BANK OF FINLAND
Institute for Economies in Transition
11.3.2003

BALTIC ECONOMIES
Bimonthly Review
2 • 2003

ESTONIA

Domestic demand supports GDP growth

Estonian GDP growth slowed down only slightly in the last quarter of 2002. According to preliminary estimates, GDP grew 5.2 % y-o-y in 4Q02 and 5.6 % in 2002. In the last quarter, household income increased as wages were up 11 % and turnover in the retail trade sector grew 15 % y-o-y. Production in construction increased 16 % and exports 11 %. The transport sector also did well. Industrial output growth slowed to 4 %. The unemployment rate (11.3 %) was lower than in 4Q01 but due to seasonal factors up from 3Q02.

In January, industrial production was up 7 % and exports 18 % y-o-y. Growth continued also in the transport sector. The loan stock of banks continued to grow and at the end of January, loans to enterprises increased 12 % and loans to households 41 % y-o-y.

Inflation has remained low since the start of the year. In February, 12-month inflation was all-time low – 2.4 %.

Current account deficit balloons in 2002

The large current account deficit – 12.5 % of GDP according to preliminary figures – was mainly due to a decrease in exports during the first half of 2002. The decrease was caused by a decline in exports of machinery and equipment (mainly mobile phones and related components), reflecting global difficulties in that sector. In the second half of 2002, export growth recovered so that the overall export decrease for the year was 2 %. Although the need for imported components declined, imports were up 5 % due to strong domestic demand and the trade deficit widened 36 %. Despite strong growth of exports in the transport sector, the service sector surplus declined as e.g. construction activities of foreign companies in Estonia increased.

Estonia has traditionally financed most of its current account deficit through foreign direct investment (FDI). Last year, FDI inflows decreased to EEK 5.6 billion (€360 million). Net inflows amounted to EEK 3.4 billion or only 26 % of the current account deficit. In addition to FDI, the deficit was financed by eurobonds launched by the government and Eesti Energia, as well as the briskly increasing foreign liabilities of credit institutions.

Although machinery and equipment exports decreased almost 30 % last year, the effects on the Estonian economy were rather limited as 75 % of the sector's exports were re-exported after inward processing and the value added was small. In 2002, exports of other key sectors – wood and wood products (up 11 % y-o-y), textiles and textile products (2 %) and metals and metal products (12 %) – increased. 70 % of Estonian exports went to EU countries. Russia's share of Estonian exports rose to 4 %.

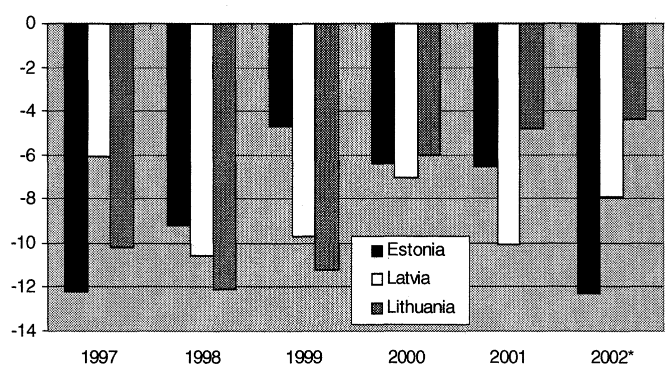
Fiscal surplus in 2002

Preliminary figures show the public sector surplus amounted to 1.2 % of forecast GDP. The surplus in the state budget was EEK 2 billion (€130 million) and was due healthy contributions to the social insurance fund and unexpectedly high tax revenues. Local government budgets ran an overall deficit of EEK 700 million. The surplus will be placed in the stabilisation fund, currently valued at EEK 2.3 billion.

Six parties surpass threshold in elections

In the March 2 parliamentary elections, six parties received more than 5 % of the vote, surpassing the threshold to win at least one seat. The leftist Centre Party retained 28 seats in the *riigikogu.* The newcomer centre-right Res Publica, which already did well in the municipal elections in October, also took 28 seats. The Reform Party increased its number of seats by one to 19. The People's Union party increased the number of seats from 7 to 13. The Pro Patria Party (7 seats) and Moderates (6 seats) each lost 11 seats. Res Publica, the Reform Party, the People's Union and the Pro Patria have started consultations to form a coalition government.

