BANK OF FINLAND
Institute for Economies in Transition
6.2.2001

BALTIC ECONOMIES
The Quarter in Review
1 • 2001

ESTONIA

SIDOTTAVA KPL

Economic expansion strong

Growth of the Estonian economy continued strong in the third quarter of last year. According to preliminary information, GDP increased 7.0 % from the same quarter a year earlier. In Q1 the growth was 5.2 % and in Q2 7.4 %. GDP growth for the whole year 2000 is estimated at 6.1-6.3 %. According to the forecast of the Central Bank, in 2001 GDP will grow 5 to 6 %, or somewhat slower than last year.

Industrial production (as measured by sales) increased 9 % in 2000. Growth concentrated in products with high value added. Manufacturing of machinery and communication equipment manifested strongest growth, over 50 %, while manufacturing of optical and precision instruments grew over 30 %. The long depressed food production recovered last year with a growth of 3 %.

In spite of the autumn slowdown, freight turnover of Estonia's ports and railways increased last year. Growth was largely due to transit cargoes, which e.g. in ports account for three quarters of all cargo. The biggest Estonian port, Tallinn, handled last year some 10 % more cargo than the year before. Railways carried 7 % more goods than in 1999, including a 26 % increase in the transportation of oil and oil products, the most important product group.

Inflation accelerated last year, reflecting the fast expansion of the economy. In December, consumer prices were 5 % higher than in December 1999.

Return to a balanced budget in 2001

The Estonian government succeeded in squeezing the fiscal imbalance significantly last year. According to a preliminary estimate of the ministry of finance, the general government budget deficit amounted to only about 400 million kroons (24 million USD). The deficit equals some 0.5 % of the expected GDP in 2000 and falls far below the limit of 1.3 % of GDP, set in the economic policy memorandum of Estonian authorities and the IMF. At the end of the year, state budget revenues amounted to 99 % of the planned figure, while expenditures were 2.5 % less than planned.

The state budget for 2001 was passed by the parliament in December. As required by the Estonian law, the budget is balanced. Both expenditures and revenues total EEK 29.8 billion (USD 1.8 billion), which in nominal terms is about 6 % larger than the 2000 budget expenditure. Tax revenue is estimated to increase nearly 7 %. The share of taxes to GDP would fall to 34.3 % from last year's 35 %.

Current account deficit still high

Estonia's current account position has worsened somewhat during the course of last year. In the first three quarters, the deficit amounted to 5.5 % of GDP, a bit higher than in the same period in 1999. However, exports rose by a record 50 % in the first three quarters of 2000 as compared to the same period in 1999. Imports increased nearly 40 %.

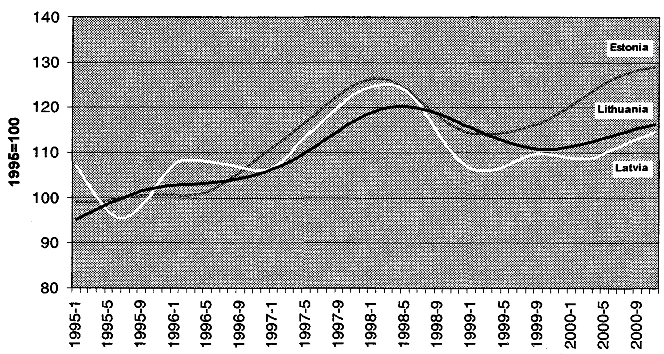
Although the surplus in services account declined slightly in the first three quarters (due to a considerable fall in Q3), it was still sufficient to cover more than 80 % of trade deficit.

Mixed results from privatisation

The third quarter of last year saw decisions on major transport sector privatisation deals, which had been in the pipeline for some time already. In November, the Estonian Privatisation Agency (EPA) sold to British GB Railway the domestic passenger carrier, South West (SW) Railway. In January SW Railway decided to cut passenger traffic, due to limited state subsidies.

