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BALTIC ECONOMIES
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ESTONIA

Domestic demand sustains growth

According to preliminary estimates of the Statistical Office, Estonian real GDP growth accelerated to 6.5 % in the second quarter of 2002. Despite the harm to Estonia's export sector from slow growth in the EU, domestic demand has sustained surprisingly high growth. Successful sectors include trade and construction. In nominal prices, retail trade increased 16 % and construction output 35 % y-o-y in 2Q02. The industrial sector has been hit harder than the service sector by weak growth in EU countries. Nevertheless, the outlook brightened in the second quarter and industrial growth overall returned to 6 %. Growth in two leading sectors – the food industry and manufacture of wood and wood products – continued to lag, however.

The annual inflation rate in August was 2.6 %.

Wages up, unemployment down

Unemployment continued to fall in 2Q02 as the ILO-defined unemployment rate dropped to 9.4 %. Employment has improved only slightly, however, and the decline was mainly due to a shrinking labour force. The labour force participation rate (share of employed and unemployed persons in the working-age population) dropped to 61.3 % (62.8 % in 2Q01). The shift reflected e.g. higher enrolments. Employment increased in real estate, rental and business activities, as well as in trade.

The average nominal monthly gross wage in 2Q02 was up 10 % y-o-y and amounted to EEK 6400 (€406). Wages were highest in the financial sector and lowest for jobs in hotels and restaurants and in agriculture. While rapid wage growth has boosted private consumption, it also has the potential to harm the competitiveness of Estonian exports in the long term.

Export decline hurts current account figures

According to the monthly balance of payments statistics, the current account deficit amounted to EEK 2.7 billion (€170 million) or nearly 10 % of forecast GDP in 2Q02. The widening deficit was driven by the trade deficit, which grew as exports declined and strong domestic demand increased imports (3 % y-o-y in 2Q02). Although the export of services, particularly in the transport sector, increased, the service sector surplus decreased in the first half of 2002 due to a growth in imports of services by the construction and tourism sectors. The income deficit grew with increased dividend payments abroad. In April-June, net inflows of FDI were sufficient to cover half of the current account deficit.

The decline in exports started in July 2001 and amounted to 9 % y-o-y in 2Q02. Problems in the machinery sector were a primary cause of the decline. Exports from all other sectors increased. According to the statistical office, when the on-year comparative figure started to fall in July, exports for all sectors (including machinery) showed growth of 6 %.

Government planning second supplementary budget

At end-July, the general government surplus was 1.7 % of annual GDP. The surplus in state budget occurred when corporate income tax collection was higher than expected and the capital expenditure was smaller than planned. Local municipalities collectively ran a small budget deficit.

Estonian government has suggested using the extra money in a second supplementary budget this year. The added spending would amount to EEK 0.8 billion (€50 million) and go to e.g. care of the sick and disabled, purchase of an embassy building in Brussels and compensation to farmers for the recent drought. The government added EEK 400 million already in June to the existing EEK 34 billion state budget. The Bank of Estonia and the IMF would have preferred to save the money for coming years when e.g. pension reform and EU membership will increase government expenses. Estonia has now preliminary closed 28 chapters of *acquis*. In July, the EU agreed to Estonia's request for a delay in fully opening its energy sector to competition until the end of 2012.

Mortgage loans increasing rapidly

The loan stock of Estonian banks continues to grow rapidly. It amounted to EEK 45 billion (€2.9 bn) at the end of July, up 18 % y-o-y. Loans to enterprises increased 15 % and loans to households 40 % as mortgage lending grew rapidly.

