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BALTIC ECONOMIES
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ESTONIA

Economic climate takes a turn for worse

Economic growth has slowed since the second quarter of 2000. Real GDP grew 5.0 % y-o-y in 2Q 2001 (7.8 % in 2Q 2000). The slowing was mainly due to deceleration of private consumption and export growth. Real household incomes increased less than expected due to persistent high unemployment and high inflation. Private consumption increased only 1.1 % y-o-y. The slowing is also partly explained by last year's high growth rates. Economic growth was sustained in the second quarter by growth in investments (11 %) and export of services (6 %). Some production went to building up inventories. One further sign of slowing growth is the fact that industrial sales increased only 2 % in September.

Inflation has fallen during recent months due to lower domestic demand and oil prices. The stronger euro has also dampened inflationary pressures. Annual inflation was 4.8 % in October.

Exports hurt

During the second quarter of 2001, Estonia's current account deficit shrank to 3.5 % of GDP (5.3 % in 2Q 2000) as exports grew faster than imports. The surplus in services declined as growth slowed in transport and tourist services. Estonia had foreign direct investment inflows of EEK 1.2 billion (€80 million) during 2Q 2001. FDI outflows, however, rose to EEK 1.3 billion as multinational corporations extended their operations to Latvia and Lithuania.

Estonia's export sector has weakened in recent months from slowdowns in its main export markets (Finland and Sweden). In the third quarter, the value of exports was 10 % less than a year earlier. Re-export of goods after processing (especially electronics), which accounts for 40 % of Estonian exports, suffered most.

Bank lending grows rapidly

Estonian banks' total loan portfolio at the end of September stood at EEK40 billion (€2.6 billion). Bank loans increased 23 % y-o-y, driven by increased lending to households (31 % y-o-y) and to other financial institutions (47 %). Estonian banks finance their own leasing companies, which then extend credit for purchasers of durable goods and housing. About three-quarters of lending is done in foreign currencies. Estonian banking sector's aggregate assets were EEK 65 billion (€4.2 billion) at the end of September, up 18 % y-o-y.

Despite rapid growth in credit and a corresponding increase in monetary aggregates, Estonia's level of monetisation remains quite low compared to most EU accession candidates. At the end of 2000 ratio of broad money M2 (including foreign currency deposits) to GDP was 39.3%. The chart on page 2 plots M2/GDP and interest rate margins in 1995 and 2000. It shows that, for most accession countries, financial deepening has been associated with lower interest rate margins, reflecting both macroeconomic stability and greater banking-sector efficiency.

Government to review 2002 budget draft

After lowering its growth forecast for 2002 from 5 % to 4 %, the government now plans to trim about EEK 500 million from proposed budget expenditures of EEK 33 billion. In accordance with Estonian law, the proposed budget for next year must be balanced.

EU membership approaches

Arnold Rüütel, who became president in October, supports Estonian membership in both the EU and NATO. He is unlikely to change Estonian policy in these areas. To date, Estonia has closed 19 chapters of *acquis communautaire*.

European Commission released its regular report on applicant countries' progress in meeting EU membership criteria in early November. Like a year ago, the Commission characterised Estonia as a functioning market economy and said it should be ready to cope with the competitive pressure within the Union in near term as long as it continues implementing its reform program. The Commission commended Estonia for strengthening its macroeconomic performance and implementing structural reforms, adding that Estonia has continued to make good progress in both adopting and implementing the *acquis*. The report said Estonia has most required institutions in place, although they still need to be further strengthened. The Commission stressed that Estonia must pay attention to its current account deficit, fiscal policy and labour market problems.

Estonia's stable macroeconomic development was also noted by the international rating agency Fitch IBCA, which raised Estonia's long-term foreign currency borrowing to A- in August. In October, an IMF representative announced that Estonia would no longer require standby-credit facilities or IMF approval to its economic policy to promote confidence of financial markets.

ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %-growth	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	5.4	H1/01
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	6.0	1-9/01
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.8	10/01
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.7	H1/01
Gross wage, USD, period average	134	207	248	257	293	302	288	311	H1/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9	12.4	Q2/01
Exports, USD million	1226	1697	1813	2292	2690	2515	3288	2500	1-9/01
Imports, USD million	1583	2363	2832	3417	3806	3337	4077	3226	1-9/01
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-5.5	H1/01

Sources: Statistical Office of Estonia, Bank of Estonia, EBRD, IMF

LATVIA

Industrial production decelerating?

