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BALTIC ECONOMIES
The Quarter in Review
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ESTONIA

KPL SIDOTTAVA

Economic growth decelerates

Growth of the Estonian economy slowed during the first half of 2001. On-year GDP growth in the first quarter was 5.8 %, compared to 6.0 % in the last quarter of 2000 and 7.3 % in Q3 2000.

Industrial sales increased 5.5 % y-o-y during the first six months of this year. Growth was mainly due to increases in manufacturing of machinery and equipment, metal products, food products and textiles. Manufacturing of radios, televisions and communications equipment declined 40 %. Monthly growth rates of industrial production can be quite volatile, but the June year-on-year change settled to only 2.5 %, after 6.9 % in May.

Growth rates of both exports and imports have decelerated during recent months due to the global economic slowdown. According to preliminary data, the value of exports increased 28 % y-o-y during the first half of the year. The value of imports rose 21 %, and consequently the trade deficit increased only 1 %. In Q1 2001, the current account deficit rose to 6.8 % of GDP. Financing of the deficit was relatively easy as foreign direct investment (FDI) flowed into Estonia at record rate amounting to EEK 3 billion (USD 190 million).

Inflation has remained relatively high this year, with the annual inflation rate at 6.3 % in July. Lower oil prices and a somewhat stronger euro have reversed the upward trend, however, as inflation was 6.9 % in June.

Growth forecasts still optimistic

Despite the clear slowdown in Estonia's main export markets, growth is forecast to remain fairly robust. Export growth will be clearly lower than in 2000, but domestic demand remains high. For example, real private consumption increased 4 % y-o-y in the first quarter. Forecasts collected by Consensus Economics indicate GDP growth of 5.4 % for this year and 5.3 % for 2002. These forecasts have remained surprisingly stable during the first half of this year. In June, the IMF forecast 5 % GDP growth for Estonia this year. Inflation is expected to decelerate somewhat in 2002.

Public sector shows surplus in first half

Estonia's government sector posted a first-half EEK 310 million (USD 18 million) surplus, which equalled 0.3 % of forecast GDP for the year. The surplus was mainly due to a 13 % y-o-y increase in revenues. Last year, the government sector had a deficit of EEK 600 million, or 0.7 % of GDP.

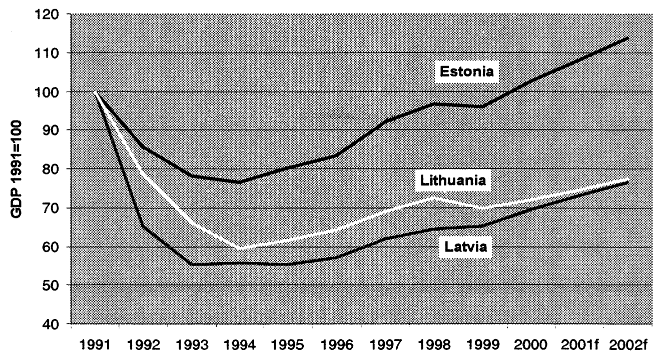
EU negotiations

As of end-July, Estonia had provisionally closed negotiations on 19 of 31 chapters in the *acquis communautaire,* including the environment chapter, which was expected to be difficult for Estonia. Other problematic chapters in terms of budgetary outlays and structural reforms (energy, transport, regional policy and agriculture) will be tackled in the second half of 2001.

Accession negotiations progressed rapidly under the Swedish presidency for most applicants. At the moment, Cyprus has provisionally closed negotiations on 23 chapters of the *acquis*. Next are Hungary (22 chapters) and Slovenia (21). The Czech Republic and Slovakia have also closed 19 chapters. None of the accession countries have yet concluded negotiations on agriculture, competition or regional policy.

The Estonian parliament will meet on August 27 to choose a new president. If no candidate gains the two-thirds majority needed in the 101-seat parliament, an electoral college consisting of MPs and local government representatives will convenes on September 21. All four major parties have named candidates. Estonia's constitution bars incumbent president Lennart Meri from seeking a third term. The new president is expected to push ahead with Estonia's foreign policy goals of membership in the European Union and NATO.

GDP levels in the Baltics 1991-2002



ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %-growth	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	5.8	Q1/01
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	5.5	H1/01
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	6.3	7/01
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.3	Q1/01
Gross wage, USD, period average	134	207	248	257	293	302	288	301	Q1/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9	14.2	Q1/01
Exports, USD million	1226	1697	1813	2292	2690	2515	3288	1884	H1/01
Imports, USD million	1583	2363	2832	3417	3806	3337	4077	2212	H1/01
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.8	Q1/01

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

LATVIA

GDP growth still strong...

