BANK OF FINLAND
Institute for Economies in Transition

BALTIC ECONOMIES
The Quarter in Review
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ESTONIA

SIDOTTAVA KPL

New government to tackle difficult tasks

Following the March regular parliamentary elections, a new right-wing government entered office under the leadership of Mr. Mart Laar (40). His coalition government unites two major right-wing parties and the right-to-the-centre Social Democrats. The coalition commands a narrow 53-seat majority in the 101-member parliament.

Mr. Laar was prime minister from 1992 to 1994, and can be considered one of the masterminds of the liberal economic reforms that Estonia has pursued ever since. No big changes in transition policies are expected.

Growth prognoses scaled down

Estonia's economy is the most open among the Baltics, with goods exports equalling some 60% of GDP in 1998. These heavy exports make the country vulnerable to international economic developments both East and West.

In 1998, the Estonian economy grew by 4 % according to preliminary information. GDP growth decelerated considerably during the year, however, with the fourth quarter showing an increase of only 0.2 % from a year earlier. According to the central bank, GDP may have declined in the first quarter of the current year. In April, the finance ministry revised its growth estimate for 1999 downwards, decreasing it from 4% to 2-2.5% due to the continuation of the Russian crisis and weakening growth prospects of Western European economies.

The effects of the Russian crisis continue to be felt. In the first quarter of 1999, industrial sales were down 11.4 % from a year ago, while the decline in the fourth quarter of 1998 was 8.4 %. The monthly decline, however, slowed during the first quarter.

Unemployment started to rise in September 1998. In February 1999, the unemployment rate was 6.1%. This rate is based, however, on data from labour authorities on registrations and job seeking, which limits its coverage. The actual unemployment rate is much higher as indicated by labour force surveys (LFS). During recent years, the LFS unemployment rate has hovered around 10 %.

Budget feels the growth slow-down

To achieve balance, the 1999 budget assumes GDP growth of 4%, which, according to the current knowledge, is far too high a figure. Budget revenues clearly reflect decelerating economic growth. January-March was not only below target, but also below last year's level. As its priority task, the new government prepared amendments to this year's budget in order to squeeze expenditures by one billion kroons, i.e. 5% of the total expenditure. However, according to the IMF, whose mission was in Tallinn in early May, expenditure cuts of over 2 billion kroons are needed to ease the situation. The parliament is set to discuss the government's proposal in June.

Inflation down, current account deficit narrows

Reflecting the slowing economic growth, inflation has continued its downward trend. In March, the 12-month rise in consumer prices was only 3.6%.

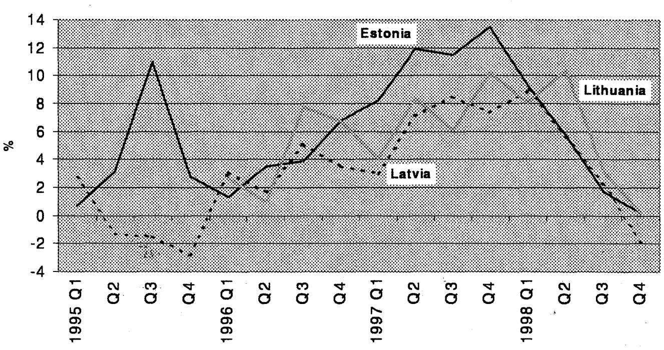
Estonia's large current account deficit improved last year, due to faster growth of exports than imports. The current account deficit amounted to 8.6% of GDP, as compared to 12% in 1997. In the first quarter of 1999, however, import growth seems to be picking up again.

Foreign direct investment hits new high

Last year, Estonia attracted a record amount of foreign direct investment (FDI). This was largely due to foreign acquisitions of the country's two leading banks. The inflow of FDI amounted to USD 565 million, i.e. 11% of Estonia's 1998 GDP. On a per capita basis, Estonia ranks third among transition economies in attracting FDI, after Hungary and the Czech Republic.

On the foreign trade front in March, Estonia completed negotiations on its membership in the World Trade Organization. For the membership to enter in force, Estonia must still amend a few existing laws and draw up several new ones.

