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BALTIC ECONOMIES
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ESTONIA

Growth slowed more than expected

Estonian GDP grew 3.5 % y-o-y in the second quarter of 2003. Growth slowed significantly from the first quarter when GDP was up 5.2 % y-o-y and also fell below the forecast of 4.1 %. As a result, many analysts have recently lowered their forecasts for real GDP growth in 2003 from 5 % to around 4.5 %.

Domestic demand sustained GDP growth in the second quarter. Both private and public consumption increased 6 % y-o-y, while growth of fixed capital formation slowed to 4 %. The moderate pace of growth reflected poor performance in the export sector. Exports of goods rose only 3 % and exports of services declined 13 % compared to the second quarter of 2002. This was partly explained by the harsh winter, which hampered freight shipments and prevented the operation of high-speed ferries between Tallinn and Helsinki until mid-May. Both tourism and the transport sectors have had difficulties in recent months re-establishing steady growth. In the transport sector, the near-by Russian ports seem to have toughened the competition and the number of Finnish tourists travelling to Tallinn has decreased.

In the third quarter of 2003, domestic demand seems to have remained strong as on-year growth of retail trade remained at the 10 % level. In addition, the stock of bank loans to the private sector was up 24 % y-o-y at the end of September. Industrial production was up 10 % y-o-y in the third quarter. Growth was fastest in many smaller sectors, e.g. the manufacturing of chemical, plastic and fabricated metal products profited from export growth. Among the main manufacturing industries, food and beverages and wood products increased only 2 % y-o-y. Manufacturing of furniture and textiles declined.

Inflation has remained low since April. In October, the annual inflation rate was 1.0 %.

Large current account deficit persists

During the first nine months of 2003, Estonia's current account deficit remained at record-high levels. The expected fall in the deficit has yet to materialise. According to preliminary figures, the deficit amounted to 14 % of GDP in the third quarter and 16 % of GDP in January-September. The main reason for the large deficit has been strong import growth combined with stagnant exports of goods and services. A significant share of imports has been directed to investments, which remained strong, but consumption has also increased imports. Net inflows of FDI financed 55 % of the current account deficit in January-September. The rest was mainly financed by external loans to credit institutions.

Estonian exports rose 8 % y-o-y in the third quarter. For the period January-September, exports increased 9 % y-o-y as exports of wood and articles of wood climbed 12 %, furniture 15 %, base metals and articles thereof 23 % and machinery and appliances 11 %. Exports of textiles declined slightly from last year. Exports to CIS countries increased by a third, although their significance remained minor, given their share of total exports was less than 6 %. Exports to EU countries increased 10 % in January-September.

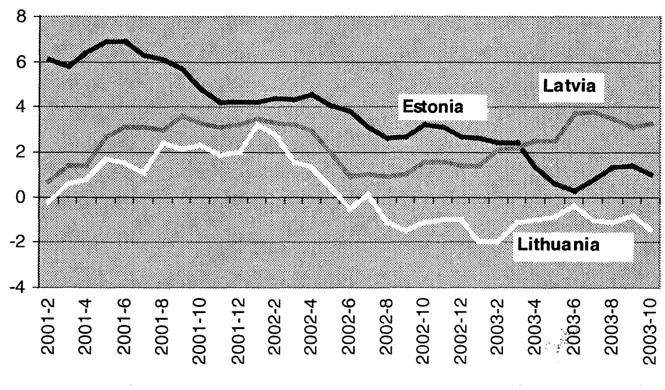
EU membership supported in Estonia and Latvia

In the referenda in September, 67 % of voters favoured EU membership both in Estonia and in Latvia.

The European Commission released in early November its final Monitoring Reports on acceding countries. According to the reports, the ten countries have reached a high level of alignment with the *acquis* in most policy areas. However, there are a few issues in each country's legislation or administrative capacity that should be completed or enhanced before accession in May 2004.

In Estonia's case, the issues of serious concern include the lack in legislation related to the mutual recognition of qualifications for certain professions, labour law and equal treatment of women and men. In addition, Estonia should enhance its anti-corruption measures and overall administrative and judicial capacity. From the macroeconomic perspective, the Commission was mainly worried about Estonia's gaping current account deficit and high unemployment.

Annual inflation rates in the Baltic countries, %



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	4.3	H1/03
Industrial production, %-growth	1.9	2.9	14.6	4.1	-3.4	14.6	7.8	4.6	9.6	1-9/03
Inflation, %-growth, end-year	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.7	1.0	10/03
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	393	442	Q2/03
Unemployment, % (end of period, LFS data)			9.8	10.2	12.9	13.9	11.9	11.3	10.7	Q2/03
Exports, € million	1242	1395	2035	2415	2364	3580	3748	3713	2923	1-9/03
Imports, € million	1728	2181	3036	3420	3137	4442	4630	4880	3999	1-9/03
Current account, % GDP	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-12.4	-16.4	H1/03

Source: Statistical Office of Estonia, Bank of Estonia.

LATVIA

Domestic and external demand drive growth

Strong economic growth seems to have continued in Latvia in the third quarter of 2003 as consumption in Latvia and exports of goods and services increased. Retail trade grew 13 % y-o-y in constant prices. Also industrial production continued its stable growth. Production was up 8 % y-o-y in July-September. Manufacturing of wood and wood products increased 16 %, rubber and plastic products grew 8 % and both food and beverages and furniture climbed 7 %. However, the production of textiles decreased 5 %. In the transport sector, the blockade of the crude oil pipeline to Ventspils continues. However, shipping and carrying of other types of freight has steadily increased. In the third quarter, freight loaded and unloaded at ports was up 15 % and cargo turnover by rail 31 % y-o-y.