Economics forecasts

	GDP, % change		CPI, % change	
	2002	2003	2002	2003
Estonia	4.5	5.5	4.2	3.9
Latvia	5.0	5.4	2.7	2.8
Lithuania	4.1	4.9	2.3	2.4

Source: Eastern Europe Consensus Forecasts

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	3.1	1-7/02
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.6	8/02
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	3.2	1-7/02
Gross wage, € period average	113	158	195	227	262	282	313	350	406	Q2/02
Unemployment, % (end-year, LFS data)				9.8	10.2	12.9	13.9	11.9	9.4	Q2/02
Exports, € million	1012	1242	1395	2035	2415	2364	3580	3748	1762	1-6/02
Imports, € million	1307	1728	2181	3036	3420	3137	4442	4630	2336	1-6/02
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-11.9	1-6/02

Sources: Statistical Office of Estonia, Bank of Estonia, EBRD, IMF
** Base year for GDP pricing changed from 1995 to 2000.*

LATVIA

Hike in salaries supports domestic demand

As in other Baltic countries, economic growth in Latvia was driven by domestic private demand in the first half of 2002, while weak demand in EU countries hurt exports. Higher salaries in 2Q02 supported domestic demand as the average nominal gross monthly wage increased 10 % y-o-y to LVL 177 (€290). Retail trade volume rose rapidly and construction output in the first half of 2002 was 7 % higher than in the corresponding period last year. Growth in the industrial sector recovered in the second quarter with industrial output up 5 % y-o-y. In July, growth accelerated to 7.5 %. All the key industrial sectors – manufacture of food products, wood and wood products, textiles and furniture – showed growth.

Annual inflation rate was 0.9 % in August. The main reason for low inflation was a drop in food prices during the summer.

Imports growing faster than exports

According to monthly statistics, Latvia's current account deficit rose to LVL 110 million (€190 million) or nearly 9 % of preliminary GDP in 2Q02. The widening deficit reflected a growing trade deficit as imports grew faster than exports. The service sector surplus, however, was up 7 % due to increased tourism. In 2Q02, the number of foreign tourists visiting Latvia was 7 % higher than a year ago. The transport sector and particularly Latvia's biggest port, Ventspils, suffered from the decline of transit shipments of crude oil. In the first half of 2002, crude oil transit via Latvian ports decreased 25 %. Transfers from EU funds increased in the second quarter compared to the corresponding period of 2001 and helped widen the current transfers surplus.

The net inflow of FDI was clearly larger than in 2Q01 and sufficient to cover almost 60 % of the current account deficit.

In April-June, export growth accelerated somewhat to 5 % y-o-y. Exports to EU countries grew 6 % y-o-y and 13 % to CIS countries. Some 60 % of Latvian exports went to EU countries and 10 % to the CIS. Germany is Latvia's biggest trade partner in terms of both exports and imports. Wood and wood products make up one-third of Latvia's exports. However, this sector has seen virtually no growth this year. Export growth has been strongest in foodstuffs (64 %), which profited from healthy economic developments in Russia. Imports to Latvia increased 15 % in April-June. The most important imports to Latvia were still machinery and electronics.

IMF and Latvia agree on fiscal deficit

After a strict budget discipline in the first half of 2002, Latvia and the IMF agreed in July on a consolidated budget deficit target of 1.8 % of GDP (LVL 90 million) for 2002. In parallel, the IMF executive board decided to continue its stand-by arrangement with Latvia.

The general government consolidated fiscal deficit amounted to LVL 16 million (€28 million) at end-July. While clearly below target, it widened substantially in July. The state budget deficit was LVL 11 million and the municipal sector deficit was LVL 13 million.

Latvia's decent budget performance was one reason for Standard & Poor's decision to raise Latvia's rating on long-term foreign currency borrowing to BBB+ in August. The new rating is one notch better than the previous one.

