BANK OF FINLAND
Institute for Economies in Transition
13.1.2003

BALTIC ECONOMIES
Bimonthly Review
1 • 2003

ESTONIA

GDP growth remained strong in third quarter
Estonian real GDP grew 6.7 % y-o-y in the third quarter of 2002. Growth was sustained by continuously brisk growth of domestic demand and a recovery in exports. Increased employment, a rise in nominal wages (10 % y-o-y) and increased credits supported the growth of private consumption (12 % y-o-y) and fixed investments (20 %). Exports of goods and services were up 17 % y-o-y.

Growth was observed in all economic sectors, except agriculture and health and social work. Fastest growth (19 %) occurred in the hotel and restaurant sector. The value added of construction work increased 18 % as the construction of infrastructure such as roads and streets grew briskly. Trade increased 12 %, manufacturing 11 % and financial services 10 %. The growth in transport, storage and communication slowed to 1 % due to dampened growth in both freight and passenger traffic.

In November, industrial production growth slowed to 0.5 % y-o-y after 8 % in October. Growth slowed in most of the key sectors e.g. food processing, textiles, wood and wood products, metal products and furniture. However, growth continued strong in two fast-developing areas – manufacturing of electrical machinery and radio, television and telecommunications equipment. Growth in retail trade remained strong (13 % y-o-y) in October-November.

Annual inflation was 2.7 % in December.

Current account deficit still large
Estonian export growth remained strong in October with exports up 19 % y-o-y. Growth was particularly strong in exports of metal products and machinery and equipment. Imports increased 17 %, keeping the trade deficit large. However, increased revenues from exports of services lifted the service balance surplus somewhat. In January-October, the current account deficit amounted to 11.5 % of estimated GDP. FDI inflows covered less than half of the deficit and net FDI inflows covered only a quarter of the deficit.

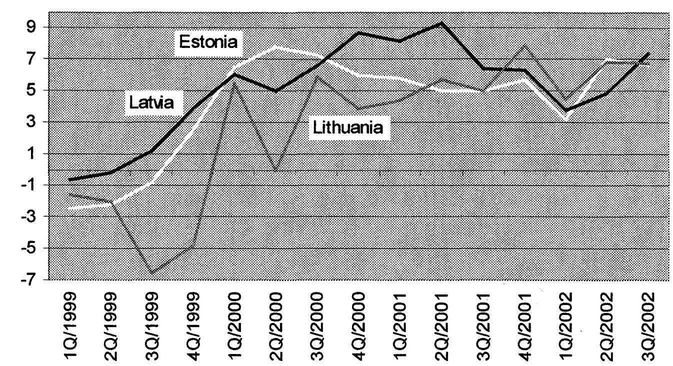
First ever deficit budget approved
Last month, the Estonian parliament approved its first budget with a deficit since 1991. In 2003, budget expenditures are EEK 38.8 billion (€2.5 billion), about 8 % more in nominal terms than in 2002. The budget deficit is EEK 320 million or 0.3 % of GDP. Budget expenditures increased with the costs of NATO membership, preparations for EU membership and costs from pension reform. Raises will go to teachers and police, support for local administrations will be increased and free school lunch programs will be continued. The budget assumes Estonian GDP to grow 4.3 % and annual inflation to be 3.5 % in 2003.

Referendum on EU membership in September
Ten countries, including Estonia, Latvia and Lithuania, concluded their EU accession talks in mid-December. These countries can accede to the EU on May 1, 2004. The accession treaties will likely be signed in Athens on April 16, 2003. According to the Ministry of Finance, Estonia will get financing of €740 million from the EU in 2004-2006. At the same time, Estonia's contributions to the EU budget will amount to €230 million and net position will thus be €510 million. In the negotiations, Estonia succeeded in increasing its milk production quota although it still remained noticeably smaller than the Estonia's request. In addition, Estonia will receive extra financing for improvement of border controls and be allowed to use the steel import quota of the EU. Estonia currently gets most of its metal imports from the CIS for which the EU applies quotas for metal imports. Russian sheet metal is estimated to cost 30-40 % less than Scandinavian sheet metal.

