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ESTONIA

Industrial output surprisingly resilient

Although the global economic slowdown has hurt Estonian industrial production, it still grew 4.2 % y-o-y in January. In 2001, industrial output as measured in sales rose 7 % and the growth was relatively stable for much of the year. Among the main production sectors, the textile industry, mechanical wood processing and furniture manufacturing increased most rapidly. Their growth continued in January. According to preliminary data, Estonian GDP growth remained brisk in 4Q 2001 and GDP was up 5.5 % y-o-y

The increase in production has also started to lower unemployment. The ILO-defined unemployment rate was down to 11.9 % in the fourth quarter of 2001 (13.9 % in 4Q 2000). The unemployment rate has fallen steadily in all parts of the country, but is still very high (20 %) in North-Eastern Estonia. Simultaneously, wages have increased. In the 4Q of 2001, the average monthly gross wage was 5,879 kroons (376 euros) or 11 % higher than the year before. At the end of last year, the best salaries were paid in the financial sector where average monthly gross salary was more than 12,000 kroons. On the other hand, the average monthly wage in agriculture was below 3,400 kroons.

Real wages were up last year as inflation slowed in the second half. In February 2002, 12-month inflation stood at 4.4 %.

Exports decreasing

Estonian exports increased 7 % in 2001 thanks to a successful beginning of the year. However, in recent months exports have suffered due to lower demand in Finland and Sweden, Estonia's two main trading partners. The contraction in exports began last summer and continues. In January, exports contracted 25 % y-o-y. Re-exports after inward processing (e.g. mobile phones), suffered most. Estonia's main exports are machinery and equipment, wood and wood products, and textiles. The share of exports going to EU countries has fallen below 70 %, while the share of exports to Russia and other CIS countries has slightly risen to 4 %. Due to diminished demand for components in Estonia, imports have decreased as well during last months. For all of 2001, imports rose 4 % and the trade deficit slightly contracted.

Bank lending grows rapidly

During 2001, Estonian commercial bank claims on their customers grew rapidly. At the end of 2001, such claims were EEK 40.7 billion (€2.6 billion). Since the end of 2000, bank claims have increased 19 % year-on-year. Growth continued unabated in January as bank claims increased to EEK 41.3 billion. In 2000 – the peak of the current economic upturn – bank lending grew by 28 %. Most bank lending is done in foreign currencies, especially euros. At the end of 2001, kroon lending accounted only for 21 % of total lending. The banking sector's consolidated balance sheet at the end of 2001 was EEK 68.4 billion (€4.4 billion), up 18 % from the end of 2000.

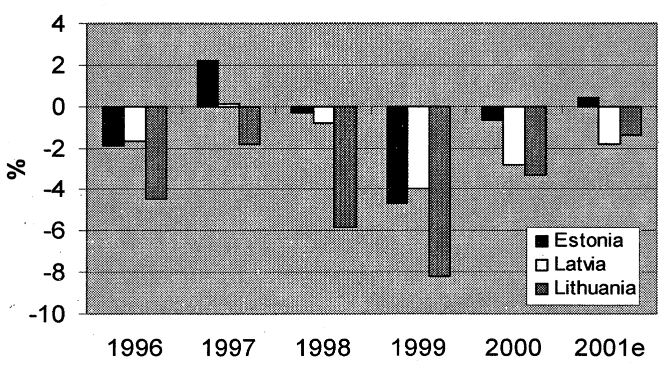
However, growth in bank lending has not been matched by increases in the Bank of Estonia's foreign currency reserves. At the end of 2001, foreign currency and gold reserves were EEK 14.6 billion (€930 million), down 6 % from the year before. Reserves cover slightly more than two months' worth of imports, which is rather low by international standards.

Budget surplus in 2001, new government sworn in

In 2001, Estonia's public sector ran a surplus of EEK 400 million (€25 million) or 0.4 % of estimated GDP due to a large surplus in the state budget. Municipal budgets continued in the red. For example Tallinn's expenses exceeded revenues by EEK 320 million according to preliminary figures.