Parliamentary elections approaching

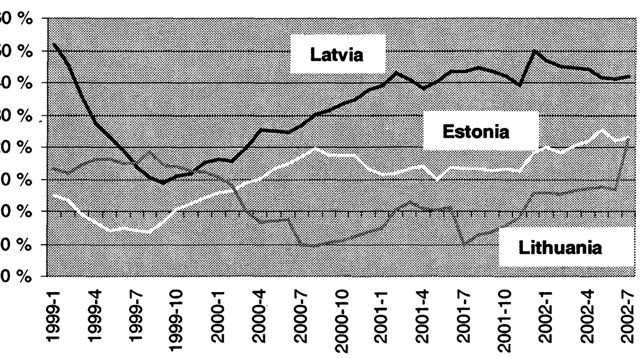
A total of 1,022 candidates are listed on 20 tickets of political parties and political unions in the 8th Seimas elections, set for October 5. The latest polls show the New Era Party, founded last year by the former Bank of Latvia governor Einars Repse, enjoying the greatest popularity. Whatever the outcome, Latvia's foreign policy is unlikely to change – all notable parties support EU and NATO memberships.

At the moment, Latvia has closed 27 out of 31 chapters of the *acquis* in its EU membership negotiations. The European Commission will release in mid-October its regular report on applicant countries' progress in meeting EU membership criteria. On the basis of the report, the European Council will assess at the end of October the eligibility of candidate countries for EU membership.

Loan stock grows rapidly

During January-July, Latvian banks granted 42 % more loans than in the corresponding period a year earlier. The significant drop in interest rates was one reason for the rapid growth. At end-July, the loan stock of Latvian deposit banks amounted to LVL 1.9 billion (€3.1 bn), or about 40 % of annual GDP. Fastest growth was observed in loans to private persons, which increased 55 % during the past 12 months. As in Estonia, mortgage loans grew rapidly. The stock of loans granted to private enterprises increased 40 %.

Credit granted to households and private enterprises, year-on-year growth



LATVIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	2.8	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	6.9	2.8	1-6/02
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	0.9	8/02
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-0.6	1-7/02
Gross wage, € period average	108	130	141	183	202	225	265	282	290	Q2/02
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	1235	1-6/02
Imports, € million	1110	1486	1800	2377	2804	2725	3387	3897	1910	1-6/02
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-10.1	-6.4	1-6/02

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

LITHUANIA

Brisk growth continued in second quarter

According to preliminary estimates, Lithuanian GDP grew 6.9 % in the second quarter of 2002. As in the other Baltic countries, domestic consumption supported growth. Household monthly income rose 4 % and monthly real wages were up 5 % y-o-y. Although the number of registered unemployed person fell, employment did not improve due to a decline in the labour force.

Increased investment led the revival in growth, but most areas of the service sector also grew. The net sales of hotels and restaurants, as well as businesses involved in trade and electricity and water supply grew about 15 % according to preliminary estimates. In the transport sector, both rail freight traffic and goods carried by sea transport increased. Investments in fixed assets were up 31 % y-o-y. Over half of investments were directed at construction and repairs. As a result, the construction sector volume rose 30 %. Industrial output climbed 8 % y-o-y in the second quarter (2 % in 1Q02). The oil refining continued to decline, but at a slower rate than earlier in the year. Growth in most other manufacturing sectors remained brisk. Growth was particularly strong in the manufacture of motor vehicles (up 66 % y-o-y in January-July) and electricity production (up 46 %).

Mazeikiu Nafta's difficulties continued in January-June, when it announced an unaudited loss of LTL 140 million (€40 million). The ownership arrangements also continued to shift; US-based Williams announced in August its intention to sell its stake in Mazeikiu Nafta to the Russian Yukos. On September 4, the Lithuanian government chose not to exercise its preemptive right to purchase the shares from Williams. Thus, Yukos will hold the majority stake in the Lithuanian oil company after the deal is closed. When buying its first stake in Mazeikiu Nafta in June, Yukos committed to deliver 4.8 million tonnes of crude oil annually to the refinery. It has already granted a $75 million loan to finance modernisation of the refinery.

Inflation has slowed down since the beginning of 2002 and in August, consumer prices were down 1.1 % y-o-y. The prices of e.g. food products, clothing and transport have declined. The decline is partly due to stronger litas against the US dollar.

