Baltic Household Outlook

April 2014

The Baltics

- Although the average net wage has exceeded the pre-crises level in all Baltic countries, the real income (income adjusted for inflation) is still below the level of 2008. At the same time, the real purchasing power of employed persons is much higher compared to 2003. In 2013 the average real wage was 57 per cent above the level of 2003 in Latvia, 52 per cent higher in Lithuania and 50 per cent higher in Estonia.
- The distribution of income is less balanced in Latvia. In Latvia the income of the wealthiest households is 6.2 times higher than the income of the poorest households. In Lithuania and Estonia this ratio is 5.3 and 5.4, respectively, slightly above the EU average.
- Latvian households experienced the biggest drop in the interest rate of housing loans in 2013, but it is still at a higher level than in Estonia and Lithuania.
- Households show modest intentions to borrow for consumption. The portfolio of consumer loans and other borrowing continues to decrease in 2014 in all Baltic countries.
- Non-performing housing loans are at the pre-crisis level in Estonia while Latvian households are still struggling with their repayment problems. Regarding the non-performing consumer loans, Estonians are back on track but there is a very slow recovery in Latvia and Lithuania.
- Estonian households are the least distressed from their housing costs. Although there are 29 per cent of Estonian households who report their housing costs to be a burden for them, the share is below the EU average of 37 per cent. In Latvia and Lithuania, there are 42 and 41 per cent of households who are strained from their housing costs.
- Growth in financial assets in Lithuania and Estonia slowed down, as compared with the year 2012. Faster increase in financial assets in Latvia was determined by reallocation of assets from cash to deposits.
- Individuals pay larger life insurance and voluntary pension accumulation premiums (in Latvia and Lithuania) and allocate more funds for housing and real estate investments (in all three Baltic countries) compared with the previous year.

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

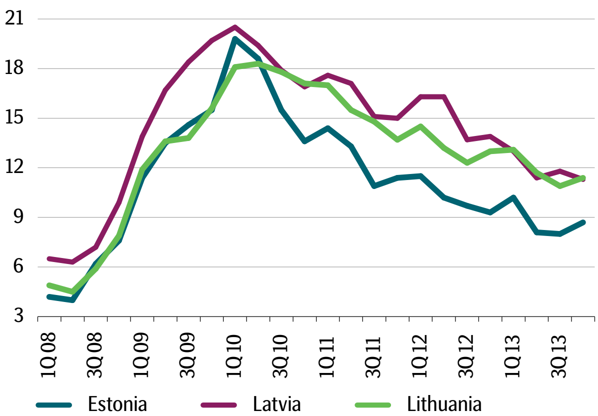
Merike Kukk
Research Scientist
Tallinn University of Technology
Telephone: +372 6204069
merike.kukk@ttu.ee

The economic growth of Baltic countries slowed in 2013. Latvia's economy expanded by 4.1 per cent, Lithuania posted a 3.3 per cent gain, while Estonia showed economic growth of only 0.8 per cent compared to the previous year. Despite the economic slowdown, the purchasing power of households in all Baltic countries continued to improve as a result of increasing employment, growing wages and low inflation.

Unemployment decreasing, long-term unemployment still high

During the year, the unemployment rate fell most in Latvia. In the last quarter of 2013, the unemployment rate in Latvia was 11.3 per cent, 2.6 percentage points lower compared to the last quarter of 2013. In Lithuania, the unemployment rate declined by 1.6 percentage points to 11.4 per cent in the fourth quarter of the last year. In Estonia, the unemployment rate decreased slightly, from 9.3 per cent in the last quarter of 2012 to 8.7 per cent in the last quarter of 2013. At the same time, Estonia still has the lowest unemployment rate among Baltic countries. In Estonia, the unemployment rate is below the EU-28 average, while in Latvia and Lithuania the unemployment rate is slightly higher than the average value of all European Union countries.

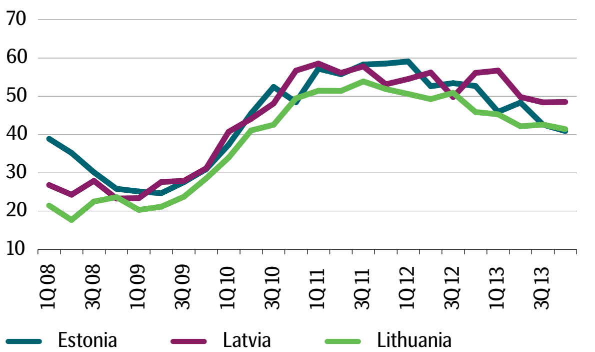
Unemployment rate (%)



Persons aged 15-74
Source: National Statistics

Unemployment is decreasing; however a large number of unemployed persons cannot find jobs. The share of long-term unemployed persons (persons who have been out of work for 12 months or longer) has decreased in all Baltic countries since the peak, but remains relatively high compared to the pre-crises period. In 2013 the largest reduction in the proportion of long-term unemployment was registered in Estonia, followed by Latvia and Lithuania. In Latvia, the share of long-term unemployment in total unemployment was 48.5 per cent in the last quarter of 2013. In Lithuania and Estonia, the share of long-term unemployment was 41.4 per cent and 40.9 per cent, respectively.
As very long periods of unemployment can erode skills, making it more difficult for persons to find a job, long-term unemployment is still a challenge for labour market policy.

Share of long-term unemployed among the unemployed (%)

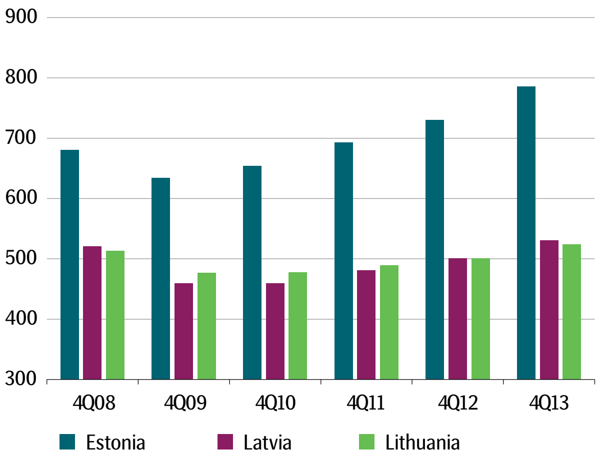


Source: National Statistics

Financial situation gradually improves

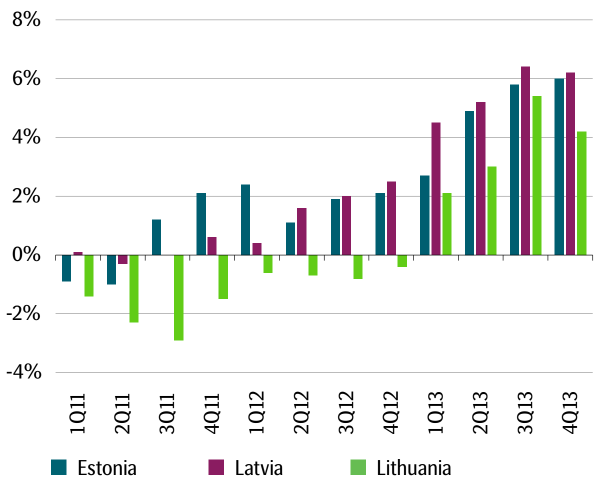
Average gross wages posted growth for the third year in a row in all Baltic countries. The fastest wage growth was recorded in Estonia, reaching 7.6 per cent in the last quarter of 2013. Wage growth was even faster in the second and third quarter of the last year, when annual growth was 8.8 per cent and 8.5 per cent, respectively.
Over the last year in Lithuania and Latvia, the average gross wages increased by 4.7 per cent and 4.6 per cent, respectively. Wage growth in Estonia and Lithuania was also supported by the increase in minimum wage.
The average net wage has exceeded the pre-crises level in all Baltic countries. Wage statistics show quite a large gap (almost 50 per cent) between Estonia and other Baltic countries. The gap has even widened in recent years. In Estonia the average net wage is now approximately 14 per cent above the pre-crises level, reaching 785 euros in the last quarter of 2013. In Latvia, the average net wage rose to 530 euros, while in Lithuania average take-home pay was 524 euros in the fourth quarter of the last year. In Latvia and Lithuania, the average net wage now exceeds the level reached in 2008 by only two per cent.
This year wage growth will continue. In Latvia and Lithuania, the wage growth rate is expected to accelerate a bit compared to 2013, while in Estonia gross wage growth is expected to slow down. In Lithuania average gross wages are expected to rise by 5.5 per cent. In Latvia, the gross wage growth rate may reach 5-5.5 per cent this year, partly due to an increase in the monthly minimum wage (by 12.5 per cent to 320 euros). Despite a low economic growth rate, in Estonia the factors driving wage growth (a tight labour market and shortages of qualified labour) remain quite strong. In addition, since 1 January, the minimum wage has increased by 11 per cent from 320 to 355 euros. Thus, in Estonia, average wage growth is expected to grow by 5 per cent.

Average net wages (in euros)



Source: National Statistics

Real wages (%, YoY)

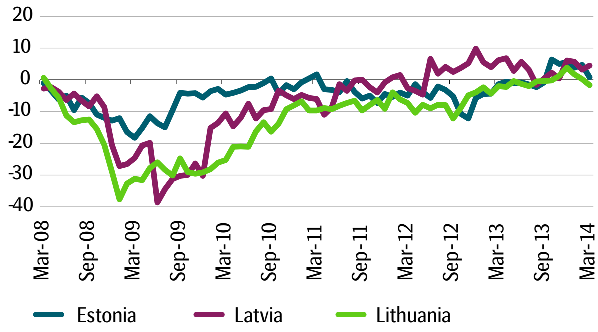


Source: National Statistics

Due to both wage growth and low inflation, the real purchasing power of employed persons continued to improve during the last year. Real wage growth (wage growth adjusted for inflation) has accelerated in all Baltic countries over the last year. Latvia posted the largest increase in real wages, reaching 6.2 per cent in the fourth quarter. In Estonia and Lithuania, real wage growth was 6.0 per cent and 4.2 per cent, respectively. In 2014 the real wage growth is expected to be robust in all Baltic countries, as inflation will be low.