GDP by quarters in the Baltics, year-on-year growth



ESTONIA	1994	1995	1996	1997	1998	1999,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.0		
Industrial sales, %-growth	-3.0	2.0	3.4	13.0	0.5	-11.4	Q1/99
Inflation, %-growth, December-December	41.7	28.9	14.8	12.5	6.5	3.6	3/99
Average wage, USD, annual average	134	208	248	256	291		
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.1	2/99
Exports, USD million	1320	1854	1814	2298	2684		
Imports, USD million	1681	2526	2835	3427	3801		
Current account, % GDP	-7.2	-5.2	-9.2	-12.0	-8.6		

Sources: Statistical Office of Estonia, Bank of Estonia

LATVIA

Production contracts

The impact of the Russian economic crisis continues to be pronounced in Latvia. In 1998, GDP grew by 3.6% – less than half the previous year's rate. In the fourth quarter of 1998, GDP dropped by 1.9%, which was the first decline since 1995. At that time, the contraction was due to a domestic banking crisis.

The finance ministry has scaled down its forecast for the current year's GDP growth from 4% to 2%. According to estimates, the first half of the year would see further contraction or perhaps slight growth. The decline of industrial output that started last September continued by 15% in January and 12% in February as compared to the same months a year earlier.

The Latvian economy is not as open as Estonia's, with goods exports amounting to about 30% of GDP. If services are added, the share increases to over 40%. The bulk of service income comes from cargo transit to and from Russia. Last year, cargo transit by rail declined by 9%. This downward trend continued in the first months of this year.

Inflation down, unemployment up

Weak foreign and domestic demand is witnessed by a constant decline of producer prices since November. In March 1999 they were 4.3 % lower than a year before. Consumer prices hit new bottom in March when the 12-month increase was 2.3 %.

Reflecting the slackening growth, unemployment has risen, breaking new records every month since November. The unemployment rate based on official registrations reached 10.1% in March. A more realistic picture of unemployment is, however, offered by the labour force surveys (LFS) carried out by Latvian authorities twice a year. The latest LFS data available are from May 1998. They showed an unemployment rate of 14.7%, while the registration-based rate was 7.0%.

Registration-based unemployment rates are not comparable across the Baltics because principles of registration differ. However, as they are produced every month, they show the current development in each country. LFS-based unemployment rates are in principle comparable between countries. According to them, unemployment has generally been highest in Latvia.

Internal and external imbalances a threat

Latvia's current account imbalance reached worrying dimensions towards the end of last year. In 1998, the deficit reached 11% of GDP, with the fourth quarter's deficit amounting to 17%. Latvian exports to Russia and other CIS states have been declining steadily since August last year. In the fourth quarter, they equalled less than 40% of their value a year ago, causing total exports to decline. Total imports started to decrease in January 1999, which offered some hope of squeezing the current account deficit.

The slowdown in economic activity also affects the fiscal situation. While the current year's budget was planned to be in balance (excluding state on-lending), the smaller-than-envisaged tax revenue collected in the first quarter signals a threat to budget balance.

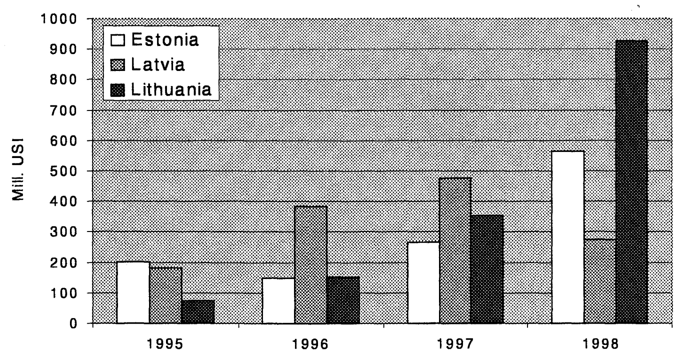
Foreign direct investment declining

The inflow of FDI amounted to USD 275 million, or 4% of GDP in 1998. This was only about half the sum received the previous year. Partly this was due to the fact that privatization of large enterprises was postponed due to disagreements in government circles concerning the principles of privatisation. Furthermore, the Russian crisis may have made Western investors more cautious towards Latvia.

Baltic free trade agreement under pressure

The Baltic free trade agreement, which entered into force in 1994, was later extended to cover agricultural products. Free trade in agricultural goods, however, has proven rather difficult to implement. During the past six months both Latvian and Lithuanian authorities have prepared measures to restrict imports of certain food products from their Baltic neighbours. In all cases, however, the respective authorities backed down from implementation of the restrictions after receiving official notes from the other Baltic countries stating that the measures violated the Baltics' mutual free trade agreement.