Current account balance, % of GDP



* Based on preliminary data

ESTONIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %-growth	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	5.7		1-9/02
Industrial production, %-growth	1.9	2.9	14.6	4.1	-3.4	14.6	7.8	4.6	7.1	1/03
Inflation, %-growth, end-year	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.7	2.4	2/03
General government budget balance, % GDP	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	1.2		
Gross wage, € period average	158	195	227	262	284	314	352	390		
Unemployment, % (end-year, LFS data)			9.8	10.2	12.9	13.9	11.9	11.3		
Exports, € million	1242	1395	2035	2415	2364	3580	3748	3677		
Imports, € million	1728	2181	3036	3420	3137	4442	4630	4880		
Current account, % GDP	-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.

LATVIA

Growth continued in fourth quarter

Preliminary estimates indicate that Latvia's GDP growth remained strong in the final quarter of 2002 due to both domestic consumption and exports. The average gross wage was up 10 % y-o-y and led, together with improved employment and continued credit growth, to an increase of 20 % y-o-y in retail trade. Industrial growth accelerated to 10 % and export growth to 22 % in 4Q02. The port of Ventspils suffered from diminished crude oil supplies, but other parts of the transport sector benefited from increased transit.

In January, industrial production increased 7 % y-o-y.

Inflation has accelerated slightly since the beginning of 2003 mainly due to a rise in the price of motor fuel. In February, annual inflation was 2.1 %.

Export growth accelerated at the end of 2002

In the second half of 2002, exports to EU countries recovered, so that exports increased 12 % for the year overall. Among Latvia's main exports, wood and wood products were up 11 %, base metals 16 %, food exports 39 % and textiles 2 %. Some 60 % of Latvian exports went to EU countries (up 11 % y-o-y) and 10 % to CIS countries (9 %). The most important export destinations were Germany, Great Britain and Sweden. Imports to Latvia rose 10 %, while the trade deficit swelled 6 %.

Despite the increasing trade deficit, Latvia's current account deficit decreased to 8 % of estimated GDP as current transfers (mainly from the EU) increased. FDI inflows increased last year to LVL 270 million (€450 million) and were sufficient to cover 70 % of the current account deficit. The largest foreign investors were the Norwegian real estate company Linstow and the Estonian Hansabank.

Budget foresees large deficit in 2003

The budget, accepted on February 28, foresees an increase in the public sector deficit to 3 % of GDP this year – the largest since 1999. Revenues are expected to rise 8 % and expenditures 11 %. The extra spending is related to memberships in NATO and the EU, as well as the government's preferences in health care, social affairs and public administration. The cuts in corporate income tax and employers' social security contributions became effective already in the beginning of the year and were left untouched.

Preliminary figures show that the public sector deficit in 2002 amounted to 2.5 % of GDP, well exceeding the target of 1.8 % of GDP. The government said the budget overrun was due to high deficit of the City of Riga and one-time commitments made by the previous government.

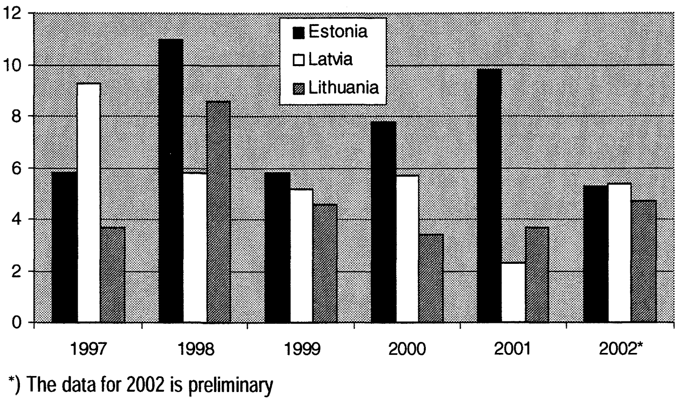
Many large privatisation projects left

Although many large, difficult privatisation projects remain on the books, Latvia hopes to close down its privatisation agency by October. The largest privatisation project last year was the sale of the **Latvian Shipping Company**. A 4 % stake is still in the state's hands, because current and retired employees only subscribed for a third of the shares offered to them in a directed emission. The privatisation will be complete when these shares are sold on the Riga Stock Exchange.