After the collapse of Mart Laar's coalition government on January 8, a minority coalition government of the Reform Party and the Centre Party was sworn in on 28 January. According to prime minister Siim Kallas, the new government's main task will be to reduce the widening social and economic divide in Estonian society. The government has no plans for fundamental changes in economic policy and remains committed to the key goals of Estonian foreign policy, i.e. memberships in the EU and NATO.

Fiscal deficits, % of GDP



ESTONIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	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	4.2	1/02
Inflation, %-growth, end-year	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2	4.4	2/02
General government budget balance, % GDP	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4		
Gross wage, € period average	113	158	195	227	262	282	313	350		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	13.9	11.9		
Exports, € million	1030	1295	1428	2028	2402	2350	3444	3696		
Imports, € million	1330	1804	2230	3024	3398	3119	4615	4798		
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

Lower growth for industrial output

Although Latvian industrial output rose over 8 % in 2001, the country also experienced the sharpest slowdown in growth of any of the Baltics towards the end of the year. In December, industrial output was up only 1.6 % y-o-y. The country's main industrial production sectors – food and textiles – revived towards the end of the year, while growth in mechanical wood processing slowed. Growth in retail trade also slowed during the second half of 2001. In December, growth was just 2 %.

Inflation has remained steady in recent months. In February, the inflation rate was 3.3 %.

Current account deficit widens

According to Latvia's Statistical Bureau, Latvian exports grew 11 % in 2001. Latvia's leading exports, wood and wood products, showed almost no growth, but among other key export fields, textiles grew 14 %, machinery and equipment 29 %, chemical products 11 % and metal products 6 %. Some 61 % of Latvian exports went to EU countries (65 % in 2000), while CIS countries' share of exports rose to over 10 % (9 % in 2000). Food exports benefited most from rapid export growth to Russia. Imports to Latvia rose 14 %.

According to the Bank of Latvia's monthly data, the current account deficit rose to LVL 480 million (€870 million) or to almost 10 % of GDP last year due to a widening trade deficit. Surplus in the service account rose 14 % to LVL 310 million. Net inflows of FDI in Latvia decreased to LVL 150 million (LVL 240 million in 2000), as there were no major privatisation projects.

Bank lending expands

Latvian banks increased their lending very rapidly during 2001. At the end of the year, total bank loans stood at LVL 1.6 billion (€2.9 billion), up 51 % from the year before. Both lending to enterprises (up 52 %) and to private persons (49 %) increased. While financial intermediation in Latvia remains quite low, it is obvious that rapid growth in bank lending may increase risks to the banking system, especially if the economy is hit by a negative shock.

At the end of 2001, the Bank of Latvia had gold and foreign currency reserves of LVL 772 million (€1.38 billion). During 2001, foreign currency reserves increased almost 37 %, reflecting strong capital inflows into Latvia. For example, Latvia borrowed €200 million in November from the international markets, which also boosted currency reserves.

Budget deficit shrank in 2001

Latvia's 2001 consolidated general government budget incurred a fiscal deficit of LVL 87 million (€160 million) or about 1.8 % of estimated GDP. The deficit slightly exceeded the ceiling of 1.75 % of GDP agreed with the IMF as municipalities ran larger deficits than planned. The fiscal deficit of the central government was LVL 68 million. Preliminary figures show the city of Riga had a deficit of LVL 21 million last year.

Privatisation advances

After minor difficulties, important privatisation projects advanced significantly during the final months of last year. The Latvian government hopes to sell its largest remaining state-owned companies in 2002. The privatisation of natural gas distributor **Latvijas Gaze** was completed when the state sold its remaining 3 % stake for privatisation vouchers in February. In January, Latvia's privatisation agency issued a new framework on privatisation of **Latvian Shipping Company** (LASCO). This time around, privatisation will start with the sale of 32 % of LASCO shares against privatisation vouchers. Another stake of 51 % will be sold for cash on the Riga Stock Exchange, a 10 % stake will be transferred to pension fund and 6 % will be sold to current and retired employees. The privatisation sale should be completed by the end of the summer and the government expects to raise some LVL 110 million (€190 million) from the sale.

