Our optimism is based on the fast development of supply and the rather strong price sensitivity of local consumers. Growing incomes in some consumer groups (young families with children, retired persons) will affect few prices (e.g. real estate, repair works, child care, medicine and health services, some food products) but the overall effect will be minimal. We consider the government's tax policy as slightly inflation-pushing.

There are indicators that Estonia has chosen to follow the path towards the high price level of Nordic neighbouring countries, and not that of Latvia, Lithuania or Germany. There are several reasons for this. Finnish tourists are definitely importing the high prices of their homeland to Estonia. There are also allegations that Nordic companies are trying to introduce high price levels in Estonia, because they want to sustain the high price levels in their domestic market (so tourists from those countries will not make very big purchases in Estonia), or looking for very high profits here. If such a policy exists, (and it seems unlikely), it would work only if all or the majority of suppliers are Finnish and Swedish companies or where domestic demand is so far thin and currently dominated by Finns and Swedes. But there are very few such possibilities and if they exist at all, then newcomers will immediately emerge from Estonia and elsewhere to capture market share with lower prices.

Latvia

Baltic Outlook 15.07.2005

Liene Kule +371 7 024 162 liene.kule@hansabanka.lv
 Maris Lauri +372 6 131 202 maris.lauri@hansa.ee

Latest Economic Developments

After one year in EU the Latvian economy is continuing to develop successfully. Among the greatest achievements are good exports growth, strong inflow of FDI and stable investment activity. The core driver of the economy is still internal demand driven by consumption and investments. Notwithstanding, the negative sideeffect of strong internal demand and convergence with Europe is a substantial pick-up in price levels.

The latest GDP data of the 1st quarter of 2005 showed only slightly weaker results than expected – 7.4% growth (8.6% in the 4th quarter of 2004). Although the pace of output growth has declined, the attained levels can still be considered strong. The main weakness was in production sector (0.1% y-o-y manufacturing decline), but other leading sectors such as construction, trade and transportation and communication sustained high growth rates.

Highlights of the 2005-2006 Forecast

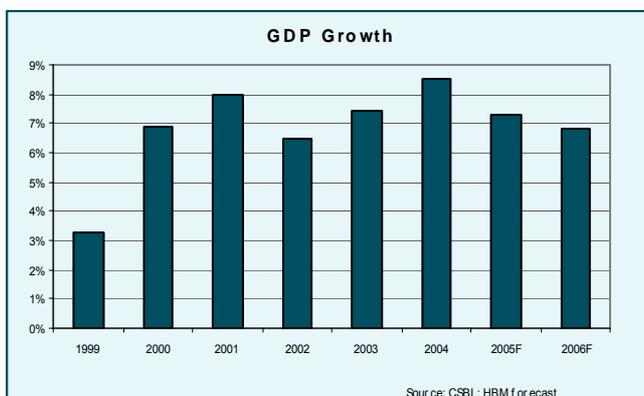
In 2005 economic growth might be lower than the previous year, i.e. 7.3% vs. 8.5%. For 2006 we expect further gradual convergence to more sustainable development (6.8% GDP growth). Both internal and external demand is contributing to growth. Although the budget is strongly in surplus, we expect the government to activate spending in the 2nd half of the year, resulting in a deficit as initially planned (~1.8% of GDP).

account deficit forecast as well as introduced a new indicator – CAD adjusted to capital account. Netted against EU fund inflows (capital account), CAD would be ~10% of GDP in 2005 and 7.4% in 2006.

Consumption has proved more resilient to inflation than we thought. This could have a second loop effect, i.e. further pressure on prices (increased consumer price inflation forecast for 2005 from 5.5% to 6.0%). Exports show strong growth, but we expect some weakening in the second half of the year. We have increased goods and services export growth forecast for 2005 and onwards. The imports forecast has had minor changes. We have increased our current

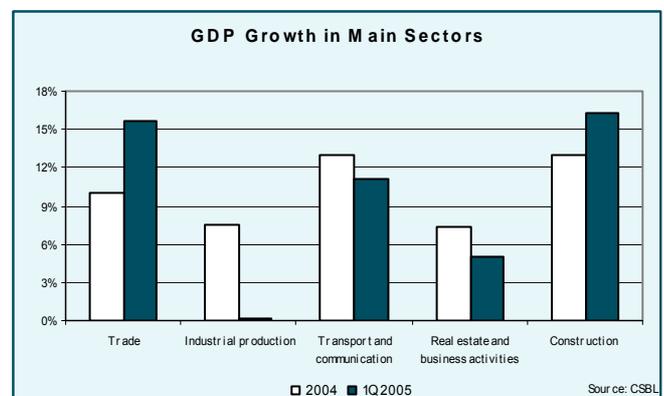
	2003	2004	2005f	2006f
Economic growth	7.5%	8.5%	7.3%	6.8%
GDP, mln EUR	9,802	10,968	11,888	13,306
GDP per capita, EUR	4,216	4,742	5,166	5,811
Inflation (GDP deflator)	3.4%	7.3%	5.8%	4.8%
Manufacturing production growth	8.0%	6.2%	6.0%	7.1%
Average growth of consumer prices	2.9%	6.2%	6.0%	4.3%
Average growth of HICP	2.9%	6.2%	na	na
Average growth of producer prices	3.2%	8.6%	9.0%	8.6%
Unemployment (ILO methodology)	10.6%	10.4%	9.7%	9.5%
Average growth of real wages	7.8%	2.4%	6.0%	5.0%
Goods and services exports growth	14.4%	20.5%	22.1%	22.0%
Goods and services imports growth	19.5%	25.8%	18.6%	15.9%
Trade and services balance, % of GDP	-12.8%	-15.8%	-15.1%	-13.1%
Current account balance, % of GDP	-8.2%	-12.3%	-12.2%	-10.1%
Current and capital account balance, % of GDP	-7.5%	-11.3%	-9.9%	-7.3%
FDI net inflow, % of GDP	2.4%	4.0%	4.4%	3.8%
Gross foreign debt, % of GDP	80.0%	93.2%	89.3%	90.0%
Government fiscal balance, % of GDP	-1.5%	-0.8%	-1.8%	-1.6%
Central government debt, % of GDP	13.4%	13.2%	14.2%	15.3%