Latvian real GDP grew 9.2 % y-o-y in the second quarter of 2001 due to steady growth in domestic demand and exports. The real consumption expenditure of households increased 9 % and exports of goods and services 10 %. Gross fixed capital formation increased 10 %.

Latvia's industrial production rose steadily this year until September, when signs of deceleration could be detected. Industrial production increased 4.3 % y-o-y.

Inflation has accelerated during recent months due to increased domestic demand and higher food prices. The annual inflation rate in October was 3.3 %.

External balance threatened by brisk import growth

Latvia's current account deficit rose 29 % in January-September. This was mainly due to a ballooning trade deficit. Latvia has recently had success in redirecting some of its exports to Russia to compensate for the weaker economic outlook in Western Europe.

The surplus in the service balance increased 6 % in January-September thanks to strong growth of transport services. However, in September there were already signs of slowing in the transport sector due to changes in Russia's port support policies. New regulations introduced in August make it cheaper for Russian cargo to be channelled through domestic ports rather than through Baltic ports. From the beginning of next year, Latvia's position in oil transit may also be threatened when the new oil terminal at Primorsk opens.

Foreign direct investment (FDI) in Latvia has rebounded after a very weak showing early this year. In January-September, Latvia received LVL 150 million (€270 million) FDI, or 9 % less than during the same period in 2000. Delays in important privatisation projects mainly account for the modest FDI inflows. The privatisation of shipping company LASCO fell through in April and the sale of the Ventspils oil terminal has been postponed until 2002.

IMF demands that Latvia reduce its planned fiscal deficit

With parliamentary elections upcoming next year, the government has had difficulties in restraining expenditures in next year's budget draft. The IMF has strongly criticised the budget draft, which currently foresees a state deficit of 2.5 % of GDP next year. The IMF does not support the government's plan to cut corporate income tax from current 25 % to 22 % at the same time with the increased expenditures to cover costs related to preparations for NATO membership and EU accession. Because Latvia failed to reach an agreement with the IMF mission on the amount of the deficit, the IMF will suspend Latvia's stand-by credit facility temporarily beginning January 2002. An IMF mission will visit Latvia again next April to decide on further cooperation.

Bank lending grows

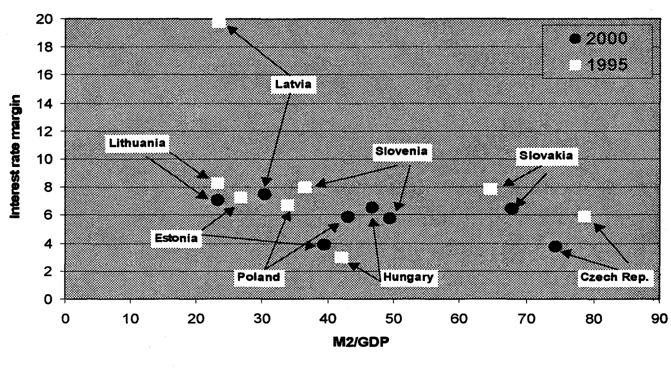
Rapid economic growth has been associated with a surge in bank activities. At end-September, Latvian banks' loans to domestic enterprises and households amounted to LVL 1164 million (€2078 million). Domestic loans were up by 43 % from the previous September. Deposits by domestic companies and households were also up 13 %. Latvian banks have traditionally been active in Russian and other CIS markets. They continue to attract deposits from these countries. As of June, approximately one-third of Latvian banks' liabilities were deposits of foreign companies and households.

EU Commission gives views

Latvia has provisionally closed negotiations on 18 of 31 chapters in the *acquis*. According to the Commission's progress report released 13 November, Latvia now has a functioning market economy. Thus, it should be able to cope with the competitive pressure in the common market in *the near term* as long as it continues to make substantial efforts towards maintaining the pace of its structural reforms. A year ago, the commission said Latvia would be competitive in EU markets only in *the medium term.*

The report commended Latvia for preserving macroeconomic stability and the progress it has made in the areas of pension reform and financial supervision. The Commission noted that the country must continue a policy of fiscal discipline, privatisation of the large enterprises and improving business environment. To ensure the reliable implementation of the *acquis,* Latvia needs to further strengthen its institutions. The Commission was particularly concerned about Latvia's substantial regional disparities and high unemployment. Latvia should continue the promotion of integration of non-citizens into Latvian society, the fight against corruption and the reform of the judicial system.