Latvian GDP grew 8.2 % y-o-y in the first quarter of 2001. Manufacturing and services contributed mostly to growth. The service sector, which accounts for 71 % of GDP, saw production rise 8.5 % y-o-y. Transport, particularly transit trade, has always been important for Latvia, but wholesale and retail trade also grew rapidly. Manufacturing, which represented 15 % of GDP, grew 11 %. The main manufacturing areas (furniture making, wood processing, textiles and metal fabrication) enjoyed brisk growth. Growth has continued, and in June industrial production was up 6.1 % y-o-y.

Domestic demand has remained strong, keeping import growth buoyant (13 % in January-June). Export growth has also remained buoyant. The trade deficit widened 9 % y-o-y during the first six months of this year. The current account deficit in 1Q 2001 amounted to 4.1 % of GDP. Foreign direct investment in the first quarter was less than a third of FDI in 1Q 2000.

The annual inflation rate in July was 3.1 %. The acceleration of inflation this year has been driven by higher prices for fuel and food. Strong domestic demand is also reflected in the increasing cost of housing services.

...but some forecasts see deceleration

GDP growth is now expected to decelerate, however, despite first quarter's higher-than-expected growth. For this year, the consensus forecast for GDP growth is 5.4 %. In 2002, growth is expected decelerate to 4.7 %. Latvia is clearly not immune to the slowdown in the EU, its main export market. The IMF was more optimistic in April concerning Latvian growth, when it forecast 6 % GDP growth for this year. Then again, the Latvian economy ministry revised its GDP growth forecast for 2001 *upwards* to 7 %. Latvian authorities are also optimistic for 2002, forecasting 5-7 % growth. The consensus forecast for inflation is approximately 3 % for both 2001 and 2002.

Fiscal deficit threatened by EU demands

Although Latvia has made considerable progress in EU membership negotiations this year (16 chapters closed at the end of July), it still needs to improve the functioning of its institutions. Implementing the *acquis,* particularly in the area of environmental protection, will put pressure on public expenditure.

Despite raising the fiscal deficit target in June to 1.82 % of GDP, Latvian officials continue to give assurances that the country will reach the 1.75 % target agreed earlier with the IMF. As of end-June, Latvia's consolidated main budget had a fiscal deficit of LVL 27 million, which is below the deficit ceiling agreed with the IMF.

Although the stand-by program with the IMF calls for a budget deficit next year of less than 1 % of GDP, the Latvian government last month accepted a preliminary budget for 2002 with a deficit amounting to 2.8 % of GDP. The government explained that the considerable budget deficit increase next year reflected costs of EU integration, additional expenses related to NATO membership and pension reform. Parliamentary elections in October 2002 may also explain some of the next year's fiscal laxity. The final budget proposal for next year should be presented in mid-September and legislated in October. Finance minister Gundars Berzins announced that the final budget proposal will show a deficit roughly similar to the deficit in this year's budget.

Privatisation proceeds slowly

In May, the World Bank decided to postpone the second USD 40 million tranche of its structural adjustment loan to Latvia because it was dissatisfied with Latvia's progress in privatisation and structural reforms. The Latvian government has yet to decide on a new privatisation procedure for Latvian Shipping Company. Its privatisation sale failed for the fourth time in April when both of the potential bidders at auction declined to pay the required security deposit by the set deadline.

On July 19, the Latvian government sold a 2 % stake in Latvijas Gaze via the Riga Stock Exchange for a surprisingly high price. Another 3 % stake will be sold on August 30. After months of negotiations, the Latvian Privatisation Agency signed a consulting contract with investment bank Raiffeisen Investment AB to arrange the sale of the state's 39 % stake in the major oil terminal Ventspils Nafta at the beginning of 2002.

Pension reform launched

Latvia was the first Baltic country to replace its pay-as-you-go (PAYG) pension system (those who work pay the benefits of current pensioners) with a three-pillar pension system (a scaled-down PAYG, mandatory funds and voluntary funds). From the beginning of July, some contributions have been directed into a mandatory pension fund. The three-pillar model is hoped to guarantee adequate income for pensioners when the overall population is ageing.