Economic Growth



We maintain our GDP forecast for 2005 of 7.2-7.4% and for 2006 of 6.8%. Although the aggregate forecast has not changed, we have made some adjustments on a more detailed level. We have increased the domestic industry output forecasts (e.g. trade, construction), but revised downwards the projections for manufacturing in 2005. Within manufacturing the weakest sectors are textiles and

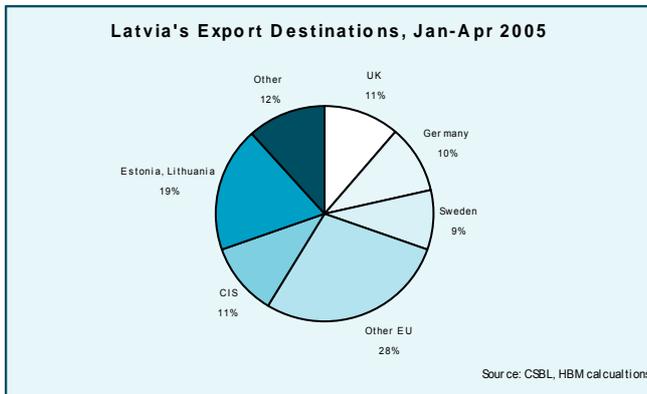
timber, also metal works showed a temporary decline (the situation should reverse in near future).



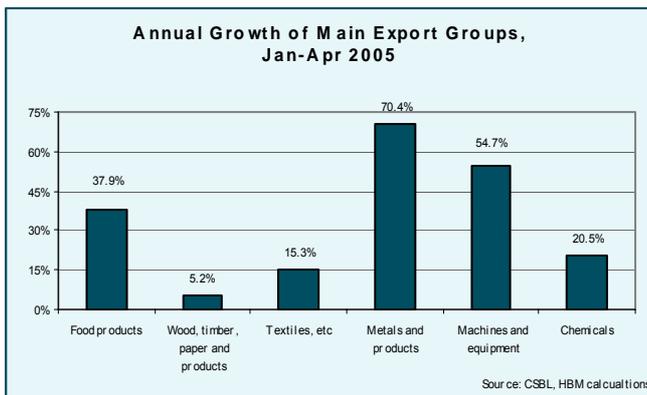
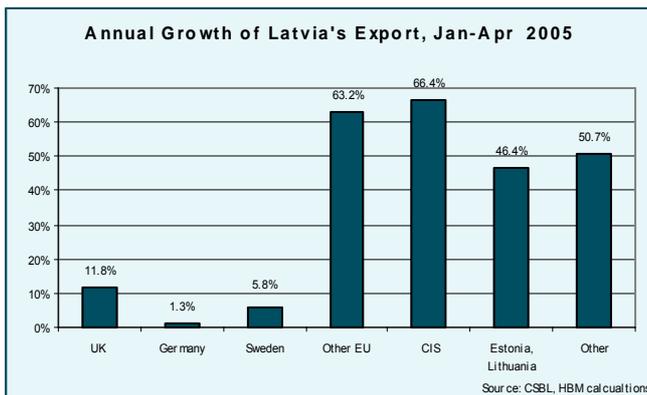
External Demand

Goods export growth (above 30%) has been better than expected: both CIS and EU10 markets have contributed to this while the traditionally dominating EU15 markets (e.g.

Germany) have been weak. As expected the wood and textile industries have been the weakest.



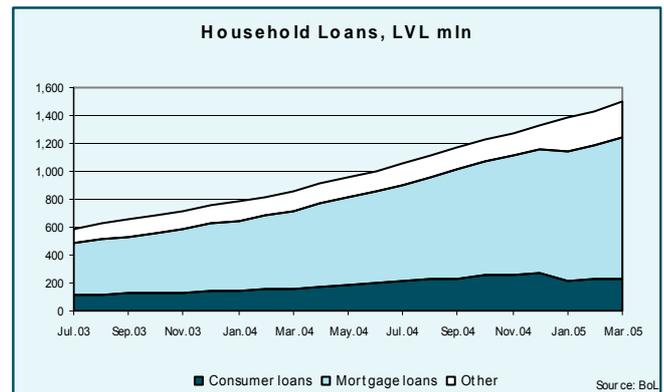
The caveat of the foreign trade data is the difference of methodology applied before and after May 2004, therefore the data dynamics are reliable only from May 2005, and we expect slower growth rates. However, we have revised upwards the 2005 export growth projections. Meanwhile, prospects of services exports are less strong, and we have revised the 2005 service exports growth downwards.



