BANK OF FINLAND
Institute for Economies in Transition
26.5.2000

BALTIC ECONOMIES
The Quarter in Review
2 • 2000

ESTONIA

Industrial structure changing

Statistical data from the first quarter of the current year show that Estonia's economy is growing at a swift pace. Industrial output was 13 % higher than a year ago. However, these growth rates are partly due to the exceptionally low level of production at the start of last year, when the repercussions of the Russian crisis surfaced in full.

Estonia's manufacturing industry is currently undergoing significant structural change, partly as a result of the Russian crisis. Manufacturing of wood and wood products, paper, communications equipment and precision instruments grew considerably during the first quarter. These sectors also showed strong growth throughout 1999, when the general trend in manufacturing was declining. These are typically products Estonia exports to the West. Estonian food exports, on the other hand, have traditionally been directed to Russia and the other CIS countries. Food production decreased by some 5 % year-on-year in the first quarter of 2000, after a decline of 20 % in 1999.

Export-led growth

The current economic growth is based primarily on exports, the kroon value of which in the first quarter was as much as 47 % higher than a year earlier. Given the rebound in economic activity, imports increased by 37 %. As imports are much larger than exports, the trade deficit is growing again after a considerable recession-induced decline in 1999.

The composition of the list of Estonia's main trading partners has undergone significant changes during the past two years, in particular as regards Estonian exports. In 1997, 26 % of Estonian exports went to the CIS (mainly Russia) and 49 % to the EU. In 1999, the respective shares were 13 % and 63 %. In 1999, Russia received only a 9 % share, and had fallen to third place among Estonia's export markets, after Finland and Sweden. The latter two countries both accounted for 19 % of Estonia's exports.

In 1999, 23 % of Estonian imports came from Finland and 14 % from Russia.

Domestic demand is also growing, although at a slower pace than exports. After declining in 1999, retail sales grew 9 % year-on-year in the first quarter of 2000. Information for the first quarter on the development of investments is not yet available. Investments in fixed assets declined considerably last year, 29 % in current prices.

FDI inflow continues brisk

Investment activity has traditionally been high in Estonia. Almost 30 % of GDP was directed to investment in the latter half of the 1990s. However, in 1999 the share declined due to the recession. A large part of investment is financed by foreign direct investments (FDI).

Last year Estonia received EEK 4.5 billion (USD 300 million) worth of FDI, which equalled 6 % of GDP. The net inflow of FDI was EEK 3.3 billion, and it covered 75 % of the country's current account deficit.

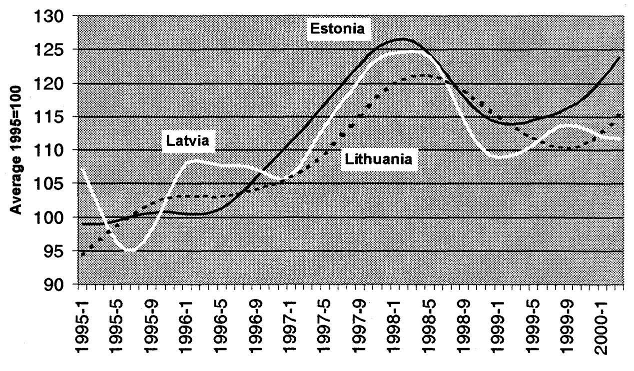
Given the small size of the Estonian economy, individual deals can significantly affect annual FDI inflows. The bulk of last year's FDI was made up by the initial public offering of Estonian Telecom, in which 24 % of the company was sold. The Estonian state is planning to sell its remaining 27 % stake in the company during the current or next year.

Railway privatisation continues

Privatisation of industrial enterprises has essentially been finished, and Estonia is currently selling infrastructure and utilities.

In April the government announced an international tender for the sale of 66 % of Estonian Railways, a company handling the country's rail cargo transportation. A strategic investor for the company will be chosen before the end of the year. The government has already long been negotiating the sale of South West Railways, which handles domestic passenger traffic. Railway companies handling international passenger traffic and commuter traffic in the greater Tallinn region were privatised earlier.

Trend in industrial production, average 1995 = 100



ESTONIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.7	-1.1		
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	12.6	Q1
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	3.1	4/00
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7		
Average gross wage, USD, period average	134	208	248	256	283	277	284	Q1
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.5	6.6	4/00
Exports, USD million	1226	1697	1821	2294	2690	2452	746	Q1
Imports, USD million	1583	2362	2832	3419	3805	3329	958	Q1
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-6.3		

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

LATVIA

GDP flat in 1999

The macroeconomic repercussions of the Russian crisis of 1998 were less pronounced in Latvia than in its two Baltic neighbours. Unlike Estonia and Lithuania, Latvian GDP did not decline last year, but, according to preliminary statistics, showed a slight 0.1 % growth. Construction rose 10 % and wholesale and retail trade 12 %, while real estate, renting and business transactions increased as much as 18 %.