Economics forecasts for 2001 and 2002

	GDP, % change		CPI, % change	
	2001	2002	2001	2002
Estonia	5.4	5.3	5.3	4.1
Latvia	5.4	4.7	2.9	3.0
Lithuania	3.6	3.9	1.8	2.7

Source: Eastern Europe Consensus Forecasts

LATVIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	8.2	Q1/01
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	7.8	1-5/01
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.1	7/01
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-0.8	Q1/01
Gross wage, USD, period average	128	170	179	207	226	241	244	243	Q1/01
Unemployment, % (2^{nd} quarter, LFS data)			22.2	15.9	14.7	14.0	14.4	13.5	Q1/01
Exports, USD million	1020	1367	1488	1838	2011	1889	2058	1119	H1/01
Imports, USD million	1321	1947	2286	2686	3141	2916	3116	1587	H1/01
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-4.1	Q1/01

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

LITHUANIA

GDP growth higher than expected...

According to preliminary figures, real GDP grew 5.1 % in the first half of 2001. Industrial output, excluding utilities, increased 19 % y-o-y. Oil refining has recovered rapidly (up 56 % in the first half of 2001), and it accounts for a sizeable share of economic activity.

Economic growth has been mainly driven by growth of exports. During January-June, the value of exports grew 25 % y-o-y. In the first quarter, the current account deficit remained at last year's level (5.4 % of GDP). The surplus in the service balance grew through increased exports of trade, financing and communications services. Foreign direct investment in Lithuania amounted to LTL 530 million in Q1 2001, almost 70 % more than a year earlier. Much of the increase came from higher retained earnings.

Inflation has remained low. July consumer prices were 1.1 % higher than a year before. In fact, without the influence of higher food prices, inflation was essentially nonexistent.

...but forecasts pessimistic

Lithuania's GDP growth is forecast to accelerate slightly in 2002. However, at 3.9 %, growth would still lag the other two Baltic countries. Indeed, Lithuania has lagged Estonia and Latvia for the past two years, and likely will continue to do so. In April, the IMF forecast this year's GDP growth to be 3.6 %. Lithuanian inflation will remain low.

Budget revenues less than planned

Due to revenues 0.7 % below projections, Lithuania's state budget showed a LTL 471 million (USD 118 million) deficit in the first half. This year's deficit target is LTL 906 million. The finance minister announced that the government will probably surpass its fiscal deficit target of 1.4 % of GDP agreed with the IMF. For 2002, the deficit target agreed with the Fund is 1.3 %.

IMF supports Lithuania's switch to euro peg

The Bank of Lithuania announced it will abandon its peg to the US dollar and repeg the litas to the euro based on the ECB's official rate of February 2, 2002. The repegging reflects a desire to integrate Lithuania's economy with its most important trading partner, the EU. The peg is also seen as part of country's preparations for EU membership, although officially the EU makes no demands on the currency arrangements of candidate countries.

The repeg was agreed with the IMF in an economic memorandum endorsed on July 26 by the government. On August 30, the IMF's board should accept the memorandum, which includes Lithuania's third stand-by agreement. The agreement for the next 18 months grants Lithuania credit line of USD 108 million and is believed to be Lithuania's last. The memorandum sets out key macroeconomic targets, including maintaining macroeconomic stability, raising economic competitiveness and accelerating structural reforms.

New government installed

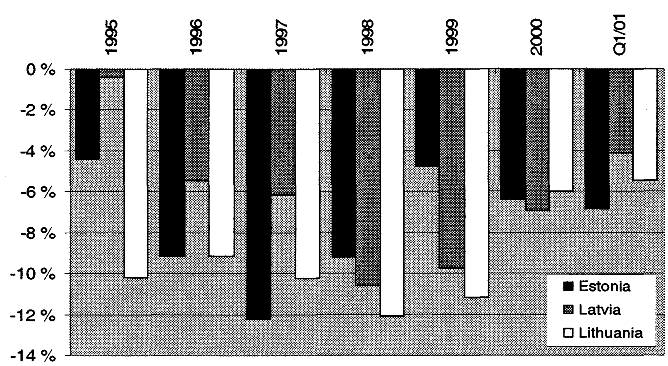
Lithuanian government fell on June 20 as Prime Minister Rolandas Paksas (Liberals) resigned after the New Union departed the government after disagreements on privatisation of the energy sector and reform of taxes, agriculture and pensions. On July 12, the parliament approved a new government coalition of the New Union party and the Social Democrats. Mr. Algirdas Brazauskas, the former Lithuanian president and leader of the Social Democrats, is now prime minister, and the government commands a majority of 76 seats in the 141-member parliament. The new government is expected to pursue policies broadly similar to those of its predecessor.

EU negotiations advance

Lithuania has made good progress in its EU membership negotiations, having closed 18 chapters of the *acquis* by end-July. Difficult chapters, such as agriculture and energy, still lie ahead. Lithuania, along with Slovakia, has now caught up with Poland (only 17 completed chapters) in the negotiations.