Despite real income growth, only some households have reported an improvement in the economic situation in their household. An evaluation of the financial situation over the last 12 months still shows negative value in all Baltic countries. At the same time, households are less pessimistic about their financial situation over the last twelve months than one year ago. In Estonia, this indicator improved eight points during the last 12 months, reaching -6 in March 2014, while in Lithuania the indicator rose seven points to reach -7. In Latvia the financial situation indicator changed slightly over the last 12 months, increasing by only one point from -7 points in March 2013 to -6 points in March 2014.

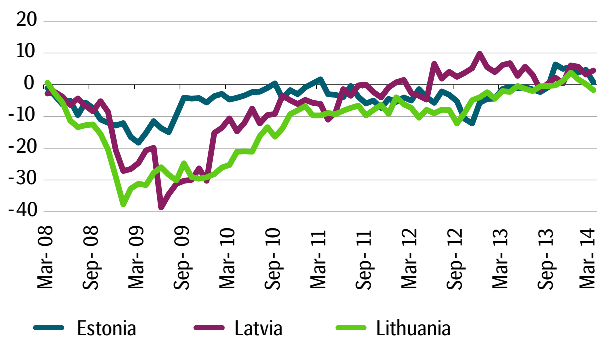
Financial situation over last 12 months



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

Consumer opinions about their financial situation over the next twelve months are less negative. In Latvia and Estonia the indicator of the future financial situation is positive, while in Lithuania it is slightly below zero (-2 points in March). At the beginning of 2014, future financial expectations were positive in all Baltic countries. A decrease in consumer sentiments in February and March may be related to the events in Ukraine. We can see an increasing number of households who expect improvements in their finances over the next 12 months. At the same time, quite a large number of households are still not so optimistic and expect their financial situation to deteriorate. There are differences among different socio-economic groups. Young people aged 16-29 are more positive, while the most pessimistic respondents are older people aged 65 and over.

Financial situation over next 12 months



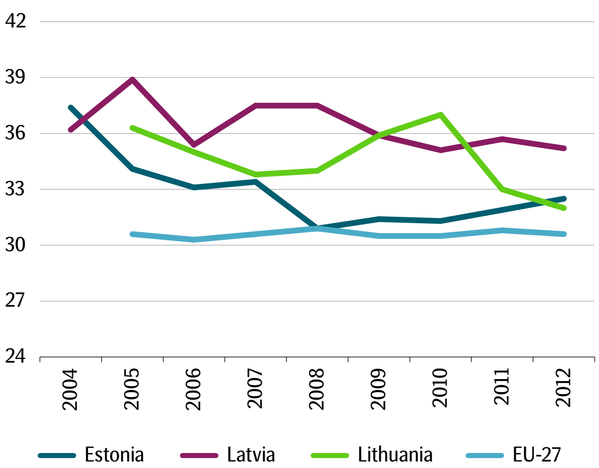
** Balances, i.e. differences between the percentages of respondents giving positive and negative replies.*
Source: Eurostat

The distribution of income shows the gap between Latvia and other Baltic countries

Most households (except higher income households), when answering question about changes in their financial situation, say that they don't see significant improvements in their finances and don't have more money in their pockets. The main reasons are uneven income growth, persistently high unemployment and difficulties in finding a good job as well as an increase in food prices and other compulsory payments. The unequal distribution of income among different socio-economic groups is one of the factors which affect a household's assessment of their financial situation.

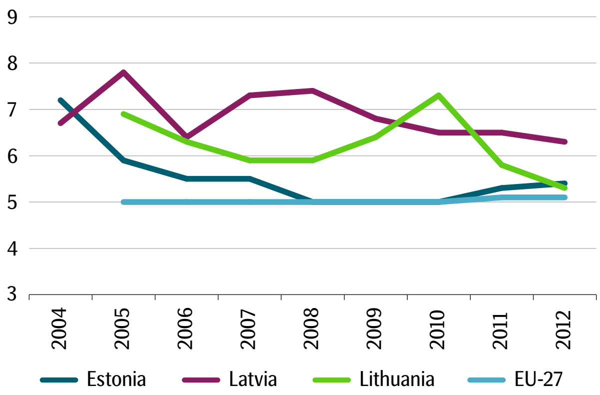
The Gini coefficient (also known as the Gini index) is one of most widely used measures of income inequality. The range of the coefficient is from 0 to 1 and the higher the coefficient, the more unequally the income is distributed. The Gini coefficient can be expressed as a percentage, a coefficient value multiplied by 100. According to Eurostat, the Gini coefficient shows inequalities in the distribution of income among EU countries. In 2012, the EU-28 average Gini coefficient value was 30.6 per cent, the lowest coefficient value (23.7 per cent) was reported in Slovenia, while Latvia had the highest value (35.2 per cent). In other Baltic countries, Gini coefficient values are lower than in Latvia but above the EU average. The data from 2004 onwards shows different trends of inequality measurements in Baltic countries. Despite some decline between 2008 and 2012, Latvia still has the highest Gini coefficient in the European Union. In Lithuania, during the economic downturn, the Gini coefficient rose to 37 per cent (the highest value in the EU) in 2010, after that it decreased by 5 percentage points to 32 per cent in 2012. In Estonia, the Gini coefficient increased from 30.9 per cent in 2008 to 32.5 per cent in 2012. From 2005 on the EU average was stable at approximately 31 per cent.

Gini coefficient of equivalised disposable income



Source: Eurostat, National Statistics

Inequality of income distribution (S80/S20 ratio)



Source: Eurostat, National Statistics

The S80/S20 ratio or income quintile share ratio is another measure of income inequality which is calculated as the ratio of total income received by the 20 per cent of households with the highest income to that received by the 20 per cent of the poorest households. The S80/S20 ratio looks only at the top and bottom quintiles and is affected by the extreme values of income distribution, while the Gini coefficient takes into account the full income distribution. According to Eurostat, the average S80/S20 ratio in EU is about 5, which means that the income of the wealthiest households (top quintile) is five times higher than the income of the poorest households (bottom quintile). The data of this income inequality measure shows a similar ranking pattern to the Gini coefficient. In Latvia the S80/S20 ratio value was 6.3 in 2012, the third highest in EU after Greece and Spain. In Lithuania and Estonia the S80/S20 ratio value was 5.3 and 5.4, respectively, above the EU average but lower than in Latvia. In Latvia a decreasing trend in this ratio has been observed since 2008. In Lithuania, after a sharp increase in inequality during the economic crisis, the S80/S20 ratio dropped from 7.3 in 2010 to 5.3 in 2012, thus reducing income inequality by 2.0 units. In Estonia this ratio was stable between 2008 and 2010; after that it rose by 0.4 points to 5.4 in 2012.

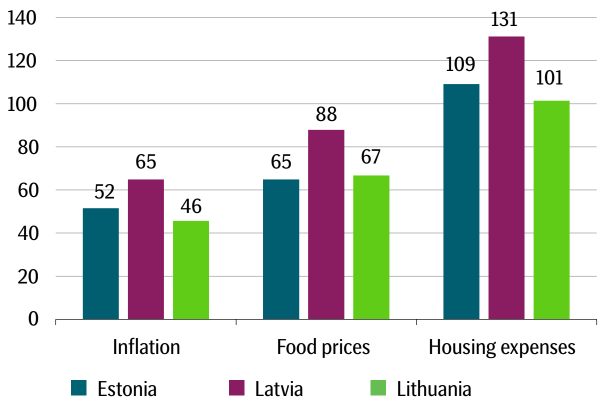
In Latvia the poorest 20 per cent of the population earned 6.6 per cent of the total income in 2012 (6.2 per cent in 2008), while the richest 20 per cent of households had 42 per cent of the total income, decreasing from 43.1 per cent in 2008. In Estonia and Lithuania, the income of first quintile was higher than in Latvia, reaching 7.3 per cent and 7.4 per cent, respectively. In 2012 the richest 20 per cent of the population earned 39.7 per cent in Estonia and 39.5 per cent in Lithuania.

Despite implemented progressive measures between 2008 and 2012, inequality measure indicators show that, among Baltic countries, the distribution of income is less balanced in Latvia. Latvia continues to implement more measures, increasing the minimum wage and tax breaks for dependent persons to further decrease inequality, narrowing the gap between Latvia and other Baltic countries.

10 years: boom, bust and recovery

Income statistics show that the average net wage and average retirement pension in nominal terms has exceeded the pre-crises level. If incomes grow faster than consumer prices, purchasing power increases, otherwise purchasing power falls. Over the last 10 years, the largest increase in price level was registered in Latvia. In 2013 consumer prices were 65 per cent higher compared to the level of 2003. The prices of housing and food rose even faster – by 131 per cent and 88 per cent, respectively. In Estonia and Lithuania, the price growth rate over the last 10 years was lower compared to Latvia.

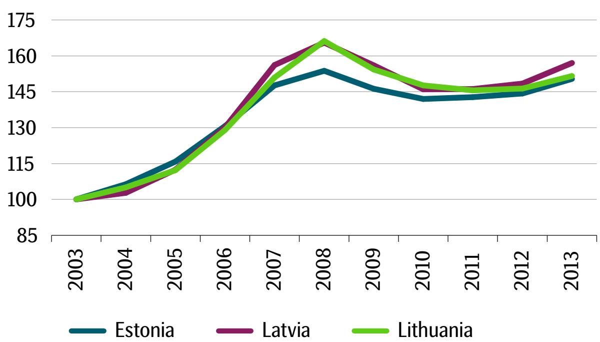
Price changes over the 10 years (Dec.2013 vs. Dec.2003)



Source: National Statistics

Taking into account changes in the price level, average net wages are below the pre-crises level in all Baltic countries. Between 2003 and 2008, the purchase power of employed persons improved significantly, as EU accession and a belief in quick convergence to EU average incomes, optimistic expectations and a real estate boom fuelled by cheap loans helped to boost average wages. All Baltic countries had a similar income growth pattern, albeit different starting positions. In 2003 there was a huge gap in average wages between Estonia and other Baltic countries, even exceeding 50 per cent. The gap narrowed during the last boom years. Despite increasing inflation, during five years (2003-2008) real wages rose by 66 per cent in Latvia and Lithuania, followed by Estonia with a 54 per cent increase. Latvians and Lithuanians experienced the largest drop in real income during the economic downturn. In Latvia and Estonia real wages started to increase in 2011, while in Lithuania real wage growth resumed only in 2013.