Industrial output, on the other hand, declined almost 9 % last year. In the first three months of 2000, it started to grow again, increasing 4 % year-on-year.

Significant redirection of exports

The structure of Latvia's foreign trade has changed remarkably as a result of the Russian crisis. Last year the value (in lats) of Latvia's exports to the CIS declined 40 %, while exports to the EU increased 5 %. In 1999, 63 % of Latvian exports were directed to the EU and 12 % to the CIS. In 1997, the EU accounted for 48 % of Latvian exports, while the share of the CIS was 30 %.

Latvia's most important export destinations in 1999 were Germany with a share of 17 %, the UK with 16 %, Sweden with 11 % and Russia with 7 %.

Among product groups, one of the biggest decreases, 46 % in value terms, was recorded in foodstuffs, which traditionally have been shipped mainly to the CIS. Their share in Latvian total exports last year fell from 7 to 4 %. The most important product group in Latvian exports is wood and wood products. Last year they accounted for 37 % of total exports. Over 90 % of these products went to the EU.

Privatisation remains a burning issue

Privatisation of large enterprises has lately been a major stumbling block in Latvia's structural reforms, and caused the demise of more than one government. Although only a few large infrastructure companies remain in state ownership, their privatisation has been drawn out for several years already. Large-scale privatisation has become highly politicised. Political blocs and parties are eager to take care of the interests of those sectors of the economy with which they have close ties.

A tender was announced to privatise the Latvian Shipping Company (LASCO). While the aim was to find a strategic investor for the country's second largest enterprise, no acceptable bids were filed by the March 27 deadline. Critics attribute the failure to weak preparation of the deal and the government's plan to hold a golden share in the enterprise. It was the third time that a tender offering for LASCO fell through.

There have been delays in deciding on the restructuring and the method of privatisation of the power producer Latvenergo and the oil transhipping enterprise Ventspils Nafta, as well as on the sale of the remaining shares in Latvian Telecom.

In March, the Latvian state sold a 27 % stake in the gas utility Latvijas Gaze via the Riga Stock Exchange. The public offering was Latvia's biggest so far, and brought the government around USD 40 million. After the sale, the Latvian state owns 10 % of the company. Other major owners include Ruhrgas and PreussenElektra of Germany, which together hold 43 % of shares. Russia's Gazprom has a stake of 18 %.

In 1999, Latvia received USD 360 million in foreign direct investment, about the same as in 1998. Most investments were made in connection with privatisation deals.

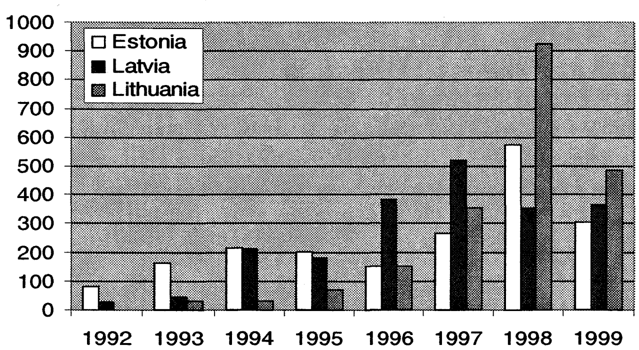
New government sworn in

In early May, Latvia received a new government, the ninth since the country's independence. The previous government fell in April as Prime Minister Andris Skele resigned due to disagreements within the government on privatisation policies. The new government consists of essentially the same political forces as the previous government, uniting four centrist and right-from-the-centre parties. Mr. Andris Berzins, Mayor of Riga, became prime minister. The government commands a majority of 69 seats in the 100-member parliament.

The new government has announced that it will pursue largely the same reform policies as those of its predecessor. These policies include approaching the EU and NATO and conducting stringent fiscal policies aimed at curbing budget and current account deficits.

As to privatisation, the government intends to complete the process within one year. It has been decided to involve international investment banks in the sale of the four major remaining infrastructure companies.

Foreign direct investment inflow, USD million



LATVIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.6	0.1		
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.8	Q1
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	3.7	4/00
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-3.5		
Average gross wage, USD, period average	128	170	179	207	226	241		
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	9.1	9.0	3/00
Exports, USD million	1020	1367	1488	1839	2012	1729	294	1-2/00
Imports, USD million	1321	1947	2286	2689	3138	2957	433	1-2/00
Current account, % GDP	-0.2	-3.6	-4.2	-6.1	-10.6	-10.2		

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

LITHUANIA

Economic growth resumes

Economic recession lasted longer in Lithuania than in its two Baltic neighbours. In the fourth quarter of last year, Lithuania's GDP still fell by 5 % year-on-year, while production began to grow in Estonia and Latvia. An abrupt pick-up in economic activity seems to have taken place in the first quarter of the current year. The Statistical Department announced that preliminary calculations based on reports of various economic sectors show that GDP grew 4.2 % from the same period a year ago.