Foreign direct investment inflow in the Baltics, USD million



LATVIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.6		
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-12.1	2/99
Inflation, % growth, December-December	26.3	23.1	13.1	7.0	2.8	2.3	3/99
Average wage, USD, annual average	128	170	179	207	226		
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	10.1	3/99
Exports, USD million	1020	1367	1488	1839	2012		
Imports, USD million	1321	1947	2286	2689	3138		
Current account, % GDP	4.8	-0.4	-5.5	-6.3	-11.1		

Sources: Central Statistical Bureau of Latvia, Bank of Latvia

LITHUANIA

Economy grows at a slower pace

In 1998, Lithuania recorded the fastest growth in the Baltics with GDP increasing by 5.1%. The slowdown in growth that started in the third quarter of last year, however, was marked. In the fourth quarter, production stayed practically at the same level as in Q4 1997.

The contraction in industrial output that started in December continued in the first quarter of 1999 with a decline of 9% from the same period a year ago. The rate of decline, however, slowed as the quarter progressed.

Goods exports amount to roughly 30% of Lithuania's GDP. Further, Lithuania has the most intense trade relations with CIS countries of all the Baltic states. Last year, about a third of exports went to Russia, Belarus and Ukraine. Hence, Lithuania's economic prospects are to a significant extent dependent on developments in these countries.

In March, the economy ministry revised its forecast for this year's GDP growth to around 4% from a previous 5.5%. Sources of output growth are, however, unclear. Hence, even the new estimate seems rather optimistic to many observers.

Depressed inflation and employment

Lithuania continues to lead the Baltics as regards the slowdown in inflation. In March, consumer prices rose only 1.3% from the same month a year ago; producer prices were almost 7% lower than a year earlier.

Unemployment, on the other hand, has reached new highs. In March, the rate of unemployment based on the number of persons officially registered as unemployed, was 8.5%, the highest figure in the 1990s. The latest labour force survey carried out last November showed an unemployment rate of 12.6% at that time when registered unemployed amounted to only 6.5% of the labour force. As in all the Baltic states, the difference in these two figures is due to the fact that not all unemployed register themselves with labour exchanges. If an unemployed person is ineligible for compensation, the incentive to register is small.

Fiscal and current account deficits to rise further?

Lithuania has traditionally run a somewhat more lax fiscal policy than its Baltic neighbours, with annual budget deficits amounting to roughly 2% of GDP. This year, the budget is planned to be in balance for the first time in several years. For January-March, however, tax revenues were more than 10% below target, foreshadowing difficulties in keeping the budget in balance this year.

Lithuania's current account deficit was the largest among the Baltics last year, reaching 12.1% of GDP. Following the Russian crisis, total exports started to decline significantly in the fourth quarter, causing the quarter's deficit to rise to 14.5% of GDP. With slackening domestic demand, imports have diminished since the start of this year, improving the trade balance somewhat. The situation continues to be worrisome, however.

Last year was exceptional as regards financing of the current account deficit as a large part of it came in the form of foreign direct investment. Lithuania's FDI income was significantly enhanced by the privatization of the Lithuanian Telecom. The FDI inflow was over USD 900 million, more than double the amount received in 1997, and amounting to 9% of GDP.

Energy sector faces difficulties

There have been several problems in Lithuania's energy sector during the past few months. They relate in part to the long overdue restructuring of the sector. The national gas company has been unable to pay its debts to the Russian supplier, Gazprom, due to nonpayments by its customers in Lithuania. In response, Gazprom has restricted gas deliveries to Lithuania and even threatened to cut them altogether. In April, the government came to the rescue and helped the enterprise to settle the debt.

There have also been periodic supply cuts of crude oil from Russia to Lithuania's oil refinery (the only one in the Baltics), which is entirely dependent on Russian crude. Some observers maintain that the cuts are related to a decision of Lithuanian authorities to sell the majority stake in the refinery to a US company.

Lithuania also has differing views with the EU concerning the fate of the Ignalina nuclear power station (also the only one in the Baltics). The EU has recommended that the station be closed in a few years' time due to its safety risks. The Lithuanians would prefer to keep the station in operation longer, as its closure would be very costly to the economy.

New government to be named

In 3 May, Prime Minister Gediminas Vagnorius handed in his resignation. There have been differences in opinion between the PM and President Valdas Adamkus for some time now concerning privatization policies and energy sector questions, among others. Under the constitution, the president has 15 days to nominate a new candidate for prime minister after the resignation of the previous PM.

