



ESTONIA

Higher-than-expected GDP growth in second quarter

Estonian real GDP growth accelerated to 7.0 % in the second quarter of 2002. Growth was sustained by robust increases in private consumption (11 % y-o-y) and investment (26 %). Growth picked up in all economic sectors, except agriculture and electricity, gas and water supply. The figures from the third quarter show strong growth continued in retail trade and industrial production.

The higher-than-expected growth, combined with a large current account deficit and rapid credit expansion, has started to worry the Bank of Estonia. In September, the central bank withdrew about one billion kroons (€64 million) of government deposits from commercial banks and placed them in foreign bonds in order to decrease liquidity in the money market and restrict loan growth. Despite the move, there were no signs of a slowdown in the credit market as the volume of loans continued to rise. The stock of loans granted to the private sector was up 23 % y-o-y at the end of September.

Annual inflation picked up slightly to 3.2 % in October. The largest price increases were registered in the health sector. Housing costs have risen steadily this year.

Exports started to grow in July

After a year of decline, Estonian exports started to rise in July. In July-September, exports were up 14 % y-o-y. The increase was mainly due to a pick-up in the machinery and equipment sector, where exports increased 24 % y-o-y. Exports of wood and wood products and metal and metal products both grew 12 %. Exports of services were up 24 % y-o-y in 3Q02, thanks mainly to increased transit shipments.

Despite higher exports, the current account deficit amounted to 12 % of preliminary GDP in 3Q02 (12 % of GDP in January-August). The deficit reflected the increase in imports of goods (18 %) and services (44 %). FDI inflows amounted to EEK 4.7 billion (€300 million) and covered 50 % of the current account deficit in January-August. FDI outflows amounted to EEK 1.7 billion in the same period.

Pension reform to increase budget deficit next year

The government submitted to the parliament a draft of next year's budget, which foresees expenditures of EEK 38.7 billion and revenues of EEK 38.5 billion. The draft budget proposes Estonia's first budget deficit (0.3 % of GDP) since 1991. The deficit is mainly the result of pension reform costs and is likely to be larger than planned as the number of people voluntarily participating in the new funded pension program far exceeds the budget forecast. Next year's budget assume

100,000 people would start contributing to funded pensions at the beginning of 2003. In fact, 207,000 people signed up by the deadline at the end of October. The government matches employee contributions two to one, i.e. when employees pay in 2 % of their gross earnings, the government pays in 4 % to the pension fund.

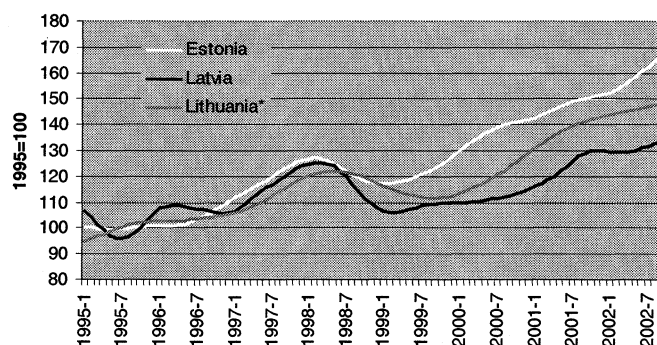
Coalition parties successful in local elections

Voter turnout for local elections on October 20 was 52.4 %. The Centre Party secured 26 % of the vote and continues as Estonia's largest party. Its government coalition partner, the rightwing Reform Party, took 12 % of the vote. The centre-right Res Publica, founded less than a year ago, received 15 % of the vote. The Pro Patria Union and the Moderates lost a great deal of their earlier support.

EU report sees unresolved issues

The European Commission released its regular reports on applicant countries' progress in meeting EU membership criteria in October. The Commission repeated its earlier statement that Estonia is a functioning market economy and should be able to cope with the competitive pressures and market forces within the Union as long as it continues with reforms. Estonia has most of the necessary institutions in place and for the most part is aligned with the acquis. However, in some fields, e.g. food safety and customs, reforms still must be pressed through. The Commission stressed that Estonia must deal with its unemployment problem, local authorities' finances and restructuring of the oil shale sector.