The EU initiated a trade facilitation agreement (PECA) with Lithuania on July 24. The agreement extends benefits of the single market to Lithuania and marks a first step towards establishing a common market in industrial sectors where Lithuania has aligned its legislation with the EU. Similar agreement with Latvia will soon enter into force, and negotiations on a PECA agreement with Estonia will soon begin.

Current account balance, % of GDP



LITHUANIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.2	3.3	4.4	Q1/01
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	19.1	H1/01
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	1.1	7/01
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	0.3	Q1/01
Gross wage, USD, period average	81	120	155	195	232	253	272	337	Q1/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1	16.6	5/01
Exports, USD million	2020	2706	3413	4192	3962	2996	3252	2260	H1/01
Imports, USD million	2220	3404	4309	5340	5480	4791	4660	2964	H1/01
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-5.4	Q1/01

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

FDI quest

by Tuuli Juurikkala*

Cumulative inflows of foreign direct investment (FDI) in the three Baltic countries reached USD 2 billion in 1999. While FDI inflows to Latvia and Lithuania started later than in Estonia, their pace has lately exceeded Estonia's. At the end of 2000, FDI stocks stood at USD 2.6 billion in Estonia, USD 2.3 billion in Lithuania and USD 2.1 billion in Latvia.

High relative importance of FDI

Measured as a percentage of GDP, FDI has been relatively substantial in all Baltic countries. In terms of FDI per capita, Estonia ranks third in Eastern Europe after Hungary and the Czech Republic. In relation to gross domestic investment, FDI inflows to Estonia and Latvia amounted to almost a third during 1997-1999.

The significance of FDI for the Baltics has also been high in terms of current account financing. During 1997-1999, FDI equalled 86 % of Estonia's current account deficit, 75 % in Latvia and 51 % in Lithuania. The significance of FDI for financing the current account was highest in the Czech Republic and Hungary, and lowest in Russia, where capital imports in the form of FDI failed even to match the rate of capital flight.

Nevertheless, some commentators have questioned the extent of FDI's presumably positive effects on Eastern European economies. They ask, for instance, "What are the effects, if any, of FDI on economic growth?"

Countries courting FDI, including the Baltics, have found it advantageous to make certain policy decisions to create investment climates attractive to investors. Studies of spillover effects tend to validate such policies as they find positive effects on local production including pressure to raise quality and make deliveries on time. These positive spillover effects are strongly displayed in subcontractor relationships between local suppliers and foreign-owned companies.

From privatisation towards greenfield investment

One of the main factors behind FDI inflows into Estonia, Latvia and Lithuania has been the privatisation of formerly state-owned companies. Privatisation started soon after independence and the process is now essentially completed except for large privatisation deals related to infrastructure (especially the energy sector). Thus, greenfield investment is rapidly becoming the main focus of FDI.

Finland, Sweden and Denmark (along with Germany and the US) have all established strong investor presences in the Baltics. The leading sectors receiving FDI were manufacturing, trade, transport and communications, and financial intermediation.

Subcontracting plays a particularly large role in the electronic equipment and textile industries.

Competition or cooperation?

Interestingly, while all three Baltics give similar investment arguments to attract FDI, they have done little to coordinate their strategies. The standard advantages they list include availability of low-cost skilled labour, good geographic location and political stability. However, in the eyes of the international investor, the reasons to invest in Lithuania, Latvia or Estonia are essentially indistinguishable from those of any country in Central and Eastern Europe. Estonia seems to have recognised this need to distinguish itself from others competing for FDI. Eight months ago, it introduced tax breaks for reinvested earnings, which have quite likely contributed to this year's increase in FDI.

Harmonisation of laws and regulations preceding EU accession makes the Baltics all the more attractive for FDI, not to mention the potential economic benefits of actual membership. Over the long term, most foreign investment will likely flow from neighbouring EU countries. Indeed, many firms in these affluent neighbours already consider the Baltics as part of their home markets.

Cumulative FDI in 1988-1999 (USD bn), selected indicators (%)

	Cumulative FDI inflows 1988-1999			FDI inflows/ Gross domestic fixed capital formation 1997-1999, %	FDI inflows/ Current account 1997-1999,%
	USD bn	% of GDP/PPP	USD per capita		
Czech Republic	16.5	12.3	1609	20	164
Hungary	19.8	17.8	1969	19	115
Poland	32.1	10.0	830	17	85
Estonia	2.0	16.9	1361	28	86
Latvia	2.1	14.2	853	29	75
Lithuania	2.1	8.4	557	24	51
Russia	20.6	2.1	141	8	-45

Source: UN/ECE Economic Survey of Europe 2001, No 1, pp. 185-225

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