BANK OF FINLAND
Institute for Economies in Transition

31.8.2000

BALTIC ECONOMIES
The Quarter in Review
3 • 2000

SIDOTTAVA KPL

ESTONIA

Production growth strong

The Estonian economy is swiftly recovering from last year's recession. In the first quarter of the current year, GDP grew over 5 % year-on-year, and in the second quarter the growth accelerated to more than 7 %. Industrial production recorded an almost 12 % increase in the first half of the year as compared with the same period a year before. Retail sales rose 13 % in the second quarter. Also investment, which suffered a considerable drop last year, is picking up. In the first quarter of 2000, fixed investment rose 17 % in current prices. Construction was up by 6 % in the first half, but was still below the level reached in 1998. Analysts predict that during the whole of 2000, Estonia's GDP will grow 4 - 5.5 %.

Decline continues in Estonia's agriculture. After an 8 % drop in total agricultural production in 1999, production of milk, meat and eggs dropped 10 % in the first half of 2000. The total land area under cultivation also fell slightly.

Inflation has accelerated, reflecting the upturn in the economy and higher oil prices. In July 2000, consumer prices rose 4 % year-on-year, recording the highest rate of growth since the start of 1999. At the same time, producer prices increased 5 %, while import and export prices grew more than 6 and 7 %, respectively. Construction prices, on the other hand, increased only some 2 % year-on-year in the second quarter. Consumer price inflation is expected to amount to 4.5 - 5 % at the end of the year.

Budget deficit down, current account deficit up

After a surge of the general government budget deficit to close to 5 % of GDP last year, Estonia has managed to reduce its deficit considerably this year. In the first half, the general government budget deficit equalled 0.9 % of estimated GDP. The outcome is in line with the requirements of the economic programme, which Estonia signed with the IMF earlier this year. In the programme, the limit for the whole year's deficit has been set at 1.3 % of GDP. Problems may loom ahead, however, because tax collection has lagged behind targets, particularly excise taxes collected on fuel and tobacco. Moreover, the parliament decided in June to set the VAT on heating energy at 5 % instead of the universal 18 % rate proposed by the government. The higher rate had been factored into the budget, which now needs altering. The new tax entered into force in July.

Estonia's current account deficit has been a major macroeconomic problem for several years. Last year's recession brought the deficit down to some 6 % of GDP. Now the deficit has started to grow again as the economy expands. In the first quarter of 2000, it reached 8 % of GDP. Imports grew by a hefty 42 % year-on-year in the first half of the current year, while exports registered an even faster growth of 49 %.

Banking recovers

The effects of the economic slump continue to fade in the banking sector. Both the aggregate loan stock and deposits grew 30 % between June 1999 and June 2000. Deposits have been at a record-high throughout the spring and summer, in part reflecting the rather sluggish private consumption.

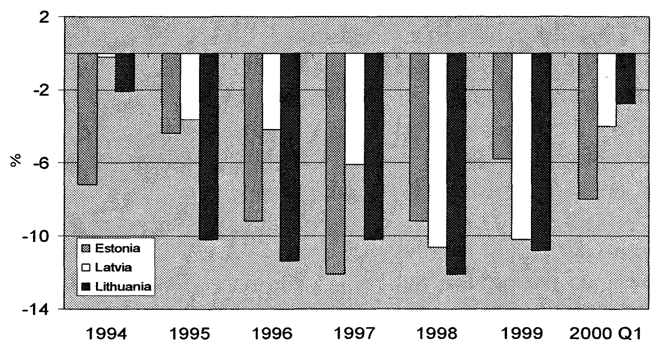
During the current year, interest rates have been relatively stable, with a slight downward trend. The weighted average interest rate on kroon-denominated loans varied between 7.5 - 8.5 % in the first half of 2000.

Foreign penetration into the Estonian banking market continued with the Finnish insurance company Sampo acquiring a majority stake in Optiva bank in June. Optiva is Estonia's third biggest bank after the majority Swedish-owned Hansapank and Ühispank, which together control 85 % of the market. Optiva's market share is 7 %.

EU negotiations on track

By mid-2000 Estonia had closed 13 out of the 31 negotiation chapters covering the EU rules and regulations that applicant countries need comply with in order to qualify for membership. Among Central and Eastern European applicant countries, Estonia has proceeded fastest in its membership talks. Thanks to its liberal economic system, Estonia has only had to request transition periods in a few cases.

Current account balance, % of GDP



ESTONIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.7	-1.1	7.5	Q2
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	11.7	H1
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	4.1	7/00
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.9	H1
Average gross wage, USD, period average	134	208	248	256	283	337	284	Q1
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.5	6.5	7/00
Exports, USD million	1226	1697	1821	2294	2690	2452	1494	H1
Imports, USD million	1583	2362	2832	3419	3805	3329	2010	H1
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-8.0	Q1

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

LATVIA

GDP expanding

Economic growth has resumed in Latvia. In the first quarter, GDP rose 5.3 % year-on-year. Based on the positive development, authorities have increased their estimates for the entire year's growth, which now vary from 4 to 6 %, after an almost flat 1999.

