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ESTONIA

Economic growth continues to slow

As forecast, Estonia's GDP growth slowed further early this year. Real GDP grew 3.2 % y-o-y in 1Q02. Growth was sustained by brisk increase in trade (7 %), manufacturing (5 %) and transport and communication services (4 %), while agricultural output fell 4 %. Warm weather reduced electricity, gas and water consumption 7 %. On the demand side, growth was very much based on domestic consumption, as exports of goods and services were down 11 % y-o-y in 1Q02. Growth in public consumption, which started to rise at the end of last year, reached nearly 5 % in 1Q02. This trend is expected to continue as elections approach. Private consumption grew less than 3 %. Although investments are apparently strong, their impact on GDP growth was less than expected as they are very much related to imports. The value-added component of construction was up 9 %.

Unemployment has decreased steadily since early 2001. In 1Q02, the ILO-defined unemployment rate was 11.2 % (14.1 % in 1Q01). In April-May, industrial production was growing faster than at the beginning of 2002. Although there are no signs of a recovery in exports, export growth is expected to accelerate in the second half of the year. The latest forecasts indicate GDP will grow about 4.5 % in 2002. For 2003 GDP is forecast to grow by more than 5 %.

Inflation has subsided in recent months; the annual inflation rate was 3.8 % in June. Administratively set prices were up 6 %. Month-on-month, food prices decreased 0.5 %.

Worsening current account deficit

Estonia's current account deficit increased to 14.5 % of GDP in the first quarter, more than doubling from 1Q01 due to a larger trade deficit as exports shrank faster than imports. The traditional service account surplus decreased as Estonians used more foreign produced services, for example, in the construction sector. Monthly data indicate the current account deficit grew in April due to worsening trade deficit.

FDI inflows to Estonia decreased in 1Q02. Net inflows of EEK 1.8 billion (€110 million) were sufficient to cover only about half of current account deficit.

Successful eurobond issue

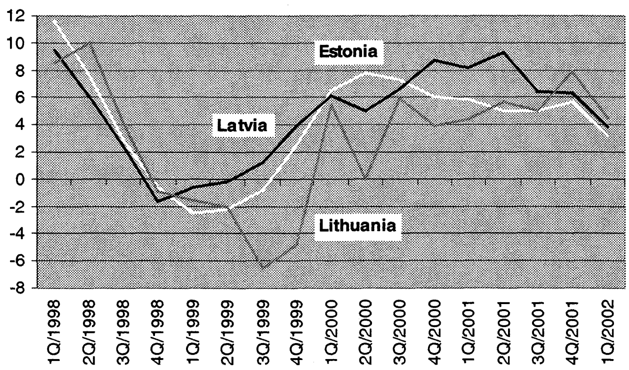
At end-May, the general government surplus was about 0.6 % of expected annual GDP. Higher-than-expected revenues allowed the government to launch a supplementary budget in June. The supplementary budget of EEK410 million (€26 million) goes to pension disbursements, municipalities and basic education. The IMF has warned Estonia against further supplementary budgets as EU and NATO-related expenditures will increase the pressure on budget.

Estonia issued its first-ever eurobond in mid-June. The €100 million, five-year paper was offered with a coupon of 5 %. The price of the bonds in primary subscription established at 99.18 %. Consequently, the eurobond had a yield of 5.19 %. The issue was 2.7 times oversubscribed.

EU negotiations in home stretch

With the end of Spanish EU presidency, Estonia had closed 27 chapters of the *acquis communautaire*. In June, Estonia preliminary finished negotiations on regional policy and taxation. Estonia will get €3.6 billion regional support annually from EU for 2004-2006. Estonia has to give up tax-free trade in marine transport, but it will retain tax freedom for reinvested profits. It must bring the taxation of dividends into agreement with EU requirements by the end of 2008. Estonia won transition periods for taxation of tobacco and district heating. Of the four chapters Estonia has yet to complete, energy and agriculture promise to be the most contentious. Estonia wants a transition period for its energy sector, and EU still lacks a common position on agricultural policy.