In December, EPA chose a consortium called Rail Estonia as the winner of a tender to buy 66 % of the Estonian Railway company. Estonian Railway manages national railway track infrastructure and cargo transport. The winner of the tender, Rail Estonia, is 90 % owned by an international consultancy, Kingsley group, while the rest is owned by two American railway companies. In January another bidder filed a lawsuit to contest EPA's privatisation decision, claiming that Rail Estonia does not have a strategic investor. This will evidently delay the final negotiations.

Trend in industrial production, 1995 = 100



ESTONIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.7	-1.1	6.6	Q1-3
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.5	
Gross wage, USD, period average	134	207	248	257	293	302	286	Q1-3
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	14.7	
Exports, USD million	1211	1660	1764	2275	2674	2437	4322	1-11
Imports, USD million	1557	2398	2876	3516	3928	3430	5569	1-11
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-5.5	Q1-3

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

LATVIA

Production growth firm

Latvia's economy expanded last year faster than projected. In the first three quarters of 2000, GDP grew 5.4 %. The Latvian Central Bank estimates that in the whole 2000, GDP increased at least 5.5 %. In January 2001, the Statistical Bureau revised the GDP figure for 1999 growth from 0.1 % to 1.1 %. Hence, Latvia suffered much less from the Russian 1998 crisis than its two Baltic neighbours, where GDP declined in 1999. For the current year, the Latvian Central Bank forecasts GDP growth of around 6 %.

Among the most important factors contributing to the GDP expansion last year were investments, which increased 19 % in January-September from the same period in 1999. Private sector investments grew as much as 35 %, accounting for 55 % of the total. Export demand remained relatively strong with exports rising 13 % in January-November.

Latvian inflation remained moderate last year. In December, the year-on-year growth in consumer prices was 1.8 %.

Fiscal policy looser than agreed

According to preliminary information, the general government budget deficit reached 2.8 % of GDP last year, which exceeded the original deficit limit of 2 % agreed with the IMF. Nevertheless, the deficit was smaller than what the government anticipated in autumn when it prepared the supplementary budget with a diminished revenue forecast. The improvement was mainly due to accelerated economic growth.

The current year's budget foresees a deficit equalling 1.7 % of GDP, again exceeding the maximum figure stipulated by the economic programme agreed with the IMF. Due to differing views on budgetary policy, the IMF did not complete its regular review of the Latvian economy in November. The IMF will resume discussions with the Latvian authorities in February.

According to advance information, Latvia's state debt amounted to LVL 570 million (USD 925 million) at end-2000. This equalled about 13 % of GDP, a share that has remained unchanged during the year. Sixty per cent of the debt was foreign.

Freight transit continues to increase

Latvia's current account position improved significantly last year. In the first three quarters, the deficit amounted to 5.6 % of GDP, much less than what was recorded in 1999. The improvement was largely due to a more than 40 % increase in the surplus of services trade. In January-September, services income covered 40 % of the trade balance deficit. The central bank forecasts that the current account deficit will again rises to some 7 % of GDP in 2001, reflecting economic expansion.

Cargo transit is the most important item generating services income. Last year, Latvian ports handled 5 % more cargo and railways carried 10 % more cargo than in 1999. Russia's decision last autumn to discontinue the special tariff discount on railway freight going to the Baltics seems to have had a moderating effect on the cargo growth rate.

Last year the largest Baltic port, Ventspils, handled 35 million tonnes of freight, well above the Port of Tallinn (29 million tonnes) and Lithuania's biggest port, Klaipeda (19 million tonnes). Summing up the capacities of all national ports, Latvia is the clear leader among the Baltic states.