The government agreed to divest the state's 32 % holding in Latvia's ninth largest bank **Latvijas Krajbanka** (Savings Bank). Some 25 % of the bank's shares will be sold at auction and another 7 % offered to the bank's current and retired employees. The government announced it will hold on to electricity utility **Latvenergo** as a state-owned company for a while. There has been no progress in the selling of the state's 51 % stake in telecommunications company **Lattelekom** due to an unsettled arbitration case between the Latvian state and Finnish Sonera, Lattelekom's other shareholder.

One of the most complex privatisation challenges involves the state's 44 % stake in oil terminal **Ventspils Nafta** (VN). 5 % of the stake is reserved to Latvijas Naftas Tranzits, which currently owns 47 % of VN. Russian oil transit company Transneft stopped crude oil shipments via oil pipeline to Ventspils last autumn. Latvia and Russian oil companies have demanded Transneft resume oil transhipments to Ventspils but it is unlikely that the issue would be resolved before the second half of 2003. The boycott has been widely interpreted as a way of pressuring the Latvian government into selling a stake in VN to Russian companies. Transneft has confirmed its interest in acquiring a stake in VN but it has linked that stake to the financing of its pipeline investments. Transneft reports its pipelines in Russian territory need to be modernised so that it can supply both the Primorsk and Ventspils terminals. Although VN increased railway transports of oil products from Russia in January, the current volume of oil handled at Ventspils is far below the levels of early 2002.

Inflow of FDI as % of GDP



*) The data for 2002 is preliminary

LATVIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, % growth	-0.8	3.3	8.6	3.9	2.8	6.8	7.7	5.4		1-9/02
Industrial production, % growth	-6.3	1.4	6.1	2.0	-8.8	3.2	6.9	5.8	6.7	1/03
Inflation, % growth, end-year	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	2.1	2/03
General government budget balance, % GDP	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-2.5		
Gross wage, € period average	130	141	183	202	225	265	282	307		
Unemployment, % (end-year, LFS data)		19.5	14.1	13.7	13.2	13.3	12.9	11.6		
Exports, € million	1044	1172	1627	1796	1765	2237	2367	2606		
Imports, € million	1486	1800	2377	2804	2725	3387	3862	4176		
Current account, % GDP	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-9.7	-6.7		1-9/02

Sources: Central Statistical Bureau of Latvia, Bank of Latvia.

LITHUANIA

Unemployment decreased in 2002

A preliminary estimate shows strong economic growth continued in the fourth quarter of 2002. According to the estimate, real GDP was up 5.4 % y-o-y in 4Q02 and 5.9 % in 2002. In the last quarter, growth was brisk in the transport sector but slowed slightly in industry and retail trade. Strong growth in investments turned into a decline in the last quarter. Construction activities continued to grow but acquisitions of machines and equipment fell behind the amount of 4Q01. The investment rate at the end of 2001 was particularly high because companies were allowed to exercise tax deductions on investments until the end of 2001.

The favourable development continued in January, when industrial output growth accelerated to 21 % and growth remained brisk in the transport sector.

Steady economic growth has helped to reduce unemployment since last spring. The ILO-defined unemployment rate showed a substantial drop last summer. However, according to the latest data on registered unemployed, the decline in unemployment has slowed down at the beginning of 2003.

Deflation continues in Lithuania. In February, the consumer prices were 2.0 % lower than a year ago.

Export growth accelerated towards the end of 2002

Export growth accelerated to 17 % in the last quarter of 2002 due to a marked pick-up in exports to EU countries. For all of 2002, Lithuanian exports and imports were up 10 %. Among key export products, the export of vehicles and related parts nearly doubled. About half of these were used cars in transit from Western Europe to Russia. Exports of metal products were up 41 %, while exports of textiles and machinery and equipment grew only 2 %. Exports of refined oil products declined 10 %, although the declining trend slowed towards the end of the year as the new ownership arrangements finally started to bear fruit and oil shipments from Russia increased. Half of Lithuanian exports went to EU countries (up 12 % y-o-y), while about a fifth went to CIS countries (up 8 %).

Monthly statistics show that the current account deficit was 4.5 % of GDP in 2002. A 12 % increase in the trade deficit was covered by a large surplus in services balance. FDI inflows amounted to LTL 2.4 billion (€690 million) and were sufficient to cover the entire current account deficit.

Another busy year for State Property Fund

Lithuania last year concluded 963 privatisation deals worth a total of LTL 350 million (€100 million). In the first half of 2003, the State Property Fund seeks to raise LTL 180 million. The biggest projects currently involve the national gas company, two shipping companies, the national airline, four distilleries and the energy sector.

