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Abstract

Russian August 1998 economic crisis effected Baltic countries more than was expected. Estonia, Latvia and Lithuania have sunk into recession. Russia remained a key trading partner and a sizeable market for all three Baltic republics' exporters also after the declaration of independence despite the sometimes tense political situation. Current year's figures show a heavy decline in Baltic's exports to Russia and also decline in the growth of these economies. Growth forecasts for each Baltic country have been revised down. Food and beverage as well as processing industries as a whole have suffered the most. The decline of purchasing power in Russia due to the rouble devaluation and the weaknesses in the Russian economy will restrain Baltic countries' exports to Russia for years to come.

Keywords: Baltic countries, foreign trade, Russia

Introduction

In August 1998 Russia experienced an economic crisis as the Central Bank of Russia floated the rouble and the government declared a moratorium on it's debt. By May 1999 the rouble had lost 70 per cent of its pre-crisis value and Russian citizens had lost 35 per cent of their purchasing power. Total output plummeted by five per cent in 1998 .

Public optimism concerning the Baltic economies has vanished in the wake of the Russian financial crisis. For obvious reasons, Russia has historically been an important trade partner for the Baltics, despite tensions in political relations. Before the August crisis, Russia accounted for 24 per cent of Lithuania's exports, 21 per cent of Latvia's, and 15 per cent of Estonia's. Russia was also an important source of imports, especially energy imports, and the servicing of Russian transit trade represented another major business for these countries. The Baltic countries have attracted foreign direct investment (FDI) predicated on the development of port, pipeline and other infrastructure facilities as well as on the production of exports for the Russian, Baltic and the broader Nordic markets. To date, the crisis has had more dramatic consequences than expected. Growth forecasts have been revised downward for all of the Baltic countries. The hardest hit industries have been food and beverages and processing.

The effects of the Russian crisis on the Baltic economies can be divided into effects on foreign investors, disturbances to foreign trade, and indirect effects via international markets.

Effects of the crisis

GDP, industrial output and employment

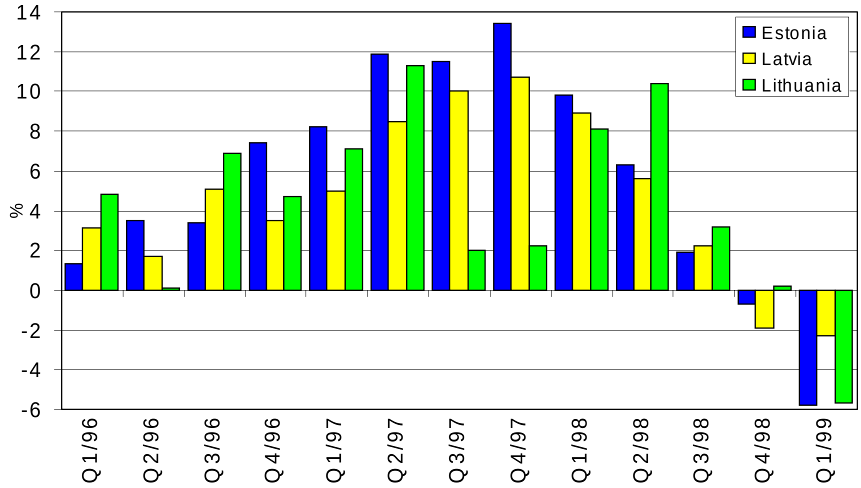
Estonia

Estonia's economy is the most open of the Baltic economies, with goods exports amounting to about 60 per cent of GDP in 1998. This makes Estonia's economy relatively vulnerable to international economic developments. Although Estonia was among the fastest growing transition economies in 1997, growth has been slowing. GDP grew by 4 per cent in 1998, which represented a sharp decline from the exceptional 10.6 per cent growth recorded in 1997. The downturn was mainly a result of the Russian economic crisis of August 1998 but was also affected by a tightening of domestic economic policy in late-1997 and early-1998. The Asian crisis, a bad harvest and difficulties in the banking sector also had negative effects on the growth rate for 1998. In the first quarter of 1999 Estonia's GDP declined by 5.6 per cent compared to the year-earlier period. Estonia's finance ministry has revised it's forecast for GDP growth in 1999 to 0.4 per cent. The finance ministry expects GDP to grow by over 4 per cent in 2000.