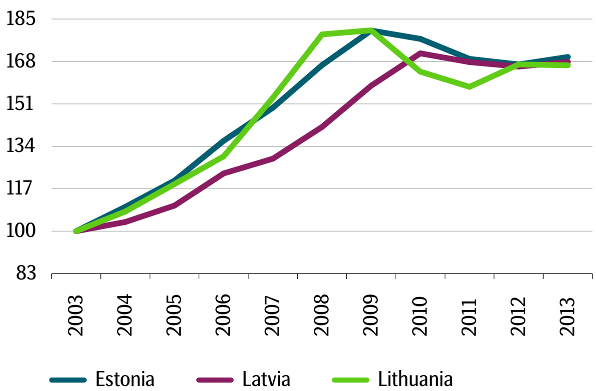
Average net wage at constant prices (2003=100)



Source: National Statistics, SEB calculations

Estonia is very close to the pre-crises level in terms of real wages. In 2013 the average real wage of Estonians was 2.2 per cent lower compared to 2008. Despite real income growth by 7.5 per cent since 2011, in Latvia the real wage was 5.2 per cent below the level of 2008. In Lithuania the purchasing power of employed persons has improved at a slower pace compared with Latvia and Estonia. In 2013 the real wage was 8.8 per cent below the pre-crises level.
At the same time, the real purchasing power of employed persons is much higher compared to 2003, however, there has been a small convergence in real wages between Estonia and other Baltic countries. In 2013 the average real wage (net wage adjusted for inflation) was 57 per cent above the level of 2003 in Latvia, 52 per cent higher in Lithuania and 50 per cent higher in Estonia.

Average old-age pension at constant prices (2003=100)



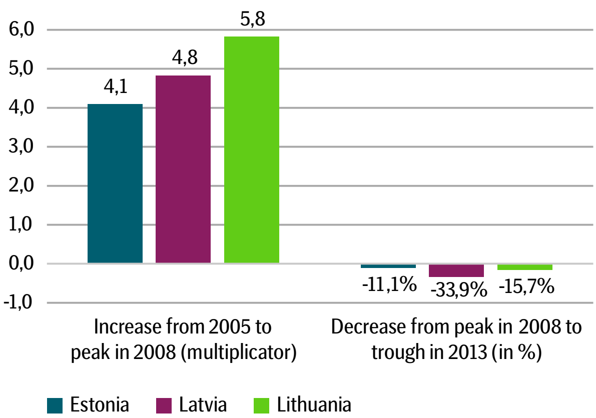
Source: National Statistics, SEB calculations

The dynamics of average pensions show an even higher growth rate. In 2013 the average real retirement pension (average pension adjusted for inflation) in Estonia was 70 per cent higher compared to 2003. In Latvia and Lithuania between 2003 and 2013, the real average pension rose by 68 and 67, respectively. In Lithuania and Estonia, in terms of seniors' purchasing power, the best year was 2009, when average real old-age pension was 81 per cent above the level of 2003, while for retired persons in Latvia, 2010 was the year when purchasing power was the highest.

Household borrowing is following distinct patterns in the Baltic countries

Following a big slump in loan volumes in all Baltic countries during the recession, the recovery period turns to be different across the countries. In Estonia and Lithuania, the deleveraging period is over and household loan volumes are increasing since April 2013 in Estonia and since June 2013 in Lithuania. In Latvia, household debt volumes are still decreasing. After the vigorous increase in loan volumes before the crises in Estonia, the drop from peak in December 2008 to trough in March in 2013 has been -11.1 per cent. Comparing the increase in loan volumes during the three preceding years, in 2005-2008, when the volumes increased four times, the downward adjustment has been relatively modest. The individual level data indicates that the increase in the loan volumes until 2008 has been accompanied by the increase in the penetration of household debt and the average debt volumes on a household level has been quite stable over the whole period. The decrease in the debt volumes since 2008 is likewise associated with lower penetration of debt among households.
In Lithuania, the drop of loan volumes from peak in January 2009 to May 2013 has been -15.6 per cent. For comparison, the loan volumes increased in 2005-2008 almost six times. In Latvia, the loan volumes have declined -34 per cent by the end of 2013 since the peak in November 2008 while the volumes have risen less than 5 times in 2005-2008. So the Baltic countries show different pattern in the loan market developments, some reasons to which will be analysed in the following sections.

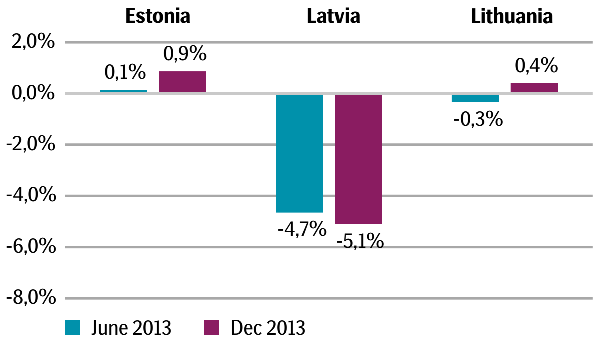
Changes in total loan portfolios



Source: Central Banks, SEB calculations

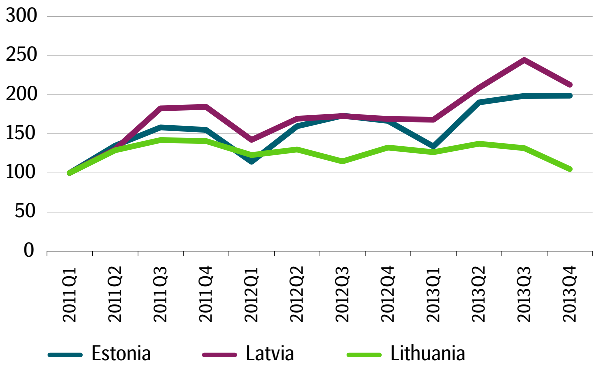
Different development is observed for housing loans and consumer credits. The increase in loan volumes in Estonia and Lithuania is mainly induced by housing loans: in Estonia, the housing loan portfolio was 0.9 per cent higher at the end of 2013 compared to 2012 and in Lithuania it was 0.4 per cent higher. In Latvia, housing loans have decreased by -5.1 per cent by the end of 2013 compared to 2012.

Change of housing loan portfolio (y-o-y)



Source: Central Banks, SEB estimations

Indexed volume of new housing loans (2011Q1=100)



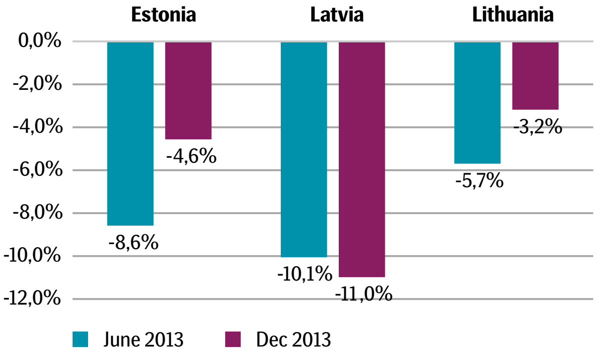
Source: Central Banks, SEB estimations

The increase in Estonia stems from the expansion of new housing loans (including refinancing). In the first half of 2013 about 20 per cent more new housing loans were issued than during the same period in 2012. In the second half of 2013 the issued volumes were around 22 per cent higher than a year ago. In Lithuania, the disbursement of new housing loans is quite stable according to the statistics of the Bank of Lithuania. However, it shows significant increase according to the statistics from the Association of Lithuanian Bankers, stating that the annual growth rate in 2013 is 40 per cent compared to 2012. Latvia shows slightly stronger upturn in new loan volumes than Estonia; the housing loan volumes increased by 26 per cent in 2013 compared to 2012. The data includes additionally to new loans refinancing of current loans issued in another bank, which might contribute substantially to the volume of new loans in light of fast amortisation of the previously issued loans. The interest in new loans is still modest in Latvia.
All Baltic countries are still below the EU average in housing conditions and the improvement of housing conditions implies new home purchases. As home purchases and improvements were postponed during the crisis, households are expected to show increased interest in enhancing their living conditions. Still, households do not hurry when deciding about home purchase. The share of home purchases financed by borrowing is much lower than before the crisis, indicating that households take more conservative approach towards borrowing.

Households show modest intentions to borrow for consumption

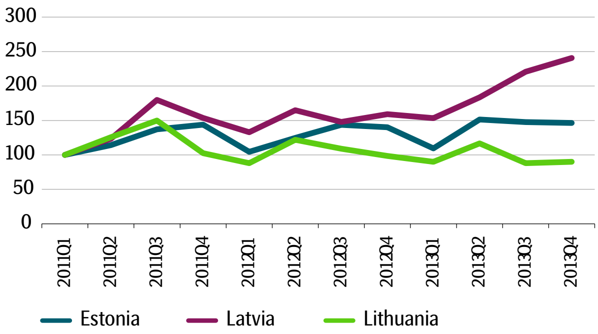
Households continue to cut their consumer credit and other borrowing in all Baltic countries. The statistics indicate decelerating speed of decline in Estonia and Lithuania while the cutback in consumer credit continues in Latvia at the same rate. In Lithuania, the balance of consumer debt and other borrowings was -5.7 per cent lower in June 2013 compared to June 2012 while the drop in December 2013 was -3.2 per cent year-to-year. Estonians reduced their stock of consumer credit and other borrowings -8.6 per cent by June 2013 and the decline was -4.6 per cent by December 2013. In Latvia, the speed of deleveraging is not slowing down and the balance of consumer credit and other lending continues to fall at the yearly rate of 10-11 per cent.