Internal Demand Household Consumption

No weakening of consumption could be observed in the 1st quarter. Thus we have upgraded our forecast for private consumption growth in 2005. Persistently high inflation has not discouraged consumers and retail sales continue to grow. Given the decrease in unemployment and improvement in incomes (after a pause, in the 1st quarter the real wages were up by 9.7% y-o-y), we expect active

spending by consumers. In addition, the banks are very competitive and eager to increase lending, thus the leverage of households continues to grow. Interest rates have declined (due to lower base and lower margins) and given the current inflation figure, the real rates are negative. Credit growth has exceeded our expectations, however, we estimate that by late 2005 growth should start to slow. We have revised downwards the unemployment forecast, but increased the projections for internal demand related industries.

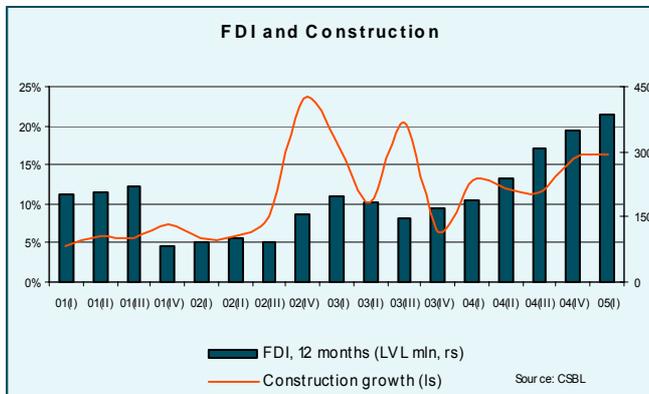


Investments

Although the preliminary data on the 1st quarter investments were rather weak (4% y-o-y real growth), we see some positive developments. Since the beginning of 2004 the significant investment driver has been FDI (net of 4.0% of GDP in 2004). Latvia's participation in the EU is definitely a good motivation for foreign investors to establish their presence here. Although a large share of the total FDI inflow is retained earnings, new capital additions have been very strong too. We have increased our forecast for net FDI inflow for 2005.

The inflow of EU funds in the 1st half-year has been slow since not many projects have been completed (and financing depends on that). The number of open activities has considerably grown in the 1st half of the year. At the end of June 68% of the planned EUR 850 mln funds were opened for applications and an additional 22% were in progress. As at mid 2005 EU structural fund projects for ~EUR 340 mln had been approved. We estimate that real investment activity must have benefited from EU project implementation both in the 1st and the 2nd quarter even the money flows from the EU have been insignificant.

Cohesion funds have shown far less progress: money inflows are small and implementation activity on the largest projects is slow. Among the main obstacles are rising construction prices, which make the preliminary project costs out-dated.



Government Spending and Policy

Currently, the situation regarding the state budget is positive. In Jan-May 2005 the consolidated budget revenues increased by 30% y-o-y, while expenditures advanced only by 25%. In the 1st quarter of 2005 the fiscal surplus reached LVL 61 mln (3.3% of GDP) and in the following two months grew further to LVL 111 mln. The main determinant of the strong revenues was the rise in dividend payments from state companies, i.e. non-tax revenues (e.g. the largest were A/S Lattelekom LVL 22.2 mln, A/S Latvian Forests LVL 12.4 mln). The EU fund inflows have been rather inactive with the five months inflows covering only 16.8% of the budgeted annual foreign aid.

In the first five months tax revenues increased by 22% y-o-y with the most active collections of excise tax, corporate income tax and VAT. Recently parliament rejected resolutions to reduce corporate income tax for small enterprises (currently 25%) and VAT on food products (from 18% to 5%); therefore, no substantial changes in the revenues from these items are expected to take place in the near future.

State budget growth, %	2003	2004	5m 2005	2005e
Total revenues	13%	19%	30%	18%
Tax revenues	11%	14%	22%	11%
Personal income tax	14%	19%	9%	na
Corporate income tax	-14%	36%	37%	17%
VAT	20%	6%	28%	19%
Excise	20%	12%	37%	9%
Custom	24%	-9%	0%	0%
Social tax	6%	14%	14%	9%
Non-tax revenues	16%	-20%	69%	-19%
Foreign aid	81%	214%	214%	215%
Current expenditures	12%	18%	25%	20%
Capital expenditures	27%	24%	12%	29%
Investment expenditures	-13%	3%	44%	86%