GDP growth, % year-on-year



ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, %-growth	-2.0	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	3.2	Q1/02
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	6.9	2.8	1-5/02
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	3.8	6/02
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	0.6	1-5/02
Gross wage, € period average	113	158	195	227	262	282	313	350	366	Q1/02
Unemployment, % (end-year, LFS data)				9.8	10.2	12.9	13.9	11.9	11.2	Q1/02
Exports, € million	1012	1242	1395	2035	2415	2364	3580	3748	1149	1-4/02
Imports, € million	1307	1728	2181	3036	3420	3137	4442	4630	1526	1-4/02
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-14.5	Q1/02

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

LATVIA

GDP growth slowed in the first quarter

Latvian GDP growth slowed to 3.8 % y-o-y in 1Q02. Sluggish growth in foreign demand was the major reason for the slowdown. Transport and telecommunications grew less than 2 %, as the main input of the sector, transhipments of oil and oil products, decreased. Growth in manufacturing (3 %) was also lower than in 2001. The service sector is currently the motor of Latvian economic growth. Retail trade was up 9 % in the first quarter, while financial services showed a brisk 6 % growth. Agricultural output increased 5 %. Construction was up 7 %, and non-financial investments in Latvia increased by 10 % y-o-y in 1Q02. About a quarter of investments went to industry, mainly to manufacture of food products and beverages and to the production of wood and production of wood and cork. Some 30 % of the investment went to the transport, storage and communications sector, while 14 % of investments went to trade.

Industrial production was up almost 6 % in April-May, but the transport sector still had difficulties because of oil transhipments.

Annual inflation rate fell to 0.9 % in June. The main reason for the drop was a decrease in mobile phone charges. Food and clothing prices also decreased in June.

The unemployment rate (percentage of jobseekers) was 13 % in 1Q02. The rate was 13.5 % a year ago.

Current account deficit decreased slightly

Latvia's current account deficit was somewhat smaller than a year ago, amounting to 3.9 % of GDP in 1Q02. The trade deficit increased slightly, however, as imports grew faster than exports. Exports suffered from weaker demand in Europe and exports to the EU decreased slightly. The growing service account surplus covered much of the increased trade deficit. According to monthly statistics, the current account deficit increased in April due to the larger trade deficit.

FDI inflows to Latvia increased in January-March from last year and totaled LVL81 million (€140 million). FDI inflows exceeded the current account deficit.

Elections threaten budget discipline?

Changes may be in store for October's parliamentary elections. The parties in the current centre-right government coalition – the People's Party, Latvia's Way and For Fatherland and Freedom – all lost support after former central bank governor Einars Repse formed his own party called New Era last winter. Latest polls show New Era is the most popular party in Latvia, supported by about 20 % of voters. Human Rights in United Latvia, Latvia's Way and the People's Party all have support below 10 %.

The proximity of the elections has made some analysts worried about the budget balance. However, the tax intake has been larger than expected and in January-May the fiscal deficit shrank to about 0.5 % of GDP.

The coming elections are expected to delay critical privatisation projects. At the beginning of July, Latvia's economy minister indicated that decisions concerning privatisation of the Ventspils Nafta oil terminal will be delayed until after the election.

The privatisation of the Latvian Shipping Company (LASCO) proceeded with the auction of 51 % of the company on the Riga Stock Exchange on June 25. A total of 102 million shares were sold for LVL 36 million (€60 million). Ventspils Nafta dominated the buying. However, after the auction, Cyprus-registered Beacon Shipping Company sued the organizers of the auction because its bid reached the Riga Stock Exchange too late. Beacon claims the delay was not its fault.