LITHUANIA	**1994**	**1995**	**1996**	**1997**	**1998**	**1999,**	**as of**
GDP, % growth	-9.8	3.3	4.7	7.3	5.1		
Industrial production, % growth	-26.6	5.3	5.0	0.7	7.0	-9.2	Q1/99
Inflation, % growth, December-December	45.1	35.7	13.1	8.4	2.4	1.3	3/99
Average wage, USD, annual average	81	120	155	196	239		
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	8.5	3/99
Exports, USD million	2020	2706	3413	4192	3962		
Imports, USD million	2220	3404	4309	5340	5480		
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1		

Sources: Lithuanian Department of Statistics, Bank of Lithuania

The Russian crisis and the Baltic financial sectors

by Rupinder Singh*

As a consequence of the Russian crisis, the Baltic economies were impacted by a triple incidence of related shocks: (i) contraction of external demand and associated spillovers into domestic demand, (ii) contagion from the financial ruptures on both the Russian and other CIS financial markets, and (iii) the decline in appetite for emerging markets.

The convergence of these factors impacted the financial sectors in the Baltics, although the shocks were asymmetric. The evolution of the banking systems, the development of a supervisory function and response to earlier banking crises implied variation in the direct spillovers for banks.

The indirect impact on banks has been through a decline in trade-finance, particularly following the effective cessation of Russian payment and settlement systems in September and October, which also impacted Baltic partners in other CIS. The financial crisis also impacted confidence in the banking system and there is evidence of both depositor withdrawal and re-allocation of remaining deposits to, in particular, foreign-owned banks.

The rise in emerging market risk in the second half of 1998 implied a rise in costs of foreign financing. Domestic interest rates rose, though more so in Latvia, but have now begun to decline.

Further, money demand declined due to real sector tightening and lenders became more risk-averse. Growth in consolidated bank assets was flat or declining in the fourth quarter of 1998, although there has been a rebound in the first quarter of this year, from 1% in Latvia to 6% in Estonia.

The real sector difficulties in the fourth quarter of 1998 for the three Baltic states, with current account imbalances and fiscal pressures in the offing due to declining revenues and higher expenditures, difficult financing conditions externally, and the suddenly "unorthodox" fixed-exchange rate regimes led to a decline in sentiment for Baltic investments. Asset prices declined, notably for the Baltic securities, lowering value of bank collateral.

Implications

As of April 1999, the negative spillovers in the Baltics seem to have bottomed out. Both anecdotal and economic indicators suggest that tentative shoots of economic recovery and credit expansion are in the offing, notwithstanding downside risks of further shocks externally or concerns about sustainable fiscal-monetary stances. In particular,

- The Russian crisis has speeded up the restructuring of both real and financial sectors, with closures or restructuring in certain industries such as dairy, food- and fish processing. This should result in the improvement in the allocation of credit and the intermediating process, evident in the higher reported demand for credit.
- Consolidation of the banking sectors has accelerated, already underway under periodic rise in capitalisation requirements towards EU norm of EUR 5 million, with voluntary exit or closure of, in particular, a number of Latvian banks, previously dedicated to the Russian financial market.
- Improved perception of the Baltic economies has led to a reduction in the Baltic risk premium, coinciding with an upturn in external demand in the first quarter of 1999, in part also due to redirection of trade toward new markets, and renewed confidence in emerging markets.

Bank regulation and supervision

Bank regulation and supervision rests with the national central banks in the Baltics. The supervisory-regulatory function has been improved in recent years. However, a number of issues arise from both the impact of the Russian crisis and the changes in structures of bank-ownership.

First, the choice of universal bank models has meant that banks have operated in different financial segments, including securities markets, insurance, asset management *etc.*, but with different regulators. Differences in the quality of regulatory regimes outside the banking sphere has led to "regulatory arbitrage" which could imply systemic consequences unless corrected. Latvian moves to "outsource" the regulatory function to a new agency may represent a partial medium-term solution, so long as there is clarity between the lender-of-last-resort and monetary functions.

The entry of foreign banks has brought greater risk-aversion and better management, know-how and improved corporate governance. However, this raises issues of cross-border cooperation with the home regulator of foreign banks, which although begun, still needs to be improved.

Furthermore, the regulatory function for banks has been refined with revisions to risk-weightings and limits on investments into CIS securities. Given excess volatility of relatively nascent financial markets and the use of such assets as collateral may require further Baltic-specific amendment to reduce the possible impact on both banks and on consumption. Further, the regulatory capacity, despite continuing improvement, remains below comparator EU standards and needs improving.

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