Industrial sales grew by only 0.5 per cent in 1998 compared to 13 per cent in 1997. In the first half of 1999, industrial sales recorded a 10 per cent decline compared to the year-earlier period. The pace of monthly decline is however slowing: In January the decline compared to the year-earlier period was 16 per cent, in February 12 per cent, and in June 7 per cent. The food and beverage industry contracted by 22 per cent in the first half compared to the first half of 1998.

Unemployment started to rise in September 1998. The official rate of unemployed job-seekers in Estonia was 5 per cent in June 1999 compared to 3.4 per cent in the year-earlier period. In February 1999 the unemployment rate was 6.1 per cent. The actual unemployment rate is much higher according to labour force surveys. The survey-based unemployment rate has hovered around 10 per cent. The latest survey, for 1999Q2, indicated an unemployment rate of 9.6 per cent.

Figure 1. Baltic countries' quarterly GDP growth, %



Sources: Statistical Office of Estonia, Statistics Department of Latvia, Lithuanian Statistics Department

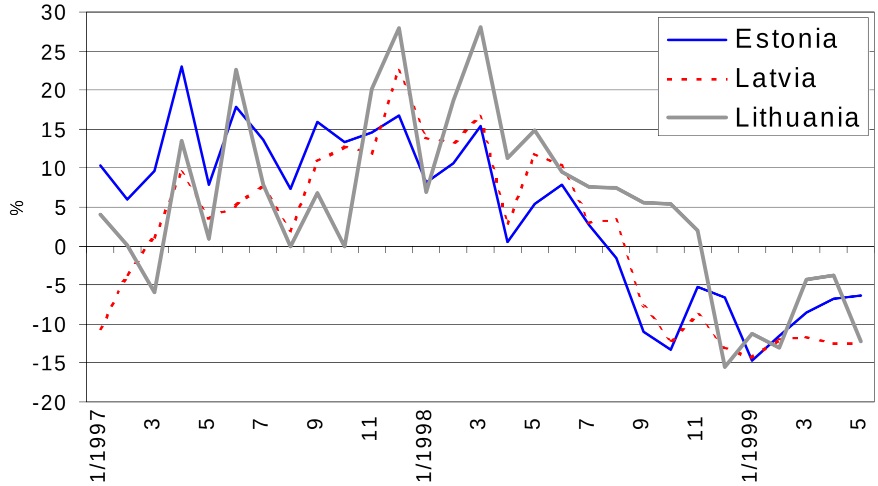
Latvia

Latvia's GDP grew for the third consecutive year in 1998, at a 3.6 per cent annual rate, following 8.6 per cent growth in 1997. Nonetheless, over the period 1989-1999, Latvia's economy has shrunk by 40 per cent, which is the steepest economic decline in that period in eastern and central Europe. The Latvian economy was hit hard by the Russian crisis. In the third and fourth quarters of 1998, a slowdown in economic activity became apparent and, in the first quarter of 1999, GDP actually declined by 2.3 per cent compared to the year-earlier period. The finance ministry has scaled down its forecast for GDP growth in 1999, from 4 per cent to 2 per cent, and Latvia's central bank is forecasting 1-2 per cent GDP growth.

The growth rate of industrial output has been declining since September 1998. For the first five months of 1999, industrial output actually declined by 13.7 per cent compared to the year-earlier period. The largest declines in production occurred in mining, the food industry, and in the manufacture of consumer electronics and telecommunications equipment. Output in the energy and metals industries recorded increases.

The slowdown of economic activity has caused a rise in the unemployment rate. Based on official registrations, the unemployment rate was 10 per cent in July 1999, but the actual rate is much higher. In May 1998 the official (registered) unemployment rate was 7.0 per cent but, according to the labour force survey, the rate at that time was 14.7 per cent. Higher expenditures on unemployment benefits also puts pressure on the state budget, which was supposed to have a deficit of 3.5% of GDP.

