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ESTONIA

GDP growth decelerates slightly in first quarter

In the first quarter of 2003, Estonian GDP grew 5.2 % y-o-y in real terms. This was slightly more than analysts expected and due in part to subdued growth in the first quarter of 2002. Among the winners, financial intermediation increased 17 % and manufacturing 11 % y-o-y. A hard winter pushed up earnings of companies supplying electricity, gas and water by 10 %. Most sectors, however, saw growth slow from last year. Growth was particularly sluggish in the service sector. Transport and communication sector increased 4 % y-o-y, real estate, rental and business activities 3 % and trade only 2 %. In addition, construction grew only 2 %. Both agriculture and forestry declined 4 %.

On the demand side, growth was driven by a 33 % increase in gross fixed investments. Private consumption expenditure rose 7 %, while public sector consumption was up 6 % y-o-y. Exports of goods and services grew 5 %, while imports increased 16 %. As a result, net exports were strongly negative.

According to preliminary figures for April-May, growth continued to slow in the second quarter. Industrial output was up only 5 % and the outlook for the transport sector weakened.

Inflation continued to slow down in June as annual inflation dropped to all-time low 0.3 %. During the last 12 months, non-administered prices rose 0.5 % while administered prices fell 0.2 %.

Modest decline in unemployment

The ILO-defined unemployment rate was in the first quarter 10.6 % (11.2 % in 1Q02). Thus, unemployment continues to fall, but at slower pace than in 2002. Alarmingly, the youth unemployment rate stayed at 18 %. Unemployment has dropped most in the central and western regions. In the northern region, which includes Tallinn, the unemployment rate rose close to 10 %. In northeastern Estonia, unemployment has remained at around 20 %.

Worries over swelling current account deficit

In the first quarter of 2003, Estonia's current account deficit increased to 21.9 % of GDP. The extremely high deficit was due to a widening trade deficit as import growth was boosted by investments. A cold winter also increased imports of mineral products. The services balance surplus also declined. Exports of transport services suffered from the difficult ice conditions in the Gulf of Finland. On the other hand, imports of services increased due to Eesti Energy's large reconstruction project, which is being handled by foreign enterprises. FDI inflows increased to EEK 4.6 billion (€290 million) in 1Q03 thanks to Stora Enso's purchase of AS Sylvester, Estonia's largest saw-milling and wood procurement company. FDI inflows were sufficient to cover almost 80 % of the current account deficit.

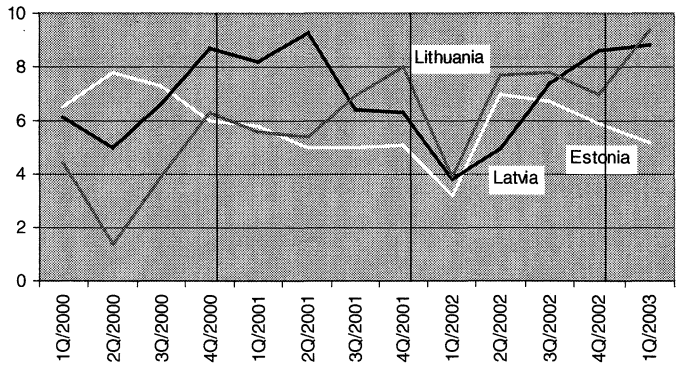
In April, the widening of the current account deficit stopped at least temporarily. Import growth slowed to 4 %, while exports were up 7 % y-o-y. The services surplus increased slightly and FDI inflows continued stable.

Despite the fact that FDI net inflows have been adequate to cover a major part of the current account deficit, the large deficit has started to worry the central bank, the ministry of finance and many analysts. Although there is no defined limit for a sustainable current account deficit, most economists see Estonia's current account figures as worrisome. The Estonian economy has become potentially more vulnerable to external shocks due to its large current account deficit.

Supplementary budget approved

Last month, the parliament approved a supplementary budget increasing this year's budget spending by EEK 1.1 billion (€71 million). Higher-than-expected tax revenues during the first months of 2003 made the extra budget possible. The additional spending will go mainly to the education sector and local administration. Construction of the Pärnu hospital and a prison in northeastern Estonia will be financed out of the state budget's treasury reserve.