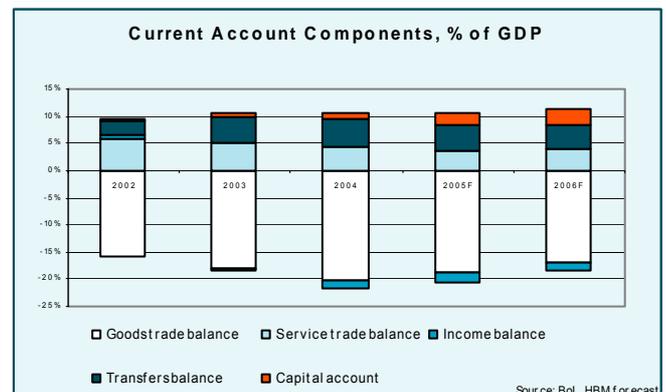
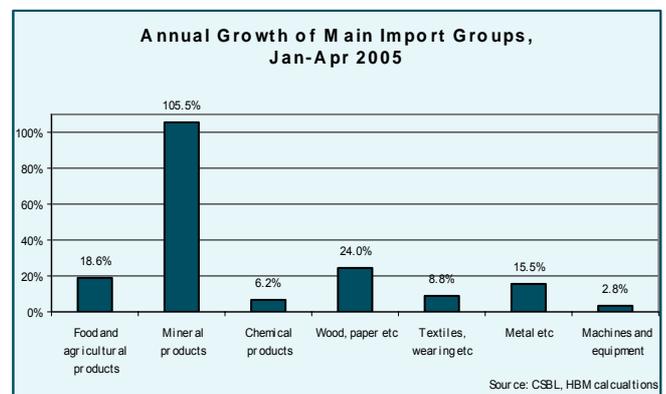
This year the Latvian government is planning to execute the privatisation of the Latvian oil company “Ventspils Nafta” with the intermediation of the Riga Stock Exchange. Currently the State owns a 38.6% stake in the company, and if the sale price is similar to the current market price, the state budget is expected to get additional revenues of about LVL 70-80 mln (almost 1% of GDP).

Nevertheless, we do not believe that the annual deficit this year will be much lower than our initial estimate of 1.8% of

GDP. The budget revision is still to take place and there are many areas that are demanding resources. The fiscal policy is expected to remain expansionary. Although no elections are scheduled until October 2006, the ruling coalition is very fragmented; thus, it would be difficult to implement socially unpopular changes. Recently the Ministry of Finance increased its budget revenue forecast for 2006 to LVL 2.9 bln. According to these projections, the expected budget deficit will be ~1.5% of GDP in 2006; we forecast that 2006 budget deficit stands at 1.6% of GDP.

External Balance

The current account deficit (CAD) increased to 10.7% of GDP in the 1st quarter. On the one hand, we saw an improvement in the goods trade, as export growth outpaced growth in imports and the trade deficit was relatively low. In April-May we expect a temporary slowdown in import activity, however, for the rest of the year strong investments (e.g. EU funds) and consumption will keep the imports growth close to 20%. On the other hand, the surplus of the services trade continued to decrease. The income account was negative due to high profits on non-resident investments. The transfers account was distorted by accounting for EU funds: these were mostly recorded in the capital account; this issue will be of high importance in the coming quarters with more active EU fund inflows. Therefore, we have included in our projections adjusted CAD forecasts that include the capital account. We project that the CAD summed to capital account would 10% of GDP in 2005 and 7.4% in 2006 (the ‘pure’ CAD could be above 12% and 10% of GDP).



The current account deficit will be financed by FDI, EU fund inflows and other capital. Banks will be the dominant

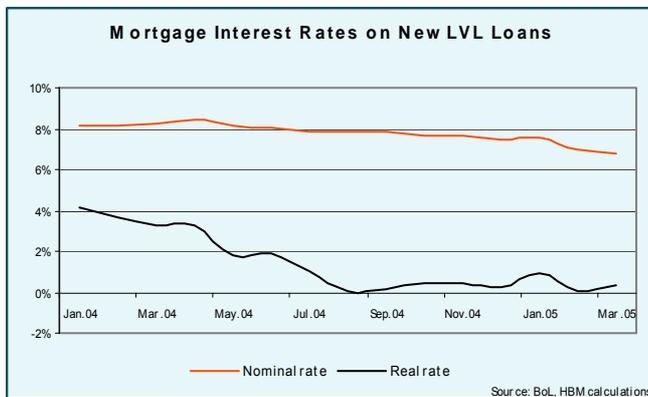
intermediates for other capital (borrowing from parent banks or directly in the international capital markets). The intensification of anti-money laundering activities is most likely to result in significant outflows of non-resident deposits. Nevertheless, this will have limited effect on the

economy since these liabilities are most frequently associated with foreign assets. Thus the outflow of non-resident deposits could decrease gross external obligations but have no substantial effect on net external debt.

Monetary Issues

Monetary Policy and Interest Rates

In May 2005 Latvia entered ERM2. We see it as a step closer to the implementation of the euro. Nevertheless, the prospects of euro adoption by 2008 are clouded by persistently high inflation. We still are of the opinion that EMU membership in January 2008 is achievable, though this requires either an improvement in the economy (prices) or in official EU demands (softening of Maastricht criteria on inflation).



Six months after the lat peg to euro (01.01.2005) we see a substantial impact on financial markets of the currency system change. During the 1st half of the year lat interest rates have converged with euro rates: now the gap is mere 70-80 basis points versus an initial 2 percentage points. Over the next 2 years lat interest rates should decrease still further.