Exports to CIS grew rapidly

Based on monthly statistics, the current account deficit widened in 2Q02 to LTL 1.1 billion (€310 million) or 8.5 % of estimated GDP. Imports to Lithuania grew faster than exports. The services surplus grew, however, as transit transport increased.

FDI inflows doubled from April-June 2001 and amounted nearly to LTL 1 billion. The increase in FDI was mainly due to the sale of a stake in national gas company and the new ownership arrangements at Mazeikiu Nafta.

In the second quarter, exports were up 8 % y-o-y and imports 17 %. Although the exports of refined oil, Lithuania's top export article, declined, nearly all other sectors experienced growth. Electricity exports boomed as did the business of importing second-hand cars to Lithuania, repairing them, and reselling them in CIS markets, mainly Russia. Exports to CIS countries increased much faster (up 28 % y-o-y in January-June) than exports to EU countries (5 %). A fifth of Lithuania's total exports were directed to the CIS, while about half went to the EU.

Lithuania has now closed 28 out of 31 *acquis* chapters in its EU membership negotiations.

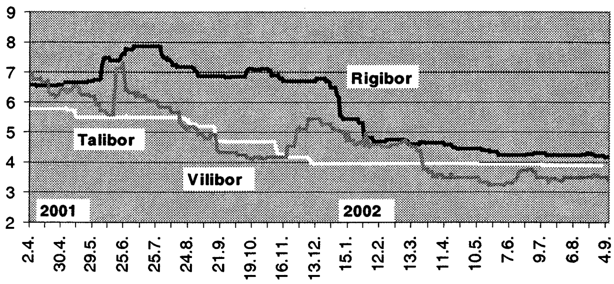
Financial sector developing

The development of Lithuania's financial sector has been slower than in Estonia or Latvia. After the slowdown in 1999, the growth of bank lending remained subdued until the end of last year. In recent months, however, development of Lithuania's financial sector has begun to approach growth rates similar to other Baltic countries.

At end-July, Lithuanian bank lending to domestic customers amounted to LTL 10.2 billion (€3 bn) and was up 23 % y-o-y. In relation to GDP (21 %), the level of loans is still rather low. The share of lending to the private sector of all loans has increased and amounted to almost 60 % at end-July. The amount of credit allocated to households has grown partly due to a substantial increase in mortgage loans, which were practically non-existent earlier. The mortgage loan growth has been reflected in the rapid growth of apartment construction.

Banking lending this year has been boosted by brisk economic growth and declining interest rates. In July, the average annual interest rate on loans was 6.6 % or 2.7 percentage points less than in July 2001. Another reason for the favourable development of banking sector is the reorganisation of the ownership in the sector. The last state-owned bank was privatised and sold to a foreign strategic investor in February. Foreign investors currently own almost 90 % of the shared capital of Lithuanian banks. Foreign investors have increased effectiveness and competition in the market, brought new technology to the sector and introduced new forms of banking services.

Three-month interbank interest rates, %



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	4.3	1-7/02
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.1	8/02
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	323	Q2/02
Unemployment, % (end-year, LFS data)				14.1	12.6	15.3	16.1	17.5	17.2	Q1/02
Exports, € million	1705	2066	2687	3710	3537	2941	4403	5432	2985	1-6/02
Imports, € million	1877	2599	3393	4726	4893	4254	5602	6663	3642	1-6/02
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-6.2	1-6/02

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

The Fiscal Situation of Baltic Municipalities

by Viktor Trasberg*

During the last decade, Baltic countries have reformed their public administrative system in reaction to the over-centralization of their Soviet pasts. The reforms seek to devolve certain expenditure functions and revenue collection to lower levels of government. Despite this restructuring, serious problems still exist. In all three Baltic countries, municipalities have limited fiscal resources to fulfil their main functions, so they remain highly dependent on the central authorities. Moreover, regional disparities in public good provision have increased. Despite the fact that most municipalities' activities became more transparent and efficient, in many sub-governments administrative capacity is still insufficient.