Estonia was the first country to officially set a date for a referendum on EU membership. The Estonian parliament decided in December to hold the referendum on September 14, 2003. According to polls at the end of November, support for EU membership among Estonians reached an all-time-high of 57 %. 36 % of Estonians said they would vote against membership.

Some 19 political parties are eligible to compete in the upcoming parliamentary elections on March 2.

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	5.7	1-9/02
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	6.9	4.5	1-11/02
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.7	12/02
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	2.3	1-10/02
Gross wage, € period average	113	158	195	227	262	282	313	350	374	Q3/02
Unemployment, % (end-year, LFS data)				9.8	10.2	12.9	13.9	11.9	9.1	Q3/02
Exports, € million	1012	1242	1395	2035	2415	2364	3580	3748	3044	1-10/02
Imports, € million	1307	1728	2181	3036	3420	3137	4442	4630	4025	1-10/02
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-11.6	1-9/02

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

LATVIA

Strong growth decreases unemployment

Latvia's real GDP growth accelerated in the third quarter to 7.4 % y-o-y. For the first nine months of 2002, GDP grew 5.4 % y-o-y. Growth was strong in nearly all production sectors in the third quarter. Trade increased 17 % y-o-y. Manufacturing output and construction activity were both up 8 %. In manufacturing, many smaller sectors (e.g. manufacture of rubber and plastics products, manufacture of other non-metallic mineral products and manufacture of furniture) continued to experience brisk growth. Growth rebounded in wood processing and manufacture of products of wood and accelerated in textile industry. The growth in transport sector remained modest (2 %) as oil shipments continued to fall. Difficulties could continue as the Latvian oil company Ventspils Nafta and Russian oil exporters have not succeeded in agreeing on oil supply contracts for 2003.

Behind the GDP growth in the third quarter were both domestic demand and exports growth. The rise in wages and increase in the number of employed persons underpinned household consumption. Nominal wages were up 7 % y-o-y, while the unemployment rate dropped to 10.8 % in the third quarter (13.3 % in 2Q02). At the same time, fixed investments were up 14 % y-o-y. Over a quarter of investments went to industry, while another quarter went to the transport sector. The trade sector garnered 13 % of total investments. Exports growth amounted to 23 % in July-September.

In October, strong growth continued in retail trade (25 % y-o-y) and exports (20 %). Industrial output was up 10 % y-o-y in October-November.

Inflation has remained sluggish in Latvia. In December, annual inflation rate was 1.4 %.

Current account deficit grew at the end of 2002

During recent months, export growth has remained strong. In October, exports were up 20 % y-o-y. However, imports to Latvia remained also strong, causing a rise in the current account deficit since September. According to monthly figures, current account deficit amounted to about 7.5 % of estimated GDP in January-October. FDI inflows covered nearly 70 % of the current account deficit.

IMF stand-by arrangement expires

The 20-month stand-by arrangement and economic memorandum, approved in April 2001, expired in December. The IMF mission visited Latvia at the end of the program and gave an optimistic overview of Latvia's current and future economic development. The Fund's representatives said upcoming EU and NATO memberships, prudent macroeconomic policies and structural reforms all have contributed to the country's strong economic performance. The IMF further stated its support for Latvia's decision to keep the lat pegged to the SDR at least until EU accession, when membership in the Exchange Rate Mechanism becomes possible. Latvian authorities have announced that they will re-peg the lat to the euro sometime after EU accession. With regard to economic development, the IMF stressed the importance of structural reforms, improvements in the business environment, battling corruption and a flexible labour market.

Fund representatives noted that the main risk to Latvia's economic development is its large current account deficit. The IMF stressed the importance of pursuing prudent fiscal policies and keeping the fiscal deficit below 1.8 % of GDP in 2003. Meeting this target may entail a delay in the planned reductions in the corporate income tax and social tax rates. The new government may no get its draft budget for 2003 to the parliament until February 17, although it has already announced that the agreed tax reductions will go through. Thus, the risk of a widening fiscal deficit is quite real.