Industrial output trend, 1995=100



*) Lithuania: industrial production excluding utilities

| ESTONIA | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | as of | |
|--|------|------|------|------|-------|------|------|------|------|--------|--------|
| GDP, %-growth* | -2.0 | 4.3 | 3.9 | 9.8 | 4.6 | -0.6 | 7.1 | 5.0 | 5.2 | H1/02 | |
| Industrial sales, %-growth | -3.0 | 1.9 | 2.9 | 14.6 | 4.1 | -3.9 | 9.1 | 6.9 | 4.7 | 1-9/02 | |
| Inflation, %-growth, end-year | 41.7 | 28.9 | 14.8 | 12.5 | 6.5 | 3.9 | 5.0 | 4.2 | 3.2 | 10/02 | |
| General government budget balance, % GDP | 1.3 | -1.3 | -1.9 | 2.2 | -0.3 | -4.7 | -0.7 | 0.4 | 2.8 | 1-9/02 | |
| Gross wage, € period average | 113 | 158 | 195 | 227 | 262 | 282 | 313 | 350 | 406 | Q2/02 | |
| Unemployment, % (end-year, LFS data) | | | | 9.8 | 10.2 | 12.9 | 13.9 | 11.9 | 9.4 | Q2/02 | |
| Exports, € million | 1012 | 1242 | 1395 | 2035 | 2415 | 2364 | 3580 | 3748 | 2661 | 1-9/02 | |
| Imports, € million | 1307 | 1728 | 2181 | 3036 | 3420 | 3137 | 4442 | 4630 | 3552 | 1-9/02 | |
| Current account, % GDP | | -7.2 | -4.4 | -9.2 | -12.1 | -9.2 | -4.7 | -6.4 | -6.5 | -10.6 | 1-6/02 |

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

* Base year for GDP pricing changed from 1995 to 2000.

LATVIA

Growth accelerated in second quarter

In the second quarter of 2002, real GDP grew 4.9 % y-o-y. The rise in GDP was mainly driven by domestic demand, as export growth remained modest. Private consumption increased 7 % and gross fixed capital formation 14 % in 2Q02. Strong domestic demand sustained growth that was higher than in the first quarter in nearly all production sectors. Among the major service categories, trade and real estate and corporate services continued to post strong growth. In the third quarter, industrial output was up 7 % y-o-y and rapid growth in retail trade continued.

As in other Baltic countries, inflation in Latvia slightly accelerated in October mainly due to seasonal factors and annual inflation rate was 1.6 %.

Exports up in July-September

In July-September, Latvian exports increased 23 %. Growth remained strong in exports of foodstuffs and accelerated in wood and wood products, machinery and mechanical appliances, as well as in the metal sector.

According to monthly statistics, Latvia's current account deficit was 9 % of preliminary GDP in 3Q02 (7 % of GDP in January-September). Difficulties in the transport sector, particularly a decline in oil shipments, cut into the service sector surplus. Moreover, the trade deficit increased slightly as strong growth of imports continued. FDI inflows remained steady and were enough to cover nearly 80 % of the current account deficit in January-September.

Supplementary budget approved

In its final meeting, the outgoing parliament increased this year's fiscal deficit by LVL 11 million (€20 million). Additional funding will go e.g. to raising medical workers' wages and to paying compensation to farmers for drought losses. With the new spending, the planned fiscal deficit in 2002 should amount to 2.7 % of GDP. According to the former government, however, the deficit should stay below the IMF-agreed limit of 1.8 % of GDP, because tax revenues are running above budget.

Parliamentary elections and new government

Voter turnout for the 8th Saeima elections on October 5 was 72.5 %. The New Era Party received 24 % of the vote to become the biggest party in parliament with 26 seats. The leftist alliance For Human Rights in a United Latvia (PCTVL) took 19 % of the vote and 25 seats in the 100-seat Saeima. Former government leader, People's Party, won 20 seats, while the Fatherland and Freedom Party took 7 seats. Latvia's Way, which has previously participated in every Latvian government, received just 4.8 % of the vote, below the 5 % vote threshold needed to gain a seat. Latvia's First

Party won 10 seats, while the Union of Greens and Farmers took 12 seats in the new parliament.

The new coalition government was established under the direction of the New Era's founder and new Prime Minister Einars Repse. New Era formed the new government with the Union of Greens and Farmers, the First Party and For Fatherland and Freedom. Collectively, they hold 55 seats. In its first declaration, the government announced it wants to create an efficient state administration, a strong and independent judiciary, achieve full-fledged memberships in NATO and the EU, and eliminate crime and corruption. The government priorities also include balanced regional development and reducing unemployment.