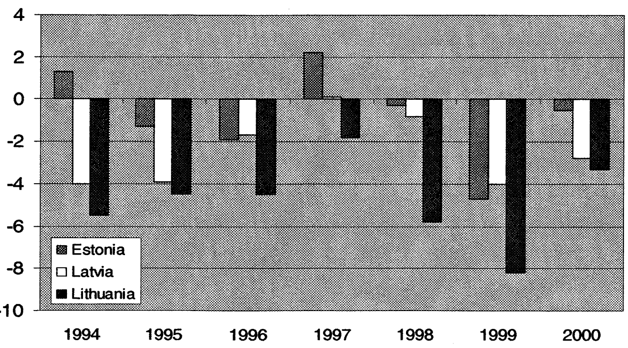
Privatisation to get a new start?

Privatisation of a major state-owned entity, Latvian Shipping Company LASCO, has entered a new phase. LASCO, the world's third biggest oil products carrier in 1999, has been on the block for four years already. When the government approved rules for its new privatisation endeavour in December, it was the fourth attempt to facilitate the sale. Under the new rules, 68 % of the company's shares will be offered to a strategic investor. To counter possible claims of opaque deals or corruption, an independent observer organisation has been contracted to monitor the sale process.

The sale of Ventspils Oil, the oil terminal operator, is planned to take place sometime this year. The government will put on sale a 39 % stake in its remaining 44 % holding in the company. The sale is thought to be even more complicated than the LASCO deal.

Privatisation remains a highly controversial issue in Latvia. The Latvian Privatisation Agency (LPA), which has pushed hard for privatisation, has received criticism from different quarters. Indeed, the LPA was to be scrapped at the start of this year, but thanks to recommendations from international financial organisations, it continues to operate.

General government budget balance, % of GDP



LATVIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	1.1	5.4	Q1-3
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	1-11
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	
Gross wage, USD, period average	128	170	179	207	226	241	244	1-10
Unemployment, % (2nd quarter, LFS data)			22.2	15.9	14.7	14.0	14.4	
Exports, USD million	1020	1367	1488	1839	2012	1729	1707	1-11
Imports, USD million	1321	1947	2286	2689	3138	2957	2999	1-11
Current account, % GDP	-0.2	-3.6	-4.2	-6.1	-10.6	-9.6	-5.6	Q1-3

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

LITHUANIA

Production grows moderately

The recovery of the economy has been slower in Lithuania than in its Baltic neighbours. According to preliminary calculations of Statistics Lithuania, GDP grew 2.9 % last year. Growth has accelerated during the year; the increase was 4.7 % y-o-y in the fourth quarter. GDP growth continues to be based largely on export demand. The growth rate of total production is expected to accelerate this year. The Central Bank forecasts that GDP will grow 4 to 5 %, while the ministry of the economy's forecast is slightly above 3 %.

Industrial output increased 7 % last year. With some 18 % share in industrial production, oil refining in the Mazheikiu Nafta refinery – the only oil refinery in the Baltics – significantly affects industrial output development. Last year, oil refining declined over 7 %, mainly due to cuts in Russian crude oil supply. Agricultural production, which fell 14 % in 1999, increased 2 %.

Due to subdued domestic demand and strong dollar, inflation remained moderate last year. In December, the 12-month rise in consumer prices was just 1.4 %.

Tighter fiscal policy

Last year's public sector deficit is preliminarily estimated at 3.3 % of GDP, down significantly from the previous year's 8.2 %. The large 1999 deficit was partly due to one-time expenditures related to the financing of the privatised Mazheikiu oil refinery. But even taking that into account, the deficit cut in 2000 was substantial.

For the current year, fiscal policy has been further tightened. The public sector deficit, which is the aggregate deficit of state and municipal budgets and the social insurance fund, is to be limited to 1.4 % of GDP. The parliament has approved legislation to reduce the social fund deficit. Measures include limits on pensions received by pensioners that still work, a general increase in the retirement age and more precise rules on maternity leave payments.

Current account deficit declines

Lithuania's extremely high current account deficit, which has exceeded 10 % of GDP since 1995, fell substantially last year. In the first three quarters, it amounted to 4 % of GDP. The decline was mainly due to a much higher growth rate of exports than imports. The latter were constrained by slack domestic demand. Exports rose 33 % in the first three quarters of last year, while imports were up 13 % y-o-y.