Preliminary rules over the sale of state's 39 % stake in **Ventspils Nafta** oil terminal has been introduced and the stake is optimistically expected to be sold in the first half of 2002. The sale of government's 51 % stake in telecommunication company **Lattelekom** is complicated by a dispute with Finnish-owned Tilts Communications, which owns 49 % of Lattelekom. Tilts and the Latvian state are currently negotiating on compensation after the Latvian side harmonised its legislation with EU and WTO requirements and cut the company's monopoly term by 10 years. The sale of the **Latvenergo** electricity utility was banned by the parliament in August 2000 and no advancement in this case is expected before next parliament is elected in the autumn. The 32 % stake of savings bank **Latvijas Krajbank** is likely to be sold only when the entire privatisation process is completed as the bank holds over 95 % of the privatisation voucher accounts in Latvia.

Economists forecasts for 2001 and 2002, GDP, % change

	2001[1]	2002[2]
Estonia	5.3	4.3
Latvia	7.1-7.3	4.8
Lithuania	5.7	3.6

[1] Source: Estonia: Statistical office of Estonia
Latvia: Bank of Latvia in February 2002
Lithuania: Statistical office of Lithuania
[2] Source: Eastern Europe Consensus Forecasts, Jan. 21,2002

LATVIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	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	8.4		
Inflation, % growth, end-year	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.2	3.3	2/02
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.8		
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	2492		
Imports, € million	1110	1486	1800	2377	2804	2725	3387	3897		
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

Industrial output contracted in January

Lithuania's industrial output growth slowed in the last months of 2001, and output decreased 4.6 % y-o-y in January. The decrease reflected a contraction in oil refining. For all of 2001, industrial output measured in sales rose 17 % and important oil refining activity was up 47 %. Textile manufacturing rose 16 %, electrical power generation and distribution 29 %, and manufacture of vehicles and vehicle parts an impressive 125 %. According to preliminary data, Lithuanian GDP growth rate rose to 7.9 % in 4Q 2001 and GDP was up 5.7 % for the year.

In the last quarter of 2001, the average monthly gross salary in Lithuania was 1,090 litas (315 euros) and just 1.3 % up y-o-y. The unemployment rate rose to 17.5 % (16.1 % in 4Q 2000). Inflation has slightly accelerated last months and 12-month rate was 2.8 % in February.

Lithuania's state budget deficit contracted last year to LTL 730 million (€210 million) and was about 1.5 % of estimated GDP. Lithuania and the IMF agreed last autumn on a public sector deficit ceiling of 1.3 % of GDP.

Export growth slows

Lithuanian exports rose 20 % in 2001 despite slowing growth in the end of the year. Lithuania succeeded in increasing its exports to Eastern Europe in the face of declining demand in Western Europe. Last year 11 % of Lithuanian exports went to Russia with substantial increases in exports of machinery and equipment, transport vehicles and parts, and food. Lithuania's leading export item (refined oil products) saw an increase of 34 % with the majority of exported oil going to EU countries. Lithuania's largest export partner last year was the UK, which buys e.g. oil products and textiles. Imports rose 15 % in 2001.

Despite higher production levels, the Mazeikiu Nafta oil group suffered an unaudited loss last year of LTL 280 million (€80 million). In 2000, the company reported a loss of LTL 180 million. The loss was mainly due to out-of-date production facilities and difficulties in securing crude oil supplies. In June 2001, Mazeikiu and Russian oil producer YUKOS preliminarily agreed on long-term crude oil supplies, ownership arrangements and financing for modernisation work. However, the parties have not succeeded to finalise the contract.

Banking sector growth accelerated at the end of 2001

For most of 2001, growth of bank lending remained quite subdued. Growth accelerated, however, during the fourth quarter. At the end of 2001, Lithuanian bank lending to domestic customers amounted to LTL 9.5 billion (€2.8 billion), up 12 % y-o-y. Bank lending grew only 4 % during 2000. The banking sector's consolidated balance sheet at the end of 2001 was LTL 15.2 billion, up 8 % from the year before.