M2/GDP and interest rate margin in eight accession countries



Source: International Financial Statistics

LATVIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	8.8	H1/01
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	6.4	1-9/01
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.3	10/01
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.5	H1/01
Gross wage, USD, period average	128	170	179	207	226	241	244	245	H1/01
Unemployment, % (2nd quarter, LFS data)			22.2	15.9	14.7	14.0	14.4	13.5	Q1/01
Exports, USD million	1020	1367	1488	1838	2011	1889	2058	1523	1-9/01
Imports, USD million	1321	1947	2286	2686	3141	2916	3116	2223	1-9/01
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-5.3	H1/01

Sources: Central Statistical Bureau of Latvia, Bank of Latvia, EBRD, IMF

LITHUANIA

GDP growth remains brisk

Lithuanian GDP grew 5.7 % y-o-y in the second quarter of 2001. The pick-up in economic growth was driven by increased exports (23 %), and was reflected in the growth of industrial production. Private consumption increased less than expected (4 % in 2Q 2001) due to apparently intractable high unemployment and zero-growth in real salaries. Perhaps more problematic is the fact that the investments have not recovered to the level before Russia's 1998 crisis. During the second quarter of 2001, fixed capital formation decreased 5 % compared to the year before. The drop in the growth of industrial output measured in sales to 13 % in 3Q 2001 (21 % in 2Q 2001) may reflect the arrival of a slowdown in economic growth. A business confidence survey by the Lithuanian statistics department also registered declining confidence in the economy. According to the preliminary figures, GDP growth was 5.1 % in the third quarter of 2001.

Inflation remains low. In October, annual inflation was just 2.3 %.

External balance improves

The current account deficit shrank to 4.6 % of GDP in the second quarter of 2001 (6.1 % of GDP in 2Q 2000). The decrease was mainly due to rapid growth in exports. The balance of services remained positive, although the growth rate in exports of services decreased due to a decline in transport services. FDI to Lithuania almost doubled in the second quarter, thanks mainly to the privatisation of the Lithuanian Shipping Company (LISCO) and Savings Bank. In the first half of 2001, FDI was sufficient to cover 120 % of the current account deficit.

In January-September, the main export sectors – refined oil, machinery and transport equipment – grew steadily. The important inward processing textile industry also benefited from the increased exports to the United Kingdom. Lithuania had been quite successful in redirecting its exports, especially foodstuffs, to Russia and other CIS countries as demand in Western Europe slowed.

Banking sector growth quite subdued

The assets and liabilities of the Lithuanian banking sector have not grown as rapidly as in the other two Baltic countries. This may be due to Lithuania's lower overall economic growth in 2000, as well as the on-going restructuring of many Lithuanian banks, which may have left fewer resources for expanding banking business itself. Banks' total claims on domestic customers were LTL 8.5 billion (€2.3 billion) at the end of September. Claims increased 4 % y-o-y. A decline of 6 % in lending to the private sector is especially worrying for the long-term growth prospects of the country. The Lithuanian banking sector's total assets at the end of September stood at LTL 14 billion (€3.8 billion). Assets were up 3 % y-o-y.

Government submits proposed budget

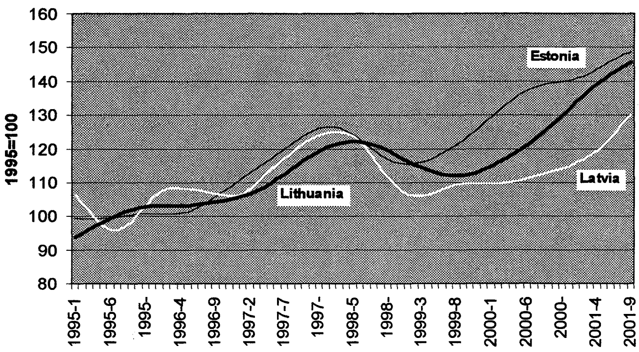
The government finalised its 2002 budget draft, which foresees the state budget deficit at 2.3 % of GDP. Earlier, the IMF had allowed Lithuania to raise its fiscal deficit ceiling for 2002 from 1.3 % of GDP to 1.5 % of GDP in recognition of the need for additional investment spending. In the draft budget, expenditures are some 5 % higher than this year mainly due to increased spending to cover costs related to preparations for NATO membership and EU accession. The Lithuanian state expects to raise a substantial amount of money next year from the privatisation sales of the gas company Lietuvos Dujos and the power monopoly Lietuvos Energija.

EU negotiations continue

The European Commission's mid-November report repeated last year's view that Lithuania has a functioning market economy. According to the Commission, Lithuania should be able to cope with the competitive pressure within the Union in *the near term* as long as it continues with the vigorous implementation of structural reforms. Last year, the Commission said Lithuania would be competitive in *the medium term*.