Figure 2. Change in industrial production, year-on-year



Sources: Statistical Office of Estonia, Statistics Department of Latvia, Lithuanian Statistics Department

Lithuania

GDP growth has declined also in Lithuania. In 1997 GDP grew by 7.3 per cent and in 1998 5.1 per cent. Forecasts for 1999 indicate a further decline in growth. In the first quarter of 1999, GDP plummeted 5.7 per cent compared to the year-earlier period. Lithuanian's Economy Ministry has revised it's forecast for 1999 GDP growth from 3.7-4.1 to 1.3-1.6 per cent. The 1999 budget was drawn up on the basis of 5.5 per cent projected GDP growth for the full year.

Despite the Russian crisis, industrial production grew by 7 per cent in 1998 compared to 1997. This was by far the largest increase in the Baltics. However, the trend has turned downward. Industrial production declined month-on-month by 3.2 per cent in November and 6.8 per cent in December. For the first six months of 1999, industrial output dropped by 7.1 per cent compared to the year-earlier period. The volume of Russian crude oil processed at the Mazeikiu Nafta refinery fell by 41.2 per cent in May year-on-year. The Mazheikiu Nafta oil refinery is important to the national economy: Some experts estimate it accounts for as much as a tenth of Lithuania's GDP and a quarter of total tax revenue.

Unemployment based on the number of persons officially registered as unemployed was 7.5 per cent in June 1999, up from 5.5 per cent a year earlier. The latest labour force survey, for last November, indicated an unemployment rate of 12.6 per cent whereas registered unemployment amounted only to 6.5 per cent.

Table 1. Baltic countries' key economic indicators

ESTONIA	1995	1996	1997	1998	1999*	* as of
GDP growth, %	4.3	3.9	10.6	4.0	- 5.6	Q1/99
Industrial sales growth, %	2.0	3.	13.0	0.5	- 10.0	H1/99
12-month inflation rate, Dec-Dec, %	28.9	14.8	12.5	6.5	3.1	6/99
Ratio of budget balance to GDP, %	- 1.2	- 1.9	2.2	-0.3		
Trade balance, USD m	- 674.0	- 1021.0	-1129.0	- 1117.0	- 400.0	1-5/99
Ratio of current account to GDP, %	- 5.2	- 9.2	- 12.0	- 8.6	- 7.0	Q1/99
Registered unemployment rate, %	5.0	5.5	4.6	5.1	5.0	6/99
LATVIA	1995	1996	1997	1998	1999*	* as of
GDP growth, %	- 0.8	3.3	8.6	3.6	- 2.3	Q1/99
Industrial sales growth, %	- 6.3	1.4	6.1	2.0	-13.7	1-5/99
12-month inflation rate, Dec-Dec, %	23.1	13.1	7.0	2.8	1.9	6/99
Ratio of budget balance to GDP, %	- 3.4	- 1.1	1.8	0.2	- 7.9	H1/99
Trade balance, USD m	- 579.0	- 798.0	- 848.0	- 1126.0	- 387.0	1-5/99
Ratio of current account to GDP, %	- 0.4	- 5.5	- 6.1	- 11.1	- 8.7	Q1/99
Registered unemployment rate, %	6.6	7.2	7.0	9.2	10.0	7/99
LITHUANIA	1995	1996	1997	1998	1999*	*as of
GDP growth, %	3.3	4.7	7.3	5.1	- 5.7	Q1/99
Industrial sales growth, %	5.3	5.0	0.7	7.0	- 7.1	H1/99
12-month inflation rate, Dec-Dec, %	35.7	13.1	8.4	2.4	0.6	6/99
Ratio of budget balance to GDP, %	- 5.1	- 4.6	- 1.8	- 5.8	- 14.9	H1/99
Trade balance, USD m	- 698.0	- 896.0	- 1147.0	- 1518.0	- 700.0	1-5/99
Ratio of current account to GDP, %	- 10.2	- 9.2	- 10.2	- 12.1	- 9.6	Q1/99
Registered unemployment rate, %	7.3	6.2	6.7	6.9	7.5	6/99