Lithuania sold a 34 % stake in natural gas distributor **Lietuvos Dujos** to a German consortium last year. Prolonged negotiations are still going on about the sale of another 34 % stake to Russian Gazprom. The State Property Fund named Lithuanian shipping company Limarko the winner in a tender for the sale of 81 % stake in the transport company **Klaipedos Transporto Laivynas**. Talks with Limarko are under way and a final contract should be signed before summer. The initial selling price was set at LTL 49 million. Three companies announced their interest in a 67 % stake in another shipping company, **Lietuvos Juru Laivininkyste** (LJL) before the submission deadline. The initial price for LJL is LTL 20 million. In December, the Lithuanian government decided to sell a 34 % stake in **Lithuanian Airlines**. The privatisation authorities approved SAS as a potential investor and SAS is now expected to submit an offer in April. In February, the government approved a plan to sell at public auction majority stakes in four state-owned distilleries: **Stumbras**, **Alita**, **Anyksciu Vynas** and **Vilniaus Degtine**. The total minimum asking price for four companies is LTL 172 million.

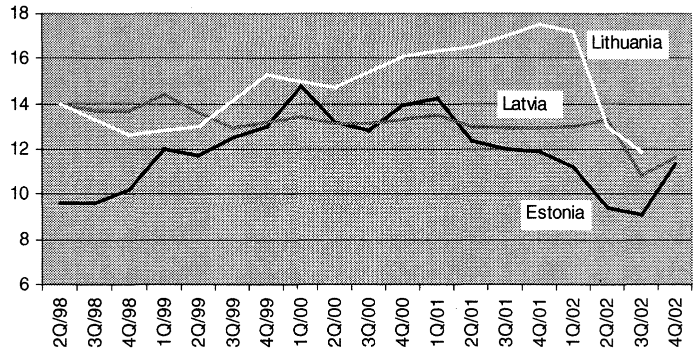
The privatisation of the reorganised **Lietuvos Energija** has been under planning for a long time. In January, a tender was launched to find financial advisors for the selling of 86 % stakes in two electricity distribution companies (**RST** and **VST**). The privatisation programs for RST and VST should be announced in May. **Lietuvos Elektrine** is not likely to be privatised before 2007 as its privatisation is related to the decommissioning of the Ignalina nuclear power plant.

Eurobond successfully placed in February

The coupon rate for the €400 million eurobond was a record-low for Lithuania – 4.5 %. Bids totalled €800 million.

Standard & Poor's raised long-term foreign currency rating for Lithuania from BBB to BBB+ earlier in February. The raise reflected Lithuania's progress in its public finances and the country's record of solid economic growth. S&P said preparations for EU accession had promoted many essential reforms. Lithuania will be the first Baltic country to vote on EU membership. A binding referendum will be held on May 10-11. Estonia and Latvia will organise referenda on EU membership among the last accession countries in September.

ILO-defined unemployment rate, %



LITHUANIA	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**as of**
GDP, % growth	3.3	4.7	7.3	5.1	-3.9	3.8	5.9	6.1		1-9/02
Industrial production in sales, % growth	5.3	5.0	3.3	8.2	-11.2	5.3	15.9	7.5	21.0	1/03
Inflation, % growth, end-year	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	-2.0	2/03
General government budget balance, % GDP	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-1.9	-0.2		Q1-Q3/02
Gross wage, € period average	92	122	173	208	231	264	296	332		
Unemployment, % (end-year, LFS data)			14.1	12.6	15.3	16.1	17.5	11.9		Q3/02
Exports, € million	2066	2687	3710	3537	2941	4403	5432	6235		
Imports, € million	2599	3393	4726	4893	4254	5602	6663	7667		
Current account, % GDP	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-3.7		1-9/02

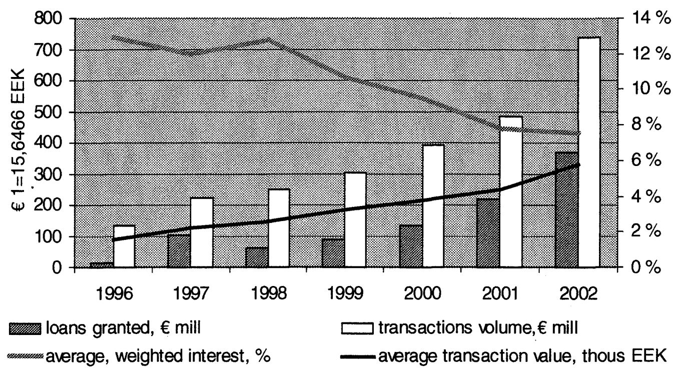
Sources: Statistics Lithuania, Bank of Lithuania.