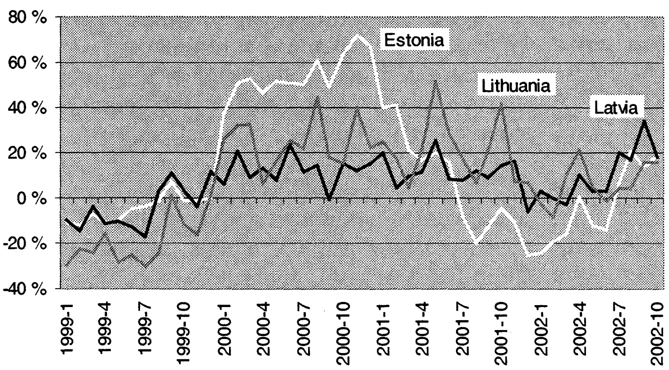
Latvia's government announced that Latvia will not sign a new cooperation memorandum with the IMF. From now on, Latvia will cooperate with the IMF under its normal monitoring procedures.

EU membership negotiations finished

Like the nine other successful applicants, Latvia finished its EU membership negotiations in December. In the final negotiations, Latvia concentrated on agricultural and budgetary issues. Latvia succeeded in getting a 49 % increase to its milk production quota. According to estimates, Latvia will receive €1.1 billion in 2004-2006 from the EU, while paying in €0.3 billion to the EU budget.

The percentage of the population supporting Latvia's EU membership decreased slightly in November to 46 %. 36 % of those polled were against membership. A referendum on EU membership is scheduled for September 20.

Year-on-year growth of exports (in local currency)



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	5.4	1-9/02
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	6.9	5.2	1-11/02
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	12/02
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-1.2	1-10/02
Gross wage, € period average	108	130	141	183	202	225	265	282	295	Q3/02
Unemployment, % (end-year, LFS data)			19.5	14.1	13.7	13.2	13.3	12.9	10.8	Q3/02
Exports, € million	857	1044	1172	1627	1796	1765	2237	2492	2160	1-10/02
Imports, € million	1110	1486	1800	2377	2804	2725	3387	3897	3356	1-10/02
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-10.1	-6.7	1-9/02

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

LITHUANIA

Growth continued in third quarter

Lithuanian GDP grew 6.8 % y-o-y in the third quarter and 6.1 % during the first nine months of 2002. Growth was observed in most economic sectors. Value added grew fastest in agriculture and forestry (15 %). Among the main service sector areas, trade increased 7 % and transport and communication were up 4 %. Value added in construction grew 9 % y-o-y. Although housing construction was down, construction of non-residential buildings increased rapidly. Investments were up 14 % y-o-y. More than 60 % of investments were directed to constructing and repairing buildings and civil engineering. GDP growth was supported by both domestic and external demand. In addition to brisk growth in investments, private consumption was up 7 % and public consumption 6 %. Private consumption was supported by higher wages and lower unemployment. Exports of goods and services were up 15 %.

In October, domestic trade (up 14 % y-o-y) and exports of goods (16 %) continued to grow briskly. However, industrial production measured in sales declined 1 % y-o-y. Growth recovered in November (4 %), but was still sluggish due to low volumes at the Mazeikiu Nafta oil refinery. Rapid growth in lending continued; the stock of loans granted to the private sector was up 32 % y-o-y at the end of November.

Despite strong economic growth, inflation has remained very subdued. Indeed, Lithuania has experienced deflation since August. In December, the consumer prices were 1.0 % lower than a year ago.

Export growth continued in October

In October, both exports and imports increased 16 % y-o-y. The largest increases were in the areas of metal and metal products and vehicles and associated transport equipment. Growth of the most important export product, refined oil, remained sluggish. The current account deficit amounted to about 4 % of estimated GDP in January-October. FDI inflows have remained steady and were sufficient to cover the current account deficit.