Real GDP growth, % year-on-year



ESTONIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %-growth	4.3	3.9	9.8	4.6	-0.6	7.3	6.5	6.0	5.2	Q1/03
Industrial production, %-growth	1.9	2.9	14.6	4.1	-3.4	14.6	7.8	4.6	8.6	1-5/03
Inflation, %-growth, end-year	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.7	0.3	6/03
General government budget balance, % GDP	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.4	1.2		
Gross wage, € period average	158	195	227	262	284	314	352	390	405	Q1/03
Unemployment, % (end of period, LFS data)			9.8	10.2	12.9	13.9	11.9	11.3	10.6	Q1/03
Exports, € million	1242	1395	2035	2415	2364	3580	3748	3677	1243	1-4/03
Imports, € million	1728	2181	3036	3420	3137	4442	4630	4880	1730	1-4/03
Current account, % GDP	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-12.4	-21.9	Q1/03

Source: Statistical Office of Estonia, Bank of Estonia.

LATVIA

Higher-than-expected GDP growth in first quarter

In the first quarter of 2003, real GDP increased 8.8 % y-o-y. Growth occurred in all sectors of the economy. Highest growth rates (17 %) were registered in trade and construction. Manufacturing output rose 10 %. Despite a fall in oil shipping, the transport and communications sector grew a healthy 7 %, most likely due to an increase in railway transport.

Both domestic and external demand supported growth. Private consumption was boosted by an 11 % y-o-y rise in nominal gross wages and an increase in the number of employed persons. The loan stock continued to grow; as of end-April, the amount of loans granted to the private sector was up 40 % y-o-y. Loan growth was linked to an increase of 20 % in non-financial investments in January-March compared to the corresponding period in 2002. A quarter of investments went to industry, particularly the manufacture of wood and wood products, as well as production of foodstuffs and beverages. The transport, storage and communications sector, as well as wholesale and retail trade also received considerable investments.

The strong economic growth seems to have persisted after March. Industrial production increased 7 % y-o-y in April. In the transport sector, the outlook has improved as more oil has been shipped by rail. In May, despite the fact that the oil pipeline to Ventspils remained blocked, the amount of loaded cargoes in Latvian ports exceeded the amount of May 2002.

Inflation has picked up in Latvia since the beginning of the year. In May, annual inflation was 2.5 %. Since May 2002, the largest rises in prices (6.4 %) have been seen in clothing and footwear. Food prices are now 2.2 % higher than a year ago. In July, inflation will likely reflect higher natural gas prices.

Strong growth in foreign trade

In the first quarter of 2003, the current account deficit amounted to 5.7 % of GDP. The deficit doubled from 1Q02 due to an increase in the trade deficit. Import growth (22 % in lat terms) outpaced export growth (17 %). The surplus in the service balance remained at last year's level. FDI inflows were enough to nearly cover the current account deficit.

According to monthly statistics, the brisk export growth continued in April. The value of imports also rose, however, enlarging the trade deficit slightly from the corresponding period in 2002. The service balance surplus decreased somewhat, but was covered by increased current transfers from e.g. the EU. As a result, the current account deficit in April stayed approximately at last year's level.

Saeima approves supplementary budget

June amendments to this year's budget increased expenditure by LVL 32 million (€49 million). The approved supplementary budget substantially raises salaries in the health care and education sectors. In addition, the budget allocates funding to farmers, local governments and the State Highway Fund. The additional financing has been made possible by successful collection of budget revenues. According to the amended budget, the fiscal deficit will amount to 2.9 % of GDP in 2003.

Central bank governor expects Latvia to join euro in 2008

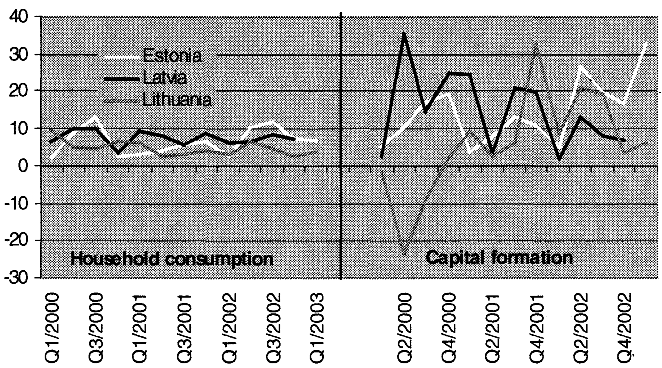
Bank of Latvia governor Ilmars Rimsevics says he expects Latvia to join the ERM-II and change the peg of the lats from the SDR to the euro at the beginning of 2005. After Latvia puts in the required two years in the ERM-II, Latvia will qualify for participation in the euro area hopefully by mid-2007. Thus, the governor sees the beginning of 2008 as a natural timing for introduction of a new currency. According to Rimsevics, the Latvian economy is performing well and currently fulfils the Maastricht criteria. However, the ceiling on the public sector deficit of 3 % of GDP may be exceeded this year.