Sources: Statistical Office of Estonia, Statistics Department of Latvia, Lithuanian Statistics Department, Statistics Finland, European Commission

Foreign trade, current account and FDI

Estonia

Although Russia's share of Estonian foreign trade was lower than the shares in the other two Baltic countries, the crisis in Russia in August 1998 had a detrimental effect on the Estonian economy. In July 1998, before the Russian crisis, Russia accounted for 12 per cent of Estonia's exports and 7 per cent of imports. Depreciation of the ruble led to a notable reduction in domestic private consumption, which in turn caused a 10.5 per cent drop in Estonian exports to Russia in 1998. Imports from Russia, on the other hand, stayed at the same level as in 1997.

The Russian crisis revealed the vulnerability of Estonia's export sector. The structure of exports is concentrated on foodstuffs and transportation services. Most affected were the country's dairy, fish and other food industries, for which Russia is an important market. The metal working, mineral products, chemical and machinery sectors were also affected. Despite a 15 per cent decrease, foodstuffs remained the main product in exports to Russia, accounting for almost 50 per cent of exports to Russia,[1] followed by transport vehicles, chemical products, metal and metal products, and mineral products. The decline in goods exports was partly offset by increased revenues from service exports, mainly in connection with transport of Russian exports. Fourteen per cent more freight was loaded and unloaded in Estonian ports in the first quarter of 1999 than in the same period a year earlier. Six-month freight turnover at the Port of Tallinn was almost 25 per cent higher in 1999 than in the same period last year. The amount of transit cargo via Estonia also increased.

In 1998 the current account deficit amounted to 8.6 per cent of GDP (12 per cent in 1997). In the first quarter of 1999 Estonia's current account narrowed to 7 per cent of GDP compared to 11 per cent in the year-earlier period. The Russian crisis substantially reduced the growth of exports in 1998. Import growth has also slowed as domestic demand has contracted. In the first four months of 1999 Estonian exports decreased by 14 per cent compared to the year-earlier period while imports fell by 22 per cent. Exports to Russia recorded a 21 per cent decline in May, year-on-year.

At end-May, Estonia held gold and currency reserves worth USD 634 million, which is less than the three-month value of imports. Compared to the end-May figure a year ago, gold and currency reserves were down 12 per cent.

The government's liberal economic policies and Estonia's prospective membership in the EU have made the country a favoured destination of FDI. The Russian crisis has not had a significant impact on FDI flows to Estonia. In 1998 Estonia took in a record amount of FDI, more than double from the 1997 figure. This was mainly due to heavy investments by Swedish investors in the two biggest Estonian banks. FDI flows to Estonia in the first quarter of 1999 amounted to USD 1.95 billion, an increase of 21 per cent compared to the year-earlier period. Estonia is thus positioned to become the second leading recipient of FDI per capita after Hungary among the central and eastern European countries.

Latvia

The Latvian economy is not quite as open as the Estonian economy. Goods exports amount to about 30 per cent of Latvian GDP, and dependency on Russia has been declining since Latvia's declaration of independence. Presently, more than half of Latvia's trade is with EU countries, and only 5-6 per cent of its GDP is directly linked to exports to Russia[2]. The impact of the Russian crisis on Latvia has been stronger than expected. In recent years the service sector has helped to drive GDP growth, along with the export sector[3]. While retail and wholesale trade grew by 20 per cent in 1998 the banking sector recorded a decline in 1998. The transport sector is important to Latvia. Cargo transit by rail declined by 13 per cent year-on-year in the first half of 1999. Cargo transport declined by 8 per cent in the first quarter of 1999 compared to the year-earlier period. However, 3 per cent more cargo was loaded at Latvian ports in the first half of 1999 compared to same period in 1998.