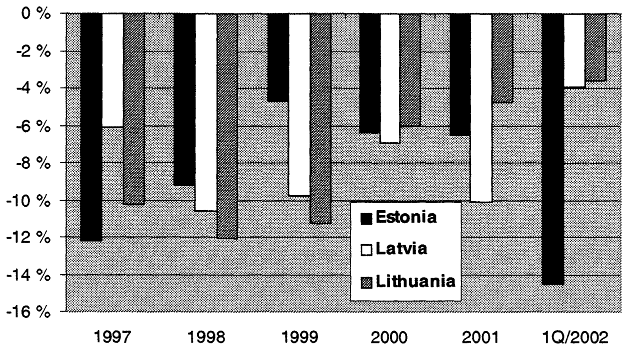
EU negotiations on track

Latvia has now closed 27 out of 31 *acquis* chapters in its EU membership negotiations. Like the two other Baltic countries, Latvia closed the chapter on regional policy in June. The country will get €1.6 billion in regional support during 2004-2006 and all of Latvia will be classified as a type-1 region, i.e. a region where GDP per capita is less than 75 % of the EU average. Latvia also closed negotiations on taxation and won a transition period for harmonisation of its tobacco taxes.

HEX buys stake in Riga Stock Exchange

On 28 June, 15 owners of the Riga Stock Exchange (RSE) signed an agreement on sale of their shares (93 % of RSE) to the HEX Group, which operates the Helsinki Stock Exchange. The deal creates an integrated market for securities and central depository and follows the model already used in Finland and Estonia. The arrangement is hoped to increase trading on the notoriously low-volume RSE.

Current account balance, % of 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	7.7	3.8	1-3/02
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	8.4	1.6	1-4/02
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	0.9	6/02
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-0.5	1-5/02
Gross wage, € period average	108	130	141	183	202	225	265	282	273	Q1/02
Unemployment, % (end-year, LFS data)			19.5	14.1	13.7	13.2	13.3	12.9	13.0	Q1/02
Exports, € million	857	1044	1172	1627	1796	1765	2237	2492	785	1-4/02
Imports, € million	1110	1486	1800	2377	2804	2725	3387	3897	1209	1-4/02
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-10.1	-3.9	1-4/02

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

LITHUANIA

Growth strongest among the Baltics

GDP grew 4.5 % in 1Q 2002, with brisk export growth helping Lithuania out-perform its neighbours. Domestic private consumption growth accelerated to 4 % in 1Q02, while fixed capital formation increased 8 %. Higher construction output (9 %) reflected investment growth as companies focused their investments on buildings, engineering facilities, machinery and vehicles. Investments were up strongest in processing industries, the transport and communications sector, and among companies involved in electricity, gas and water supply. Transport and communications grew 10 % and trade 8 % in 1Q02, while manufacturing growth was essentially stagnant.

Manufacturing growth accelerated in April-May. Industrial sales were up 6 % y-o-y in May. However, in June growth decelerated slightly to 4.1 %. Excluding the volatile oil sector, industrial production was up 5.5 % y-o-y. In the first six months of the year, Lithuania's industrial sales were up 4.4 %.

Oil refining should show better growth now that Russia's number-two oil company YUKOS has purchased a 27 % stake in Mazeikiu Nafta. In addition to paying $75 million for the stake, YUKOS granted an equal-sized loan to finance modernisation of Mazeikiu Nafta's refinery. YUKOS is further committed to delivery of 4.8 million tonnes of crude oil annually to the Mazeikiu Nafta over the next ten years.

Unemployment remains high in Lithuania. In the final quarter of 2001 the unemployment rate was 17.5 %, according to the labour force survey. Registered unemployment is lower (12.5 % in 4Q01), but it has shown only little tendency to decrease. In June the unemployment rate was 10.7 %, down from 12.3 % in June 2001.

Inflation remains quite low in Lithuania. In June, the consumer price level fell 0.5 % y-o-y. The decline is due to the stronger litas against the US dollar and lower oil prices. Prices of food products also declined in June.

