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ESTONIA

Industrial output starts to contract

It took approximately half a year for the slump in global economic activity to take its toll on the Estonian economy. Prior to March, the downturn affected the Estonian economy mainly via exports as demand for subcontracted items decreased. In the first quarter industrial output fell 0.1 % y-o-y. Manufacture of food products, metal products, machinery and equipment and communications equipment suffered. On the other hand, some main production sectors, e.g. the textile industry and wood processing continued to do well in March.

As in 2001, economic growth will be strongly dependent on domestic demand due to lower external demand for a large part of this year. Most analysts still believe, however, that exports will recover in the autumn and economic growth will pick up.

Annual inflation was 4.6 % in April. A hike in administered electricity prices drove the on-month rise in the consumer price index. March inflation was 4.3 %.

Exports decreasing

In the first quarter of 2002, Estonian exports decreased 25 % y-o-y according to monthly balance of payments data. The decrease, which started last summer, continues mainly due to low world demand for mobile phones. The exports of other main sectors – wood and wood products, textiles and food – remained at last year's level.

By some calculations, mobile phones and their components constituted about 25 % of Estonian exports a year ago. The difficulties of electronic manufacturing services provider Elcoteq, in particular, is having impact on the Tallinn region. The region's unemployment rate, once quite low, has risen since major employer, Elcoteq, laid off 600 workers last year. Moreover, Elcoteq says it plans to lay off another 270 workers.

According to monthly data, Estonia's current account deficit doubled in 1Q 2002 y-o-y. The main reason for the widening of the current account was increase in the trade deficit as imports fell less than exports. Income outflow also grew significantly, probably due to increase in reinvested earnings.

In 2001, FDI inflows to Estonia reached a record EEK 9.4 billion (€600 million) and almost completely covered the current account deficit. Reinvested profits accounted for a substantial share of FDI. The largest inflows came from Finland and Sweden; the main share of investment went to the financial sector, municipal infrastructure, manufacturing and the trade sector. FDI outflows from Estonia tripled in 2001 and went mainly to other Baltic countries. Large inflows of FDI continued in 1Q 2002, when inflows amounted to EEK 2.4 billion (€160 million).

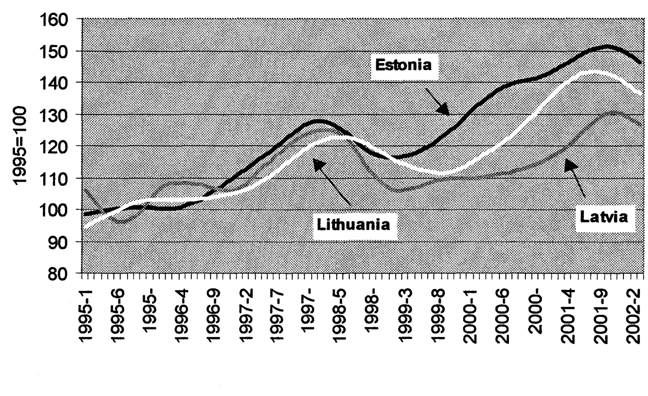
EU negotiations proceeding to the difficult chapters

After a more than a year of slow progress in EU negotiations, Estonia preliminary closed four chapters of the *acquis communautaire* in March. These included chapters on transport and free movement of people. On free movement of people, Estonia accepted the possibility of a seven-year transition period – the same terms as other accession countries had to accept.

So far, Estonia has closed 24 out of 31 chapters. The negotiations on the most complicated chapters are now under way. Estonia wants a transition period for opening its energy sector to protect its oil-shale-based power industry. The issue is socially important, as the oil shale industry is an important employer in Northeast Estonia. The Estonian government said that it may have to give up its demand on a transition period of six-and-a-half years for tax-free trade on ships to close the chapter on taxation. Estonia has announced its disappointment on the draft proposition of the European Commission on agriculture and Estonia is keen to have its production quotas of milk and grain considerably larger than planned in the draft.

Estonian public support for EU membership has risen during recent months. According to survey at the end of February by Emor, a market research company, 59 % of Estonians favour EU membership.