At the same time, industrial production increased 4.5 % year-on-year after a fall of 15 % in the fourth quarter of 1999. In manufacturing, growth was particularly strong in wood and paper production and in the production of electrical and communications equipment, ranging from 25 to 50 %. Growth was much smaller, between 1 and 9 %, in traditional Lithuanian manufacturing sectors such as food, textile and clothing production. Before the Russian crisis, these sectors made up more than 40 % of Lithuania's manufacturing. Oil refining accounted for a fifth of Lithuanian manufacturing at that time. In the first quarter of 2000, its output continued to fall, although only slightly, after a drop of 37 % in 1999. Here the major reason for the decline lies in problems of crude deliveries from Russia, the main supply source for Lithuania's Mazheikiu Nafta oil refinery.

Lithuanian domestic demand is recovering, as retail sales grew 8 % year-on-year in the first quarter of this year. This was the first increase since the autumn of 1998. In 1999, retail trade declined 7 %.

Exports rise

Lithuania's exports declined by almost 20 % in 1999, mainly due to a considerable fall in sales to Russia, Ukraine and Belarus. The value of total exports started to increase again in the first quarter of 2000, growing 34 % year-on-year. Exports to non-CIS destinations grew most. Also imports turned into growth, but at slower pace than exports. Last year imports fell 17 %, largely as a result of the economic slump.

The Lithuanian currency, the litas, is pegged to the US dollar, so it has strengthened against the euro during the past year. This may have somewhat impeded the growth of Lithuanian exports to the euro area, which is an important export destination for Lithuania. Nevertheless, Lithuania managed to increase its exports to the EU last year.

In 1999, Lithuania's biggest export markets were Germany and Latvia, accounting for 16 and 13 % of total exports respectively. Russia occupied the third place with a share of 7 %. Last year, 50 % of Lithuanian exports went to the EU and 18 % to the CIS. In Lithuanian imports, Russia continues to hold the first position with 20 %. Crude oil and natural gas are the most significant import items from Russia.

Budget deficit diminishes

Lithuania recorded its biggest general government budget deficit ever in 1999 – equivalent to about 7 % of GDP. Thus, balancing the budget has become the most important macroeconomic task facing Lithuania. The government has agreed with the IMF that the deficit will not exceed 2.8 % of GDP this year.

According to government calculations, in the first three months of 2000, the central government budget deficit was slightly below the maximum allowed by the budget plan. Revenues from all major taxes, including VAT, excise duties and profit tax, were smaller than foreseen, but so were expenditures. Lithuanian authorities expect that as economic growth picks up this year, tax revenues will also increase.

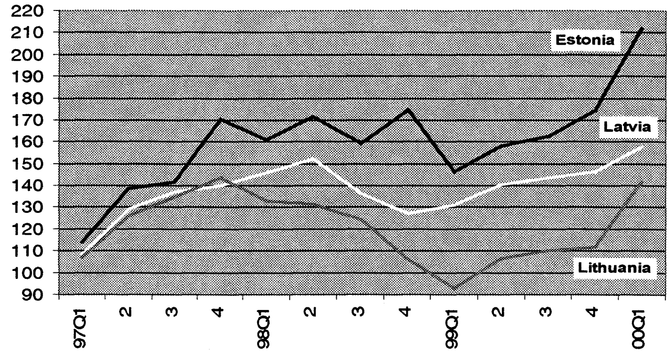
However, during their mission to Lithuania this month, IMF officials expressed their concerns over Lithuania's fiscal stance, in particular regarding the deficit of the social security fund and problems with balancing municipal budgets.

EU accession talks proceed

Lithuania and the EU started negotiations this March on Lithuania's membership in the Union. The European Commission decided in the first phase to open talks on eight of the 31 negotiation chapters that comprise the body of EU legislation. The chapters to be tackled include the easiest topics such as culture, statistics and external relations. Lithuania aims at concluding its membership talks by the end of 2002 and entering the Union in 2004.

In early May, the Lithuanian parliament passed a law enabling the decommissioning of the first of the two reactors of the Ignalina nuclear power station by 2005. The European Commission has stressed the importance of shutting down the Chernobyl-type power station as soon as possible.