The growth of industrial output has accelerated recently. In June, industrial production was 8 % higher than a year before. Among different product categories, the largest increase was in the manufacturing of machinery, clothing and paper and cellulose. Also other sectors of wood processing, Latvia's leading export industry, showed significant growth. The importance of wood-related branches of industry in the economy continues to grow, given the increasing utilisation of the country's relatively abundant forest resources.

Freight transportation by rail grew 10 % in the first half of the current year from the corresponding period a year earlier. Most freight is transit cargo, which saw its volume increase 10 %. Construction volume increased 4 % in the first half, after an 8 % rise in 1999.

Domestic demand is recovering with investment growing 6 % year-on-year in the first quarter. Retail trade was up almost 4 % in the second quarter.

Inflation has so far remained moderate. In July, consumer prices increased 2.8 % year-on-year.

Budget deficit slashed

During the current year, Latvia managed to reduce its general government budget deficit significantly from last year's high figure. This was accomplished mainly through tight expenditure policies. In the first half of 2000, budget deficit amounted to about 2 % of the period's estimated GDP. The economic memorandum agreed upon between Latvia and the IMF last year spells out the basic parameters of the country's economic policy, and sets a limit of 2 % of GDP for this year's budget deficit.

External balance improves

Latvia's large current account deficit, which in the first quarter of last year equalled 7 % of GDP, declined to 4 % in Q1 2000. Expanding service income, especially in transportation, was one of the factors behind the remarkable reduction of the deficit. Net income from services covered two-thirds of the deficit in the trade balance. Another factor at play was the moderate domestic demand in the beginning of the year, which dampened import growth.

As Latvia's economic recovery proceeds, its current account deficit is likely to expand. Signs have already emerged: during the period January-June the trade deficit increased 11 % year-on-year as a result of a 13 % increase in both imports and exports. Latvian exports to the EU have to some extent suffered from the depreciation of the euro against the SDR, to which the lats is pegged.

The central bank estimates the current account deficit will equal 7.5 - 8 % of GDP at the end of the year. In May, the Latvian government agreed with the IMF to prepare a contingency plan that would cut budgetary expenditure, should the current account deficit grow excessively.

Banking rebounds

The Latvian banking sector is now recovering from the repercussions of the Russian crisis. In the first half of the current year, commercial banks posted an aggregate profit of LVL 22 million (USD 36 million), or nearly double the profit in the whole of 1999. In June 2000, banks' aggregate credit portfolio was 12 % larger than at the start of the year, while deposits had grown 20 %.

Interest rates continue to be high. In July, the average short-term lending rate was 12 % and long-term rate 10 %.

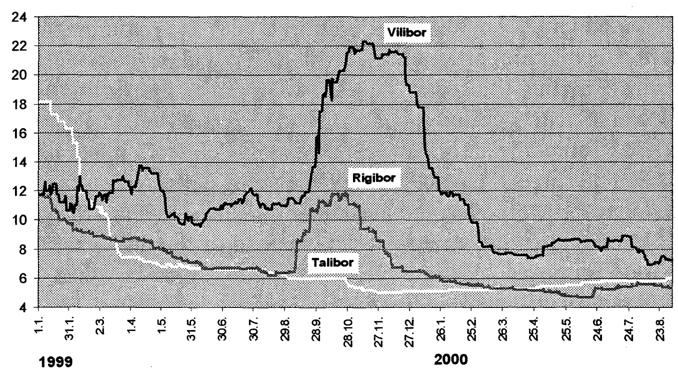
Latvia's financial supervision has improved markedly, and is now largely in conformity with international standards. In June, the parliament decided on the reorganisation of financial sector supervision. A new unified agency will be established to supervise banking, insurance and securities markets. The supervision of these three sectors has so far taken place in separate institutions. The agency should be operative in July 2001.

Structural reforms continue

During the past couple of years Latvia has enhanced structural reforms in order to improve business climate, cut down bureaucracy and make the country more attractive for foreign investors. Business polls reveal that corruption and bureaucracy are identified as the biggest problems companies face.

As to legislation, from the start of 2001, a new competition code will step into force. The code was drawn up according to the EU model. It unifies several formerly separate laws and simplifies regulations governing fair competition.