Bank lending has been boosted by strong economic growth and stable interest rates, as well as successful reorganisation of the Lithuanian banking sector. Lithuanian banks have long been reluctant to extend credit, but things are apparently changing. New foreign owners may have also prompted the increase in lending. The willingness of banks to lend may increase further in April, when the Bank of Lithuania is expected to lower the minimum reserve requirement from 8 % to 6 %.

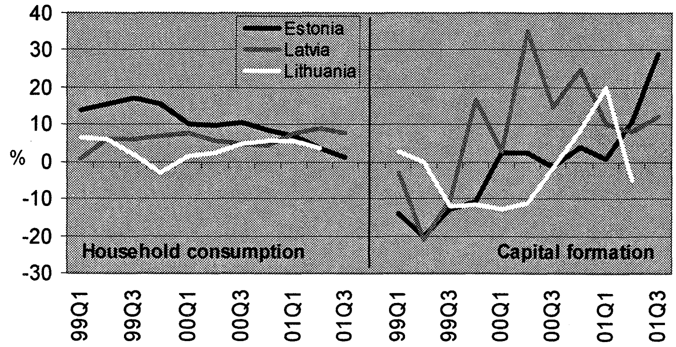
The Bank of Lithuania's foreign currency reserves increased during 2001. At the end of 2001, they stood at LTL 6.7 billion (€1.9 billion), up 23 % from the year before. Lithuania's currency reserves were enough to cover almost three months' worth of imports.

The repegging of the litas from the dollar to the euro had no significant effect on financial markets. The 3-month Vilibor spiked 40 basis points on January 30, but came back down on February 1. The litas was pegged to the euro on February 2 at the European Central Bank's official rate (1€ = 3.4528 litas).

Privatisation progress

In 2001, Lithuania privatised 842 facilities and posted privatisation revenues of almost LTL 470 million (€140 million). In 2002, Lithuania plans to sell a few large companies and forecasts privatisation revenue of LTL 1.2 billion. The last state-owned bank, **Zemes Ukio Bankas**, was sold in February to German Nord/LB. Nord/LB will pay LTL 71 million for the 76 % stake of the bank and is committed to invest another LTL 65 million in the bank. German Ruhrgas was the only strategic investor to submit a timely preliminary bid on a 34 % stake in gas company **Lietuvos Dujos**. Final offers must be submitted before 2 April. After the strategic investor is chosen, another 34 % stake of Lietuvos Dujos will be sold to a Russian gas supplier later this year. As part of privatisation of the energy sector and harmonisation with EU standards, Lithuania's energy monopoly **Lietuvos Energija** was split into five independent companies at the beginning of 2002. However, the privatisation of these companies will not be completed before 2003. No decision on the sale of air carrier **Lietuvos Avialinijos** has yet been reached.

Househol consumption and fixed capital formation in the Baltics, year-on-year growth



LITHUANIA	1994	1995	1996	1997	1998	1999	2000	2001	2002	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-3.9	3.9	5.1		1-9/01
Industrial production, % growth	-26.6	5.3	5.0	3.3	8.2	-11.2	7.0	16.9	-4,6	1/02
Inflation, % growth, end-year	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0	2.8	2/02
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-1.4		
Gross wage, € period average	68	92	122	173	208	231	264	296		
Unemployment, % (2nd quarter, LFS data)			17.1	16.4	14.0	13.0	16.1	17.5		
Exports, € million	1697	2066	2687	3710	3538	2941	3953	4782		
Imports, € million	1866	2598	3393	4726	4893	4253	5815	6689		
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

Developments in transit transport between Russia and the EU

By Juhani Laurila*

Transit transport is the business of transporting goods through one country to a third country. Three factors seem to influence the direction and volume of transit transport between EU countries and Russia. First, there is the structure of trade between Russia and the EU. Second is Russia's unwillingness to purchase transit transport services from its new border republics. Finally, there are geo-strategic security considerations relating to Russia's long-term needs as an energy exporter and short-term efforts to exert political pressure on its neighbours.