In June, Estonian central bank governor Vahur Kraft announced that Estonia aims to join the euro area in summer 2006. His Lithuanian colleague, Reinoldijus Sarkinas, said that Lithuania's goal is to introduce the euro in 2007. Currently, both the Estonian kroon and Lithuanian litas are pegged to the euro under currency board arrangements.

Vike-Freiberga wins second term

The parliament voted to give 65-year-old president Vaira Vike-Freiberga a second four-year term on June 20. 88 deputies in the country's 100-seat parliament supported the re-election of the popular president. Vike-Freiberga was the only official candidate running in the popular election. Upon winning her second term, Vike-Freiberga reaffirmed EU and NATO memberships as the top short-term goals in Latvian foreign policy.

Year-on-year changes in GDP by expenditure approach in real terms, %



LATVIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, % growth	-0.8	3.3	8.6	3.9	2.8	6.8	7.7	6.1	8.8	Q1/03
Industrial production, % growth	-6.3	1.4	6.1	2.0	-8.8	3.2	6.9	5.8	9.1	1-4/03
Inflation, % growth, end-year	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	2.5	5/03
General government budget balance, % GDP	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-2.5	0.5	1-5/03
Gross wage, € period average	130	141	183	202	225	265	282	307	271	Q1/03
Unemployment, % (end of period, LFS data)		19.5	14.1	13.7	13.2	13.3	12.9	11.6	10.7	Q1/03
Exports, € million	1044	1172	1627	1796	1765	2237	2367	2570	888	1-4/03
Imports, € million	1486	1800	2377	2804	2725	3387	3862	4008	1368	1-4/03
Current account, % GDP	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-9.7	-7.8	-5.7	Q1/03

Source: Central Statistical Bureau of Latvia, Bank of Latvia.

LITHUANIA

Strong growth in most sectors

Lithuanian GDP grew 9.4 % y-o-y in real terms in the first quarter of 2003. Although the rapid growth arose partly from the low figure for the first quarter of 2002, it also indicates that the Lithuanian economy has been more resilient than expected against the global economic slowdown.

Most sectors experienced brisk growth in January-March. Growth was highest (27 %) in the electricity, gas and water supply – mainly a reflection of sharply increased production at the Ignalina nuclear power plant. Manufacturing climbed 16 %, while construction activity rose 18 % y-o-y. Almost half of all construction was new production, i.e. the share of reconstruction and repairs declined. Most construction activity (77 %) occurred in and around Vilnius. Despite the building boom, costs in the sector have risen modestly. In March, construction costs were only 0.3 % higher than a year earlier. Wages and salaries in the sector were up 3.7 %. In 2002, construction increased 13 %.

Growth slowed in the service sector in January-March. Among the most important service industries, wholesale and retail trade, as well as transport and communications, were up 8 % y-o-y.

Economic growth derived to a large extent from strong export growth. On the domestic side, public consumption (up 5 % y-o-y) and household consumption (4 %) continued to grow steadily. Growth of gross fixed investments slowed to 6 %.

The economic outlook appears to have deteriorated in April and May, although industrial output only declined slightly compared to the same period in 2002. The main reason for the decrease was the shutdown of Mazeikiu Nafta oil refinery for refurbishment, but there were also other areas of industry experiencing subdued growth. The transport sector was indirectly affected by the interruption in oil refining. Strong growth, however, continued in retail trade, where sales rose 14 % y-o-y in April.

Deflation has continued to abate and annual deflation in May ran at just 0.9 %.