Change of consumer credit and other lending portfolio (y-o-y)



Source: Central Banks, SEB estimations

Indexed volume of new consumer credit and other borrowing (2011Q1=100)



Source: Central Banks, SEB estimations

The same story unfolds from the data concerning disbursement of new consumer credit and other borrowing. In Estonia and Lithuania, issuing of new loans has been quite stable for the last years and does not show any increasing trend. In Latvia, the volumes of new loans have increased significantly in 2013 and again, it may be related to refinancing of previously issued loans from another bank. The substantial increase is also induced by the low base value of 2011; the overall interest in new consumer loans in Latvia is restrained.

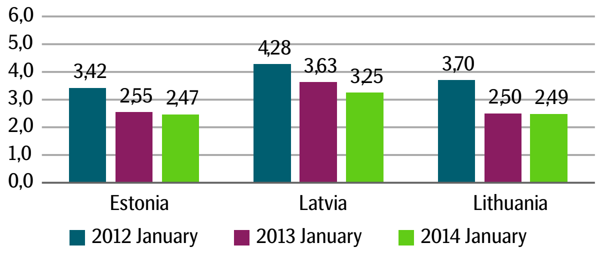
The demand for consumer credit remains limited in the following periods as households are more aware of the threats related to borrowing after the crisis. Households prefer to finance consumption from their income or savings; for big items hire-purchase is preferred to consumer loans. In 2006-2007 households had experienced substantial increase in their income which made them very optimistic about further boost of their earnings. In these circumstances households wanted to consume their future income earlier which they could do by borrowing. After the crisis households are more conservative about their income prospects; they realise that future income increase is far from being guaranteed and it is not reasonable to consume it in advance. Therefore consumer credit is expected to decrease further in 2014 in all three countries as households continue to repay their current loans while there is modest need for new loans.

Latvian households have experienced a drop in the interest rate of housing loans

Following the decrease of Euribor rate since 2009, households have benefited from favourable interest rates of housing loans. The most significant fall of the interest rates took place in 2012 when the reduction in interest rate of housing loans occurred in all three countries. In 2013, the changes have been marginally downward in Estonia and Lithuania while further drop was observed in Latvia. However, the gap between the interest rates in Latvia and other Baltic countries is ¾ percentage points. The introduction of euro in the beginning of 2014 will support further decline of the interest rate in Latvia. However, due to higher repayment problems and borrowing risk in Latvia compared to other Baltic countries the interest rate will not yet reach the same level as in Estonia and Lithuania.

The interest rates are on their historical low levels in Estonia and Lithuania, hence in the future they can move only upwards. Different surveys reveal that households with variable interest rate contracts expect the initial interest rate to prevail. Therefore some households might perceive the rise of the interest rate in the future as a negative shock which may also affect their repayment ability. On the other hand, households are more conservative in their current borrowing and calculate their repayment capacity thoroughly when borrowing. This should ensure that households can also meet their responsibilities when the economic environment changes.

Average interest rate of housing loans (%)

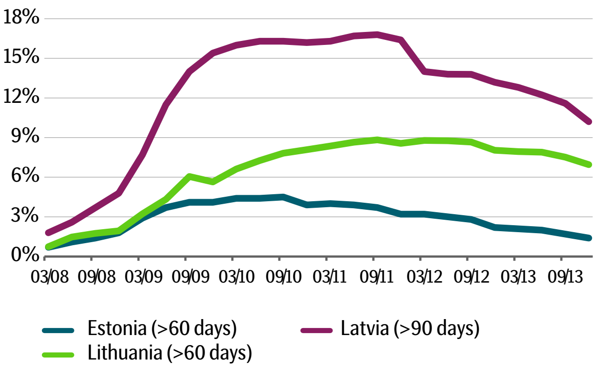


Source: Central Banks

Non-performing housing loans are at the pre-crisis level in Estonia while Latvian households are struggling the most with their repayments

The demand for new loans is closely related to the households' experience with current loans. If one has had problems with paying back previous loans, financial institutions are reluctant to provide new loans. The share of households with limited ability to borrow has increased considerably due to debt repayment problems during the recession. Non-performing loans or loans overdue for more than 60 days (in Latvia 90 days) show big swings over the last years in all Baltic countries. An upsurge in repayment problems occurred in 2009 when many individuals lost their jobs and more households experienced income drops. Debt burden that seemed reasonable in good times turned to be unsustainable when real wages decreased or disappeared due to the unemployment. These developments were foreseen neither by households nor the financial institutions before the crisis.

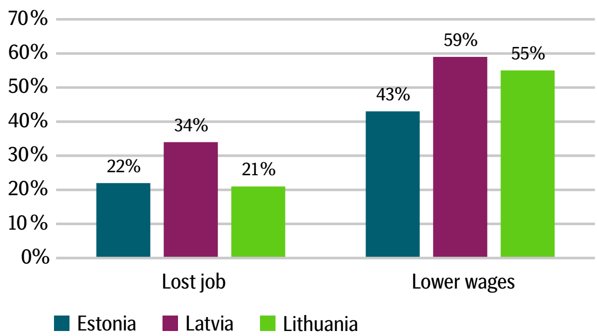
Share of overdue loans in housing loan portfolio (%)



Source: Central Banks

A study of Brown (2013) highlights that 74 per cent of Latvian households experienced negative income shock during the crisis – they either lost their job, received lower income, less remittances or less business income.[1] Around 59 per cent of households faced lower income while 34 per cent lost job. In Estonia, 57 per cent of households reported that they experienced negative income shock and it is close to the average level of the European and Central Asian countries which were participating in the survey. Around 43 per cent of households reported less earnings and 22 per cent lost job. In Lithuania, the share of households who experienced loss of employment was close to the level of Estonia while the share of households losing some of their income is close to the level of Latvia. Hence households of Latvia were hit the most during the crises while households in Estonia suffered the least. Nevertheless, more than 50 per cent of households in all Baltic countries experienced some kind of drop in their income.

Negative income shocks during the crises
% of population



Source: Brown (2013)

EBRD Transition Report has highlighted that Latvian and Lithuanian households were among the hardest-hit transition countries during the crisis.[2] Estonia seemed to be an outlier, where collapses in output and increases in unemployment were severe but these were not reflected in the assessments of households about the impact of the crisis on their economic conditions.

Consequently, in Latvia, the share of non-performing housing loans rose from 4.8 per cent of the total loan portfolio at the end of 2008 to 15.4 per cent at the end of 2009. The peak was in the third quarter of 2011 at 16.5 per cent and dropped to 10.2 per cent by the end of 2013. The share of problematic housing loans is still at a very high level compared to Estonia and Lithuania where the peak was at 4.5 per cent and at 8.8 per cent, respectively. Although the housing loan volumes increased less in Latvia than in Lithuania during 2004-2008, substantially more loans experienced difficulties in Latvia. As housing loan payment is one of the first priorities for households, the statistics reveals the dramatic situation for Latvian households during the recession.

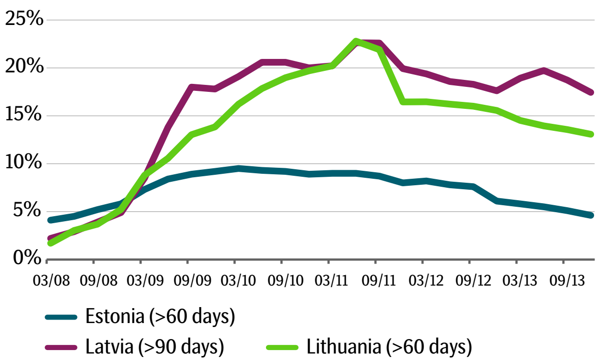
[1] *Brown, M. (2013). The Transmission of Banking Crises to Households. Lessons from the 2008-2011 Crises in the ECA Region. The World Bank Policy Research Working Paper No. 6528.*
[2] *EBRD Transition Report 2011. Crisis and Transition: The People's Perspective.*

In Estonia, the share of non-performing housing loans started to decrease much earlier than in Latvia and Lithuania. The share started to decline at the end of 2009 while in Latvia and Lithuania the downward trend began only in 2012. In Estonia, the share of non-performing loans was at 1.4 per cent at the end of 2013 which is comparable to the level of the pre-crisis period. In Lithuania, the drop of the share of NPL has been very slow and it is still at 7.5 per cent at the end of 2013. The problems with housing loans originate from the recession period; there is much less problems emerging from new housing loans. Households have adjusted to the lower income levels, both households and financial institutions are more responsible as concerns the borrowing behaviour.

Non-performing consumer loans back on track in Estonia while slow recovery in Latvia and Lithuania

The share of non-performing consumer loans reached higher levels than non-performing housing loans during the crises. In this loan category Latvia is not standing out but shows similar pattern to Lithuania. Again, in Estonia, the share of non-performing consumer loans has been the lowest, although the pre-crises expansion of consumer credit has been most vigorous. The peak in non-performing consumer loans occurred in Estonia in the third quarter of 2010 at 9.5 per cent. It is a consequence of the peak in unemployment in the first quarter of 2010 when a bulk of households faced problems with covering their expenses from significantly dropped income levels. The problems have been gradually solving while less new problems arise, hence leading to gradual decrease in non-performing consumer loans.

Share of overdue loans in consumer credit portfolio (%)



Source: Central Banks

Similarly in Latvia and Lithuania the repayment problems of consumer loans result from the worsened financial situation of households during the recession but it has taken longer time for households to solve the difficulties. The peak of non-performing consumer credit was in the second quarter of 2011, at 22.6 per cent and at 22.8 per cent, respectively. The share of non-performing consumer loans has declined gradually in Lithuania, reaching 13.1 per cent by the end of 2013. The number of non-performing loans increased in Latvia in the second half of 2013 due to reclassification of some consumer loans but the decreasing trend is clearly present. In Latvia, the share of non-performing consumer loans reached 17.4 per cent by the end of 2013.