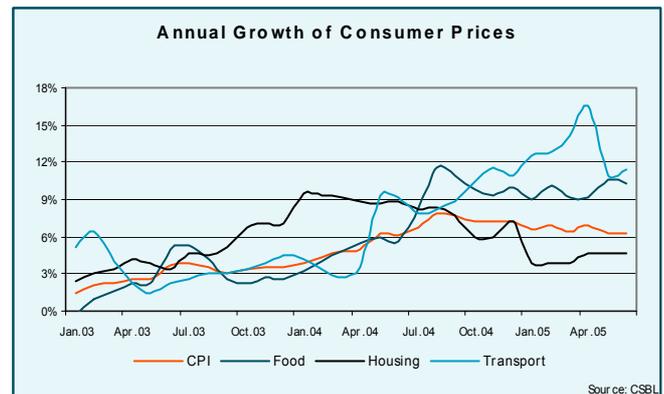
The role of the euro has grown in several markets: most real estate prices are now quoted in euros (previously in dollars) and most of the lending to households is in euros. Active borrowing in euros (both locally and internationally) ensures a large demand for lats in foreign exchange market. The central bank has performed multiple and large-scale intervention in the market in order to prevent the lat from appreciating above the set fluctuation band. The Latvian lat remains very strong relative to the peg rate.

Inflation

In June the annual CPI rise was 6.3% (May HICP was 6.5%), producer prices rose even steeper. Moreover, the GDP deflator (in the 1st quarter) shows a similar pattern.

Consumer price inflation has not declined as fast as expected in 2005. Several external factors (e.g. high oil prices, and the relatively high EUR/LVL peg rate) have

contributed to price growth. Along with the integration of neighbouring markets the food prices are continuously rising (annual change of over 10%). Given high weight of food in the consumption basket, this has considerable effect on CPI. The administrative price changes have been of less importance in the 1st half of the year (except high inflation in health care), though we expect increasing pressures in the 2nd half. Approval of new gas tariffs (rise in period 2005-2007) will also have a substantial indirect effect both through heating costs and through general inflation expectations. Inflation in other sectors is substantial and we believe that this is indicative either of strong purchasing power or considerable inflationary expectations, or both.



Given the current trends and strong internal demand, we have raised our CPI forecast to 6% for 2005 (previously 5.5%) and to 4.3% for 2006 (4.1%). Although the government has expressed willingness to tackle inflation, it might have insufficient political will to do so. Although general elections are more than one year away, politicians are already wary of making unpopular decisions. The main remedy for inflation is to remove inflationary expectations in society as a whole. At the moment we see two general lines of action:

- 1) the government should clearly communicate the expected administrative price changes (uncertainty in the area of regulated prices is a ground for speculation and further increases inflation fears);
- 2) the government should define which budget areas are of less importance and where efficiency improvements are possible (although several expenditure areas are socially critical, the large budget deficit is unacceptable).

Lithuania

Baltic Outlook 15.07.2005

Vidmantas Saferis +370 52 684 598 vidmantas.saferis@hansa.lt
 Maris Lauri +372 6 131 202 maris.lauri@hansa.ee

Latest Economic Developments

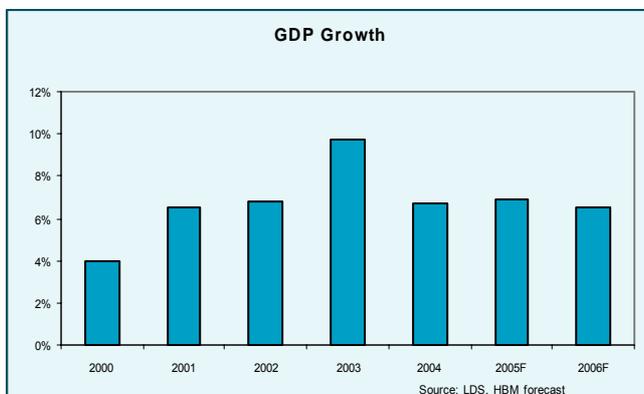
The growth of the Lithuanian economy in the 1st quarter of 2005 reached 5.7% and was below our forecast for the full year (6.8%) or the last year GDP growth (6.7%). Consumer price inflation has decreased to 2% in June, as the momentum effect of the price increase upon entering the EU has largely faded. Our inflationary expectations have also decreased for the nearest months. Export markets have been very favourable for food products, mineral products and fertilizers, however the growth in imports is also very strong. The economic sentiment indicators have slightly improved from previous years, especially in the construction sector. We consider our GDP forecast for 2005 to be in the upper range of the likely outcomes (6.4-6.8%), however we choose not to downgrade the forecast but rather to monitor developments in domestic demand over the coming months. We expected domestic demand to lead economic growth in the next several years, which is not fully supported by the 1st quarter results, therefore in the following chapters we will concentrate on household

consumption and government related issues (including tax reform). As the forecast (with the exception of that for inflation) remains unchanged from the previous Baltic Outlook, other topics will not be discussed in detail.