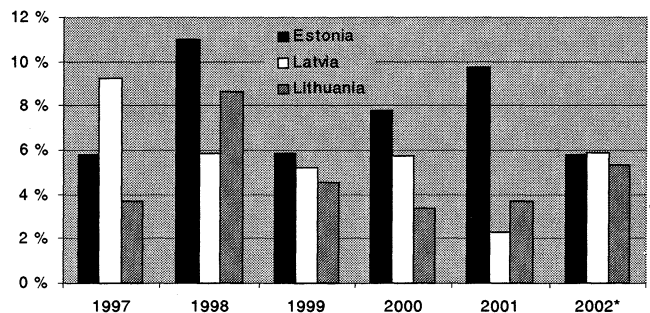
EU accession report released

In its regular report, the EU commission concluded that Latvia is a functioning market economy that should be able to cope with the competitive pressures within the EU as long as it continues with its current reforms. The report said Latvia has progressed well in many areas of the *acquis*, but there are still a number of challenges. The report mentions that corruption is still a cause of serious concern in Latvia. The administrative capacity in Latvia remains inadequate in certain areas and further efforts are needed to build up administrative capacity to manage structural funds and implement the Common Agricultural Policy. The EU also wants Latvia to emphasise prudent fiscal policy and improve labour market efficiency.

To date, Latvia has preliminary closed 27 chapters of the *acquis*. In addition to agriculture and budgetary issues, which are still under negotiation with all accession candidates, Latvia has yet to close the chapter on institutions.

On October 10, the Latvian parliament approved the deputy chief of the security police Guntis Rutkis to head the Corruption Prevention Bureau. The bureau was established in July to meet EU and NATO membership criteria. With its leader now designated, the bureau can begin actual operations.

Inflow of FDI as % of GDP



*) For 2002 the information is from January to September

| LATVIA | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | as of |
|--|------|------|------|------|-------|------|------|-------|------|--------|
| GDP, % growth | 0.6 | -0.8 | 3.3 | 8.6 | 3.9 | 2.8 | 6.8 | 7.7 | 4.4 | H1/02 |
| Industrial production, % growth | -9.5 | -6.3 | 1.4 | 6.1 | 2.0 | -8.8 | 3.2 | 6.9 | 4.1 | 1-9/02 |
| Inflation, % growth, end-year | 26.3 | 23.1 | 13.1 | 7.0 | 2.8 | 3.2 | 1.8 | 3.2 | 1.6 | 10/02 |
| General government budget balance, % GDP | -4.0 | -3.9 | -1.7 | 0.1 | -0.8 | -4.0 | -2.8 | -2.1 | -0.6 | 1-9/02 |
| Gross wage, € period average | 108 | 130 | 141 | 183 | 202 | 225 | 265 | 282 | 290 | Q2/02 |
| Unemployment, % (end-year, LFS data) | | | 19.5 | 14.1 | 13.7 | 13.2 | 13.3 | 12.9 | 13.3 | Q2/02 |
| Exports, € million | 857 | 1044 | 1172 | 1627 | 1796 | 1765 | 2237 | 2492 | 1910 | 1-9/02 |
| Imports, € million | 1110 | 1486 | 1800 | 2377 | 2804 | 2725 | 3387 | 3897 | 2939 | 1-9/02 |
| Current account, % GDP | -0.2 | -0.4 | -5.5 | -6.1 | -10.6 | -9.7 | -6.9 | -10.1 | -6.6 | 1-6/02 |

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

LITHUANIA

Brisk growth continues

According to preliminary estimates, Lithuanian GDP grew 6.6 % in the third quarter. Growth was observed in most economic sectors. Growth rates in the construction and service sectors (e.g. transport and communication and trade) were highest. Industrial output growth slowed from the second quarter to 5 % y-o-y in the third quarter. GDP growth for January-September was estimated at 6.1 %.

Analysts claim growth was supported by a rapid increase in investments that caused a surge in bank credit. The stock of loans to the private sector was up 33 % y-o-y at the end of September. Private consumption was still rising, along with a lively expansion in the retail trade. Growth in exports of goods and services (8 % y-o-y) supported GDP growth in the third quarter.

According to a labour force survey, unemployment dropped suddenly from 17.1 % in 1Q02 to 13 % in 2Q02. The monthly figures, based on registered unemployment, showed a substantial drop in the number of unemployed persons. However, statistical errors probably account for some of the four-percentage-point drop.

The decline in consumer prices stopped in October as consumer prices were up 0.6 % from September. Prices were up e.g. in transport and clothing. However, the annual inflation rate was still negative and showed deflation of 1.1 %.

