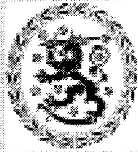


BANK OF FINLAND
Institute for Economies in Transition
27.4.2001

BALTIC ECONOMIES
The Quarter in Review
2 • 2001

SIDOTTAVA KPL

ESTONIA

Economic growth slows

Growth of the Estonian economy slowed somewhat towards the end of last year. According to preliminary information, GDP increased in the fourth quarter 5.9 % compared to the same period in 1999. For all 2000, GDP growth was 6.4 %. Economists expect that GDP will grow 5 to 6 % this year.

In constant prices, the level of investments remained at the same level during January–September compared to the same period in 1999. Gross fixed capital formation for the period was valued at EEK 14 billion. The ratio of investments to GDP for the period was 23 %. Retail sales rose 15 % last year, while construction activity was up 13 %. Growth has continued this year, but at a slower pace. In the first quarter of 2001, industrial output measured by sales was 5.8 % higher than in the same period in 2000.

Unemployment increasing

Unemployment has been rising since the beginning of 1998. According to the most recent labour force survey, the unemployment rate in the fourth quarter of 2000 was 13.9 %, up from 13.0 % a year earlier. The unemployment rate varies considerably by regions and by education. Unemployment was highest in northeastern Estonia. Rising unemployment in a period of high growth reflects productivity gains and possible structural unemployment.

Annual inflation has accelerated in Estonia since last summer. This is due in part to the depreciation of the euro, which has raised import prices. In March, the annual inflation rate was 5.8 %. Officials do not expect inflation to slow before summer.

Current account deficit widened last year

Estonia's current account deficit in 2000 was EEK 5.7 billion (USD 330 million), or 6.8 % of GDP. The current account deficit increased as economic recovery gathered steam. Estonia's trade deficit last year equalled about 16 % of GDP. Estonian exports rose 55 %, while imports increased 43 %. Estonia's main trading partners were Finland and Sweden. Over 70 % of Estonia's foreign trade in 2000 was with the EU. Key export goods included machinery and equipment, textiles, and timber and paper products. A strong increase in imports swelled the trade deficit in January and February.

For several years, large surpluses in the balance of services have partly offset Estonia's trade deficit in goods. Last year the services surplus rose to nearly EEK 10 billion, driven by transport, travel, financing and information technology.

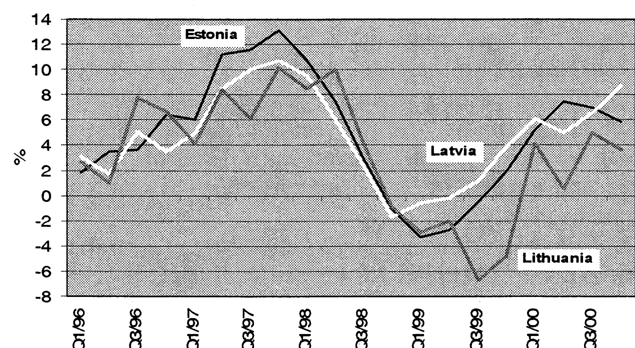
Estonia received EEK 6.8 billion in foreign direct investments last year, an increase of 50 % from 1999. The net inflow of FDI was EEK 4.1 billion, enough to cover over 70 % of the current account deficit.

Estonia a front-runner in EU negotiations

Estonia continues to enjoy steady progress in its EU negotiations. It has already closed 18 of the 31 chapters in the *acquis communautaire* and has started negotiations on another eleven chapters. As with other accession candidates, negotiations between Estonia and the EU on agriculture, energy, the environment, and the free movement of persons are expected to be difficult. The Estonian government wants to complete its negotiations by July 2002.