Estonia's flourishing residential housing market

by Kadri Männasoo and Mari Tamm*

Estonia's residential housing market, measured by trade volume, grew 30 % in 2002. Some factors driving the boom reflect normal transition adjustments. For example, Estonia's low level of household debt – just 15.6% of GDP at the end of 2002 – is typical of transition economies. A substantial drop in interest rates over the past two years also accelerated growth and swelled the mortgage portfolios of banks. Banks, taking a pro-active stance, granted 50 % more mortgage loans in 2002 than in 2001.

Volume, interest and average value of transactions



Underlying demand further accounts for growth in Estonia's real estate market. Privatisation put 94 % of the housing stock in private hands. Dwellings were acquired in exchange for privatisation vouchers, which were allotted on the basis of years of employment. Much of the real property transferred to private ownership was often out of alignment with the actual needs and preferences of households. Further, the generation entering labour market during or after the 1990s got nothing. Estonia also has yet to develop a rental market with flexibility and adequate supply. Renting generally remains an inferior alternative to home-buying. Increased labour mobility and widening regional differences further militate for an efficient housing market.

Several new factors boosting real estate sales, particularly residential housing, emerged in 2002. Presently, 95 % of mortgage loans are fixed to the EURIBOR, which has dropped more than a third over the past two years. Strong economic growth (estimated at 5.3% for 2002 by the Bank of Estonia) has also lifted general incomes and opened the mortgage loan market to a broader selection of customer groups. The launch of second pillar of pension reform undermined the role of grey economy by giving incentive for employees to declare their earnings as an official wage record facilitates access to bank credit. Banks, discerning attractive business opportunities in the mortgage segment, responded with campaigns to capture, or at least protect, market share. Risk margins subsequently fell; a reflection of tougher competition and the good quality of mortgage portfolios. Along with improvements in institutional and country ratings, banks gained better access to international money markets. Favourable pricing of external funds enabled asset growth even with a modest domestic savings rate. The gap between fast rising property prices and decreasing cost of capital also promoted speculative investment. Tax-deductible mortgage interest also plays a substantial role as it lowers the real interest burden of borrowers. A survey by the research company Emor found that about 13 % of households had taken loans for acquisition of real property. The same survey indicated about 6 % of households plan to take loans this year.

To help young families, the government provides supplementary credit guarantees covering 70 % of the minimum downpayment, which is currently set 34% of the dwelling's price. This arrangement reduces the actual downpayment to 10% of the purchase price. While statistics show only 15-20 % of households qualify as borrowers, nearly a fifth of residential loans granted in 2001 were backed by this supplementary guarantee. The government plans to continue the present measures, so housing market growth should remain robust for a while at least.

While apartment and home construction has recovered, the pace is far from adequate to meet the demand for modern living space created by more than a decade of inadequate supply. In also cannot compensate for the rapid amortization of the present housing stock. The stock of low-quality (in terms the environment, aesthetics and construction) Soviet-era apartment blocks, built during 1971-1989, represents a third of the present housing stock. The government's housing development plan estimates renovation of such dwellings will cost €77-115 million annually.

Given that the supply of real estate is fairly rigid over the short run, prices tend to be demand driven. Tallinn and its vicinity accounts for three-quarters of all real estate transactions. New apartments in up-scale parts of Tallinn are in particular demand (most such apartments are sold before they are completed). Banks are also inclined to accept lower downpayments for new houses and apartments, which facilitates access to credit for borrowers with a low capital base but good earning prospects. Construction costs and persistent demand have pushed prices for new buildings significantly higher than for older buildings.

Some of the above-mentioned drivers will exert one-time effects or vanish in the near future, paving the way for stable growth of the Estonian housing market. Nevertheless, fundamental historical and social factors will sustain growth in the housing market that is higher relative to mature markets for many years to come.

** The authors are economists at the Bank of Estonia's Financial Stability Department.*

BALTIC ECONOMIES
Bimonthly Review
2/2003, 11 March 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