Three-month interbank interest rates



LATVIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	0.1	5.3	Q1
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	5.2	Q2
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	2.8	7/00
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	2.0	H1
Average gross wage, USD, period average	128	170	179	207	226	241	266	Q1
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	9.1	8.2	7/00
Exports, USD million	1020	1367	1488	1839	2012	1729	944	H1
Imports, USD million	1321	1947	2286	2689	3138	2957	1504	H1
Current account, % GDP	-0.2	-3.6	-4.2	-6.1	-10.6	-10.2	-4.0	Q1

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

LITHUANIA

Growth slows

The Lithuanian economy continued to expand in the second quarter of the current year, but at a slower pace. According to the Statistics Department's preliminary estimate, GDP growth year-on-year was only 0.2 % in the second quarter, after a 4 % rise in Q1. During the first six months of the year, GDP increased 2 %. The IMF expects Lithuanian GDP to increase some 2.5 % during the current year, while Lithuanian authorities' forecast is around 3 %.

After an almost 5 % growth in the first quarter of the current year, industrial production contracted 6 % year-on-year in Q2. The decline in oil refining, one of Lithuania's main industries, was the major factor behind the drop. Lithuania's only oil refinery, Mazheikiu Nafta, has suffered from supply cuts from Russia, its main crude oil supply source.

Retail sales started to recover in 2000 and increased 10 % in the first half from the same period of the previous year. In 1999 retail sales decreased 7 %.

The sluggish recovery is reflected in unemployment. It hit an all-time high in July when the unemployment rate based on registrations amounted to 11.6 %. Unemployment rate based on the ILO methodology would most probably be even higher, but it is calculated only twice a year and comes out with a considerable lag.

Lithuania's inflation remains the lowest in the Baltics, at 1.4 % in July.

Difficult budgetary situation

Lithuania's budget deficit has declined markedly during the current year, but significant problems remain. Last year's exceptionally large deficit – over 8 % of GDP – was in part due to one-time factors that increased expenditure above normal. Expenditures related to the savings compensation scheme and government's financing obligations in connection with the privatisation of the Mazheikiu Nafta refinery together amounted to some 3 to 4 percentage points of GDP, increasing the budget deficit by the same figure.

In the first half of 2000, the general government budget deficit equalled some 4 % of estimated GDP, and exceeded the limit set in the economic policy memorandum signed with the IMF at the start of the year. The main reason for the deficit is that budgetary revenues lag their targets. Both VAT and excise tax revenues were below last year's levels in the first half of 2000. Budget outlays, on the other hand, were in control thanks to the tight expenditure policies of the government.

The economic policy memorandum sets the limit for the budget deficit for the current year at 2.8 % of GDP. In August, Lithuanian authorities announced that due to difficulties in revenue collection, the government will ask the IMF to increase the deficit limit to 3.5 % of GDP.

In June, the Lithuanian government sold a 25 % stake in Lietuvos Telekomas, the Lithuanian Telecom through an initial public offering. The sale flopped and brought in far less than the planned USD 300 million. Due to adverse market conditions, the government decided not to sell its entire 35 % stake in the company, but retain 10 % for the future.

A third of the privatisation revenue will be used for investment programmes, while the rest was transferred to a fiscal reserve fund for future use.

External balance improves

In the first quarter of 2000, the current account deficit equalled only about 3 % of the quarter's GDP, down from almost 11 % in 1999.

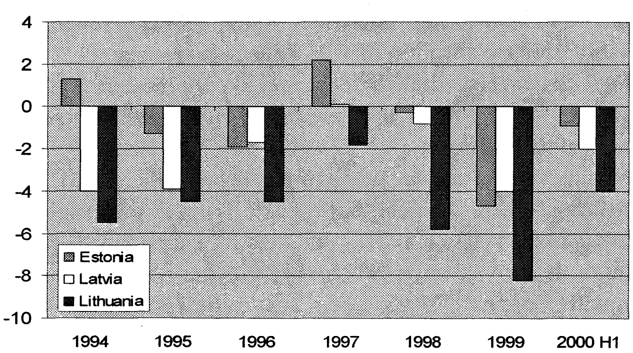
In the first half of the current year, trade deficit was cut by 16 % from the same period of the previous year. Exports rose a quarter, while imports were up 10 %. The rather moderate import growth reflects the slow recovery of domestic demand and tight fiscal policies, while export earnings were boosted by high oil prices. Mineral products make up a fifth of Lithuania's exports.

Banking sector's slow recovery

The recovery of the banking sector from the repercussions of the Russian crisis in 1988 proceeds slower in Lithuania than in its Baltic neighbours. In the first half of the current year, the aggregate profit of Lithuanian commercial banks shrank to a mere LTL 0.4 million (USD 0.1 million) from LTL 66 million (USD 17 million) a year earlier. At the same time, total deposits grew 10 %, but total loans declined 5 %.

The average interest rate on bank lending was 12 % in July. Although lending rates have come down slightly during the past year, real interest rates are still prohibitively high.