Exports from Latvia increased by 10 per cent in 1998 and imports by 19 per cent. Latvia's exports to CIS countries accounted for 19 per cent of total exports in 1998 (30 per cent in 1997). The EU's growing share in trade with Latvia amounted to 57 per cent for exports (49 per cent in 1997) and 55 per cent for imports (53 per cent in 1997). Exports to Russia, which accounted for 12 per cent of total Latvian exports in 1998, declined by 37 per cent compared to 1997. Food sector exports declined the most (15 per cent) while machinery exports fell by 11 per cent. Latvia imported mostly machinery, part of which (mostly automobiles) was re-exported to Russia. After the crisis in August, this type of transit export virtually disappeared.

In May 1999 Latvia's exports to Russia fell by 50 per cent year-on-year. Agricultural companies, including dairies, fisheries and fish processors, have suffered the most from the crisis. Foodstuffs comprised the most important sector in total exports to Russia (25 per cent share), followed by machinery and electrical equipment (12 per cent) and textiles (10 per cent). Imports from Russia fell during the same period by 8.6 per cent. Mineral products (35 per cent share) and metals (22 per cent) were the primary import sectors in Russian trade.

The current account deficit in the first quarter of 1999 was 8.7 per cent of GDP, which was higher than in the first quarter of 1998 (5.7 per cent) but lower than in the fourth quarter of 1998 (17.2 per cent). This decrease resulted from a narrowing of the trade deficit due to a bigger decline in imports than exports. In the first five months of 1999, the trade deficit narrowed by 19 per cent compared to the year-earlier period. Exports declined by 10 per cent and imports by 14 per cent.

Latvia's foreign reserve assets came under pressure during the Russian crisis but the situation eased toward year-end. The country's gold and foreign exchange reserves stood at LVL 706 million (USD 1.2 billion) at end-May, which was 11 per cent higher than a year earlier. Latvia's reserves cover nearly five months of its imports.

FDI to Latvia, which increased significantly in 1996 and 1997, was probably hurt by the Russian crisis. In 1998 the inflow of FDI fell by about 50 per cent compared to 1997 and amounted to 4 per cent of GDP. During the first quarter of 1999, FDI to Latvia amounted to 6.4 per cent of GDP compared to 5.5 per cent a year earlier.

Lithuania

The trade deficit widened throughout 1998. Lithuania has also been hit by knock-on effects of economic problems in Belarus and Ukraine. Before the crisis, Russia's share of Lithuania's exports amounted to over 20 per cent and Ukraine and Belarus together to another 20 per cent. Exports amount to 55 per cent of GDP. Exports to Russia fell month-on-month by 34 per cent in August 1998 and 60 per cent in September. In 1998 exports to CIS countries declined by 25 per cent while exports to the EU increased by 10.5 per cent. In the first five months of 1999 exports to Russia fell by 75 per cent compared to the year-earlier period; imports fell by 31 per cent. Cargo flows via Lithuanian ports increased year-on-year by 3 per cent in the first half of 1999. In the same period 3.8 per cent less freight was carried by rail.

Several sectors are suffering from the crisis. Because their customers have been largely located in Russia, the food and textile industries and automobile exporters have been particularly hard hit. For example, since the crisis fur production has decreased by more than 50 per cent and leather production by 45 per cent. The food industry accounts for about 30 per cent of Lithuania's industrial production, and its most important market area has been Russia (36 per cent share in 1997). Used car sales are an important export activity, accounting for 20 per cent of total exports to Russia. In the first five months of 1999, vehicle exports to Russia declined by 83 per cent, chemistry goods by 78 per cent and minerals by 86 per cent compared to the year-earlier period. Agricultural enterprises sold 80 per cent of their exports to Russia.

The current account deficit continued to grow and amounted to 12.1 per cent of GDP in 1998 compared to 10.2 per cent in 1997. In the first quarter of 1999 the deficit decreased to 9.6 per cent vs 14.4 per cent in the fourth quarter of 1998. Lithuania's trade deficit fell by 11 per cent year-on-year in the first five months of 1999. Exports fell by 24 per cent and imports by 20 per cent. Russia's share in Lithuania's total exports amounted to 7 per cent in the same period (21 per cent in Jan-May 1998), and Russia's share in imports was 19 per cent.