FDI inflows enough to cover current account deficit

Monthly statistics indicate the current account deficit held at 3 % of GDP in July-September due to increased exports of services. Trade deficit was wider than in 3Q01 due to a strong growth in imports (13 % y-o-y). Exports were up 7 %. For January-September, the current account deficit amounted to 5 % of preliminary GDP. FDI inflows remained strong and were sufficient to cover the entire current account deficit in January-September.

Presidential elections in December

The first round of presidential elections will be held in conjunction with local elections on December 22. To run in the election, a candidate must collect at least 20,000 supporter signatures by November 7. Signature rolls were collected by 17 candidates including current President Valdas Adamkus, Deputy Parliament Chairman Vytenis Povilas Andriukaitis from the Social Democratic Party, former prime minister Eugenijus Gentvilas from the Liberal Union and Parliament Chairman Arturas Paulauskas from the New Union Social Liberal Party. If no candidate wins an absolute majority in the first round, a second run-off vote between the two leading candidates will take place on January 5.

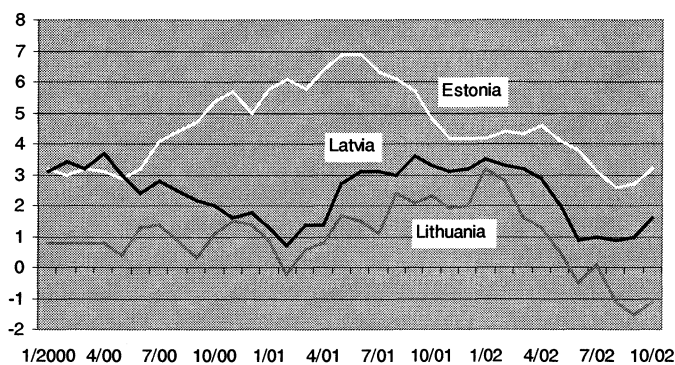
EU releases regular report in October

The European Commission October report says the EU expects Lithuania to be able to assume the obligations of EU membership by the beginning of 2004 as long as it continues the implementation of the commitments it has made during its membership negotiations. Lithuania is included in the group of ten nations expected to conclude EU membership negotiations by the end of the year. Currently, Lithuania has closed 28 chapters of the *acquis*.

In its report, the Commission repeats its earlier view that Lithuania is a functioning market economy that should be able to cope with the competitive pressures within the Union if it continues with its current reforms. The report points out Lithuania must reinforce the administrative capacity of the institutions and take measures against administrative corruption. The Commission also wants to see Lithuania improve its management of public finances, deal with its high unemployment and complete its pension reform program.

One of the most difficult issues in Lithuania's EU membership negotiations has been the EU's demand that Lithuania shut down the Ignalina nuclear power facility. In June, Lithuania agreed to shut down the two reactors by 2005 and 2009. However, how the decommissioning will be financed is still unclear. In October, the Lithuanian parliament approved an energy strategy extending the deadline for shutting down the Ignalina nuclear power facility in the event the EU and other international donors fail to come up with adequate funds to decommission the facility. So far, the EU and other donors have granted some €450 million for the decommissioning. The Lithuanian government estimates the costs of shutdown may reach €2.5 billion. When weighing the options of energy production after the decommissioning of Ignalina, the strategy includes the option of building a new nuclear reactor. The strategy also includes integration of the Lithuanian grid via the Polish grid with Western Europe to diversify Lithuania's access to electrical energy.

Inflation rates in the Baltic countries, %



| 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 | 3.8 | 5.9 | 5.7 | 1-6/02 | |
| Industrial production in sales, % growth | -26.6 | 5.3 | 5.0 | 3.3 | 8.2 | -11.2 | 5.3 | 16.9 | 4.7 | 1-9/02 | |
| Inflation, % growth, end-year | 45.1 | 35.7 | 13.1 | 8.4 | 2.4 | 0.3 | 1.4 | 2.0 | -1.1 | 10/02 | |
| General government budget balance, % GDP | -5.5 | -4.5 | -4.5 | -1.8 | -5.8 | -8.2 | -2.8 | -1.9 | -0.9 | Q1/02 | |
| Gross wage, € period average | 68 | 92 | 122 | 173 | 208 | 231 | 264 | 296 | 323 | Q2/02 | |
| Unemployment, % (end-year, LFS data) | | | | 14.1 | 12.6 | 15.3 | 16.1 | 17.5 | 13.0 | Q2/02 | |
| Exports, € million | 1705 | 2066 | 2687 | 3710 | 3537 | 2941 | 4403 | 5432 | 4511 | 1-9/02 | |
| Imports, € million | 1877 | 2599 | 3393 | 4726 | 4893 | 4254 | 5602 | 6663 | 5506 | 1-9/02 | |
| Current account, % GDP | | | | -2.1 | -10.2 | -12.1 | -11.2 | -6.0 | -4.8 | -6.3 | 1-6/02 |

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

Baltic States on their way to the European Union

by Soili Mäkeläinen-Buhanist*

The historic process launched in Copenhagen in 1993 to overcome the divisions in Europe and enlarge the European Union is about to be completed.