A survey by Emor, a market research company, revealed that public opinion in Estonia has turned against EU membership in recent months. The April survey found that 53 % (compared to 46 % in February) of citizens entitled to vote opposed EU membership. Only 36 % (45 %) supported Estonia's membership in the EU. Even so, all of Estonia's major political parties are committed to EU membership as a cornerstone of foreign policy. There has been recent public discussion on the possibility of combining a referendum on EU accession with the parliamentary elections in March 2003.

GDP by quarters in the Baltics, year-on-year growth



ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.7	-1.1	6.4		
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	5.8	Q1/01
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	5.8	3/01
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7		
Gross wage, USD, period average	134	207	248	257	293	302	288		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9		
Exports, USD million	1211	1660	1764	2275	2674	2437	3259	615	1-2/01
Imports, USD million	1557	2398	2876	3516	3928	3430	4237	755	1-2/01
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-6.8		

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

LATVIA

GDP growth accelerated at the end of last year

The Latvian economy grew 6.6 % last year, with real GDP growth accelerating in the fourth quarter to 8.7 % y-o-y. Economists expect growth to slow somewhat this year.

The rapid growth was mainly due to an increase in services, particularly trade, transport and business services. The service sector accounted for 70 % of GDP last year. Manufacturing was up 6%.

Gross fixed capital investments totalled LVL 740 million, or 24 % of GDP, during the first three quarters of 2000. Investments increased 19 % y-o-y in constant prices. Retail trade turnover rose 9 % and construction volume in constant prices was up 8 % compared to 1999.

Output has continued to rise during the first months of this year. In February, industrial output was up 6 % y-o-y. In the first two months of this year, the volume of retail trade was up 12 % from the same period in 2000.

Inflation remained moderate during the first quarter of 2001. In March, the on-year increase in consumer prices was 1.4 %.

Unemployment has remained fairly high in Latvia during recent years. In November, a labour force survey estimated the unemployment rate at 14.6 %. By comparison, the November 1999 rate was 14.5 %. The combination of high unemployment and fast economic growth likely reflects structural unemployment. Indeed, unemployment in Latvia has consistently been more prevalent in rural areas than in cities.

IMF memorandum signed

In early April, the Latvian government and the IMF signed a memorandum on Latvia's economic policies for 2001-2002. The memorandum preceded a 20-month stand-by program which grants Latvia a credit facility of USD 42 million.

The economic program agreed by Latvia and the IMF foresees the budget deficit decreasing to 1.75 % of GDP this year, then below 1 % next year. Subsequent budgets should be balanced. Latvia's general government budget deficit reached 2.8 % of GDP last year, exceeding the original deficit ceiling of 2 % agreed with the IMF.

Along with fiscal balance, another key objective is continuing the successful exchange rate peg to the SDR currency basket in the run-up to EU accession. Latvia also seeks a smooth transition to consolidated supervision of its financial sector, and the new financial supervision agency will start its operations in July 2001.

This is Latvia's fourth stand-by arrangement with the IMF. Latvia has never borrowed from the IMF under the previous arrangements and it does not intend to do so now. The arrangement is seen as an affirmation of the policies and measures outlined in the memorandum.

Current account deficit dwindles

Latvia's current account deficit fell to LVL 296 million (USD 500 million) last year. The deficit equalled 6.8 % of GDP compared to 9.6 % in 1999. The current account deficit reflected a negative balance of merchandise trade, which increased 8 % last year and amounted to LVL 640 million. Latvian exports rose 13 % compared to 1999, reaching LVL 1.2 billion (USD 2 billion). However, imports increased to LVL 1.9 billion. Key export goods were wood and base metal products. Latvia's most important trading partner was Germany. Some 60 % of Latvia's foreign trade was with EU.

The current account deficit was kept in check by strong surplus in the services balance. The services surplus of LVL 300 million was sufficient to cover over 40 % of the overall trade deficit.

Latvia received foreign direct investments amounting to LVL 250 million in 2000. FDI was up 15 % compared to 1999 and covered 83 % of the current account deficit.