Current account deficit narrows

Lithuania's current account deficit shrank in January-March to 3.6 % of GDP. The decrease was due to a decline in trade deficit as exports grew faster than imports. Exports increased 9 % y-o-y in 1Q02. Exports to CIS countries grew strongly (34 % y-o-y in January-April), as did exports to the EU. Increased exports of vehicles and related transport equipment compensated for the decline in refined oil exports. The service surplus remained at last year's level thanks to an increase in transport service exports. According to monthly statistics, increased imports of capital goods widened the trade deficit slightly in April.

FDI inflows decreased somewhat y-o-y and amounted to LTL 320 million (€90 million) in the first quarter of 2002, enough to cover almost 80 % of the current account deficit.

Privatisation proceeding

Budget revenues have been higher in the first half of 2002 than expected and the public financing situation is fairly good. In 1Q02, the general budget deficit was 0.9 % of GDP.

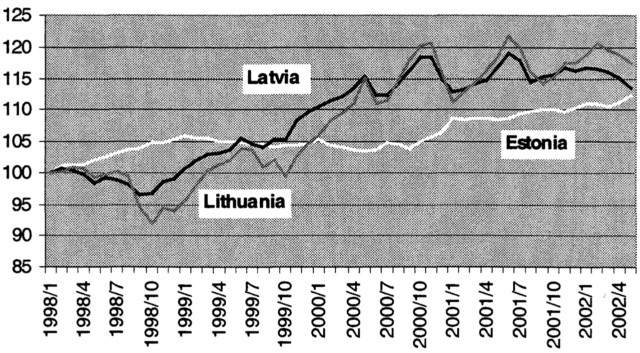
In April, Lithuania issued a eurobond with a nominal value of €400 million and maturity of ten years. The money raised will be used to finance, among other things, the budget deficit and investment projects. The eurobond carries a coupon of 5.875 %. At launch the bond's yield was 94 basis points over the corresponding German government bond.

The public sector will also get additional financing from ongoing privatisation projects. In May, Lithuania sold 34 % of gas company Lietuvos Dujos to a German consortium for LTL 116 million (€34 million). Interested gas suppliers are expected to soon announce their intent to submit bids for another 34 % stake in the company. The government hopes to seal the deal by the end of 2002.

Lithuania closes energy chapter in EU negotiations

Lithuania has now preliminarily closed 28 chapters of the *acquis communautaire*, and shares the lead in negotiations with Cyprus. Lithuania still must negotiate on agriculture and budgetary provisions. Lithuania would also like to reopen negotiations on the sale of agricultural land to foreigners. When negotiations closed earlier on that chapter, no transition period had been agreed. Now that other applicant countries have obtained transition periods, Lithuania will also try to seek one. In June, Lithuania finished negotiations on regional policy and energy. The closure of the energy chapter was directly linked to the agreement between the Lithuanian government and the EU on shut-down of the Ignalina nuclear power plant. Lithuania will close the first reactor by 2005 and the second reactor by 2009. The EU has promised additional (amount still undecided) financing for the decommissioning. The Lithuanian government now puts the costs of decommissioning at €2.4 billion. So far EU commission has proposed extra financing for the decommissioning €245 million in 2004-2006.

Real effective exchange rates, Jan 1998=100



Source: BIS

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	4.5	1-3/02
Industrial production in sales, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	5.3	16.9	4.4	H1/02
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-0.5	6/02
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	1.9	-0.9	Q1/02
Gross wage, € period average	68	92	122	173	208	231	264	296	315	Q1/02
Unemployment, % (end-year, LFS data)				14.1	12.6	15.3	16.1	17.5		
Exports, € million	1705	2066	2687	3710	3537	2941	4403	5432	1934	1-4/02
Imports, € million	1877	2599	3393	4726	4893	4254	5602	6663	2314	1-4/02
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-3.6	1-3/02

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

The real exchange rate as an indicator of Baltic competitiveness

By Sinimaaria Ranki*

The real exchange rate is generally considered a key macroeconomic indicator. Indeed, a large body of evidence supports the view that when exchange rates get seriously misaligned with economic fundamentals they can cause substantial macroeconomic imbalances. The Balassa-Samuelson model further suggests that a country with high growth will experience higher inflation due to price increases that are higher in the services-loaded non-tradable sector than in the tradable sector. These higher prices reflect higher productivity in the tradable sector, which implies that such high growth countries will tend to see their real exchange rates appreciate over time.

