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ESTONIA

Global downturn to slow economic growth

Real GDP grew 5.0 % in the third quarter of 2001. In the first nine months of 2001, GDP at constant prices was 5.3 % higher than a year ago. Growth was slightly higher than expected in July-September. However, the Bank of Estonia warned that slump in global economic activity would affect the Estonian economy with a delay of approximately half a year, so that economic growth would begin to slow from the beginning of 2002. The central bank thus cut its estimates of real GDP growth to 4.7 % for 2001 and to 3.5 % for 2002.

Growth in the third quarter was mainly influenced by a rapid increase in gross fixed capital formation (29 %). Exports of services grew as transport and tourism services increased. Although nominal gross wages were 12 % higher than a year earlier, real private consumption grew only 4 %. Exports of goods shrank due to a slowdown in Estonia's main export area, the EU. However, in October-November, growth in industrial sales accelerated to around 10 %.

The ILO-defined unemployment rate was slightly down to 12 % in the third quarter of 2001 (12.8 % in 3Q 2000). Inflation also slowed in recent months due to the lower oil prices and weakening domestic demand. In December 2001, 12-month inflation stood at 4.2 %.

Current account deficit widens as exports shrink

During the third quarter of 2001, Estonia's current account deficit rose to 5.8 % of GDP (3.7 % of GDP in 3Q 2000) as exports decreased faster (12 %) than imports (3 %). The surplus in services grew. In the first nine months of 2001, the current account deficit amounted to 5.1 % of GDP (4.3 % of GDP in 1-3Q 2000).

Estonia received foreign direct investment inflows of EEK 2.6 billion (€170 million) during 3Q 2001 or 33 % more than the year before. The major part of FDI came from Finland, the UK and Sweden, and they were directed to real estate, transport and communications and trade sectors. FDI outflows, EEK 1.4 billion, were directed mostly to Latvia and Lithuania.

2002 budget approved, government resigned

In accordance with Estonian law, the budget is balanced with equal revenues and expenditures of EEK 35 billion (€2.2 billion), a 12 % increase from last year. Budget expenditures are particularly aimed at pension reform, as well as measures required for EU and NATO membership (e.g. improvements in environmental protection and defence).

According to prime minister Mart Laar's announcement on December 19, the government resigned on 8 January 2002. Laar decided to resign after a coalition partner, the Reform Party, struck an alliance with the largest opposition party in Tallinn's municipal government. Laar's government served from March 1999. President Arnold Rüütel should designate a prime minister candidate by January 22.

Sell-off of Estonian power stations to the US-based NRG Energy has apparently been cancelled. NRG Energy was unable to secure the required financing for the renovation of power stations, and now the deal is off. Initially Estonia and NRG agreed on the purchase in August 2000.

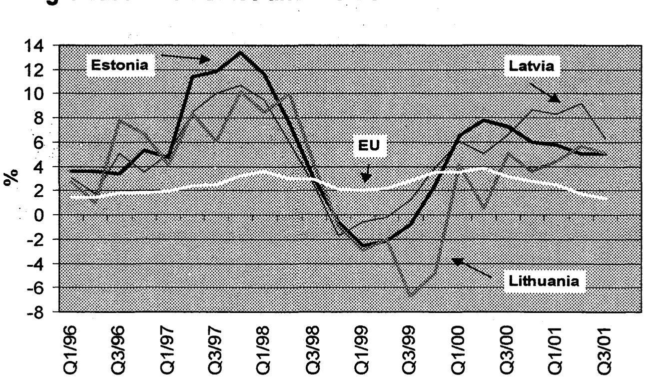
EU negotiations advance slowly

Estonia closed only one chapter (competition policy) of the *acquis communautaire* under the Belgian EU presidency during the second half of 2001. Estonia has now closed 20 chapters, fewer than either of its Baltic neighbours. The chapter on free movement of persons remains open as the Estonian government has not accepted EU-demanded restrictions for Estonian labour. Estonia is looking for special status for oil-shale energy and a transition period of six and a half years for tax-free trade on ships.