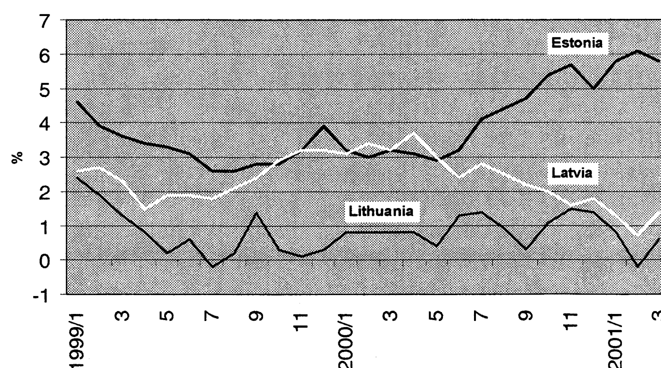
EU negotiations continue

Latvia has closed eleven chapters of the *acquis* so far, and has started negotiations on another 13 chapters. During the first negotiation round of Sweden's turn as EU president, Latvia closed chapters on the free movement of goods and cultural policies.

In April 53 % of Latvian citizens and 55 % of non-citizens supported Latvia's integration into EU. Opposition was smaller, 33 % of citizens and 28 % of non-citizens were against integration.

Latvia and the EU also signed an annual finance agreement on a Special Accession Program for Agriculture and Rural Development (SAPARD) at the end of March. In January, Latvia and the EU agreed on multi-annual financing program, which foresees financing of EUR 30 million per year for Latvia's agricultural and rural development. The annual SAPARD allocation for Estonia was fixed at EUR 12 million and for Lithuania at EUR 22 million.

Baltic 12-month inflation



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		
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	6.0	2/01
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	1.4	3/01
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8		
Gross wage, USD, period average	128	170	179	207	226	241	244		
Unemployment, % (2nd quarter, LFS data)			22.2	15.9	14.7	14.0	14.4		
Exports, USD million	1020	1367	1488	1839	2012	1729	1707	315	1-2/01
Imports, USD million	1321	1947	2286	2689	3138	2957	2999	487	1-2/01
Current account, % GDP	-0.2	-3.6	-4.2	-6.1	-10.6	-9.6	-6.8		

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

LITHUANIA

Modest rise in production last year

Economic growth was slower in Lithuania than in the other Baltic countries last year. Real GDP growth was 3.3 %. In the last quarter of 2000, GDP growth was 3.6 % y-o-y. In 1999, GDP decreased by 3.9 %, mainly due to after-effects from the crisis in Russia.

Manufacturing output and transport increased over 10 % last year. Wholesale and retail trade rose 6 %, while agriculture showed slight growth. Construction activity and utilities (electricity, gas and water) declined.

Gross fixed investments in Lithuania amounted to LTL 6 billion during the first nine months in 2000, down 17 % on-year in current prices. The investment rate was 18 % during the first three quarters of 2000.

Inflation has been low, mainly due to a strong dollar and subdued domestic demand. In March, the 12-month change in consumer prices was 0.6 %.

Unemployment remains relatively high in Lithuania. In the fourth quarter of 2000, a labour force survey (ILO definition) found that unemployment had risen to 16.1 %. A year earlier, the unemployment rate was 15.3 %. Unemployment varies among regions, and was lowest in the Kaunas and Vilnius counties.

A shrinking current account deficit

Lithuania's current account deficit contracted significantly last year to LTL 2.7 billion (USD 700 million), or 6 % of GDP.

Lithuania's trade deficit also continued to decline last year, thanks to a 29 % increase in exports versus a 13 % increase in imports. This situation partly reflected slow economic recovery and sluggish domestic demand. The trade deficit last year was LTL 4.4 billion (USD 1.1 billion). Almost half of Lithuania's exports went to the EU, while 16 % went to CIS countries. The most important Lithuanian export products were mineral products, textiles and machinery. Driven by a 23 % increase in transportation, Lithuania's services balance showed a LTL 1.5 billion surplus.