General government budget balance, % of GDP



LITHUANIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.1	2.0	H1
Industrial production, % growth	-26.6	5.3	5.0	3.3	7.0	-9.9	-6.0	Q2
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	7/00
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-4.0	H1
Average gross wage, USD, period average	81	120	155	196	239	293	268	H1
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	10.0	11.6	7/00
Exports, USD million	2020	2706	3413	4192	3962	2996	1835	H1
Imports, USD million	2220	3404	4309	5340	5480	4791	2573	H1
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-10.8	-2.8	Q1

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

Privatisation bogs down

by Iikka Korhonen*

Only a few state assets remain...

Although the three Baltic countries chose somewhat differing privatisation approaches in the early years of transition, the overwhelming majority of Baltic companies today are privately owned. Lithuania relied heavily on the voucher method in privatising its state-owned assets, while Estonia was particularly vigorous in seeking tenders for cash payments coupled with additional commitments from the buyer such as capital investment. All three countries used voucher systems to privatise housing.

By 1995, even with different approaches (and different speeds) in privatisation, the private sectors in Estonia and Lithuania produced some 65 % of GDP, and Latvia approximately 55 %. The private sector's share of GDP currently exceeds 70 % throughout the Baltics. Despite these impressive gains in privatisation, the Baltics still retain large infrastructure companies in the state hands. Privatisation of these remaining state assets has proven difficult.

... but political differences slow privatisation of infrastructure

Privatisation of infrastructure companies has been a politically sensitive issue in most OECD countries, not just the Baltics. Even when the mechanics of privatisation seem straightforward, many things can go wrong. For example, early on Latvia sold a large stake in its telecommunications monopoly to the Finnish Sonera. Since that privatisation, however, many aspects of the deal have been fiercely debated in Latvia. The Latvian government is currently seeking to shorten the time of monopoly it originally promised Sonera in its sale of Lattelekom so that Latvia complies with WTO and EU rules. The matter must now be settled in arbitration court. Estonia and Lithuania also sold off large chunks of their national telecoms, but unlike the Latvian approach, Eesti Telekom and Lietuvos Telekomas were sold through public offerings and listed on local stock exchanges. Notably, the privatisation of fixed-line service providers has lacked controversy due to the rapid emergence of mobile phone networks, which have devalued the monopoly positions of older telecoms.

Privatisation of energy companies, on the other hand, has been fraught with political battles. The Latvian government, for example, has had major difficulties in its attempts to push through the privatisation of Latvenergo, the national power company. Originally, Latvenergo was to be restructured and a majority stake sold off. In the ensuing political battle, the opposition succeeded in collecting enough signatures to call for a referendum on the sale. This, in turn, forced the parliament to cancel the privatisation altogether in August. It is uncertain at present how the necessary investments for Latvia's energy infrastructure will be financed in the future.

In Estonia, successive governments have negotiated with US-based NRG Energy for close to five years about the partial sell-off of the national power utility Eesti Energia. This summer a deal to sell 49 % of the company was finalised, but only after a widespread outcry against the deal. The main complaint was that the privatisation process itself has been very opaque. Despite opposition from a wide variety of political figures and even the acting management of Eesti Energia, the deal is going forward.

These examples show how difficult it can be to privatise large infrastructure companies, which serve most of the population either directly or indirectly. The common view is that privatisation usually is followed by price increases, but it should also be noted that the public sector itself often lacks the resources for needed capital investment and modernisation. In any case, the turmoil associated with privatisation of infrastructure companies seems likely to make Baltic governments more cautious in the future.

Second time's a charm in bank privatisation?

Estonia and Latvia were quick to privatise their larger banking institutions, while the Lithuanian state still retains a majority in the country's second and third-largest commercial banks. Privatisation of these two banks has proven very difficult. A tender for the sale of Taupomasis Bankas (Savings Bank) will be announced in early September, but the bank will remain in state hands well into 2001 even if the tender goes well. Moreover, it is by no means certain that the government will be able to sell the bank at reasonable terms. In a tacit acknowledgement of this, the Lithuanian government recently increased the yield on the government securities held by the Savings Bank. Investors still fear that the credit portfolios of the state-owned banks will contain unpleasant surprises. Estonian and Latvian authorities, meanwhile, have been involved in a second round of bank privatisation. In the aftermath of the Russian crisis in 1998, the central banks in Estonia and Latvia were forced to take over illiquid banks that threatened the stability of their financial systems. A little more than a year ago these banks were again sold to private investors.

Unhurried pace of privatisation

It now seems that further privatisation will be a long and drawn-out process. Projects will encounter opposition for both economic and political reasons, and this is bound to influence the behaviour of international investors.

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The Quarter in Review
3/2000, 31 August 2000
ISSN 1456-4963 (print)
ISSN 1456-5900 (online)

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