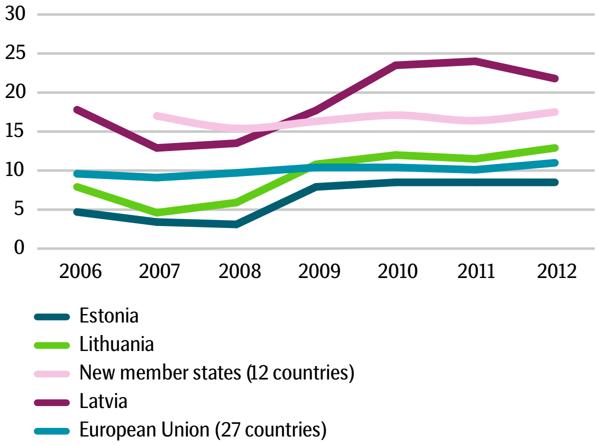
To summarise, there are considerably more households who have bad experience with consumer loans. The share of non-performing loans is just a peak of the iceberg; the statistics does not contain problems with hire-purchases or SMS loans. There is no public information about debt repayment problems for this type of loans but it is assumingly considerably higher than for consumer loans issued by commercial banks. On top of that, prolonged loans contain a hidden repayment problem. All these households have limited possibilities to obtain new loans which results in slow recovery of the consumer loan market.

Households are financially more vulnerable compared to the pre-crisis period

The developments in non-performing loans are closely related to the financial vulnerability of the Baltic households which have been affected substantially by the recession. The Statistics on Income and Living Conditions (EU-SILC) is collected from all EU member states providing comparable statistics at the European level. EU-SILC provides among other things comprehensive insights to the financial situation of households. Although the latest data is available from 2012, it provides accurate picture about the developments during the economic growth period, recession and aftermath of the crises.

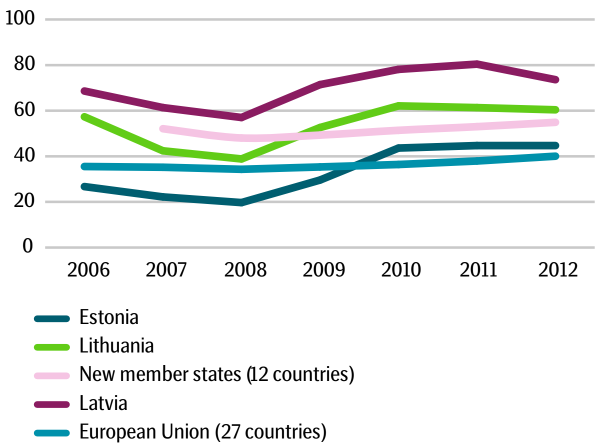
According to EU-SILC, the share of households who are not able to cover their everyday expenses from their earnings differs across the Baltic States substantially. In Latvia, 22 per cent of total population was not able to make their ends meet in 2012 while in Lithuania the share was 12 per cent and in Estonia 8.5 per cent. The share in Estonia is below the EU average while the share in Latvia is far above the average of EU New Member States. The share increased substantially during the crisis in all Baltic States and has remained on higher level compared to the pre-crisis levels. For comparison, in EU on average the share has been quite stable over the business cycle, even when considering only the New Member States.

Inability to make ends meet % in population



Source: EU-SILC, Eurostat

Inability to face unexpected financial expenses % in population



Source: EU-SILC, Eurostat

There are much more households who are not able to cover unexpected expenses of 200-300 EUR (at-risk-of-poverty threshold in a country) from their own resources: In Latvia 74 per cent of households, in Lithuania 60 per cent and in Estonia 45 per cent of all households in 2012. The highest share in Latvia is related to the fact that income is also most unequally distributed in Latvia, as highlighted in one of the previous sections.

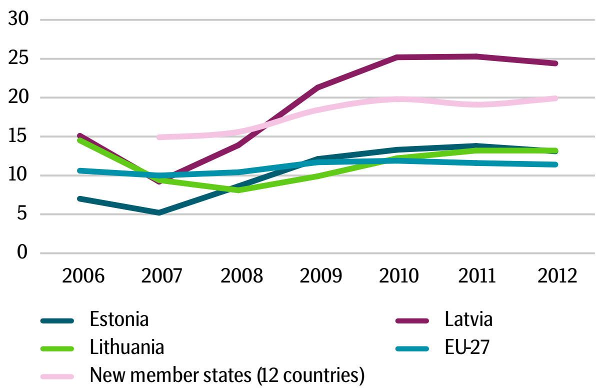
Again, similar pattern is observed over the business cycle: the share of households who are unable to cover unexpected expenses increased significantly during the recession and the decline afterwards has been modest. The improvements have been very modest since 2010, e.g. in Estonia the share of households with no buffers for unexpected expenses has remained more or less on the same level as during the crisis. It indicates that the recession has changed the financial situation of households permanently and there are more households whose financial situation is fragile compared to pre-crises period. It does not apply only to the households with low income - households above the 60 per cent median equalised income experience similar difficulties.

This data discloses better the financial situation of households than aggregate data. Although the aggregate volumes of financial assets have increased substantially referring to improved financial situation of households, the improvement is not distributed equally among households. The share of households who are struggling with their everyday costs has not decreased.

Every fourth household in Latvia reports arrears on utility bills

The difficulties to make the ends meet spill over to real problems such as arrears. In 2007 the share of households who reported to have arrears was on the same level in Latvia and Lithuania - at 9 per cent and in Estonia at a slightly lower level - at 5 per cent. Already in 2008 the share of households who report to have problems with paying any kinds of bills, either utility bills, rent, hire-purchase or loan repayments, started to increase in Estonia and Latvia while in Lithuania the rise started in 2009. The biggest increase in the share of households in arrears occurred in Latvia, where it reached 25 per cent in 2011. In Lithuania the share reached 13 per cent and in Estonia it reached 14 per cent in 2011. Majority of problems are related to utility bills in all the Baltic countries, which is also expected. Likewise, according to the EBRD Report, the delays in utility bills are most prevalent among households when they meet financial difficulties.

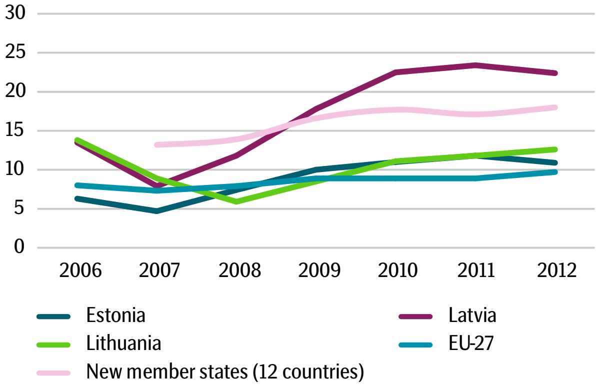
Arrears % in population



Source: EU-SILC, Eurostat

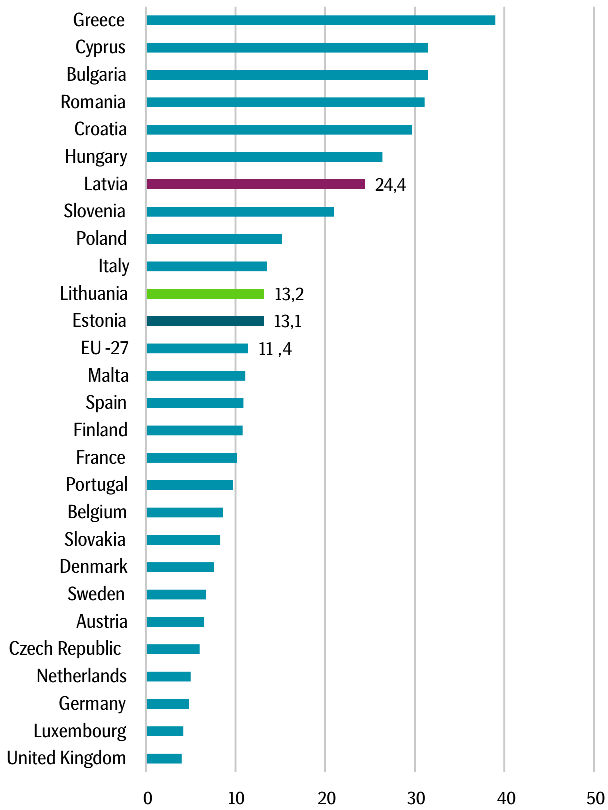
The share of households who report the arrears has declined only marginally in 2012, indicating persistent difficulties of households which have not been alleviated neither by decline of unemployment rate nor by increase in the average real wage in recent years. It suggests that the low levels of arrears in 2007 will not be reached fast, if at all.

Arrears on utility bills % in population



Source: EU-SILC, Eurostat

Any kind of arrears (utility bills, hire purchase, mortgage or rent) % in population



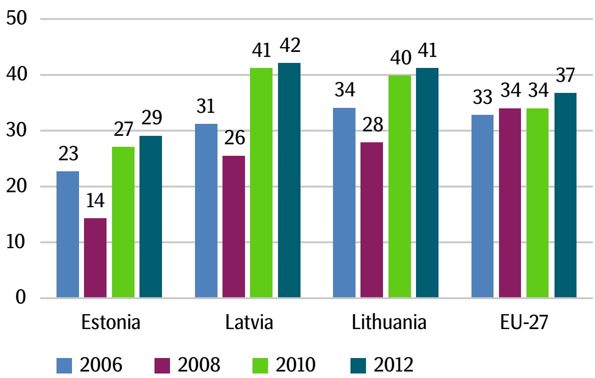
Source: EU-SILC, Eurostat

The financial situation of Estonian and Lithuanian households is on the EU average of 2012 and better than the situation of households in Poland, which escaped from the recession. The share of households with arrears in Estonia and Lithuania is 13 per cent while the EU average is 11 per cent. For comparison, in Finland the share is 11 per cent and in France 10 per cent. The results suggest that even if there has been a substantial increase in households with difficulties in Estonia and Lithuania, the countries do not stand out comparing with other European countries. The situation in Latvia is worse, as 24 per cent of households have arrears; still households in 6 European countries meet more difficulties than Latvia.