Trend of industrial production, 1995=100



ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %-growth	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	5.4		
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	6.9	-0.1	1-3/02
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	4.6	4/02
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	0.4	1-3/02
Gross wage, € period average	113	158	195	227	262	282	313	350		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9	11.9		
Exports, € million	1012	1242	1395	2035	2415	2364	3580	3748	823	1-3/02
Imports, € million	1307	1728	2181	3036	3420	3137	4442	4630	1132	1-3/02
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5		

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

LATVIA

Growth slows

Growth in industrial output slowed sharply in late 2001 and early 2002. Industrial output decreased 5 % y-o-y in March, and was down 1.2 % for the first quarter. Growth came to a standstill in the key food processing and wood and wood products industries, while growth in the furniture and textile industries continued.

Latvian real GDP grew 7.6 % in 2001. Brisk growth continued the entire year, despite signs of slowdown at year's end. Last year's growth was driven by strong domestic and external demand. At the beginning of 2002, external demand decreased and growth rates for exports of goods and services slowed. Nevertheless, domestic demand remained relatively stable and retail trade increased 12 % y-o-y in 1Q 2002. External demand is expected to start to grow again at the end of 2002, while real GDP is expected to grow about 5 % in 2002.

The transport sector causes some uncertainty to economic forecasts. Although cargo handling at the largest ports and railway cargo volumes each increased 3 % in January-April, the opening of Russia's Primorsk oil terminal in the Gulf of Finland at the beginning of 2002 has been followed by a decline in oil volumes shipped via the Ventspils terminal. Latvia's transport sector also suffered from Russia's rail tariff policy, which favours Russian ports. While Russia has promised to the WTO that it will harmonise its rail tariffs, action on the matter has yet to be seen.

Inflation remained stable during the past twelve months. On-year inflation was 2.9 % in April. For the month, food prices decreased, and fuel prices rose.

Export growth grinds to a halt

Latvian exports have recently suffered from the economic slowdown in Western Europe. According to balance-of-payments figures, exports began to slide slightly in March after recording slow growth in January-February. There was no overall change in exports between 1Q 2002 and 1Q 2001. Latvia's leading exports, wood and wood products, decreased slightly, while food exports increased, thanks mainly to a boom in exports to Russia. Although the growth rate of imports has also fallen, imports still increased 6 % in 1Q 2002 y-o-y.

According to the Bank of Latvia's monthly report, the current account deficit rose 20 % in January-March to nearly LVL 57 million (€100 million). Although the surplus in the service account increased, it could not compensate for the increased trade deficit.

After a relative trickle of foreign direct investment inflows last year, Latvia received FDI of LVL 84 million (€150 million) in January-March. While this amount exceeded the current account deficit, it should be pointed out that the decrease in net FDI in 2001 is partly explained by the financial reorganisation of the Hansabank group.

EU negotiations on track

Latvia has now closed 24 out of 31 chapters of the *acquis* in its EU negotiations. The most recently closed chapter concerns telecommunications. Of the remaining chapters, agriculture will likely be difficult for Latvia. The Latvian government has declared its disappointment with the Commission's proposition on agriculture. Latvia will ask for higher production quotas and increased direct payments in its upcoming negotiations on agriculture. Negotiations about taxation are also complicated as Latvia wants transition periods for applying EU taxation policies. The transition periods include a minimum excise rate on cigarettes, a value-added tax and special economic zones.

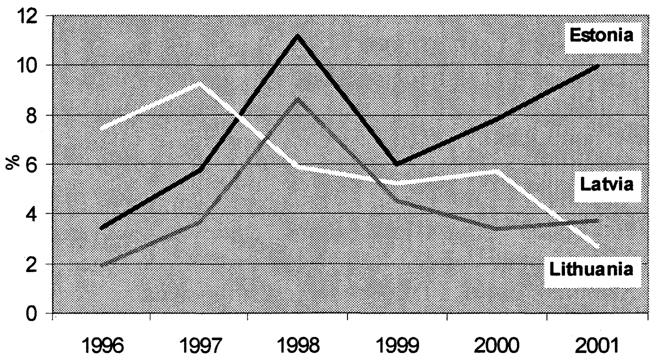
According to the most recent opinion poll, only 36 % of Latvia's residents would have voted for joining EU in February. 43 % of respondents oppose EU membership. Thus, the rise in EU scepticism seems to be a reaction to the Commission's agriculture proposal. Young people are more likely to favour EU membership than old people.