The closing of the OSCE representative office in Estonia at the beginning of 2002 was seen as an important advance in Estonia's progress towards EU membership. The decision to close the office was made after the Estonian parliament relaxed rules on the language requirements for parliamentary deputies and other public officials.

Estonian public support for EU membership (38 % in October) is the lowest among candidate countries. At the same time, 79 % of Estonians considered themselves poorly informed about enlargement issues.

GDP growth in the Baltics and the EU



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	5.3	1-9/01
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	9.1	6.9	1-11/01
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	1.9	1-9/01
Gross wage, € period average	113	158	195	227	262	282	313	342	1-9/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9	12.1	Q3/01
Exports, € million	1030	1295	1428	2028	2402	2350	3574	3326	1-11/01
Imports, € million	1330	1804	2230	3024	3398	3119	4432	4411	1-11/01
Current account, % GDP	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-5.1	1-9/01

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

LATVIA

GDP growth still strong although decelerating

Latvian real GDP grew 6.3 % y-o-y in the third quarter of 2001. Growth rate in the second quarter reached 9.2 % and during the first nine months of 2001 Latvian GDP grew 7.9 %. In the first half of 2001, GDP growth exceeded analysts' expectations and estimates of the GDP growth in 2001 have been raised to around 7 %. However, the global economic slowdown has started to affect the Latvian economy and economic growth is expected to decelerate to 4-5 % in 2002.

All main sectors – trade, transport and communications, manufacturing, and real estate and business services – grew steadily in the third quarter of 2001. However, due to declining global demand, the growth rates of trade and transport decelerated more than expected. On the other hand, the growth of exports and industrial production picked up again in October.

Inflation has been quite stable for the past months, and in December inflation rate was 3.2 %. Although lower oil prices have diminished inflationary pressures, e.g. prices of food and education have increased clearly, reflecting buoyant domestic demand.

Trade deficit widens

Latvia's current account deficit rose to 10.5 % of GDP in the third quarter of 2001 (6.2 % of GDP in 3Q 2000). This was mainly due to an increased trade deficit as imports of goods (14 %) outpaced increased exports (9 %). The slowdown in the growth on exports of goods was related to falling demand in EU countries, the destination of nearly two-thirds of all Latvian exports. Two key export articles – wood and wood products – were hardest hit.

Higher demand for transport and travel services boosted the surplus in the services balance, which was enough to cover a third of the goods deficit. However, the growth rate of exports of transport services decelerated due to new regulations introduced in Russia that make it cheaper for Russian cargo to be channelled through domestic ports rather than through Baltic ports. Riga's 800th anniversary celebration last summer likely enhanced revenues from travel services.

In January-September, Latvia received FDI inflows of LVL 70 million (€125 million), or 40 % more than during the same period in 2000. However, for the whole of 2001, the inflow of FDI was less than expected. If the plans for privatising shipping company LASCO and the sale of the Ventspils oil terminal are realised this year, Latvia will see a large jump in FDI in 2002.

IMF and Latvia disagree on budget deficit

The Latvian parliament approved the budget for 2002 with a deficit of 2.5 % of forecasted GDP. The IMF refused to approve such a large deficit as it clearly exceeded the deficit levels agreed between the IMF and Latvia last spring. As a result, the IMF suspended Latvia's stand-by credit facility at the start of 2002. Continuation of the arrangement will be discussed in April, when the fiscal performance of the first quarter is known.

