BANK OF FINLAND
Institute for Economies in Transition
12.8.1999

BALTIC ECONOMIES
The Quarter in Review
3 • 1999

ESTONIA

Economic activity declines...

Recent statistics reveal a large contraction in Estonian output in the first half of this year. Preliminary estimates show GDP contracted 5.6% year-on-year in the first quarter of 1999. In comparison, GDP declined 0.7% in Q4/98.

For all 1998, Estonia's GDP growth was 4%. While this growth was spread rather evenly across different expenditure classes, the driving force of growth was fixed capital formation, which increased by 8.1%. General government consumption expenditure also expanded rapidly (7.4%) after two years of practically no change.

Negative changes in the GDP have been largely driven by the dismal performance of industrial production. Year-on-year changes in the industrial sales have been negative since August 1998, when the Russian crisis hit. In fact, growth rates were declining even before the crisis. During the first six months of the year, industrial sales decreased 9.9% from the corresponding period in 1998. As the year progressed, however, the rate of decline has decelerated; for May and June the on-year change was approximately –7%. The sector worst hit by the Russian crisis is the food and beverage industry, which earlier exported the bulk of its output to Russia and other CIS countries.

The Ministry of Finance recently updated its GDP growth forecast for 1999 to 0.4%. For 2000, growth of 4.1% is expected. The ministry still expects a pick-up in growth in the latter half of the year.

...and unemployment grows

Declining economic activity has also meant lower demand for labour. According to the Labour Market Board, the registered unemployment rate was 5% in June, up from 3.4% the year before. Labour force surveys, which are more useful for international comparisons, indicate a much higher unemployment rate. The latest available survey puts the unemployment rate at 9.6% in the second quarter of 1998.

So far wages in Estonia have not responded much to the changed situation in the labour market. In the first quarter of 1999, the average gross wage showed an on-year increase of 11.5%. In the fourth quarter of 1998, the year-on-year change was 9%.

Supplementary budget to cut expenditures

A steadily deteriorating macroeconomic situation is also reflected in public finances. In first half of the year, the state budget showed a deficit of EEK 1.2 billion (USD 80 million). This figure excludes privatisation receipts of EEK 3 billion from the sale of Eesti Telekom. In the first six months of 1999, the general government deficit came to EEK 2.4 billion (USD 160 million). The Estonian parliament accepted a supplementary budget at the end of June cutting state expenditures by EEK 1 billion (USD 67 million), or approximately 5% of total expenditures. While government leaders hope this will be enough to balance the state finances in 1999, others, including the IMF, say cuts on the order of EEK 2 billion are needed.

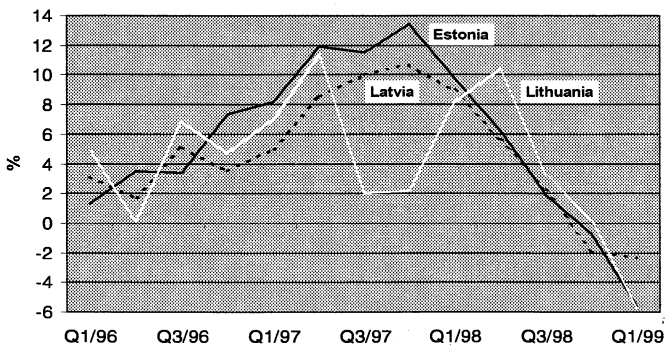
Inflation down, trade deficit narrows

Inflation remains subdued. In July, the 12-month rise in consumer prices was only 2.6%. The on-year changes in producer price index have been negative since December 1998, and in June it was –2.3%. Inflation is expected to remain low for the remainder of the year, although higher oil prices might raise both consumer and producer price indices somewhat.

Estonia's trade balance began to improve already last year as domestic demand reacted to tighter economic policies in 1997 and early 1998. In January-May, the value of exports was EEK 16.4 billion, down almost 15% from the same period in 1998. The value of imports was EEK 22.6 billion, down 22%.

The current account deficit also declined in the first quarter to EEK 1.2 billion (USD 79 million), or 7% of GDP. The current account deficit last year was 8.6% of GDP. This year the deficit in all likelihood will be lower.