IMF likes surprisingly small budget deficit

According to the Ministry of Finance, Latvia's fiscal deficit was LVL 3.2 million (€6 million) or about 0.3 % of estimated GDP in the 1Q 2002. The deficit was thus far below the IMF target of LVL 20 million. The IMF temporarily suspended Latvia's stand-by credit facility at the start of 2002, when the IMF and Latvia could not agree on budget deficit for 2002 at the end of last year. The IMF mission visited Latvia at the beginning of May and said that an annual fiscal deficit of 1.8 % of GDP seems to be possible. An agreement on the deficit could be reached in mid-June if good budget performance continues in April-May.

Latvia's finance minister announced that Latvia will not sign a new cooperation memorandum with the IMF after the current memorandum expires this fall. According to Minister Berzins, Latvia does not need the memorandum anymore. The government must make the final decision on continuation of the memorandum.

Ratio of FDI to GDP



LATVIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	1.1	6.8	7.6		
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	8.4	-1.2	1-3/02
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	2.9	4/02
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.8	0.3	1-3/02
Gross wage, € period average	108	130	141	183	202	225	265	282		
Unemployment, % (2nd quarter, LFS data)			22.2	15.9	14.7	14.0	14.4	13.3		Q3/01
Exports, € million	857	1044	1172	1627	1796	1765	2237	2492	590	1-3/02
Imports, € million	1110	1486	1800	2377	2804	2725	3387	3897	893	1-3/02
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-10.1		

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

LITHUANIA

Growth decelerating

According to preliminary Statistics Department figures, Lithuanian GDP grew 4.1 % in 1Q 2002. Growth was mainly the result of changes in production of agriculture, electricity supply, retail trade and insurance companies. Decreased external demand has hampered Lithuanian export growth in recent months. On the other hand, the growth in retail trade continued despite persistent high unemployment and a slow rise in real wages. Growth is mainly associated with falling interest rates and increasing popularity of consumption and mortgage loans. Industrial output measured in sales grew only 1.7 % y-o-y in the first quarter. Production of furniture and textiles continued to increase, but production in the country's most important industry, oil refining, shrank 16 %.

Lithuanian real GDP rose 5.9 % last year. This brisk growth was due mainly to a rapid increase in Lithuanian exports. Fixed capital investments also increased, particularly at the end of 2001.

Inflation remains low due to a slow recovery in domestic demand. The 12-month inflation rate was 1.3 % in April.

Exports disturbed by unstable oil refining

Rapid growth in exports hit the wall at the beginning of 2002. In January-February, exports decreased 6 % y-o-y. The drop was due mainly to a decrease in refined oil exports. One reason for the fall was a scheduled two-week downtime in February for repair and maintenance of the Mazeikiu Nafta oil refinery. Exports rebounded in March when the refinery was brought back on stream. For the quarter overall, exports remained at the level of 1Q 2001. Exports to EU countries increased 6 %, while exports to Russia, mainly food and vehicles, increased an impressive 66 %.

Monthly data indicate the current account deficit in January-February was slightly higher than a year before. The rise was mainly due to widened trade deficit caused by fewer exports and higher imports. FDI inflows remained at last year's level and amounted to LTL 270 million (€80 million). In 2001, Lithuania's current account deficit equalled 4.8 % of GDP. The deficit was reined in as exports grew faster than imports. The rising service account surplus was driven by growth in the transport sector. FDI inflows into Lithuania increased last year so that investments covered nearly 80 % of the current account deficit.