Foreign direct investments to Lithuania decreased 22 % and amounted to LTL 1.5 billion. FDI was sufficient to cover 56 % of the current account deficit.

Ignalina decommissioning may slow EU negotiations

The Lithuanian government announced its desire earlier this year to accelerate negotiations on EU membership. During the first three months of the year, Lithuania closed six chapters of the *acquis*, including the one on the free movement of capital. Lithuania has now completed negotiations on 13 out of 31 chapters and is thus the most advanced country in the "second wave" Helsinki group of accession candidates. Lithuania has opened negotiations on nine more chapters and hopes to open another seven chapters in May. Many of the remaining chapters to be negotiated have to do with complex issues such as the environment, energy and the free movement of goods, persons and services. At the beginning of April, 50 % of Lithuanians (46 % in February) were in favor of EU membership and 28 % (21 %) opposed the membership.

The EU argues that, until Lithuania adopts a new energy strategy that contains a deadline for the final shut-down of the Ignalina nuclear power plant, Lithuania is effectively barred from completing its EU accession negotiations. The EU insists that Lithuania also commit to decommissioning the whole nuclear plant, which the EU considers dangerous, by 2009. Lithuania wants to wait until 2004 to make its final decision about the closing.

Lithuania is committed to shut-down of the first of the two reactors at Ignalina by 2005. Participants at a meeting of financial donors in June 2000 agreed to provide over EUR 200 million in financial and technical assistance for decommissioning the first reactor. On 5 April, the EBRD, which administers the fund, and Lithuania agreed on a schedule for disbursements.

Although by no means a precondition for the membership, another important step for Lithuania towards joining the EU is the repegging of the litas to the euro. The Seimas recently accepted assurances that there would be no devaluation of the litas in connection with the repeg at the beginning of next year. Analysts expect this guarantee to increase confidence and stability in the financial markets. At the end of March, the parliament also adopted a new central bank law, which complies with the stipulations of the Maastricht treaty and ensures the Bank of Lithuania's independence. It defines price stability the central bank's main objective.

WTO membership

The Lithuanian parliament ratified on 24 April the treaty on Lithuania's membership in the World Trade Organization. Negotiations on membership started in 1994 and finished in October 2000. The WTO approved Lithuania's eligibility for membership last December. Lithuania will become the 141st member of the WTO. It is the last among EU associate member countries to join the global trade body.

Economics Forecasts for 2001

	Real GDP % change	CPI % change	Current Account Balance USD, bn
Estonia	5.4	4.7	-0.4
Latvia	4.8	3.2	-0.6
Lithuania	3.5	2.3	-0.8

Source: Eastern Europe Consensus Forecasts

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		
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	16.5	1-2/01
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	0.6	3/01
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-3.3		
Gross wage, USD, period average	81	120	155	195	232	253	272		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1		
Exports, USD million	2020	2706	3413	4192	3962	2996	3252	697	1-2/01
Imports, USD million	2220	3404	4309	5340	5480	4791	4660	904	1-2/01
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-11.2	-6.0		

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

How indebted are the Baltic countries?

by Iikka Korhonen*

The Baltic countries had zero public debt when they regained their independence ten years ago. Russia took over all the Soviet Union's foreign liabilities and assets. Moreover, companies in the private sector had had no real chance to become indebted abroad.

During the '90s, all Baltic countries recorded high current account deficits, i.e. they were large net importers of capital. This is hardly surprising. Transition towards a market economy requires large-scale upgrading and restructuring of both private productive capacity and public infrastructure. Presumably, the Baltics, as other transition countries, expect to repay their foreign debts once they have built up sufficient export capacity. First part of the strategy has worked so far. The Baltics have attracted considerable foreign investment and the value of exports has risen many-fold. However, the rising standard of living has been accompanied by a rapid increase in imports. High current account deficits, in turn, prompt concerns about the sustainability of Baltic foreign exchange regimes from time to time.