Parliament approved budget for 2003

State expenditures will rise this year about 8 % in nominal terms to LTL 10.9 billion (€3.1 billion). Higher budget spending will be mainly caused by the country's preparations for EU and NATO accessions. In particular, expenditures on defence and administration are expected to increase. The state budget deficit will rise to 2.5 % of GDP. Budgets at the local level are expected to remain balanced and the budget for Sodra, the social security fund, will be in surplus. Thus, the total public sector deficit is expected to remain at 1.5 % of GDP, or the 2002 level.

Paksas surprise president

As none of the presidential candidates received more than 50 % of the vote in the first round on December 22, a runoff election was held on January 5. In the first round, incumbent President Valdas Adamkus took over 35 % of the vote, while former Prime Minister Rolandas Paksas from Liberal Democrats received 20 % of vote. Surprisingly, Paksas received 54.9 % of the vote in the runoff and voter turn out was 52.3 %. The five-year presidential term in Lithuania will begin February 26.

In the local government council elections, out of a total of 1,560 seats on local councils the Social Democrats (LSDP), led by Prime Minister Algirdas Brazauskas, received 332 seats. That was 56 more than in 2000. The conservative Homeland Union won 193 seats, while the leftist Union of Farmers and New Democracy took 190 seats. The number of seats of New Union, the big winner in the 2000 local elections, dropped from 270 to 138.

EU

Lithuania also completed its EU membership negotiations in December. According to some calculations, Lithuania is among the countries benefiting most from EU financial assistance during 2004-2006. When balanced the financial assistance EU will pay to Lithuania with the payments Lithuania will make to the EU, Lithuania will get a surplus of almost €1.4 billion or €390 per capita during the period. The same figure is estimated at €360 for Estonia and €350 for Latvia. Lithuania's higher figure reflects EU support for decommissioning of the Ignalina nuclear power plant. In the final stretch of negotiations, the EU agreed to increase its financing for the decommission to €285 million in 2004-2006 and gave €10 million for the implementation of Kaliningrad transit policy. Lithuania received 21 transition periods. Most of these periods are related to agriculture. Lithuania also succeeded in increasing its many agricultural production quotas. Quotas were increased for e.g. sugar and milk.

Among Baltic citizenries, Lithuanians favour EU membership most. According to the latest poll, 68 % of Lithuanians said they would vote for EU membership, while only 18 % were against membership. A referendum on membership is likely to be held in May.

Budgetary positions after EU enlargement during the period 2004-2006, in 1999 prices, million euros

	Estonia	Latvia	Lithuania
Financing from the EU	**735**	**1117**	**1863**
out of which:			
Agriculture	*213*	*314*	*595*
Structural actions	*237*	*406*	*545*
Payments to the EU	**231**	**287**	**511**
Net balance	**504**	**831**	**1352**

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	6.1	1-9/02
Industrial production in sales, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	5.3	16.9	4.1	1-11/02
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	12/02
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	327	Q3/02
Unemployment, % (end-year, LFS data)				14.1	12.6	15.3	16.1	17.5	13.0	Q2/02
Exports, € million	1705	2066	2687	3710	3537	2941	4403	5432	5158	1-10/02
Imports, € million	1877	2599	3393	4726	4893	4254	5602	6663	6295	1-10/02
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-3.7	1-9/02

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

Profitability in Northern Europe and the Baltic Economies
by Richard Walton*

A survey, in UK Economic Trends, ONS, October 2002 showed that Norway had the most profitable companies in 2001 and that UK service sector companies were the fifth most profitable for the second year running. On a global level, the profits of Norwegian companies surged strongly in 2000 and 2001 - largely driven by companies in the service sector and by companies involved in production and in oil and gas exploration. Elsewhere in northern Europe, Finland's boom in company profitability came to an end in 2001. However, despite a fall in the net rate of return from 15.1 per cent in 2000 to 14.0 per cent in 2001, Finnish companies were still the second most profitable in the world - mainly as result of their mix of IT companies and 'old' economy industries.