Rating agencies and IMF pleased with development

The favourable economic development in Lithuania has attracted the notice of the international credit ratings agency Standard & Poor's, which raised Lithuania's long-term foreign currency rating to BBB from BBB- at the end of April. S&P noted that its decision was mainly based on Lithuania's disciplined fiscal policy and its speed-up in structural reforms. S&P also commended Lithuania for its rapid progress in EU accession talks, which has led to needed administrative and legislative reforms. Fitch Ratings and Moody's affirmed their ratings (BBB- and Ba1) for Lithuanian debt in February and revised Lithuania's outlook from stable to positive. Lithuania benefited from higher ratings when it issued a Eurobond of €400 million. The issue has a maturity of ten years, and yielded 94 basis points over corresponding German bond when launched.

An IMF mission visited Lithuania at the beginning of May. It gave a positive evaluation of reforms in Lithuania and the macroeconomic development in 1Q 2002. However, the IMF pointed out that the ongoing tax reform must be balanced to avoid budget losses. The IMF encouraged Lithuania to strengthen management of municipal finances.

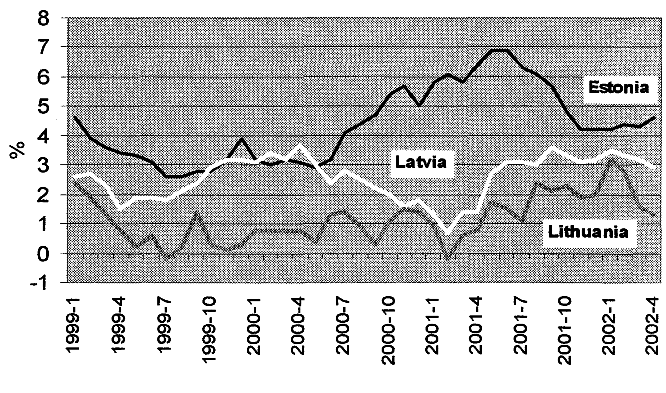
No solution for Ignalina yet

Lithuania presently is near the front of the pack in EU membership negotiations. It has already preliminarily closed 26 chapters of the *acquis*, only one chapter less than the leader Cyprus. No one doubts, however, that the remaining chapters will also be the most difficult for Lithuania.

In March, Lithuania closed the taxation chapter. Its concession included abolition of its free economic zones before accession. Lithuania will also align its excise duties on cigarettes to the overall minimum excise duty in the EU directive by the end of 2009. While Lithuania and EU have reached agreement on all technical issues of the energy chapter, it cannot be closed due to ongoing disputes over the closure of the Ignalina nuclear power plant. The EU insists that Lithuania should close the second reactor at Ignalina by 2009. Lithuania argues that it cannot meet the deadline met without further financial support from the EU. As a part of financial package for enlargement, the Commission proposed in January to allocate €70 million annually in 2004-2006 to support the decommissioning of the plant. The EU earlier provided financial support for the closure of the first reactor.

In March, 49 % of Lithuanians supported EU membership.

Inflation rates in the Baltic countries



LITHUANIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-3.9	3.8	5.9		
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	16.9	1.7	1-3/02
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	1.3	4/02
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-1.4		
Gross wage, € period average	68	92	122	173	208	231	264	296		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1	17.5		
Exports, € million	1705	2066	2687	3710	3537	2941	4403	5432	1410	1-3/02
Imports, € million	1877	2599	3393	4726	4893	4254	5602	6663	1641	1-3/02
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8		

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

The importance of nominal convergence for candidate countries

By Marketta Järvinen*

The conventional wisdom in EU circles is that candidate countries should focus on real convergence rather than the nominal convergence criteria. While politicians and academicians generally agree on this, they differ on how real convergence is best achieved. In candidate countries, on the other hand, the discussion tends to centre on exchange rate strategies and nominal convergence during the – hopefully brief – run-up to EMU. Indeed, the discussion between the EU and the candidate countries on EMU appears to suffer from a certain deafness on both sides. EU seems to ignore the intention of candidate countries to adopt the euro as soon as possible, while candidate countries have failed to address real convergence issues.