In order to finance the current account gap, Lithuania has been compelled to resort to borrowing more than the other Baltic states. Hence, Lithuania's state debt is the highest in the Baltics, although still low by international comparisons. At end-2000, the debt amounted to LTL 12.7 billion (USD 3.2 billion), which equals 29 % of GDP. In dollar terms, the state debt grew 5 % during the year. Seventy-eight per cent of the debt was foreign.

In 1999, foreign direct investments (FDI) covered 40 % of current account deficit, but in January-September 2000, the share was almost 80 %. The most important factor contributing to the increase in the FDI inflow was the international flotation of the shares of Lithuanian Telecom last summer.

Two large banks for sale

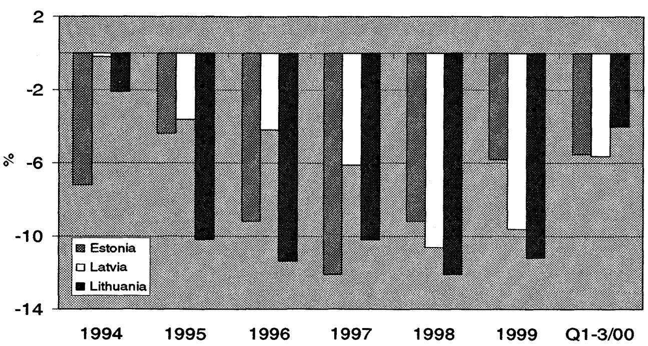
Lithuania's state-owned banks interest few buyers. An international consortium in November broke off talks on the privatisation of the Agriculture Bank, Lithuania's third largest bank. The consortium was the sole bidder in the tender. In another privatisation, talks are currently going on between the State Property Fund and the Estonian Hansapank, the only bidder for the purchase of Lithuania's second largest bank, Savings Bank.

Litas repeg announced

The Lithuanian currency, the litas, has been pegged to the dollar since 1994 at a rate of 4 to 1. Although a decision was made in 1997 to repeg the litas in 1999 to a basket that included the euro and the dollar, uncertainties in emerging markets and the Russian rouble crisis of 1998 caused the shift to be put off until 2001. In late January, the central bank announced that the litas would be pegged to the euro in early 2002. To dampen possible speculation of a simultaneous devaluation of the litas, the central bank has proposed that the law on litas be amended to prohibit a devaluation or revaluation of the litas at the repeg.

The peg to the euro is needed for Lithuania's realignment to EU monetary rules. It was also called for by Lithuanian exporters, who complained they were hurt by the strengthening dollar.

Current account 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	-4.2	2.9	
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-3.3	
Gross wage, USD, period average	81	120	155	195	232	253	272	
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	14.7	
Exports, USD million	2020	2706	3413	4192	3962	2996	3252	1-11
Imports, USD million	2220	3404	4309	5340	5480	4791	4660	1-11
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-11.2	-4.0	Q1-3

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

Dollarization in Lithuania

by Igor Vetlov*

In an environment of high inflation and excessive exchange rate volatility, the ability of a domestic currency to deliver the basic functions of money can be significantly distorted. Such conditions motivate economic agents to substitute the domestic currency with a more stable foreign currency. This shift to a foreign currency as a store of value and unit of account is often referred to as "dollarization." In the context of macroeconomic stabilization, the evolution of dollarization can serve as a direct indicator of the domestic currency's credibility and the overall success of stabilization efforts.

A measure of credibility

At the earlier stages of economic transition, Lithuania, like other transition countries, experienced a flight from its domestic currency triggered by near hyperinflationary levels of inflation and a substantial devaluation of the domestic currency. The US dollar increasingly became the store of value and unit of account, as well as a medium of exchange. The currency reforms of 1992–1993, and the subsequent tightening of monetary policy and stabilization of the exchange rate, helped restore public trust in the domestic currency and significantly reduced dollarization. In particular, the introduction of a national currency, the litas, in June 1993 led to a dramatic fall in the dollarization ratio in the course of the second half of 1993 (LT in the figure below).