"How much can we borrow?"

Should Baltic policymakers be concerned about increasing foreign indebtedness? After all, many emerging markets have experienced large speculative attacks in recent years when investors perceived foreign debt had grown excessive.

Looking at the Baltics' net international investment positions at the end of 2000, we observe that all are clearly indebted. The net international investment position of Estonia was EUR –3 billion (–56 % of nominal GDP), Latvia EUR –2.3 billion (–31 %) and Lithuania EUR –3.7 billion (–36 %).

Gross indebtedness, however, may be a better indicator of the sustainability of a country's exchange rate – at least in the short run. We should note that the Baltics have accumulated also foreign assets, mainly as central bank foreign currency reserves. Thus, their gross liabilities (108 % of GDP for Estonia, 87 % for Latvia and 60 % for Lithuania) are much higher than their net liabilities.

Indeed, the Baltics' liabilities look fairly normal by international comparisons. They have relatively modest gross liabilities in comparison with a cross-section of some 60 countries represented in the IMF's database (see figure). However, Baltic net international investment positions are clearly more negative than the world average, i.e. the Baltic countries have relatively fewer foreign assets than other countries.

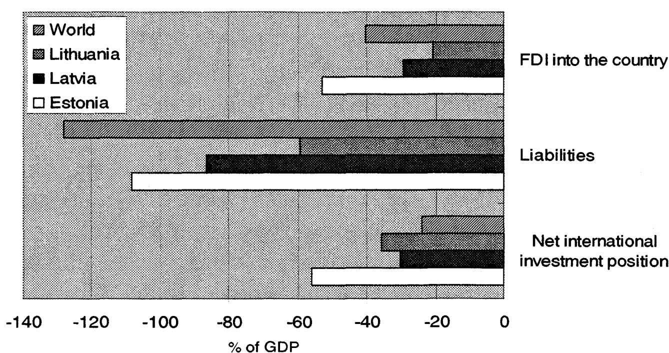
Naturally, the structure of liabilities also matters. Portfolio investments, e.g. into treasury bills, are much easier to cash out on than, say, foreign direct investment (FDI) in a manufacturing plant. The share of portfolio investment in foreign liabilities is also relatively small in the Baltics as the local debt and equity markets are still relatively undeveloped. Their share is highest in Lithuania, where the stock of foreign portfolio investment is 17 % of all foreign liabilities. The share of FDI in foreign liabilities at the end of 2000 was 35 % in Lithuania, 49 % in Estonia and 34 % in Latvia. FDI is obviously less responsive to short-term shifts in investor sentiment, so its large share confers a degree of credibility on Baltic exchange rate arrangements.

At the end of 2000, Estonia's public foreign debt was 4 % of GDP, Latvia's 8 % and Lithuania's 17 %. Total public debt levels remain quite low in all three countries.

"Can we keep up with the payments?"

The level of debt does not necessarily reveal how well a country can service its foreign debt. A country's ability to service its debts becomes especially important in times when a country finds itself in a position where it is unable to roll over its debts. For example, in Estonia the ratio of more liquid liabilities (i.e. gross liabilities minus the FDI) to foreign currency reserves was approximately three at the end of 2000. In Latvia, the corresponding figure was almost five, and in Lithuania it was three. In this sense Estonia, which has the highest gross liabilities, may be better insulated from sudden capital outflows than, say, Latvia.

Net investment position at the end of 2000



Source: Baltic central banks, IMF, World = average of 58 countries in 1999.

The Baltic countries have become quite indebted in a short time. Although the level of indebtedness is by no means extraordinary, it may impose constraints on the countries' policies in the future, especially if the inflows of FDI decrease now that privatisation is completed. Fortunately, a low level of portfolio investment also decreases the risk of sudden reversals in capital flows. Large foreign ownership of the Baltic banking sector also decreases risks associated with foreign indebtedness.

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