Administrative structure

In the euphoria of re-establishing new local administrative units in the early 1990s, the main emphasis in Estonia and Latvia was on restoring the system that existed prior to World War II. The mixture of nostalgia and economic naïveté led to the re-establishment of numerous low-population, financially weak local municipalities. In Lithuania, local public sector reform has moved slowly, and the problem remains as to how to transform Soviet-style administrative units into true representatives of local interests.

Table 1. Administrative division of Baltic countries, 1999

	Estonia	Latvia	Lithuania
Rural authorities	205	472	60
Towns	42	73 + 7 big	
Regional government	15	26	10
Sub-governments, total	247*	578	60*

Source: OECD Country Reports 2001

* regional governments not included

There are many more municipalities in Estonia and Latvia than in Lithuania, where the number of sub-governments will rise from 60 to 93 in 2003 (see Table 1). In Estonia and Latvia, the majority of municipalities have few people. Some 85 % of municipalities in Estonia and 91 % in Latvia have fewer than 5,000 habitants. In Lithuania, only 7 % of communities have fewer than 10,000 inhabitants. Moreover, in Estonia and Latvia, population is concentrated in capital city regions, which creates huge revenue disparities between capital areas and low-density rural municipalities.

Are transfers the answer?

The share of Baltic municipalities in consolidated budgets remains less than one-fourth. Sub-national governments receive most of their revenues from income tax, which is a shared tax in Estonia and Latvia and a solely local tax in Lithuania. Other local taxes (e.g. land tax and property tax) are insignificant, mainly due to low tax basis. In Lithuania, tax revenues form 97 % of total revenues. In Estonia and Latvia, tax revenues represent less than half of total revenues (see Table 2).

Municipalities' non-tax revenues consist of incomes from their economic activities, privatisation transfers, fees, fines and user charges. They cover less than a fifth of all revenues in Latvia and Estonia and only 2 % in Lithuania.

In Estonia and Latvia, local municipalities receive a substantial share of their income in the form of central government grants as specific or general (equalization) fiscal transfers. The largest proportion of specific grants in Estonia and Latvia cover transfers to support education. General grants-in-aid (27 % of Estonian municipalities' total revenues) equalise revenues, but also increase political dependency on the central authorities.

In Lithuania, increased tax revenues since 1997 have cut the amount of grants from central budget annually. In 2001, no transfers were made from the central budget to local budgets. Lithuanian local governments have fewer functions than their Estonian and Latvian counterparts and therefore need less money.

EU accession motivates further reforms

Territorial and local budget reforms in all three Baltic countries continue to improve administrative functionality and overcome the above-mentioned problems. This is crucial for the EU accession process as adequate administrative capacity on the part of municipalities is an important requirement for membership.

In Estonia and Latvia, reforms have focused on consolidation of small municipalities into larger units to secure a tax base and fiscal autonomy, as well as maintain their functions with fewer central government grants. In Lithuania, the thrust of reforms is to optimise the size and functions accorded to municipalities, as well as limit central government influence.

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Table 2. Overview of Baltic municipalities' budgets, 2001

	Estonia			Latvia			Lithuania		
	million €	(1)	(2)	million €	(1)	(2)	million €	(1)	(2)
Tax revenue	282	48.7%	14%	429	54.4%	30.2%	812	97.2%	21.5%
Non-tax revenue	50	8.6%		32	4.2%		21	2.5%	
Grants	215	37.2%		205	26.0%			0%	
Other revenue	32	5.6%		122	15.4%		3	0.3%	
Total revenue	579	100.0%	24%	786	100.0%	25.2%	836	100%	20.0%

Sources: Ministry of Finance websites Code: (1) Local Revenue Structure ; (2) Local Revenues as a Share of Total Public Sector Revenues.

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