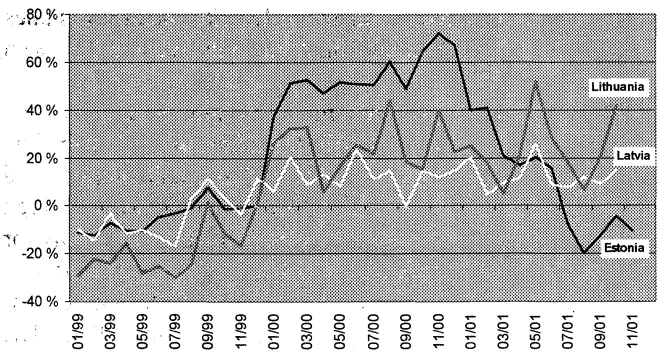
Budget expenditures in 2002 will increase 7 % from 2001. The largest growth will be in defence spending, which has been boosted in anticipation of NATO membership. Additional funds will also go to reform of health care and the pension system. A substantial raise for teachers' salaries will increase spending on education. The revenue side will be affected by an amendment that lowers corporate profit tax from 25 % to 22 % from the beginning of 2002. The budget assumes Latvian GDP will grow 6 % in 2002 and inflation will average 3 %.

Rapid progress in EU negotiations

Latvia has closed 23 chapters of the *acquis* so far. During the second half of 2001, Latvia made rapid progress in its EU membership negotiations. The eight recently closed chapters included energy and competition policy. The chapter on justice and home affairs, which is considered difficult for Latvia, remains still open. The EU has repeatedly demanded that Latvia fight corruption and reform its court system. To complete negotiations in the field of telecommunications, Latvia must also approve new legislation. The new competition law and commercial law took effect on 1 January 2002. These laws are important in making Latvian legislation consistent with EU standards. The new commercial law is aimed at improving the business environment, for example, by strengthening protection of creditors and minority shareholders. The government has also committed itself to liberalising the Latvian gas market in the near future. The OSCE's decision to close its mission in Riga at the end of 2001 was considered an important step on the road to EU and NATO memberships.

According to a survey commissioned by the European Commission, 46 % of Latvians supported EU membership in October 2001.

Year-on-year growth of exports (in local currency)



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	7.9	1-9/01
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	3.2	8.8	1-10/01
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.4	1-9/01
Gross wage, € period average	108	130	141	183	202	225	265	278	1-9/01
Unemployment, % (2nd quarter, LFS data)			22.2	15.9	14.7	14.0	14.4	13.3	Q3/01
Exports, € million	857	1044	1172	1627	1796	1765	2237	2076	1-10/01
Imports, € million	1110	1486	1800	2377	2804	2725	3387	2867	1-10/01
Current account, % GDP	-0.2	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-7.1	1-9/01

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

LITHUANIA

GDP and exports grow

Lithuanian GDP grew 5.0 % y-o-y in the third quarter of 2001. Although growth slowed from the second quarter (5.7 %), it was still higher than expected last spring. Estimates of GDP growth in 2001 have been raised to 4-5 %. The same growth rate is expected to continue in 2002.

Lithuania's brisk growth is mainly due to strong exports. Gross fixed capital formation increased 8 % y-o-y in July-September thanks to the growth in construction. Private consumption was up only 2 % due to a fall in real wages and persistent high unemployment. Manufacturing activity increased 12 % y-o-y in 3Q 2001, and growth has remained brisk during October and November.

Inflation has remained low mainly due to subdued domestic demand and lower oil price. In December, the annual inflation rate was 2.0 %.

Tiny current account deficit

Lithuania's current account deficit shrank to 0.4 % of GDP in the third quarter of 2001 (3.4 % of GDP in 3Q 2000). In the first nine months of 2001, the deficit was 3.3 % of GDP (5.0 % of GDP in 1-3Q 2000). The decrease was mainly due to a rapid growth in exports of goods (16 % in 3Q 2001) and in exports of services (10 %). Exports of refined oil, transport equipment, machinery and prepared foodstuffs showed the strongest increases. Growth of imports decelerated due to low crude oil prices. Almost a half of revenues from service exports come from the transport sector. Exports of business, travelling and computer services also increased.

Lithuania received FDI inflows of LTL 430 million (€120 million) in 3Q 2001, up nearly 50 % from a year earlier. Most investments came from Estonia and Sweden. FDI increased mostly in the financial and trade sectors.