Exports (in euros), average 1996=100



LITHUANIA	1994	1995	1996	1997	1998	1999	2000,	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.8	4.2	Q1
Industrial production, % growth	-26.6	5.3	5.0	3.3	7.0	-9.9	4.5	Q1
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	0.8	4/00
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-7.1		
Average gross wage, USD, period average	81	120	155	196	239	293	264	Q1
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	10.0	11.2	4/00
Exports, USD million	2020	2706	3413	4192	3962	2996	939	Q1
Imports, USD million	2220	3404	4309	5340	5480	4791	1243	Q1
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-10.8		

Sources: Lithuanian Department of Statistics, Bank of Lithuania, EBRD

Baltic energy resources

by Seija Lainela*

Roots in the Soviet period

The energy solutions used today in the Baltics date back to the Soviet period, when an integrated energy system was created to service the whole Soviet Union. Centralised planning, together with the natural endowments of individual Baltic states, conferred specific energy profiles on each country.

Thanks to its large oil shale deposits, Estonia became an electricity producer. Lithuania was chosen as the site of the region's only nuclear power station and oil refinery. Latvia became a major transit hub for fuel transhipment due to its good ports.

Estonian oil shale

More than 90 % of Estonia's electricity generation is based on combustion of oil shale. Estonia also exports electricity, mainly to Russia and Latvia.

Estonia's large oil-shale deposits are situated in the north-eastern part of the country, and are sufficient for another 100 years at the current rate of exploitation. Unfortunately, the use of oil shale is in itself problematic. Its low energy content makes it a rather uneconomical source of energy, and it tends to burn dirty, making it a major source of pollution. Also the mining of oil shale, which takes place partly in open pits, creates environmental damage.

Oil shale is burned in Narva at two power stations with a combined capacity of 3000 MW. The Narva facilities will require extensive modernisation to bring them into compliance with EU environmental standards. Estonia is currently negotiating with a US-based energy corporation on the privatisation of the two power stations. The state would sell a 49 % stake in the facilities, but hang on to the rest of Eesti Energia, the national power company – at least for the time being.

Lithuanian nuclear power

Lithuania's electricity production capacity also exceeds national consumption. The Ignalina nuclear power station was build in mid-1980s. With its capacity of 2600 MW, it currently produces over 70 % of the electricity used in the country and also allows for electricity exports.

Due to EU safety considerations, the Lithuanian government recently agreed to close the first of the two reactors at Ignalina by 2005, well ahead of the end of its design lifetime. Similarly, the second reactor is expected to be closed by 2010. However, the Lithuanian authorities maintain that with appropriate upgrading, the second reactor may be kept in operation much longer. Lithuania is hoping to receive international financing – mainly from the EU – for the closure of the nuclear power station.

Lithuania also has heavy fuel and natural gas-based power stations, which will keep the country more than self-sufficient in energy even after the eventual closure of Ignalina. Power stations are owned by the national energy utility Lietuvos Energija, in which the Lithuanian state holds 86 % of shares.

Latvian hydropower

Latvia is the only Baltic country where electricity production is inadequate to cover domestic consumption. Unlike in Estonia and Lithuania, Latvia's existing power generation capacity does not pose major environmental risks. Hydropower stations on the Latvian largest river, Daugava, are the main source for electricity generation. They belong to Latvenergo, the national energy corporation, which is currently being prepared for restructuring and partial privatisation.

Latvia possesses a rare natural underground storage for gas in Inčukalns. The storage caverns receive natural gas from Russia through a pipeline, and are filled in the low season of summer for utilisation in winter. Cavern capacity exceeds the consumption in Latvia and makes it possible for the country to re-export gas from the storage. More extensive re-exporting of gas would, however, require the construction of gas pipelines from Latvia to Western Europe. The Inčukalns storage is owned by Latvijas Gaze, whose privatisation was started in 1997.

Cooperation among the Baltics searched

Various schemes to redefine the Baltic energy system are currently under discussion. The Baltic countries are planning to form a unified power market covering the three countries. Later on, it would be a part of the intended Baltic Energy Ring, also covering other countries around the Baltic and joining the Baltic states with other parts of Europe.

In May 2000, the Estonian and Latvian governments announced their intention to start cooperation between the two state-owned electricity producers, Eesti Energia and Latvenergo. The aim is to enhance competitiveness of the two enterprises in anticipation of liberalising energy markets in Europe. The exact forms of cooperation remain to be defined, but the parties did not exclude an eventual merger. Lithuanian participation in the project has not been discussed so far.

To enable transmission of Lithuanian energy southwards, Lithuania and Poland are planning to build electricity lines to join Lithuania and the other Baltic states to Poland, and beyond to Western and Central Europe. The two countries currently seek financing for the project.

**The author is an economist at BOFIT.*

BALTIC ECONOMIES
The Quarter in Review
2/2000, 26 May 2000
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