For economists, the real exchange rate has little meaning without a reference value. A suitable reference would be an equilibrium exchange rate, i.e. the real exchange rate that would prevail when the economy was simultaneously in internal and external balance. This equilibrium real exchange rate may vary over time, so we cannot say whether a movement of the observed real exchange rate actually reflects a change of the equilibrium exchange rate. However, where there is no movement in the equilibrium exchange rate and the real exchange rate moves, the actual real exchange rate deviates from the equilibrium real exchange rate. Such misalignments are widely believed to influence economic behaviour. In particular, overvaluation is expected to hinder economic growth while undervaluation is thought to provide an environment conducive to growth.

Against this theoretical background, the experience of the Baltic states, which have seen their real exchange rates appreciate throughout the 1990s, raises several questions. Do the Baltic currencies suffer from sustained misalignments? Should policymakers be worried about this development? These issues were analysed in a recent joint study by researchers from the central banks of Estonia, Lithuania and Latvia. The Bank of Estonia published the study.

Which fundamentals determine real exchange rates?

The authors consider the interaction of the real exchange rate and key macroeconomic variables. In Estonia, the determinants of the real exchange rate are the productivity differential in the tradable versus non-tradable sectors, and the terms of trade. The effect of the productivity differential follows the prediction of the Balassa-Samuelson model. The effect of the world interest rate, in turn, can be in either direction. In the short run, an increase in world interest rate induces a capital outflow, which results in a depreciation of the real exchange rate. The long-term effect may be an appreciation of the real exchange rate as part of the current account is financed by interest income from abroad.

For Latvia, the key determinants of the real exchange rate were found to be openness of the economy and productivity differential in tradable versus non-tradable sectors. The productivity differential, again, reflected the prediction of the Balassa-Samuelson model. The more open the economy, the higher the trade flows, and thus, the larger the amount of imports that must be financed by exports. Higher exports, in turn, are promoted through depreciation of the real exchange rate. Increased government expenditure was also found to imply a depreciation of the real exchange rate.

In Lithuania's case, the key variables determining the real exchange rate were the relative productivity in the domestic economy and the world economy; openness of the economy measured as the ratio of foreign trade to GDP; the real price of oil; and the real interest rate differential between domestic and world rates. Again, we observe the Balassa-Samuelson effect in the productivity differential as the explanatory variable. The effect of the oil price is specific to Lithuania because oil-related products represent a large share of Lithuanian foreign trade. The effect of the openness of the economy is the same as in the case of Latvia, and the effect of world interest rates has an impact similar to the Estonian case.

The productivity gap, thus, emerges as the common feature characterising real exchange rate developments in the Baltics. This, in turn, implies that the main driving force behind the currency appreciations is the catching-up process of the economies just as predicted by the Balassa-Samuelson model. Apparently, the extreme openness of these economies also matters, as changes in foreign demand rapidly affect the demand for (and thus prices of) domestic goods.

Equilibrium real exchange rates and misalignments

The authors derive equilibrium real exchange rates and calculate the misalignments by subtracting the equilibrium real exchange rate from the actual real exchange rate. The results show that the deviations from the equilibrium real exchange rate have been transitory and surprisingly small (15 % at the highest). Hence, referring to previous research showing that only very high overvaluations appear to be associated with slower economic growth, the authors conclude that, thanks to growing competitiveness, the short periods of relatively small misalignments of Baltic real exchange rates pose little concern for policymakers from either the stability or sustainability points of view.

** The author, currently Head of Research at the Helsinki Business Polytechnic, was research supervisor at the Bank of Estonia as the study was conducted.*

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