However, further stabilization measures, which included adoption of a currency board arrangement (CBA) and pegging of the litas to the US dollar in April 1994, did little to reduce dollarization of the economy. That could be seen as a reflection of the CBA's initial low credibility. Rumors of an impending devaluation of the litas persisted throughout the first half of 1995. As a result, dollarization ratio hit a peak in the summer of 1995 – up 50 % from the level prevailing in 1994.

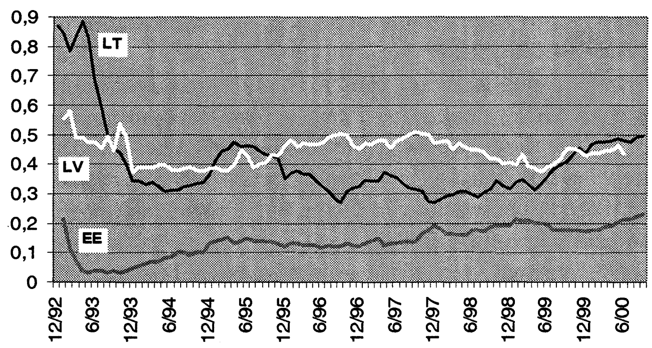
During the subsequent years, apart from a banking crisis and the resignation of the prime minister at the beginning of 1996, there were other more direct tests of the credibility for the CBA. These included statements of the Governor of the Bank of Lithuania on the dismantling of the CBA at some point of time. The latter probably was one of the reasons leading to significant disturbances in the foreign exchange market in November 1996.

The Russian crisis in the second half of 1998 again increased dollarization in Lithuania, although, given the circumstances, the increase was surprisingly small. The big surge in the ratio came in the second half of 1999, when dollarization reached its highest level since 1995. This surge may have been a lagged response to the Russian crisis, but more likely it reflected the rise in interest rates paid on dollar-denominated assets abroad, which put upward pressure on the interest rate paid on foreign currency deposits in Lithuania. The continuing rise in the dollarization ratio may also be related to the approaching re-pegging of the litas to the euro. It has been rescheduled several times during the past few years. According to the latest announcements of the Bank of Lithuania, the re-pegging is due to take place early 2002.

Baltic countries compared

The figure below shows that, over the discussed period, the ratio of dollarization in Lithuania was on average comparable to the corresponding ratio in Latvia (LV). Notably, the dynamics of the two ratios have little in common besides the rise in both ratios since mid-1999. During most of 1993, the dollarization ratio in Lithuania was considerably higher than in Latvia, but in the period 1996–1998 it was significantly lower.

Dollarization in Lithuania (LT), Latvia (LV), and Estonia (EE)



Source: Bank of Lithuania, Bank of Latvia, Bank of Estonia, author's calculations.
Note: Dollarization is calculated as the ratio of foreign currency deposits held by residents to the domestic currency denominated components of M2 (cash and deposits).

As is seen in the figure, the ratio of dollarization in Estonia (EE) has been on an upward trend since mid-1993. However, the Estonian ratio of dollarization consistently remains well below the levels of Lithuania and Latvia. This may indicate the relative success of the Estonian CBA (introduced in June 1992) as opposed to the Lithuanian CBA in establishing credibility of the domestic currency. Estonia's less extensive dollarization may also be attributed to the country's restrictive regulations on the use of foreign currency during the early years of transition.

** The author is a senior economist at the Bank of Lithuania's Economic Research Center.*

BALTIC ECONOMIES
The Quarter in Review
1/2001, 6 February 2001
ISSN 1456-4963 (print)
ISSN 1456-5900 (online)

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Seija Lainela