Parliament approves 2002 budget

State expenditures will be LTL 10 billion (€2.8 billion) and revenues LTL 9 billion in 2002. The finance ministry claims that the overall public sector deficit will stay below the ceiling of 1.5 % of GDP agreed with the IMF. The budget assumes that GDP will grow 4 % and inflation will average 2.6 % in 2002.

The Lithuanian government is promoting a broad tax reform. The aim is to bring the Lithuanian tax system in line with EU requirements, broaden the tax base, and simplify and liberalise the system. Initially, corporate profit tax was lowered at the start of this year from 24 % to 15 % and the profit tax for small businesses was reduced to 13 %. Reinvested profits, which used to be untaxed, are now taxed at 15 %. The corporate dividend tax was also lowered to 15 % from 29 %. The plan is to harmonise the value-added tax with EU standards in the near future. The government also seeks to reduce the income tax from its current 33 % from the start of 2003.

Litas repeg approaches

The litas peg to US dollar will be changed to the euro on February 2. The litas rate against the euro will be based on the dollar's value against the euro as announced by the ECB on February 1. The repegging reflects a desire to integrate Lithuania economically and politically with the EU – Lithuania's most important trading partner. Almost a half of Lithuanian exports go to the EU area.

EU negotiations proceeds quickly

Lithuania made fast progress in its EU membership negotiations during the second half of 2001, closing six chapters. Lithuania has now closed a total of 23 chapters, making it one of the most advanced accession candidates. The remaining chapters include those on agriculture and regional policy, where the EU itself has yet to formulate its negotiation positions. For Lithuania, the energy chapter may be the most difficult. Lithuania has still not yet decided when the second reactor of Ignalina nuclear power station will be closed. The EU says a decision is necessary to complete the membership negotiations. Lithuania, like Estonia and Latvia, has requested a transitional period on cigarette taxation. This has slowed negotiations on the taxation chapter.

According to a survey made last October, 50 % of Lithuanians supported EU membership. As in other candidate countries, most Lithuanians (71 %) felt themselves poorly informed on EU membership issues.

Progress in EU accession negotiations

	Provisionally closed chapters of the acquis		Support for EU membership*	
	December 2001	June 2001	For %	Against %
Slovenia	26	20	56	22
Cyprus	24	22	62	25
Hungary	24	22	70	10
Czech Rep	24	19	54	18
Lithuania	23	17	50	20
Latvia	23	15	46	32
Slovakia	22	17	66	11
Estonia	20	19	38	27
Malta	20	16	40	36
Poland	20	16	54	26
Bulgaria	14	10	80	4
Romania	9	6	85	3

*Eurobarometer 2001

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	5.1	1-9/01
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	18.6	1-11/01
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-2.7	1-9/01
Gross wage, € period average	68	92	122	173	207	236	296	294	1-9/01
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1	16.5	Q2/01
Exports, € million	1697	2066	2687	3710	3538	2941	4402	4051	1-9/01
Imports, € million	1866	2598	3393	4726	4893	4253	5602	4681	1-9/01
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-3.3	1-9/01

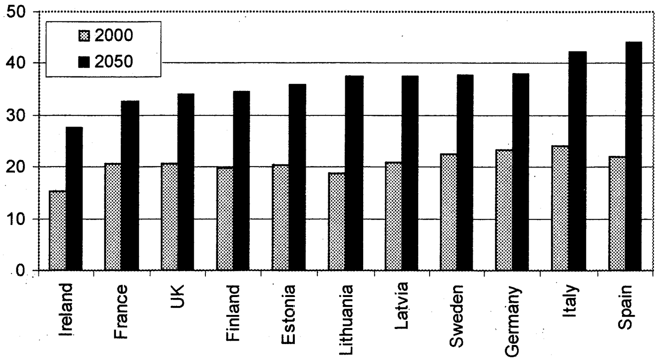
Sources: Statistics Lithuania, Bank of Lithuania, EBRD, IMF