To their credit, the candidate countries have political reality on their side. EU membership will be a political decision. EMU entry, on the other hand, demands the application of economic criteria that do not include real convergence. To ensure EMU decisions do not become political, as well as the smooth functioning of the enlarged euro area, the relevant EU authorities (finance ministries, the ECB and EU central banks) need to be prepared to discuss nominal criteria, i.e. inflation, interest rates, exchange rates and public finances, focusing on their sustainable fulfilment.

To date, exchange rate regimes have by far generated the most discussion. Inflation has ceased to be a major macroeconomic problem in most countries and the soundness and sustainability of public finances is gaining more attention through Pre-accession Economic Programmes (PEP) submitted by candidate countries.

The Fiscal Theory of the Price Level

The Fiscal Theory of the Price Level (FTPL) appears appropriate to provide a framework for analysing the interaction between the variables of nominal convergence. It combines monetary and fiscal policies and provides a holistic approach to macroeconomic analysis, as noted in a recent Commission paper (Ballabriga and Martinez-Mongay 2002). According to Woodford (1995), fiscal policy can be either Ricardian (monetary dominant), where primary surpluses (i.e. surplus before debt servicing costs) adjust to guarantee fiscal solvency for any sequence of prices, or non-Ricardian (fiscal dominant), where a government's inter-temporal budget constraint is satisfied for some, but not all, price paths. An example of an "irresponsible" (non-Ricardian) policy is setting the primary surplus at a fixed level.

As noted by Christiano and Fitzgerald (2000), the non-Ricardian assumption is not a good characterisation of policy in all times and places. Nevertheless, the mere recognition that such policies could exist may help avoid them. It has been shown (Canzoneri and Diba 1996, Woodford 1996) that the Maastricht criteria on deficit and debt force countries into a Ricardian regime. A similar reasoning underlies the Stability and Growth Pact (SGP), whereby Member States commit to respect the medium-term budgetary objective of positions close to balance or in surplus.

Fiscal policy and exchange rate regimes

Applying the FTPL in different exchange rate regimes shows that no exchange rate regime in itself can impose fiscal responsibility. Irresponsible fiscal policy affects the price level in all exchange rate regimes. If fiscal policy is responsible, the price level is determined in the traditional way by monetary policy and the fiscal variables have no effect.

In a monetary union, irresponsible fiscal policy by one member country raises the price level of the entire union. For fixed exchange rate regimes, irresponsible fiscal policy is inconsistent with a fixed exchange rate regime while a flexible exchange rate can absorb the effects of irresponsible fiscal policy. Moreover, currency boards are best at forcing fiscal discipline. Euroisation may not be beneficial from the point of view of the euro area, as it may experience some effects to its price level.

In the EU context, these results confirm that responsible fiscal policies are essential for the functioning of EMU, which is probably why the EU has agreed on the SGP. If the exchange rate is to be credibly fixed within ERM II, the candidate country must conduct responsible fiscal policy or exit the peg. The requirement for responsible policies is naturally strengthened by the Maastricht criteria (fiscal responsibility and price and exchange rate stability).

For the pre-ERM II period, countries with irresponsible fiscal policies are probably better off sticking to flexible regimes that can absorb the effects of irresponsible policies. A forced exit from the ERM II would certainly not impress the EU and would very likely prove costly in economic terms. On the other hand, the credibility of responsible policies may be enhanced by a commitment to a fixed exchange rate regime.

Thus, the dialogue between the EU and the candidate countries on the topic of nominal convergence needs to deepen – and soon. Such dialogue would support the conduct of responsible policies that extend beyond the point of acceptance into the monetary union. Rapid changes in fiscal stance are possible as witnessed in the deterioration in Poland in 2001 and the amelioration in Lithuania in 2000, which, coincidentally, can be seen as confirming the above results: irresponsible fiscal policy is possible with a floating regime, while a currency board supports the conduct of responsible policies.

** The author is an economist at the Ministry of Finance. The views expressed are solely those of the author.*

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