Profitability ranking in 2001

Ranking	All companies	Manufacturing	Services
1	Norway	Belgium	USA
2	Finland	Australia	Norway
3	Belgium	Finland	Finland
4	UK	Spain	Spain
5	Estonia	Denmark	UK
6	Italy	Netherlands	Mexico
13		UK	

In America, overall company profitability fell from 8.6 per cent in 1999 to 6.9 per cent in 2001 - the lowest since 1983. Although service sector companies in the USA were the most profitable in the world in 2001, the profitability of American manufacturing companies fell dramatically from 20.8 per cent in 2000 to just 4.4 per cent in 2001. This means that the manufacturing sector, which was top of the international league table, became the second least profitable in the world.

European companies now more profitable than American ones

The survey includes data from 34 of the world's largest economies, 14 of them for the first time. Italy and France have this year submitted data on company profitability which has allowed a measure of company profitability for the Euro area to be constructed. This figure, which allows economists to compare rates of return between the USA, the UK and Euro area companies, shows that European companies are now more profitable than companies in the USA and that UK companies maintained higher profitability ratios than Europe by an average margin of 4.5 per cent since 1994.

The article also reviews the profitability of other countries including the Baltic economies-Estonia and Latvia as well as Canada, Israel, Australia, China, Mexico and Russia. It also looks at the profitability of oil and gas companies in both Norway and the UK. In the UK, the profitability of oil companies was almost 35 per cent in 2000 and 2001 whereas the average rate of return was 14 per cent in the 1990s. In Norway, the rate of return of oil companies was over 40 per cent in 2000 and 2001 - compared with an average rate of return of 17 per cent in the 1990s.

Iceland's profitability dropped from 9.5 per cent in 2000 to just 0.8 per cent in 2001. This could have resulted from a change in the government' s exchange rate policy which for years had maintained a high krona. Private and non-financial listed companies suffered losses equivalent to 1.3 per cent of GDP in the first half of 2001, compared to profits of 0.8 per cent in the same period in 2000.

The most striking feature of corporate profitability is the difference between the manufacturing and service sectors. The UK, US, Spain and Norway have more profitable service than manufacturing sectors, but the majority of economies' manufacturing sectors outperform their service sectors. In Finland, the mobile phone boom was one main factor in the steady growth in services sector profitability at 16-17 per cent between 1997-2001 allowing the services sector to match the traditionally profitable manufacturing sector.

Rates of return in 2000, %

Country	All companies	Manufacturing	Services
Norway	20.8	6.7	16.6
Finland	14.0	18.9	15.9
Estonia	11.4		
Latvia	6.0		
Iceland	0.8		

Profitability in Estonia increasing rapidly

Estonia experienced the greatest increase in profitability of any country that supplied data. Profitability of Estonian non-financial companies rose from 1.6 per cent in 1999 to 11.4 per cent in 2000, putting Estonia in fifth in the world league table. This could be related to domestic investment which grew 24.4 per cent in 2000. The current level of investment is 25 per cent of GDP. Companies in the IT and telecommunications sector benefited from higher investment.

Profitability of Latvian business fell slightly from 6.2 per cent to 6.0 per cent in 2000. Falls in profitability were recorded in the fishing, household goods, manufacturing, tourism and real estate sectors. Fishing and tourism were substantially loss making, with profitability of –10.6 per cent and –32.1 per cent respectively. Construction experienced the greatest rise in profitability, reaching over 22 per cent in 2000, making it the most profitable private sector. The electricity, gas and water sector which is the largest employer in Latvia remains profitable at 12.3 per cent.

** The author is an International adviser on statistics in the Bank of England.*

BALTIC ECONOMIES
Bimonthly Review
1/2003, 13 January 2003
ISSN 1456-4963 (print)
ISSN 1456-5900 (online)

Bank of Finland
Institute for Economies in Transition
PO Box 160 • FIN-00101 Helsinki
Phone +358 9 183 2268
Email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Tuuli Koivu