Estonian households are the least distressed from their housing costs

The financial burden of any kind of housing costs, i.e. expenses on utilities, rent or mortgage payments, is likewise higher than before the crises. In Estonia, 29 per cent of all households perceive a financial burden of total housing costs. However, it is a much lower share than in the South European countries and somewhat lower than the EU average. For comparison, in EU on the average, 37 per cent of the population feels the burden from regular housing payments. Hence the situation is relatively good in Estonia, even if it was better before the recession. It suggests that Estonian households have more capacity to improve their living conditions without falling into troubles than Latvian and Lithuanian households. This would explain also the faster increase in housing loan portfolio in Estonia compared to Latvia and Lithuania.
In Latvia and Lithuania the share of households who feel the burden is at 42 and 41 per cent, respectively. The share of households has increased in all income groups since the recession. Although households feel strained by their housing costs, the same survey reveals that minor share of the burden results in arrears. Nevertheless, the survey results suggest that significant share of households is struggling with their compulsory housing expenses in Latvia and Lithuania. Even if these households would like to improve their living conditions, most probably they cannot afford it.

Perceive financial burden of the total housing cost (% in population)

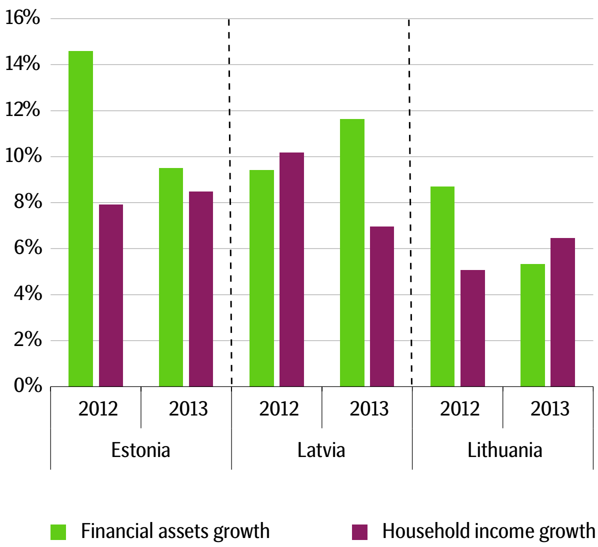


Source: EU-SILC, Eurostat

Slower growth in financial assets

In the year 2013, financial assets held by households (the total of deposits held in financial institutions, debt securities and other financial instruments, funds accumulated under the life insurance and voluntary pension accumulation agreements, and Pillar II Pension Funds) grew in all three countries: by 11.6 per cent – in Latvia, by 9.1 per cent in Estonia and by 5.3 per cent in Lithuania. Growth in financial assets in Lithuania and Estonia slowed down, as compared with the year 2012. (see Annual growth in financial assets and compensations to employees in 2012-2013).

Annual growth in financial assets and compensations to employess in 2012-2013 (in per cent)



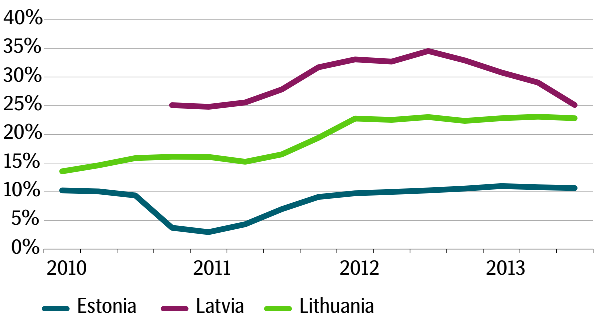
Source: National Statistics, SEB calculations

Slower growth was determined by changing household behaviours. Change in the household income (calculated as the change in compensations to employees at current prices) in Lithuania and Estonia in the year 2013 was larger than in the year 2012 also due to growing average wage and due to decreasing unemployment rate. Improving economic environment stimulates expectations of households thus the fear of the rainy is decreasing, and individuals more willingly spend larger amounts for consumption needs instead of saving every additional cent. Slightly different situation in Latvia is not deemed to be an exception. Household income growth pace in the year 2013 was slower than in the year 2012 but financial assets grew faster. However the main reason for accumulating larger volume of savings was the euro introduction expectations. A large number of the Latvian households, which previously kept cash, have deposited their money at financial institutions seeking to facilitate exchange of their savings into the euro. It means that increase in financial assets in this country to a large extent was determined by a simple temporary reallocation of assets from cash to deposits.
A portion of the financial assets per capita in Estonia, as previously was the largest – 5976 EUR, followed by Lithuania (3899 EUR) and Latvia (3731 EUR).
If the economic environment does not change remarkably, growth in financial assets held by households should be also slightly slower in the year 2014. Irrespective of the wage growth forecast in all countries, and shrinking unemployment in Lithuania and Latvia, if expectations do not reverse, a larger portion of income will be spent for consumption needs. Wage growth makes a direct impact on the value of assets accumulated in Pillar II Pension Funds as contributions depend on the amount of wage. Temporary increase in the financial assets, which was observed in Estonia in the year 2010 and last year – in Latvia, is also expected in Lithuania.

Towards cashless society

Temporary increase in the financial assets mentioned above is related with the euro introduction. Prior to the new currency introduction, private individuals deposit their savings at the financial institutions seeking to conveniently exchange money. The above phenomenon was also observed in Estonia at the end of the year 2010. Based on the preliminary calculations, the identical scenario of events should be observed in Latvia.

Household cash to deposits ratio development



Source: Central Banks

Calculations based on the total currency in circulation announced by the Central Bank show that, until to the third quarter of the year 2013, households in Latvia kept the greatest volume of savings in cash. Cash reserve, as compared with deposits in accounts at the financial institutions in this country, at the beginning of the year 2013 made up nearly 33 per cent. Meanwhile Estonia has the highest cashless society indicator. This ratio fluctuates at 10 per cent. Cash to deposits ratio making 22 per cent in Lithuania enabled it to take the second position among the three countries. However at the end of the year 2013, prior to the euro introduction date, our estimates showed that Latvian households have deposited nearly 40 per cent of their cash savings in accounts at the financial institutions and have reached the cashless society level of Estonia. However it might be just a temporary decrease as it was in Estonia in 2011. Also, the same development of cash to deposits ratio might be expected in Lithuania in the year 2014.

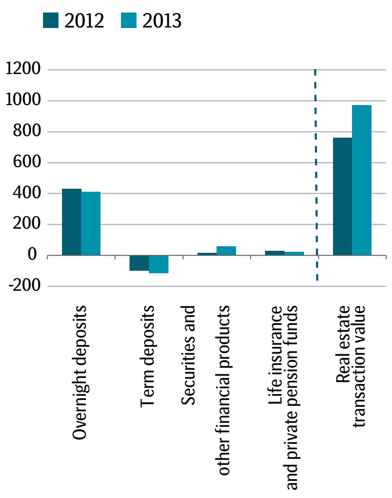
Use of payment instruments by households is one more indicator showing willingness of households to pay in cash. If a household receiving non-cash income withdraws cash from ATM instead of making non-cash transactions, such feature shows that cash is vital in society. Based on our estimates, at the end of the year 2013, the countries took the following positions in terms of this indicator: Estonia was again rated as the most cashless society with approximately 50 per cent ratio of card payments to total card turnover. In Latvia this ratio made up 35 per cent. Lithuania remains in the last position (30 per cent).
A conclusion can be made that Latvian households give priority to savings in cash, as compared to Estonia and Latvia. However the situation changed in principle prior to the euro introduction date. Lithuanians prefer to pay in cash. However in the long-run, and mostly for convenience purposes Lithuania and Latvia should decrease their cash levels. It is useful for the local economies: the shadow economy share is shrinking and money is used in a more efficient way.

Value of assets does not decrease and is only reallocated

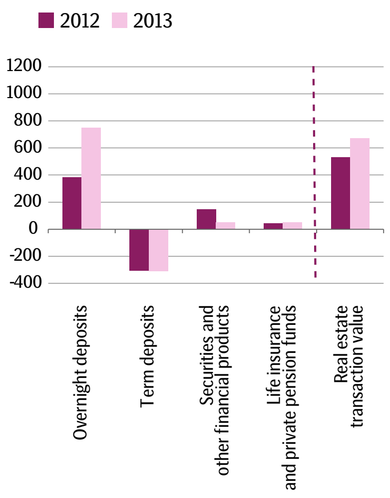
Some changes are already observed in the financial asset distribution statistics. A term deposit is no longer the most popular savings instrument if we speak about the new savings. This trend became obvious in the year 2013. Term deposits are substituted by overnight deposits, and the households with the aim of generating higher returns are looking for alternatives in securities markets, especially those who are entitled to receive personal income tax exemption.
The main reason of decrease in the term deposits is record low interest rates, which do not stimulate transfer of free funds to the term deposit accounts or extension of the deposit agreements at maturity even if the interest rate exceeds the inflation rate (in Latvia and Lithuania). Still, individuals in all three Baltic countries are unwilling to spend their savings for consumption (excluding the housing consumption) – they pay larger life insurance and voluntary pension accumulation premiums (in Latvia and Lithuania) and allocate more funds for housing and real estate investments in all three Baltic countries.

Investment in real estate rather often is equalled to investment in gold by investors (protection against inflation), as the real estate ensures the additional benefit to its owners: possibility to live or rent, and the homeownership increases security and satisfaction feeling. If the mortgage loan is obtained for acquisition of the residential property, such step may be considered the decision to accumulate assets. It is rather difficult to explain from the economic point of view, however the empiric observations show that households who have no potential to accumulate savings or assets (as they spend all earnings for consumption needs), if they obtain a mortgage loan they have sufficient funds for the loan instalments. Households are not able to save but they are able to reallocate their consumption to home improvement or purchase purposes.