	2003	2004	2005F	2006F
GDP, %	9.7%	6.7%	6.8%	6.5%
GDP, mIn EUR	16271	17927	19700	21600
GDP per capita, EUR	4711	5218	5850	6570
Industrial sales, %	16.1%	12.4%	8.0%	7.0%
Inflation (GDP deflator), %	-0.8%	3.0%	2.9%	3.0%
CPI average, %	-0.2%	1.2%	2.8%	3.0%
PPI average, %	-0.5%	6.7%	4.0%	2.5%
Unemployment (ILO), %	12.4%	11.4%	10.0%	9.0%
Average real wages, %	7.8%	3.7%	6.0%	9.0%
Goods and services exports, %	6.2%	12.1%	8.5%	9.0%
Goods and services imports, %	6.9%	12.8%	10.0%	11.0%
Trade and services balance, % of GDP	-5.8%	-6.3%	-7.2%	-7.5%
Current account balance, % of GDP	-6.6%	-7.2%	-8.0%	-8.5%
FDI inflow, % of GDP	1.3%	3.3%	3.7%	4.5%
Total external obligations, % of GDP	40.5%	42.2%	43.0%	44.0%
Government fiscal deficit, % of GDP	1.2%	1.4%	2.5%	2.4%
General government gross debt, % of GDP	21.4%	19.6%	19.0%	19.0%
Interest payments over exports, %	3.0%	2.5%	na	na

Economic Growth

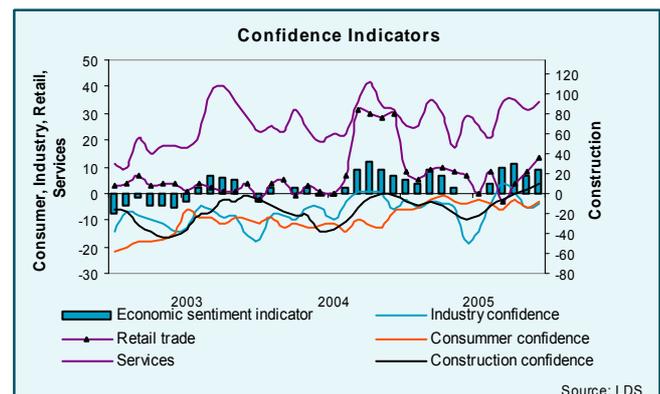
The domestic growth drivers of the economy in the 1st quarter were investments (total gross capital formation grew 21.4%), while household consumption (4.8%) and government spending (2.6%) were considerably weaker. Household consumption grew on a very strong comparable basis of the 1st quarter of 2004 (13.3%) as did government spending (8.3%), and this may be a part of the explanation. However, the situation has lately been very dynamic in both areas, which need to be considered separately. As we see it, both areas suggest a stronger growth in domestic demand in the near future.



Household Income and Consumption

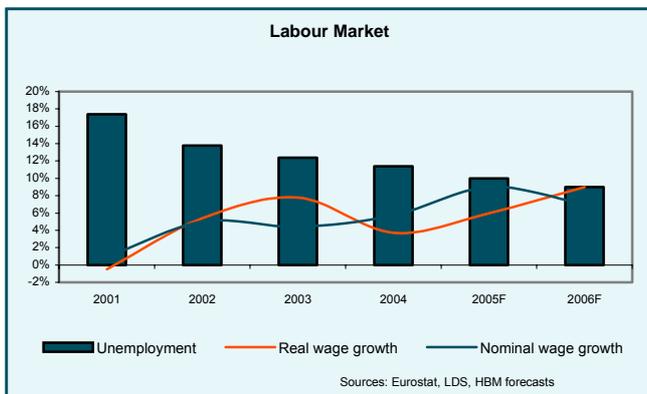
Household income is generally improving with faster wage growth, lower levels of unemployment and higher social subsidies.

Wage growth in the first quarter of 2005 accelerated to 10.8%, from 8.4% the previous quarter, the public sector being an important growth driver. The constraints in the labour market are evident despite the rather high unemployment level, which decreased to 10.2% in the first quarter from the 13.0% level of a year ago.

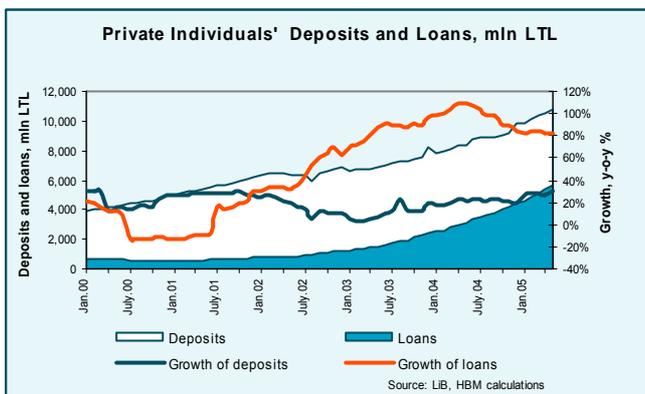


Old-age pensions in the 1st quarter were 14.3% higher than a year ago, while another increase was implemented starting 1st of July, when both the Lithuanian minimum salary and base pension rates were increased. The minimum salary was increased 10% from LTL 500 to LTL 550 (EUR 159). Minimum salary level applies to 20% of all employees, mostly in services, though arguably many of them may get paid avoiding taxes or via tips (as hotels, restaurants). Therefore, no severe lay-offs in the labour market are expected, but rather better collection of taxes. The basic pension rate was increased 16.2% from LTL 172 to LTL 200 (EUR 58), which will significantly affect

around 900 thousand people who receive social support, 600 thousand of whom are old-age pensioners.