The report noted that Lithuania has preserved macroeconomic stability, reduced its fiscal and external imbalances and moved ahead with privatisation of state assets. It said Lithuania's high unemployment and low level of investments need greater attention. The Commission would like Lithuania to continue its reforms in the energy sector and prepare for the decommissioning of Ignalina nuclear power plant. The Commission concluded that Lithuania's capacity to implement the *acquis* is still fragile and needs improvement. Lithuania has now closed 18 chapters of the *acquis*.

Trend of industrial production, 1995=100



LITHUANIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.2	3.3	5.1	1-9/01
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	15.2	1-9/01
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.3	10/01
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	0.3	Q1/01
Gross wage, USD, period average	81	120	155	195	232	253	272	263	H1/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1	16.6	Q2/01
Exports, USD million	2020	2706	3413	4192	3962	2996	3252	3380	1-9/01
Imports, USD million	2220	3404	4309	5340	5480	4791	4660	4531	1-9/01
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-5.0	H1/01

Sources: Statistics Lithuania, Bank of Lithuania, EBRD, IMF

Financial supervision in the Baltic countries

by Jaana Rantama*

The banking systems in Estonia, Latvia and Lithuania are still in the early stages of development. Banking structures were only established in the 1990s following independence from the Soviet Union. The initial years in the banking sector were characterized by both robust growth and crises. Banks were forced to learn how to operate in a market-led environment and the paradigm of a supervisory framework was established. Over the last decade, the respective authorities of the three Baltic nations have built their supervisory and banking regulation systems virtually from scratch.

No Baltic country managed to avoid a banking crisis, so each well understands the importance of effective regulation and supervisory functions. Latvia and Estonia have decided that combined supervisory authorities would serve their needs most effectively, while Lithuania maintains several agencies to supervise financial institutions. The situation remains dynamic, however. Development of the supervisory framework is still in progress as legislation and regulations are brought into line with Western standards and EU directives.

Financial supervision in Estonia to be renewed by the end of 2002

Financial supervision in Estonia is currently undergoing a complete restructuring. About three years ago, Estonian authorities decided to combine supervision functions for the banking, insurance and securities market sectors. This integrated "superagency" launches its operations at the start of next year and is to be staffed by some 50-60 persons. The agency will be financed by contributions from the market participants, but during the initial stage the Bank of Estonia and Estonian government will cover part of the costs related to setting up the agency. Their involvement in financing will last only until 2004. It is hoped that the combined supervisory authorities will bring about an overall improvement in sector supervisory standards, particularly in capital markets.

Latvian financial supervision commenced in July 2001

In 1997, with the support of the World Bank and the Swedish government, Latvia worked out a combined supervisory authority framework. Legislation on the combined Financial Supervisory Authority was accepted in June 2000 and the new body began its operations, as scheduled, in July 2001. The mandate of the Financial and Capital Market Commission (FCMC) is supervision of banking, securities, insurance and pension fund sectors, as well as administration of deposit insurance funds. The FCMC's objective is to promote the interests of investors, depositors and insurance policyholders and the stability and development of financial and capital markets.

The Law on the Financial and Capital Markets Commission guarantees the authority political independence. This is guaranteed to give the Commission the possibility to influence the appointment and dismissal of its leadership. The scope of FCMC's operative independence is defined by law, so that the agency can issue operational licences and secure financial self-sufficiency. Initially, funding of the authority is provided by the Bank of Latvia and through supervision fees levied on insurance companies. By 2007, it is expected that the entire operation will be entirely financed through supervision fees collected from supervised bodies. For the sake of efficiency, the Latvian authorities have decided to set up function-based organisation. As a result, the new 98-strong Commission includes 70 directly involved as supervisors.

Lithuanian financial supervision shared among three authorities

Financial supervision in Lithuania belongs to the mandates of three separate authorities. The Bank of Lithuania's 68-person supervisory division has responsibility for the oversight of credit institutions (banks, banking groups and credit companies). The Securities Commission oversees securities dealers. It was established in 1992 through an initiative from the Ministry of Finance. Its status was altered in 1996, re-establishing it as an independent authority directly responsible to the parliament. The State Insurance Supervisory Authority (SISA) operates under the auspices of Lithuania's Ministry of Finance.

In December 2000, the Bank of Lithuania, the Securities Commission, and SISA signed an agreement, facilitating the role of the authorities in the coordination and exchange of data. This cooperative agreement has special importance, as Lithuania has not contemplated physically combining the functions of its supervisory authorities under a single organisation.

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