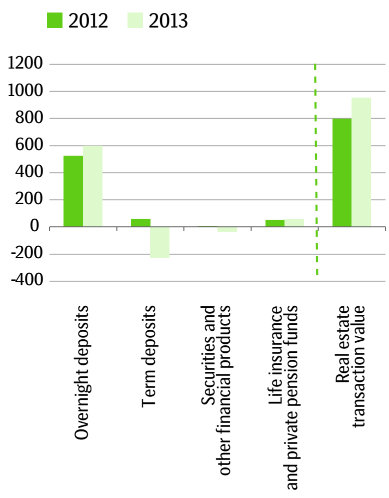
Real estate transaction value and net change in financial assets (mEUR), Estonia



Real estate transaction value and net change in financial assets (mEUR), Latvia



Real estate transaction value and net change in financial assets (mEUR), Lithuania

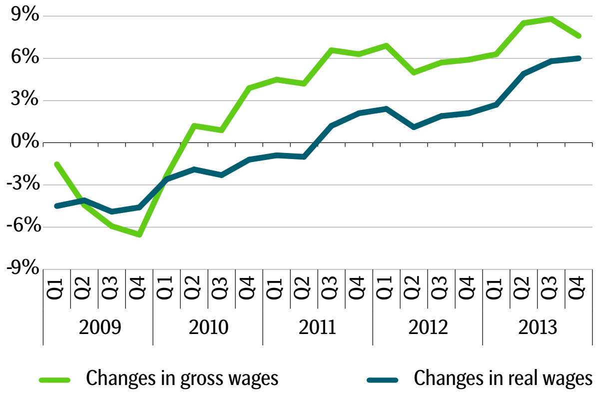


Source: SEB calculations

Estonia

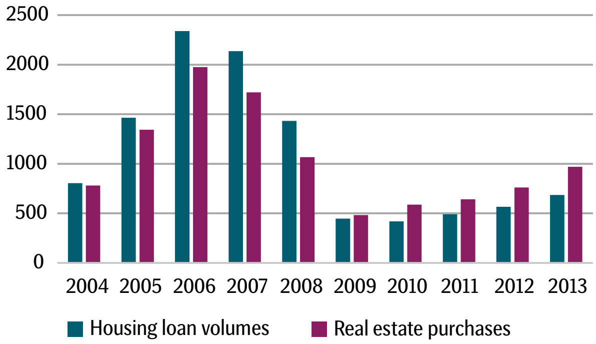
- In 2013 the average real wage has increased at an accelerating rate, reaching yearly growth of 6 by Q4 2013. The wage increase is uneven across different sectors reflecting low mobility of workers between the sectors. Real wage continues to increase but the unemployment rate is expected to decline in 2014 only marginally from the level of 8.7 per cent, which it had reached by the end of 2013.
- The housing loan market has started to recover in 2013 when housing loan volumes increased by 0.9 per cent compared to 2012. Households show increased interest in housing loans, while being still more careful about borrowing, and a significant share of real estate purchases are not financed by debt. In 2013, the real estate purchases by households exceeded the new housing loans by 41 per cent; for comparison, during the economic growth period the new housing loan volumes exceeded the value of real estate purchases.
- The volume of consumer credit and other loans decreased in 2013 by 4.6 per cent compared to 2012 and the negative trend is to continue in 2014. Households prefer to finance the consumption from their income or with hire-purchase instead of borrowing. Leasing volumes showed strong upsurge in 2013 (by 9.1 per cent) and the rise is expected to continue at the same pace in 2014. The remarkably high growth rates base on the sharp drop of leasing volumes during the recession and the share of current volumes is still 2/3 of the peak volumes in 2008.
- The volumes of deposits increased in 2013 by 6.4 per cent and are expected to grow at slightly lower rate in 2014. Although the inflation rate exceeds the interest rate of deposits, turning deposits into an unattractive way to keep one's savings, the uncertainty on stock markets does not encourage the use of more risky alternatives for keeping the savings. The shift from term to demand deposits continues.
- The overall financial situation of households continues to improve. At the end of 2013, the total loan volumes exceeded the deposits by 38 per cent, similarly to Q3 2005. The share of pension assets from total financial assets is increasing steadily and reached 26 per cent by the end of 2013 while being 18 per cent in 2008. The share of other investments makes 10 per cent of total financial assets and does not show any upward trend.
- Lack of good saving options might encourage households to spend the money instead. The retail sale has been continually growing at the yearly rate of 4-6 per cent in 2013 and at a slightly higher rate of 7 per cent in January 2014. According to the consumer survey from the beginning of 2014, there are more households who are ready to spend compared to the same period in previous years. The consumer confidence has been increasing as households perceive less uncertainty about the economy and their financial situation. However, the events in the Ukraine withhold the overly optimistic expectations. In February 2014, the retail sale increased by 3 per cent compared to a year ago.

Changes in gross and real wages (y-o-y, %)



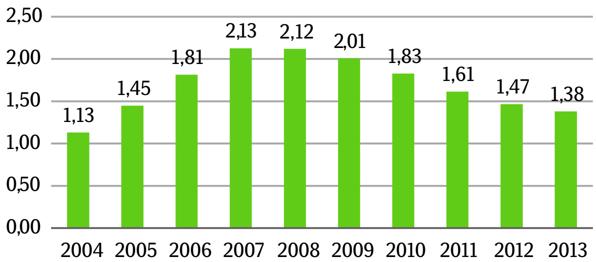
Source: Estonia Statistics

Housing loans and real estate purchases (mEUR)



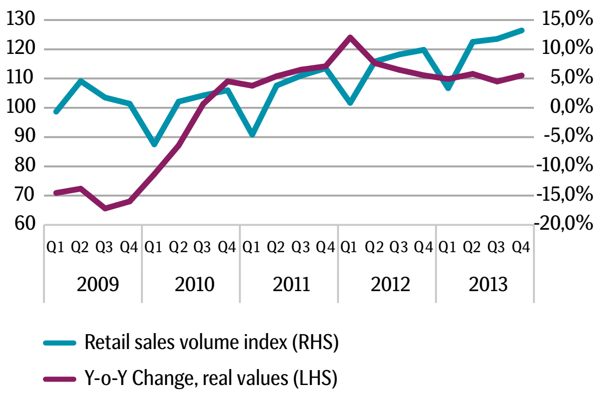
Source: Bank of Estonia

Ratio of loans to deposits



Source: Bank of Estonia

Retail sales in real volumes



Source: Statistics Estonia

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

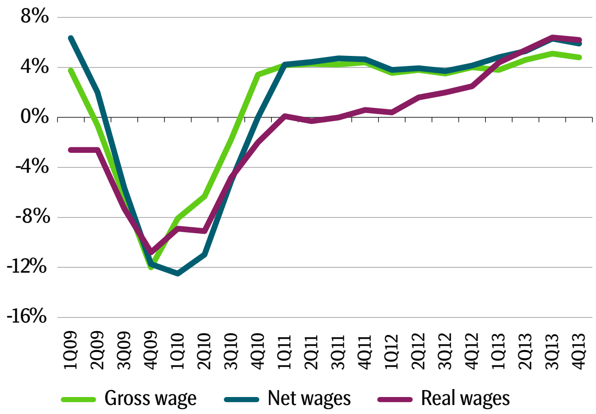
	2008	2009	2010	2011	2012	2013
Financial assets	**5067**	**5583**	**6049**	**6448**	**7160**	**7840**
Demand and overnight deposits	1635	1616	2054	2219	2649	3061
Term and other deposits with maturity	1966	2076	1860	2110	2012	1897
II pillar pension funds	728	947	1068	1130	1466	1766
III pillar pension (Funds + insurance)	179	214	254	255	283	304
Other investment via financial institutions*	121	281	307	256	332	365
Other securities**	438	449	506	479	419	448
Liabilities	**8252**	**7940**	**7614**	**7402**	**7253**	**7287**
Housing loans	6209	6111	5973	5882	5846	5896
Consumer loans	856	765	671	599	608	591
Other loans	647	618	600	582	451	419
Leasing	539	446	370	338	348	380
Net value of financial assets	**-3185**	**-2357**	**-1565**	**-954**	**-93**	**554**

Source: Bank of Estonia, Estonian Central Register of Securities, Financial Supervision Authority, SEB calculations
** Private portfolios, foreign investment funds and unit-link insurance*
*** Registered at Estonian Central Register of Securities*