Household consumption as well as retail sales in the 1st quarter were growing slower than in previous years, though the comparison base was also somewhat higher (pre-consumption before EU entrance), while retail sales have shown a recovery in the recent months. The booming market in housing loans is fuelling growth in the construction market as well as in sales of related items (housing equipment, furniture etc). The excessive demand puts price pressure on non-tradable items (real estate, construction services).



Tax reform and government spending

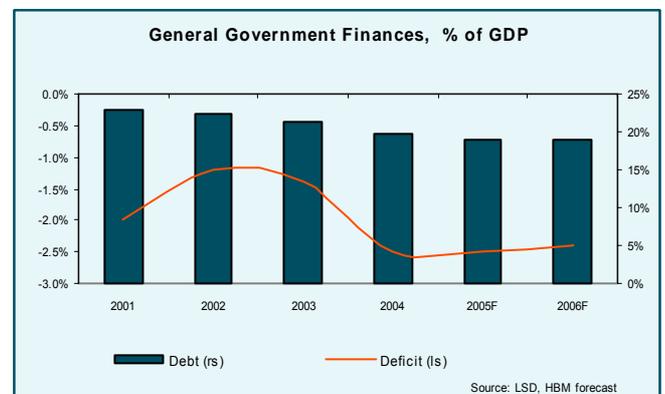
Tax reforms were finally approved in July, envisaging the following changes:

- Personal income tax will be lowered from the present 33% to 24% in two steps: from 33% to 27% starting July 2006, and from 27% to 24% starting January 2008.
- Temporary "social" tax is to be introduced on corporate profit during 2006-2007, which is in essence a temporary increase of corporate profit tax by 4 percentage points for 2006 and 3 percentage points for 2007. The effective rate of tax on corporate

profits will be 19% in 2006 and 18% in 2007, thereafter falling to the present level of 15%.

- There is to be a new tax on real estate owned by private persons but used for commercial purposes.

Since the corporate profit tax will be increased six months before personal income tax is reduced, we expect it to create some additional surplus in the 1st half of 2006, which is positive considering that Lithuanian budget position will be monitored to fit Maastricht criteria (3% of GDP) in the mid-2006. The decrease in personal income tax is expected to stimulate economic growth through higher consumption and lowered wage-growth pressures. The temporary introduction of "social tax" (rather than balancing budget through tighter spending) somewhat offsets the positive aspects of the reform, and puts stress on the budget for 2008.



The present situation of budget collection is very positive, with central government revenues of the 1st half of the year (excl. EU support) being 2.7% above that planned, mainly as a result of better profit-tax collection. But after a mid-summer review some additional spending was encouraged and the approved budget still points to a deficit of around 2.5% of GDP for this year.

The Lithuanian general government deficit figure for 2004 was revised from a preliminary figure of 2.48% to 1.4% of GDP, after the European Commission initiated adjustments in the reporting methodology of the central government deficit data. Adjustments to previous years also took place. For the last decade Lithuania has approved (mostly in 1997) significant compensation for land, forest, and real estate nationalized in the Soviet era that could not be returned in kind, and also for deposits lost in the Soviet banks. Such compensation used to be recorded as expenses only when the money was paid out, while the EC's requirement is to record the expenses at the time of the underlying decision (in this case 1997).

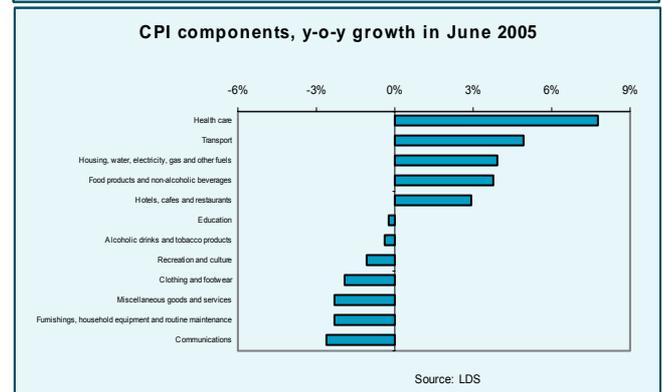
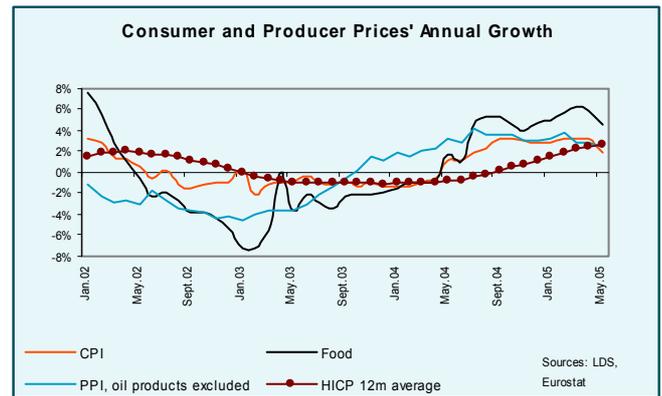
Monetary Issues

Inflation

Strong domestic demand, rising wage costs and rising oil prices have not yet fuelled price growth in the general

economy, with the CPI index showing 2% annual inflation in June. The annual inflation rate has decreased from the beginning of this year, as the comparison base starting May 2004 is considerably higher (the price-shock effect of entering the EU). The 12-month average CPI inflation

stands at 2.7% and is expected to remain at the same level in the nearest months. However, estimating the present resilience of prices, we see the average annual inflation in 2005 to be lower than initially forecast, at around 2.8% (previous forecast 3.2%). Achieving the Maastricht criteria on inflation in mid-2006 cannot be claimed with assurance as yet, though the regulatory authorities seem to be working in favour of lower price growth – the majority of regulated prices are to be kept stable, while the recently approved (in effect starting July 2005) prices of gas for regulated customers are on average 6% lower than previously.