Current issues in pension reform in the Baltics

by Tuuli Koivu*

The Baltic states inherited pay-as-you-go (PAYG) pension systems from the Soviet Union. Under a PAYG, those who work pay the benefits of current pensioners. These systems rapidly became unsustainable after independence due to demographic shifts (aging populations with low birth rates) and rising unemployment. As they lacked a strong link between contributions and benefits, employees had little incentive to pay taxes. It was soon apparent that Baltic pension systems had lost their ability to guarantee pensioners an adequate standard of living. In 3Q 2001, the average monthly old-age pension was just € 102 in Latvia, € 101 in Estonia and € 89 in Lithuania.

Proportion 60 years and more of total population in 2000 and 2050



Source: UN World Population Prospects: The 2000 Revision

The Baltic countries moved to reform their pension schemes in the mid-1990s. The objective was to adopt a three-pillar pension system that would ensure long-term affordability of the welfare system, while preserving an adequate social safety net for all. The first pillar would be a scaled-down PAYG system. The second pillar would be a fully funded system of privately managed savings accounts, financed from payroll taxes. The third pillar would be based on voluntary pension fund contributions.

Reforms to date

The earliest pension reforms in the Baltics involved downsizing PAYG systems by raising retirement ages, eliminating extra benefits and strengthening the link between contributions and benefits. Next, the voluntary pension scheme was created in 1998-1999. Despite the fact that contributions are tax deductible, voluntary schemes have yet to become popular. In Latvia, which has made the most progress in Baltic pension reforms, there were only 9,100 participants in private pension plans in September 2001.

Latvia's second pillar has been in place since July 2001. Second-pillar contributions are mandatory for employees below 30, while contributions by those between the ages of 30 and 49 are optional. Few have chosen to participate in the scheme. Moreover, contributions will rise gradually from 2 % of income in 2001-2006 to 10 % from 2010 onwards and contributions to the first pillar will be reduced proportionally. Second-pillar funds will initially be managed by the State Treasury to reduce administrative costs. The funds will be primarily invested in state securities and time deposits with banks. Starting from 2003, each resident will have the right to choose the manager of his savings from among reputable investment companies licensed by the state.

In Estonia, workers born during or after 1983 will start making mandatory pension fund contributions in July 2002. They will pay 2 % of their income and the Tax Board will contribute 4 % or a fifth of the 20 % social tax that employees currently pay under the first pillar of the social security system. The state will cover payments transferred from the Tax Board.

Lithuania has yet to pass legislation on its second pillar. Under a proposal of Lithuania's cabinet, the second pillar would take effect in 2004. The system would require workers up to 30 years of age to contribute 5 % of their income to the second pillar.

Pros and cons of three-pillar systems

Three-pillar pension systems should provide a higher rate of return on savings than the PAYG system and thus allow the state to provide the present level of benefits without raising the contribution rate even when the number of pensioners increases and the number of employees declines. By providing a clearer connection between lifetime contributions and pension benefits, the new system may also improve the efficiency of labour markets. The model is expected to stimulate savings, which could increase investments in productivity-improving projects. Despite this optimism, empirical data offer little to support this view. Proponents of three-pillar systems even claim they will accelerate development of financial markets. However, constraining regulations on investments could likely limit the impact of such systems on capital markets.

The increased risks to pensioners and high administrative costs of the system have also been criticised, but the most difficult problem by far in pension reform is the financing of transition costs. The bigger the amount of participating workers and the bigger the contributions to the second pillar, the higher the transition costs. The Baltic countries calculate that the transition will cost 0.5-1.0 % of GDP annually for 5-10 years. They will likely finance part of the costs from privatisation funds and borrow the rest. Lithuania has considered a possibility of borrowing from the World Bank. Thanks to relatively modest external debt levels, borrowing should not cause any problems in the Baltic countries.

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