On-year change in Baltic GDP



ESTONIA	1994	1995	1996	1997	1998	1999,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.0	-5.6	Q1/99
Industrial sales, %-growth	-3.0	2.0	3.5	15.2	2.3	-9.9	H1/99
Inflation, %-growth, December-December	41.7	28.9	14.8	12.5	6.5	2.6	7/99
Average gross wage, USD, period average	134	208	248	256	283	291	Q1/99
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.1	6/99
Exports, USD million	1320	1854	1814	2293	2680	588	Q1/99
Imports, USD million	1681	2526	2835	3419	3795	769	Q1/99
Current account, % GDP	-7.2	-5.2	-9.2	-12.1	-9.2	-7.1	Q1/99

Sources: Statistical Office of Estonia, Bank of Estonia

LATVIA

GDP and industrial production down

In the first quarter, the on-year change in GDP was –2.3%, compared to –1.9% in Q4/98. While production in Latvia has slumped following the Russian crisis, the Latvian Ministry of Finance is still predicting GDP growth of 2% for 1999. This forecast assumes a clear pick-up in economic activity in the latter half of this year. In 1998, GDP growth was 3.6% with growth driven by private consumption, which was up by 5.8%.

The Russian crisis has hit Latvian industrial production particularly hard. In the first five months of the year, the volume of industrial production dropped 13.7% from the corresponding period in 1998. In June, the on-year change was 14.5%. Latvia's food and beverage industry has been severely affected by the Russian crisis.

Along with contracting economic activity, unemployment has been rising since last autumn. However, it appears that during the spring and early summer the unemployment rate stabilised, so that in June registered unemployment was 10%, up from 7.2% the year before. Naturally, the usual caveats concerning figures for registered unemployment also apply in the case of Latvia; the actual unemployment rate is likely somewhat higher.

Price convergence closer to international levels and weak domestic demand have kept inflation under 5% for over a year now. In July, 12-month inflation was 1.8%. Year-on-year changes in the producer price index have been negative since last November. In June, it was –5.2%.

External balance slightly improving

Last year, both the trade and current account deficits increased considerably due to a considerable drop in exports to CIS countries. The value of exports to Russia in January-May 1999 was approximately half that of a year ago. The value of exports to the EU, however, increased. They now account for 64% of total exports.

In January-May, the total value of Latvian goods exports was LVL 417 million (USD 706 million), down 10.2% from the corresponding period in 1998. The value of imports was LVL 650 million, down 13.7%. The seasonally adjusted monthly trade deficit appears to have been declining since the beginning of 1999. Weak domestic demand has put downward pressure on imports.

The current account deficit fell to LVL 77 million (USD 131 million) in the first quarter. This was 7.7% of GDP, significantly down from over 17% in Q4/98. The services account surplus was LVL 33 million, up from LVL 24 million in Q4/98.

Public finances deteriorating

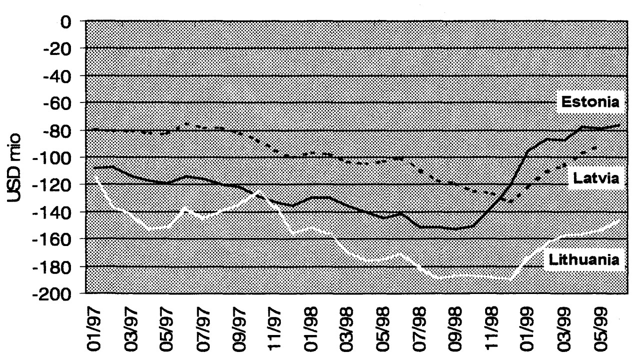
As in other Baltic countries, Latvia's public finances weakened in the aftermath of Russian crisis. Last year the general government deficit, excluding receipts from privatisation deals, was 0.8% of GDP. Privatisation receipts amounted to approximately one per cent of GDP last year. State finances showed a clear weakening in the last quarter of 1998. While the original 1999 budget called for a deficit of 2.8% (including privatisation revenue), it was obvious by early summer that this goal was unattainable. Accordingly, the new government cut expenditure by LVL 28 million, or 1.9% of the consolidated expenditure. The general government deficit in the first half of 1999 was LVL 67 million (USD 114 million).

New government and president for Latvia

Latvia's economic troubles toppled the three-party government coalition led by prime minister Vilis Krishtopans. Mr Krishtopans handed in the resignation of his government on 5 July. The Fatherland and Freedom party had entered into secret negotiations with People's Party, the leading opposition party. The Krishtopans government survived less than eight months. On 16 July, the leader of the People's Party, Andris Shkele, was approved as the new prime minister by the parliament. Mr Shkele's government consists of People's Party, Fatherland and Freedom, and Latvia's Way. The centre-right government has a comfortable majority (62/100) in the parliament, and it has stated that one of its main objectives is to cope with the current economic downturn.

On 16 June, the Latvian parliament elected Ms Vaira Vike-Freiberga (61) as the new president. The former Canadian national was a complete outsider to Latvian politics.