Lithuania held gold and currency reserves of LTL 5.4 billion (USD 1.35 billion) in May, which reflected a 16 per cent increase from May 1998. Lithuania's reserves cover about four months of imports.

FDI flows to Lithuania in 1998 amounted USD 900 million, which is more than twice the amount for 1997. The manufacturing sector attracted the largest share of FDI (31 per cent) in 1998. However, during that year the emphasis switched to communications, retail trade, transport and tourism. In the first quarter of 1999, inward FDI amounted to USD 75 million, ie almost 10 per cent less than in the same period of 1998.

Table 2. Key trade partners in Baltic country exports, %

Share of Estonian exports			
Country	1997	1998	1999 I-IV
Finland	15.7	18.7	19.4
Sweden	13.5	16.5	18.3
Russia	18.8	13.4	8.8
Latvia	8.6	9.5	8.2
Germany	5.6	5.5	7.8
Share of Latvian exports			
Country	1997	1998	1999 I-III
Germany	13.8	15.6	17.3
United Kingdom	14.3	13.5	16.0
Sweden	8.3	10.3	11.3
Lithuania	7.5	7.4	6.8
Russia	21.0	12.1	6.5
Share of Lithuanian exports			
Country	1997	1998	1999 I-III
Germany	11.4	12.9	16.6
Latvia	8.6	11.2	11.0
Belarus	10.3	8.8	7.5
Russia	24.5	16.7	7.1
Ukraine	8.8	8.0	2.9

Sources: Statistical Office of Estonia, Statistics Department of Latvia, Lithuanian Statistics Department

Financial and banking sector

In August 1998 Moscow defaulted on its GKO treasury bills (rouble-denominated short-term government paper), after which the Russian rouble collapsed. Some Baltic banks, especially in Latvia, were hit hard because of large investments in GKOs. The Bank of Latvia has estimated that Latvian banks had about 8 per cent of their combined assets invested in Russia, of which more than 40 per cent was tied up in short-term GKOs. Estonian and Lithuanian banks were much less directly exposed to the GKO market.

Estonia

Of the transition economies, Estonia was the first to adopt a currency board as its monetary system, in 1992. The currency board arrangement has been very useful in achieving macroeconomic stabilisation. The Estonian kroon is pegged to the Deutschemark.

While the direct effect of crisis on Estonian banking system has been modest, it is clear that banks have been hurt by the general economic slowdown. Moreover, there has been extensive restructuring in the financial sector. Out of twelve banks in existence at the start of 1998, three have been closed and the other six merged into three bigger banks. One was taken over by the state. There has been a heavy inflow of FDI to the banking sector, and the two biggest banks in Estonia are now in the hands of Swedish banks. These events have broadened the capital base of the Estonian banking system, eased access to international capital markets, and possibly upgraded corporate governance. Estonian banks were not heavily invested in Russian debt instruments. These accounted for only 0.1 per cent of Estonian banks' total assets at end-July 1998. The Estonian bourse has started to recover from the moderate shock caused by the Russian crisis in autumn of 1998. From the start of the year to 22 July, the Tallinn stock exchange's TALSE index rose by about 29 per cent, although it was still 19 per cent lower than a year earlier.

Last autumn after the Russian crisis, the one-month Talibor rate began to climb, from about 10 per cent in August to 15 per cent in September and to over 18 per cent in the last two months of 1998. There has been a rapid drop in nominal interest rates since the start of 1999, both in the interbank market and in lending to customers. The one-month Talibor rate has fallen from 17 per cent at the start of 1999 to below 6 per cent.

Latvia

The immediate impact of the Russian debt moratorium on the assets of Latvian banks was quite substantial. Their exposure to Russia amounted to about 8 per cent of total banking sector assets. The exposure of Latvian banks to Russian GKO bills totalled 3 per cent of combined banking sector assets. The most important bank affected was Rigas Kommercbanka, which previously was the fourth largest bank in Latvia. Latvia's central bank has closed or suspended three banks. Many of the Latvia's biggest banks suffered heavy losses in 1998.