Redirecting bulky exports requires heavy investment

About 40 % of Russian exports and 60 % of oil exports are transported via the Baltics. Virtually all trade between the EU and Russia is transported through one of the six corridors shown in the table below. More than 70 % of Russian exports consist of oil, gas and other raw materials, whereas about 90 % of Russian imports consist of consumption and investment goods. This is reflected in the unit values of transit flows. The value of eastbound flows averaged $1,170 per tonne but only $158 per tonne for westbound flows. The highest unit value goods – over $2,100 dollars per tonne (mostly cars, electronics) – to Russia were delivered via Finland. The lowest unit value transit flow went via Slovakia-Ukraine (less than $70 per tonne, mostly natural gas and oil).

Transit transport flows between EU and Russia in 1999

	Shares by corridor		% of corridor total	
	Total		Westbound	
Corridor	Volume	Value	Volume	Value
Finland	2	6	76	30
Estonia	11	9	86	68
Latvia	22	25	95	70
Lithuania-Belarus	5	9	83	47
Poland-Belarus	24	38	94	72
Slovakia-Ukraine	37	14	98	80
Total share, %	100	100	94	68
Total	193	42273	181.3	28579
Total	mill. t	mill. USD	mill. t	mill. USD

Source: Author's calculations based on data from Russian customs authorities and Arkonsuo in Transit and Arbitrage Trade with Russia (ETLA 2000)

Consumption and investment goods from EU countries to Russia are delivered mostly in containers that provide flexibility in transport options. By contrast, the export of fuels and raw materials from Russia to the EU is tied to heavy transport infrastructures consisting of pipelines, railroads and ports. Any major redirection of Russian exports, therefore, requires large investments.

The price for transport autarky is high

Russia's large construction program, the Baltic Pipeline System (BPS), seeks to funnel part of its trade transport with the EU through a number of ports located near St. Petersburg, and thereby divert transport away from the Baltic countries. All three Baltic countries earn a substantial amount of their GDP from transit (Estonia 7-9 %, Latvia 8-10 % and Lithuania 4-6 % of GDP in 1999). Naturally, they are concerned about Russia's plans.

Russia seems reluctant to pay for transport services through former Soviet republics as these services were available free-of-charge during the Soviet era. According to Russian sources, bypassing the Baltics will save Russia some $1.0-1.5 billion a year it is allegedly losing by purchasing transit transport services from the Baltic countries.

Russia has also had trouble agreeing on transport fees with Ukraine, which led to construction of a bypass on Russian soil to the Black Sea. The plan to transport Barents Sea gas directly to Germany via a pipeline laid on the bottom of the Baltic Sea instead of via the Ukraine-Slovakia corridor or the Belarus-Poland corridor also reflects Russia's preference for direct transport outlets.

Russia may also use (as it has in the past) diversion of transit as leverage to impose its political and commercial ends on its neighbours. In 1992, crude supplies to the Ventspils terminal in Latvia were cut due to a dispute of ownership of the pipelines. Crude deliveries were also cut in 1998 when Russia wanted to influence the treatment of Latvia's Russian-speaking minority. Throughout the past decade, Russia has continuously regulated Baltic transit by tariffs and licensing. Currently, Russia attracts transports to St. Petersburg by offering lower railway tariffs than those to the Baltic countries.

Russia seems to be prepared to opt for transport autarky to warrant the security in its foreign trade transport – even if it comes at a high cost. For instance, the cost estimates of the BPS project are in the range of $3-5 billion. According to Western sources, equivalent additional capacity can be created by investing just $0.3-0.5 billion in existing pipelines from Russia to port of Ventspils in Latvia. The heavily subsidized prices in Russia's transport sector may have created an illusion about good profitability of the investments in domestic transport in comparison with the use of foreign transit transport services. Whatever the case, it also means that Russia is prepared to pay a high price for its national transport independence for the sake of its perceived political and economic security.

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