Small current account deficit in January-March

In the first quarter of 2003, the current account deficit shrank to 3.6 % of GDP. A year ago, the deficit amounted to 4.6 % of GDP. This positive development largely reflected rapid growth of exports, which sharply decreased the trade deficit. The services surplus declined slightly compared to the first quarter in 2002. FDI inflows increased considerably compared to 1Q/02 and were sufficient to cover the entire current account deficit. In January-March, most foreign direct investments were allocated to communications, production of petroleum products and real estate.

The current account deficit widened in April as exports declined 10 % y-o-y. Again, the decline mainly reflects the modernisation project at the Mazeikiu Nafta oil refinery and the consequent decrease in the amount of exported refined oil. Textile exports also decreased slightly. The value of imports grew 1 % and the trade deficit widened. The services surplus decreased from April 2002 due to declines in transport and tourism.

Amendments to 2003 budget

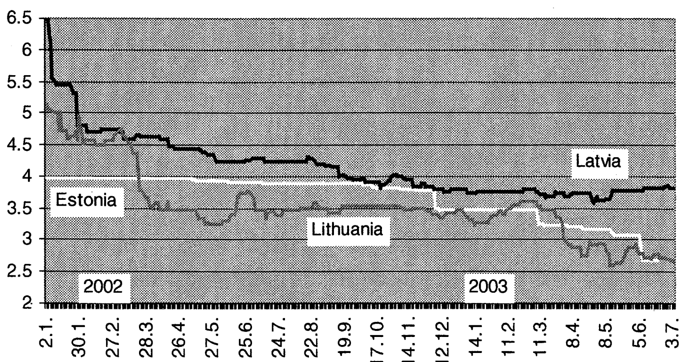
The Lithuanian parliament approved changes to this year's budget on July 3. Mainly due to decreased state debt servicing costs, LTL 193 million (€56 million) were redistributed. Increased funding will be allocated to agriculture, investments and law enforcement. The public sector deficit target of 2.1 % of GDP remains unchanged.

IMF encourages further reforms

The IMF mission conducted Article IV consultations with Lithuania in June. The IMF congratulated Lithuania for its robust economic growth, which, it noted continued to be driven by export growth in the face of a slowdown in EU economies. The Fund also praised the country's leaders for consistent implementation of sound economic policies and raised the GDP growth forecast from 5.3 % to 5.8 % for 2003.

Despite its successes, the IMF reminded Lithuania of the importance of continued reforms. Two particularly important objectives are following through on pension reform and moving ahead with the remaining large privatisation projects. The Fund's representatives also said attention needs to be paid to banking and insurance supervision and administrative capacity. As the country's upcoming EU membership will increase public expenditures, Lithuania will need to keep an eye on both the expenditure and revenue sides of the budget. In this context, the IMF expressed special concern about the decline in tax revenues as a share of GDP, and encouraged the government to seek new sources of revenue.

Three-month interbank interest rates, %



LITHUANIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, % growth*	3.3	4.7	7.0	7.3	-1.8	4.0	6.5	6.7	9.4	Q1/03
Industrial production in sales, % growth	5.3	5.0	3.3	8.2	-11.2	5.3	15.9	7.5	8.3	1-5/03
Inflation, % growth, end-year	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	-0.9	5/03
General government budget balance, % GDP	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-1.9	-1.2		
Gross wage, € period average	92	122	173	208	231	264	296	332	326	Q1/03
Unemployment, % (end of period, LFS data)			14.1	12.6	15.3	16.1	17.5	13.0	13.6	Q1/03
Exports, € million	2066	2687	3710	3537	2941	4403	5432	6235	2179	1-4/03
Imports, € million	2599	3393	4726	4893	4254	5602	6663	7667	2505	1-4/03
Current account, % GDP	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-5.3	-3.6	Q1/03

Source: Statistics Lithuania, Bank of Lithuania.