The Baltic stock exchanges have followed the same trends as in most developing countries. The downtrend in prices through most of 1998 was affected by the southeast Asian crisis and ripple effects from the Russian financial crisis. The Dow Jones Riga Stock Exchange index (DJRSE) was around 590 in September 1998, 189 in mid-August 1998, and 98 by year-end. Since the start of 1999 year the DJRSE index has fallen by about 15 per cent. The heavy decline in the share prices underlines the high dependency of Latvia on Russia as a commercial and financial partner

The one-month Rigibor rate was at the 5-6 per cent level during the months prior to the Russian crisis. The rate then started to rise, breaching the 11 per cent level in November. The one-month Rigibor has been falling since then, to less than 6 per cent in July.

Lithuania

As mentioned before, Lithuania's monetary system is based on a currency board arrangement, introduced in 1994. Since the litas is pegged to the dollar, the euro's weakness has caused problems for Lithuanian exporters. Lithuania' central bank is considering a new exchange rate regime in which the litas would be pegged to a euro-dollar basket. It is anticipated that ultimately the litas will be pegged exclusively to the euro.

The Russian crisis has not had as serious an impact on Lithuania's banks as on those of the other Baltic countries. Total banking system exposure to Russia at the start of September amounted to 1.4 per cent of total assets. Lithuanian banks' indirect exposure, via bank loans to companies heavily involved in exporting to Russia, is greater than that of banks in other Baltic countries because of Lithuania's larger exposure to the Russian market. Although many Lithuanian firms are suffering, no significant Lithuanian company has yet gone bankrupt because of its dependence on Russian trade. Most Lithuanian banks generated profits for all of 1998. By 21 July 1999, the Lithuanian bourse index had fallen by some 25 per cent over the past 12 months. Since the start of 1999 the Litin has depreciated by about 2-3 per cent.

Average annual interest rates in Lithuania on instruments with maturities up to one month have stablized at less than 14 per cent compared to over 20 per cent in February. These rates started to climb in autumn 1998 after the economic crisis in Russia, reaching about 12 per cent in September, 15 per cent in December and over 17 per cent in January.

Future prospects

The decline of purchasing power in Russia due to the rouble devaluation and economic problems will restrain Baltic countries' exports to Russia for years to come. In the first three months of 1999 Russia's total imports fell by about 50 per cent from the previous year. Restrictions on rouble convertibility have caused additional problems for foreign enterprises. Any further administrative hurdles would render foreign enterprises even more cautious regarding the Russian market.

GDP will probably start to rise gradually after the slowdown in the early months of 1999. The evolution of foreign trade in the first quarter of 1999, when exports fell less than imports, suggests that the current account deficit will continue to narrow, unless economic growth and import demand increase dramatically in the second half of 1999. The Baltic banking sectors seem to have overcome the Russian crisis, and most of banks earned profits in the first half of 1999.

The Baltic countries are facing wide budget deficits for the current year and budget cuts are probably inevitable. The Latvian government decided to freeze state spending for June, July and August. The decision on a possible negative supplementary budget will be made later. Estonia's parliament already endorsed a billion kroon budget cut in June 1999. This was in response to a larger-than-expected state deficit caused by a slowdown in economic growth.

In the future the EU and world economies will pose a greater threat or opportunity to the Baltic countries than will the Russian economy, and the importance of the EU will increase. More than half of Baltic countries' trade is with EU countries. The most important goal of the

Baltic countries is probably accession to the EU, but much must be done before this can achieved. Also of importance as regards foreign trade for Estonia and Lithuania is to gain WTO membership; Latvia is already a member.

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Notes

[1] The collapse of the rouble abruptly halted foodstuffs exports from the Baltic countries to Russia, so that the food industry was forced into layoffs and furloughs. Foodstuff exports to Russia are recovering but prices are still much lower than pre-crisis levels. In June the producer price index fell (year-on-year) by 1.9 per cent in Lithuania, 2.3 per cent in Estonia and 5.2 per cent in Latvia .

[2] See Suomen Ulkomaankauppaliitto: Muuttuva Itä-Eurooppa 2/99

[3] See Suomen Ulkomaankauppaliitto: Muuttuva Itä-Eurooppa 2/99