Monthly trade balance, six-month moving average (USD million)



LATVIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.6	-2.3	Q1/99
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-4.0	Q1/99
Inflation, % growth, December-December	26.3	23.1	13.1	7.0	2.8	1.8	7/99
Average gross wage, USD, period average	128	170	179	207	226	229	Q1/99
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	10.0	6/99
Exports, USD million	1020	1367	1488	1839	2012	456	Q1/99
Imports, USD million	1321	1947	2286	2689	3138	635	Q1/99
Current account, % GDP	4.8	-0.4	-5.5	-6.1	-11.1	-8.7	Q1/99

Sources: Central Statistical Bureau of Latvia, Bank of Latvia

LITHUANIA

Lithuania in recession

Although GDP growth was still up 0.2% in the fourth quarter of 1998, the first quarter of 1999 saw a –5.7% drop in GDP. The main cause of this sharp decline in economic activity was the Russian crisis. Of all the Baltics, Lithuania has the most extensive trade ties with Russia, Ukraine and Belarus. In 1998, GDP increased by 5.1% and gross fixed capital investments, in particular, increased rapidly.

As in the other Baltic countries, industrial production slumped after the Russian crisis. During the first half of 1999, industrial production was down 8.5% from the corresponding period in 1998. The 12-month change in June was –8.6% and –12.2% in May. Notably, production of electricity (an important export to the CIS), water and gas has suffered. In H1/99, production in these sectors was 15.5% lower than in H1/98.

Grim data from the first half of the year have prompted many observers to lower their GDP growth forecasts for this year. Lithuania's Ministry of Finance recently forecast that GDP growth in 1999 would be 1-1.5%. This year's budget originally assumed GDP growth of 5.5%. The revised March forecast was still approximately 4%.

Registered unemployment showed a marked increase after the Russian crisis. In June the official unemployment rate calculated by National Labour Exchange was 7.5%, up from 5.5% in June 1998. Lithuania's unemployment rate is higher in labour force surveys that use internationally comparable methods. The latest labour force survey from May 1999 calculated an actual unemployment rate of 13.1%.

Lithuanian wages have grown at fairly rapid pace for years (in 1998 growth was 21.6%). Despite slumping economy and rising unemployment, a clear increase in the real wages can still be observed. In June, gross monthly wages were 6.9% higher than in June 1998.

Inflation vanishes

Weak domestic demand has induced deflation in Lithuania, In July, the 12-month change in the consumer price index was negative, -0.2%. As another indicator of the weak situation facing Lithuanian industry, the 12-month changes in producer prices have been negative since the beginning of 1998. The June figure was –1.9%.

Trade deficit slowly narrows

Weak demand for imports in Russia, Ukraine and Belarus has hit Lithuanian exports hard. In the first five months of 1999, exports to CIS countries were 67% lower than in the corresponding period in 1998. Total exports declined 24% to LTL 4.9 billion (USD 1.2 billion). In January-May, imports decreased 20% to LTL 7.7 billion (USD 1.9 billion). On a monthly basis, the trade deficit has been declining since November 1998.

In the first quarter, the current account deficit was LTL 860 million, significantly down from LTL 1,602 million in Q4/98. First quarter deficit was 9.6% of GDP, whereas in the fourth quarter of 1998 the deficit was still 14.4%.

At the end of March, Lithuania's net international investment position was LTL –11.1 billion (USD –2.8 billion). This was 26.2% of the nominal GDP in Q2/98-Q1/99. At the beginning 1998, the net investment position was LTL –7.3 billion. In gross terms, the general government had foreign liabilities of LTL 5.5 billion (USD 1.4 billion).

Lithuanian government also want to cut expenditure

During its transition, Lithuania has consistently run higher fiscal deficits than the other two Baltic countries. If one does not take into account the privatisation receipts as revenue, the public sector deficit in 1998 was almost 6% of GDP. According to Lithuanian authorities' own estimates the deficit was only 1.3%.

This year's balanced budget was drafted with the assumption that GDP would grow by 5.5%. As economic activity has strayed from plan, so have budget revenues and expenditures. In the first half of 1999, state budget revenues were LTL 2.9 billion, 15% below budget. The deficit for the first half was LTL 400 million (USD 90 million). The Ministry of Finance is currently planning spending cuts of LTL 600 million, but these will have to be approved by parliament when it reconvenes in September. If the cuts are approved, state expenditure would be reduced by 8%.

New government

On May 18, the parliament approved Vilnius mayor Rolandas Paksas (42) as the new prime minister. Like his predecessor, Gediminas Vagnorius, Mr Paksas represents the Conservative Party. The new government also includes representatives from the Christian Democrats and Centre Union as well as independent ministers.

LITHUANIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-5.7	Q1/99
Industrial production, % growth	-26.6	5.3	5.0	0.7	7.0	-7.1	H1/99
Inflation, % growth, December-December	45.1	35.7	13.1	8.4	2.4	-0.2	7/99
Average gross wage, USD, period average	81	120	155	196	239	262	1-5/99
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	7.5	5/99
Exports, USD million	2020	2706	3413	4192	3962	765	Q1/99
Imports, USD million	2220	3404	4309	5340	5480	1019	Q1/99
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-9.6	Q1/99

Sources: Lithuanian Department of Statistics, Bank of Lithuania

The widening of Baltic public deficits

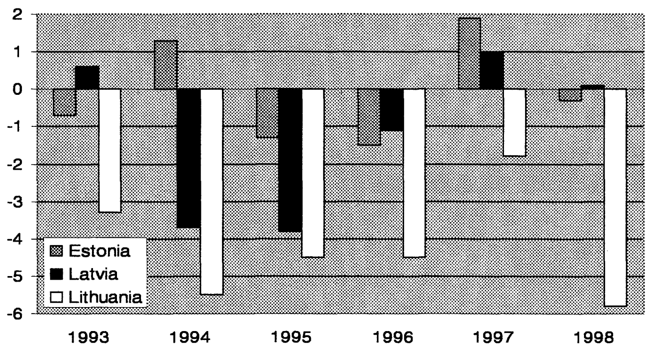
by Iikka Korhonen*

The fallout from the August crisis in Russia has depressed economic activity throughout the Baltics. Public sector finances, in turn, have suffered clearly from depressed economies. Adding to the hurt are decisions taken last year by the Estonian and Lithuanian governments for large increases in the public expenditures. In Estonia, the government approved a hike in public sector wages. In one sense, the move was justified in that public sector wages had long lagged behind the private sector. However, it is now also apparent that this decision immediately endangers Estonia's commitment to balanced state budgets. In Lithuania's case, the government has chosen to press on with its program to compensate depositors for the lost real value of their rouble savings in 1992. The present government has also pledged to support companies hit by the crisis in CIS countries.

Reducing expenditure

One big reason Baltic countries still have rather modest total public debts is that all three countries had no public debt at all when they regained they independence. At the end of 1998, Estonia's net general government debt was only 3.3% of GDP. Latvia's central government debt was 9.9%. Lithuania's central government debt was 22.4%.

General government balance (excluding privatisation receipts), % of GDP



Source: EBRD

As noted in the previous pages of this issue, all three Baltic countries are in the process of cutting back public expenditures. Typically, declining economic activity would be countered with fiscal stimulus. Although the automatic stabilisers work properly, the huge external imbalances of the Baltics constrain their governments from any additional fiscal loosening. To do so would widen external imbalances and possibly invite speculation that the exchange rate regimes were no longer sustainable. Already on numerous occasions in recent weeks, Latvia's central bank has been forced to intervene in the foreign exchange markets.

At the end of June, the Estonian parliament approved a supplementary budget that cut state expenditure by approximately one billion kroons (USD 67 million). Over half of the cuts were aimed at investments. After the cuts, the state deficit for the year is forecast at EEK 1.5 billion and the deficit of the entire public sector at EEK 2 billion. However, one should note that the Estonian authorities do not count privatisation receipts as current revenue, but rather as financing items as per IMF recommendations.

Latvia's parliament voted to trim LVL 28 million (almost 50 million dollars) from state expenditure this year. This was still significantly less than originally proposed by the Ministry of Finance and recommended by, for example, the Bank of Latvia. After the cuts, the state should have a deficit of LVL 141 million (USD 240 million), or 3.5% of GDP. In the first half of 1999, the central government fiscal deficit was LVL 68 million (USD 115 million).

The Lithuanian government is preparing expenditure cuts of LTL 600 million (USD 150 million) for this year. These cuts will have to be approved by the parliament when it reconvenes in September.

General government expenditures, % of GDP

	1995	1996	1997	1998
Estonia	41.4	40.5	37.4	36.8
Latvia	38.2	39.0	38.9	42.5
Lithuania*	36.8	34.1	34.6	40.0

*Source: EBRD, * includes net lending*

Baltic public sectors already large

In comparison to many transition economies, the Baltic countries have fairly large public sectors. Public expenditures have been around 35-40% of GDP in recent years. Notably, the relatively high proportion of public sector outlays is a common feature among the more successful transition economies. For example, the first five countries invited to start EU accession talks had average general government expenditures of almost 44% of GDP in 1998. However, the public sectors are larger than in countries with similar standards of living. Given this constraint on further spending and the need to prepare for rising future costs such as higher pension outlays, the Baltics cannot afford large increases in public sector spending.

**The author is an economist at BOFIT.*

BALTIC ECONOMIES
The Quarter in Review
12 August 1999
ISSN 1456-4963 (print)
ISSN 1456-5900 (online)

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web www.bof.fi/bofit

Editor-in-Chief Seija Lainela