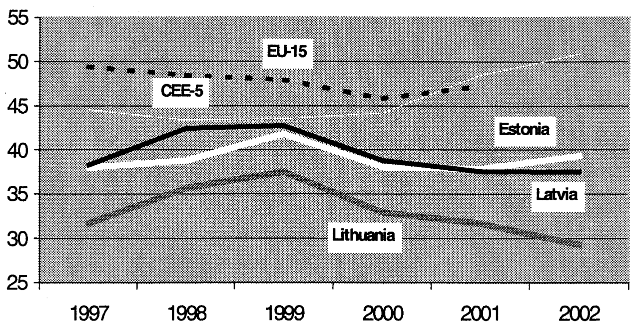
** Base year for GDP pricing in 1996 – 2003 changed from 1995 to 2000.*

Fiscal policy issues in the Baltic countries

by Tuuli Koivu and Iikka Korhonen*

The size of the public sector as a share of GDP increased in all Baltic countries in 1998-1999 as Russia's financial crisis caused an economic slowdown in the Baltics. Since then, the size of the public sector has decreased steadily. Baltic public sectors are currently considerably smaller than in the EU area or the five accession countries in central Europe. As a medium-term goal, the Baltics aim to further reduce the size of their public sectors.

General government expenditure, % of GDP



Note: CEE-5 = Czech Republic, Hungary, Poland, Slovakia and Slovenia
Source: EBRD, Eurostat

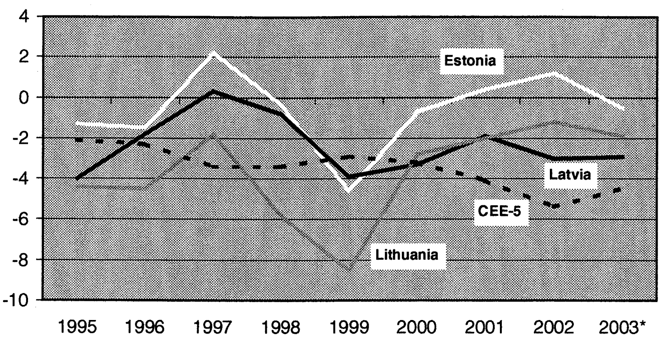
When comparing the expenditure of the public sectors of the Baltic countries to those in other accession countries or in current EU member countries, one notices a few differences. First, due to the low level of public debt, the Baltic countries use considerably less money on debt servicing. Second, spending on social and health sectors is noticeably smaller. As regards to the spending on housing and community amenities, the Baltic countries are closer the low amounts of spending in the EU countries than in central European countries. The Baltics also pay very small subsidies e.g. to agricultural producers.

With few exceptions, the basic elements of the Baltic tax systems are the same as in the EU countries. Most exceptions and concessions that prevailed in the first half of 1990s have been eliminated. In accession talks, the EU required that the Baltics abandon certain problematic features of their tax systems. Indirect taxes remain an important source of revenues and the Baltics apply flat rates in personal income taxation. Social security taxes are already at the level of the EU average in Estonia and Latvia. On the other hand, the Baltic countries have decreased their corporate income tax rates to attract foreign investment. In Estonia, reinvested profits are untaxed.

Small fiscal deficits

If one ignores the one-time effect of the Russian crisis in 1999, the Baltic countries have, on average, produced smaller fiscal deficits than other accession candidates. However, due to its higher deficits, Lithuania was an exception in the second half of 1990s. In the past two years, Lithuania has managed to keep its deficits below the level of central European accession candidates.

General government balance, % of GDP



* *Forecast.*
Source: EBRD, European Commission

There are apparently several factors contributing to small deficits. Rapid GDP growth and lower levels of public debt have helped the Baltics keep their deficits small. One explanation may be the fixed exchange regimes, which have placed restrictions on the conduct of fiscal policy. In addition, the Baltic countries, particularly Latvia and Estonia, seem to have budget institutions that are highly conducive to responsible fiscal policies. Indeed, Lithuania's higher deficits in the 1990s may be partly explained by its relatively weaker institutions. In the end, however, the interaction of multiple factors makes it impossible to identify any single determinant of low fiscal deficits.

Future spending pressures

The Baltics presently face strong pressures to spend. The forces militating for higher expenditures are led by the costs of pension system reform and additional costs related to EU and NATO memberships. All Baltic countries have announced that they will lift the share of defence spending to 2 % of GDP in preparation for NATO membership.

Net pressures for public finances stemming from EU membership are difficult to estimate. In any case, the overall direction is clear. Net expenditures will increase unless cuts are made in other areas. On the other hand, EU membership should confer significant indirect benefits on the Baltics. For example, structural reforms are likely to lift tax revenues.

The Baltic countries, faced with significant spending pressures in coming years, must now deal with the age-old balancing act that confronts all governments at some point, i.e. decrease expenditures or increase taxation.

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