Hansabank Markets

Hansabank Markets Research:

<u>Estonia</u>			
Senior Macro Analyst	Maris Lauri	+372 6 131 202	maris.lauri@hansa.ee
Senior Analyst	Mihkel Torim	+372 6 131 564	mihkel.torim@hansa.ee
Senior Analyst	Sander Daniel	+372 6 131 664	sander.daniel@hansa.ee
<u>Latvia</u>			
Senior Analyst	Liene Kule	+371 7 444 162	liene.kule@hansabanka.lv
<u>Lithuania</u>			
Senior Analyst	Vidmantas Šaferis	+370 5 268 45 98	vidmantas.siferis@hansa.lt

Hansabank Markets

Head of Hansabank Markets	Allan Marnot	+372 6 131 678	allan.marnot@hansa.ee
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Hansabank Markets Equities Desk:

<u>Estonia & Lithuania</u>			
Head of Equities	Lauri Lind	+372 6 131 355	l.lind@hansa.ee
Trading	Romet Teppel	+372 6 131 663	r.tepper@hansa.ee
<u>Latvia</u>			
Sales & Trading	Janis Ogsts	+371 7 444 154	janis.ogsts@hansabanka.lv
<u>Lithuania</u>			
Head of Equities	Linas Grinevičius	+370 5 268 45 33	linas.grinevicius@hansa.lt

Hansabank Markets Sales

<u>Estonia</u>			
Sales	Gunnar Mäemets	+372 6 131 457	gunnar.maemets@hansa.ee
<u>Latvia</u>			
Head of S&T	Elmars Priksans	+371 7 444 160	elmars.priksans@hansabanka.lv
<u>Lithuania</u>			
Head of S&T	Vytautas Eidukaitis	+370 5 268 45 24	vytautas.eidukaitis@hansa.lt

Hansabank Markets Fixed Income & Derivatives Desk:

<u>Estonia</u>			
Fixed Income	Ott Jalakas	+372 6 133 098	allan.marnot@hansa.ee
Derivatives	Pärt Kivaste	+372 6 131 467	part.kivaste@hansa.ee
<u>Latvia</u>			
Fixed Income	Alina Beguna	+371 7444 145	alina.beguna@hansabanka.lv
<u>Lithuania</u>			
Fixed Income	Vaidas Paukštys	+370 5 268 45 14	vaidas.paukstys@hansa.lt

Hansabank Markets FX Desk:

<u>Estonia</u>			
Head of FX Desk	Art Lestberg	+372 6 131 653	art.lestberg@hansa.ee
FX - Trading	Darius Gecevičius	+372 6 131 655	darius.gecevicus@hansa.ee
<u>Latvia</u>			
Senior Dealer	Sandris Pavlovs	+371 7 444 143	s.pavlovs@hansabanka.lv
<u>Lithuania</u>			
FX desk chief dealer	Aurelijus Dzendulėtas	+370 5 268 44 78	aurelijus.dzenduletas@hansa.lt

Hansabank Treasury Products:

<u>Estonia</u>			
Head of Treasury	Petteri Lappalainen	+372 6 131 925	petteri.lappalainen@hansa.ee
<u>Latvia</u>			
Treasurer	Maris Nelsons	+371 7 444 181	m.nelsons@hansabanka.lv
<u>Lithuania</u>			
Head of Treasury	Marius Adomavičius	+370 5 268 44 93	marius.adomavicius@hansa.lt

Hansabank Asset Management

Equity & Balanced Funds			
Head of HAM	Mihkel Õim	+372 6 131 871	mihkel.oim@hansa.ee
Fixed Income Fund Manager	Tõnis Rätsep	+372 6 131 598	tonis.ratsep@hansa.ee
Equity Fund Manager	Alvar Roosimaa	+372 6 133 859	alvar.roosimaa@hansa.ee

Hansabank Private Wealth Management

Head of PWM	Kristel Meos	+372 613 1881	kristel.meos@hansa.ee
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Hansabank Securities and Correspondent Banking Services:

<u>Estonia</u>			
Relationship Manager	Helen Poolake	+372 6 131 908	helen.poolake@hansa.ee
<u>Latvia</u>			
Manager	Anrijs Ceksters	+371 7 444 142	a.ceksters@hansabanka.lv
<u>Lithuania</u>			
Manager	Vytenis Jurkus	+370 5 268 41 45	vytenis.jurkus@hansa.lt

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Hansabank Markets
Tel. +372 6 131 670
Fax. +372 6 131 545

Liivalaia 8
15040, Tallinn
Estonia

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