The accession negotiations of ten candidate countries are in their final stage. On October 24-25 in Brussels, the European Council took an important step towards wrapping up the accession negotiations at the Copenhagen European Council in mid-December.

Signing of the Accession Treaty is planned for April 2003. After that, both the current member states and the new member states must ratify the Treaty before the new members can enter the Union in 2004. The Baltic states, like most candidate countries, will also organise a referendum on the accession to the Union after the signing of the Treaty.

A look at the negotiations

Estonia started its negotiations in 1998; Latvia and Lithuania began in 2000. Since then each country has made steady progress in transposing and implementing the *acquis*.

Estonia and Lithuania have provisionally closed 28 and Latvia 27 of the 31 negotiation chapters. The Commission's latest progress report notes that the three Baltic states already meet the political criteria and should be able to fulfil the economic criteria and assume the obligations of membership in 2004. The Commission will closely monitor the commitments undertaken in the negotiations by the candidates and produce, six months before the date of accession, a report monitoring further progress.

Sensitive issues

None of the Baltics are satisfied with the agricultural production quotas offered by the EU. They argue that the Russian crisis in 1998 had serious negative consequences for their agricultural trade. This should therefore be considered in determining EU production quotas. In addition, most candidates argue for direct payments on a par with current EU members from the date of accession.

The EU member states reached agreement on budgetary and financial issues related to agriculture and structural operations at the Brussels European Council. As regards common agricultural policy, direct payments will be introduced gradually so that new member states reach the support level in 2013 then applicable to current EU members. The Council also decided to freeze market-related spending and direct payments in nominal terms during the period 2007-2013.

The future member states are worried about delays in receiving payments from structural and cohesion funds during the early post-accession years. The Brussels Euro-

pean Council confirmed that if the forecast cash flow balance with the Community's budget compared to 2003 is negative for individual candidate states during 2004-2006, temporary budgetary compensation will be offered.

The future member states also consider freedom of movement for persons an important issue. Some current members want safeguards on labour movements after enlargement. On the initiative of the Union, a reciprocal transitional arrangement was agreed for a maximum of seven years. A number of member states opted for immediate liberalisation of their labour markets. Finland, for example, will keep its current work permit system in place for two years after the enlargement and review the situation thereafter.

Estonia may continue oil shale production

The EU and Estonia have agreed on the most sensitive aspects of energy and taxation policy. In recognition of Estonia's need to restructure its oil shale sector, the EU accepted last July Estonia's request for a transition period to the end of 2008 before opening its electricity market to competition.

On the other hand, Estonia's request to maintain for six-and-half years after accession its right to engage in tax- and duty-free sales on ferries and other ships serving EU countries was rejected. The EU found the regime would distort competition in the internal market.

Latvia to focus on administrative capacity and judicial reform

Besides agriculture, Latvia has encountered few major problems in its accession negotiations. Nevertheless, the EU remains concerned about corruption and believes Latvia needs to further develop its administrative and judicial systems.

Ignalina, Kaliningrad dominate Lithuania's talks

The major challenge for Lithuania is the closing of the Ignalina Nuclear Power Plant and coping with the economic and social implications. Lithuania has confirmed that Unit 1 will be closed before 2005 and Unit 2 by 2009. The EU has promised to support the decommissioning of Ignalina.

Another complicated issue is how to organise the transit to and from the Russian enclave of Kaliningrad. The recent EU-Russia Summit established a basis for elaborating a pragmatic resolution of this issue.

* *The author is Counsellor at the Ministry for Foreign Affairs of Finland, Unit for EU-Enlargement.*

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Bank of Finland

Institute for Economies in Transition

PO Box 160 • FIN-00101 Helsinki

Phone +358 9 183 2268

Email bofit@bof.fi

Web www.bof.fi/bofit

Editor-in-Chief Tuuli Koivu

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