Latvia

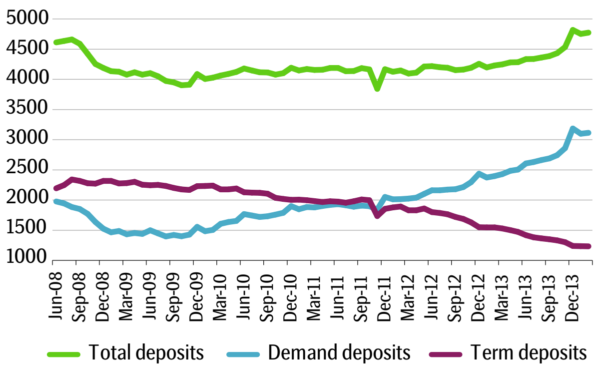
- Labour market improvements continue. In 2013 the unemployment rate dropped by 3.1 percentage points to 11.9 per cent, while the number of employed persons rose by 18.3 thousands. Employment grew more slowly compared to the previous year, indicating that slower economic growth affects job creation. As economic activity growth slows and uncertainty increases, companies are cautious about hiring of new employees. In 2014 job creation is expected to be sluggish; however, unemployment rate will continue decreasing.
- Household income is increasing. The average gross and net wages increased by 4.6 per cent and 5.6 per cent respectively, exceeding the pre-crises level. Wage growth continues to outpace inflation, improving the purchasing power of workers. In 2013 the average real wage increased by 5.6 per cent which is the fastest growth rate since 2008. However, the average real wage is still below the pre-crises level. In 2014 the purchasing power of households is expected to improve, as wage growth will continue (partly due to both a minimum wage increase and tax wedge reduction).
- The volume of deposits which grew only very sluggishly during the previous three years showed substantial increase in the last quarter of 2013. In 2013 the volume of household deposits grew by 13.3 per cent or by approximately EUR 555 million to EUR 4.72 billion, reaching the historically highest volume. The observed money inflow into deposits was primarily related to the euro changeover process, as households chose to put the cash savings into their bank account to convert lats to euros automatically and the amount of cash savings owned by households decreased substantially as well. Due to the record low deposit rates, households continue to shift their term deposits to demand deposits. In 2013 demand deposits rose by 30.8% while the volume of term deposits shrank by 19.9%.
- Households seeking higher returns are looking for alternatives to deposits. Ability to receive personal income tax exemptions for amounts transferred to private pension funds and life insurance savings facilitates the long-term savings. In 2013 the total contributions and payments to private pension funds was EUR 41.3 million, demonstrating 37 per cent increase compared to 2012. Contributions by pension plan participants rose even at a quicker pace (51 per cent y-o-y), reaching the highest level, while contributions paid by employers to personal pensions of their employees climbed only by 4 per cent. The total volume of private pension savings rose by 16.3 per cent during the last year. This increase resulted from both a net cash inflow and a positive investment result. The share of pension savings in total household financial assets is expected to increase further.
- The financial situation of households is gradually improving and demand for new loans is rising. In 2013 commercial banks granted to households EUR 334 million in new loans, up by 27.7 per cent from 2012. New mortgage loans totalled EUR 220 million, rising by 25.9 per cent y-o-y. Although demand for new loans is picking up, the amounts of newly granted loans are still low compared with the amortisation of previously issued loans. Last year the total household loan portfolio continued downward trend, decreasing by 8.3 per cent. Housing loans portfolio shrank by 5.1 per cent, while the stock of consumer loans was down by 42.5 per cent. Huge drop in volumes of consumer loans was partly due to the loan reclassification made by several commercial banks. Without shift from consumer loans to other loans, mainly housing loans, the decrease in consumer loans would be approximately 16 per cent compared to 2012. As household borrowing behaviour remains careful, the lending activity is expected to be modest. In 2014 the total household loan portfolio will continue to decrease, and the growth of the loan portfolio could resume only in 2015-2016.

Changes in average wages (%, YoY)



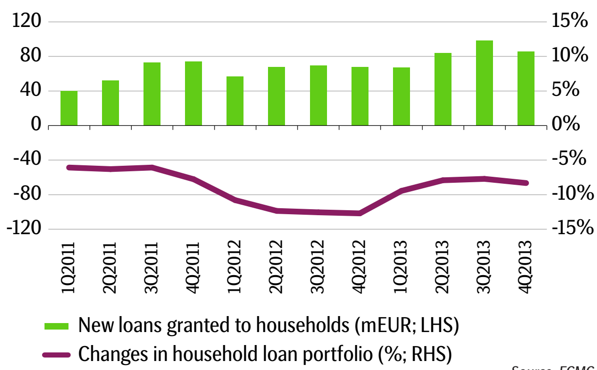
Source: CSB

Household deposits (mEUR)



Source: Central Bank

New lending to households and changes in household loan portfolio



Source: FCMC

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

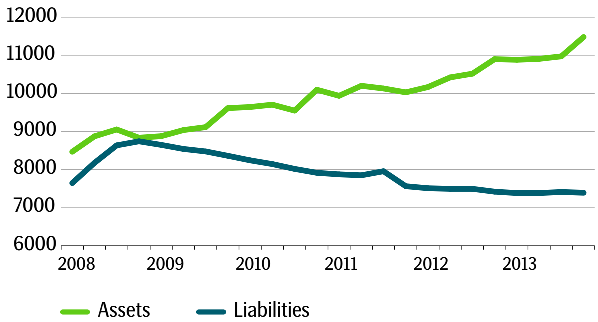
	2008	2009	2010	2011	2012	IIQ 2013	IVQ 2013
Financial assets	**5421**	**5677**	**6117**	**6125**	**6702**	**6850**	**7482**
Deposits	4109	3999	4108	4090	4257	4349	4735
Securities and financial instruments	394	375	485	411	559	541	592
Life insurance and private pension funds	259	301	347	377	424	440	474
Pillar II pension funds	660	1002	1178	1247	1462	1521	1681
Liabilities	**9559**	**8944**	**8400**	**7735**	**6748**	**6451**	**6162**
Mortgage loans	7188	6866	6554	5985	5328	5288	5055
Consumer loans	1121	1012	920	864	770	519	488
Other loans	755	736	682	679	481	486	453
Leasing	494	329	244	207	170	158	166
Net value of financial assets	**-4138**	**-3267**	**-2284**	**-1610**	**-46**	**399**	**1320**

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

Lithuania

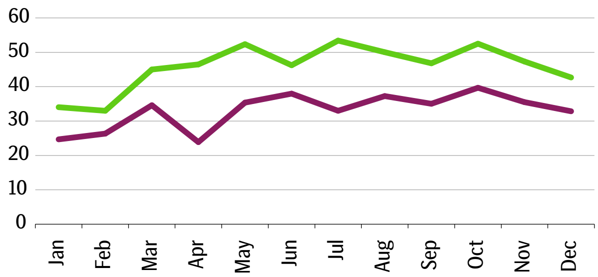
- Household income statistics show that the crisis period is now over. In 2013, the average wage and average pension increased, i.e. net wage – by 5 per cent and amounted to LTL 1809 (EUR 524), pension – by 1 per cent and amounted to LTL 826 (EUR 239). Wages and income grew at a faster pace than inflation.
- During a period of one year, the number of unemployed people dropped by 25.3 thousand, and the number of the employed grew by 29.2 thousand. Such figures enable to make an assumption that the unemployment rate is decreasing due to other factors than emigration.
- Based on the consumer sentiment survey data, positive changes of current financial standing are primarily identified by the young generation. Based on the data of the Statistics Department, in all age groups expectations related to changes in the future financial standing improve.
- Increase in income and improving expectations stimulate spending money for various consumption needs. However households demonstrate their resistance to the excessive spending temptations. Analysis of the retail trading volume in December, when consumption is the most intensive, shows that the pre-crisis trading volume of the Christmas season is not reached. Valuation at constant prices shows that the volume of food products and non-food products trading in December of the year 2013 is lower than six years ago, even if a decreased number of inhabitants is used in the recalculation.
- The volume of term deposits is gradually shrinking. During the period of one year, it decreased by LTL 785 (EUR 227) million. The main reason of decrease in the term deposits is extremely low interest rate, which does not stimulate transfer of free funds to the term deposit accounts or extension of the deposit agreements at maturity. Still, individuals are unwilling to spend accumulated savings or all income – they pay larger life insurance premiums, voluntary pension accumulation premiums and allocate more funds for investment in real estate.
- Based on the data of the Centre of Registers, in the year 2013 the amount spent for the residential property acquisition amounted to LTL 3.5 billion (EUR 1 billion) and exceeded the volume of the year 2012 by one third. Investment in real estate rather often is equaled to investment in gold by investors (should protect from inflation), as the real estate ensures the additional benefit to its owners: possibility to live or rent, and the homeownership increases security and satisfaction feeling.
- The mortgage market recovers much faster than the consumer loan market. As compared to the year 2012, volume of the new mortgage sales in 2013 was higher by 40 per cent, and of the new consumer loans – by 10 per cent. On the one hand, if the possibilities allow the residents give priority to long-term assets, instead of short-term hedonistic needs.
- In the near future such trends should continue: improvement of the economic environment will stimulate rational behavior of the majority of households when spending money for consumption needs. Assets accumulated in the financial institutions should grow – due to higher income and also due to expected introduction of the euro, as the experience of the neighboring countries showed that money kept in cash is deposited in the accounts with such institutions. Growing willingness of households to obtain loans will limit the retail loan portfolio shrinking or it may slightly grow.

Household financial assets and liabilities (mEUR)



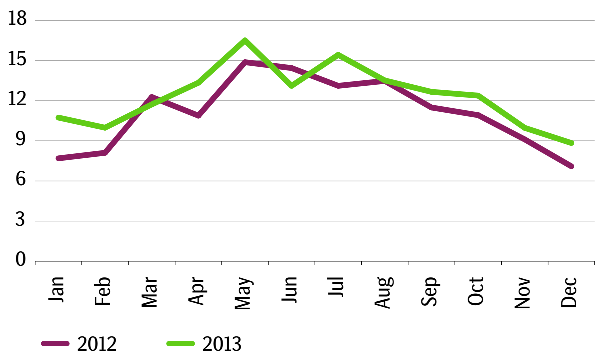
Source: SEB calculations

New mortgage loans (mEUR)



Source: Lithuanian Bankers' Association

New consumer loans (mEUR)



Source: Lithuanian Bankers' Association

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

	2008	2009	2010	2011	2012	2Q 2013	4Q2013
Financial assets	**8830**	**9614**	**10096**	**10028**	**10900**	**10908**	**11480**
Deposits	7152	7392	7856	7720	8322	8261	8702
Bonds (Lithuanian corporate bonds and Government bonds)	493	580	241	322	332	335	333
Units of investment funds offered by the banks	121	183	264	207	201	211	164
Savings under life insurance agreements	420	514	618	599	653	652	710
Pillar II pension funds	644	945	1117	1180	1392	1449	1571
Liabilities	**8740**	**8362**	**7917**	**7560**	**7418**	**7381**	**7391**
Mortgage loans	6055	6027	5983	5934	5874	5872	5897
Consumer loans	1265	1026	932	691	656	654	661
Other loans	1420	1309	1002	935	888	885	834
Net value of financial assets	**90**	**1252**	**2179**	**2468**	**3482**	**3527**	**4089**

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