Latvia's banking sector continued to enjoy strong growth. At the end of September, the stock of loans allocated to domestic enterprises and private persons was up 41 % y-o-y. Deposits were up 22 % y-o-y at end of September.

Inflation has remained rather high in Latvia over recent months. Higher rates compared to Estonia or Lithuania are partly due to the rises in administrative prices and also due to rising import prices as the lat is not pegged to the euro like the Estonian kroon and Lithuanian litas, but to the IMF's SDR, where the US dollar has biggest weight. In October, the 12-month inflation rate in Latvia was 3.3 %.

Growth of imports widens current account deficit

According to monthly figures, Latvia's current account deficit amounted to 9 % of forecast GDP in January-September and 10 % of GDP in 3Q03. The deficit was thus larger than in January-September 2002. The deficit ballooned due to fast growth of imports (20 %). Exports also increased, but only by 13 %. Imports have been driven by both investments and consumption. The service account surplus remained at last year's level and the increased transfers from EU slightly decreased the current account deficit. In January-September, FDI covered about 40 % of the current account deficit. The rest has been basically financed through increased external liabilities of banks.

In the third quarter, export growth slowed slightly, but continued strong (9 % y-o-y). In January-September, exports to every major market increased strongly. Exports to EU countries were up 22 % (share of exports 63 %) and to CIS countries 14 % (10 %). All the three main categories saw increased exports: wood and wood products (26 %), base metals and base metal semi-manufactures (18 %), as well as textiles and textile articles (15 %).

Fiscal deficit to decrease in 2004

Latvian parliament approved the budget for 2004 on November 13. The budget foresees the fiscal deficit to decrease to 2.0 % of GDP. In 2004, budget expenditures will rise 13 % in nominal terms to LVL 2.1 billion (€3.2 billion). Contributions to the EU budget, co-financing the EU projects and administrative costs related to the EU funds will increase the budgetary costs by LVL 90 million. Because of NATO membership defence spending will increase to 2 % of GDP. On the other hand, spending on health care will rise only 3 % and expenditures on education will remain at this year's level. On the revenue side, the main change is the lowering of corporate profit tax from current 19 % to 15 %. The budget assumes Latvian GDP to grow 6.1 % in 2004.

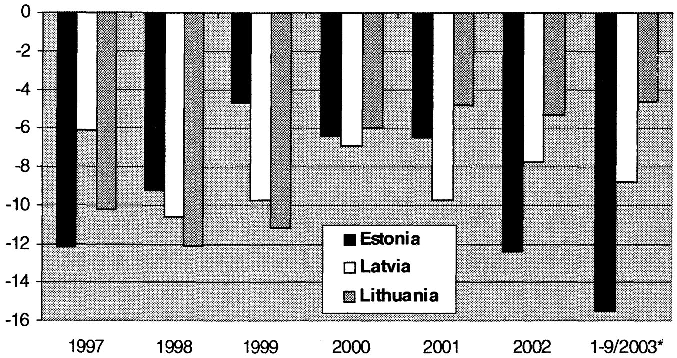
In November, the Latvian parliament approved also its second supplementary budget for 2003. The supplementary budget increased budgetary costs by LVL 19 million (€30 million). The key amendments were increases in compensation paid to farmers and subsidies to municipalities for renovation of schools, hospitals, roads, etc. After the supplementary budget, the fiscal deficit is estimated to be 2.8 % of GDP in 2003. The estimation was slightly decreased as the GDP growth forecast was raised.

In January-September, the general government budget had a small surplus as the favourable economic development boosted tax revenues. Traditionally, Latvia's deficit tends to increase sharply towards the end of the year.

EU Commission releases regular report

In its regular report, European Commission demanded that Latvia take immediate action to get its legislation on value-added taxation into compliance with the *acquis*. The Commission also wants Latvia to harmonise its system of mutual recognition of qualifications for certain professions. In addition, Latvia has to enhance the surveillance on some animal diseases and improve administrative and operational capacity in the customs. According to the report, corruption still remains a concern in Latvia and the fight against corruption is particularly important. The reform of public administration, especially the judiciary, should be continued. According to the Commission, structural rigidities still remain in the labour market and the environment for the creation of new enterprises should be improved.

Current account balance, % of GDP



* Based on preliminary data

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	7.5	H1/03
Industrial production, % growth	-6.3	1.4	6.1	2.0	-8.8	3.2	6.9	5.8	7.2	1-9/03
Inflation, % growth, end-year	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	3.3	10/03
General government budget balance, % GDP	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-2.5	0.2	1-9/03
Gross wage, € period average	130	141	183	202	225	265	282	307	308	Q2/03
Unemployment, % (end of period, LFS data)		19.5	14.1	13.7	13.2	13.3	12.9	11.6	10.6	Q2/03
Exports, € million	1044	1172	1627	1796	1765	2237	2367	2570	2069	1-9/03
Imports, € million	1486	1800	2377	2804	2725	3387	3862	4008	3338	1-9/03
Current account, % GDP	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-9.7	-7.6	-8.5	H1/03

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

LITHUANIA

Growth remains strong

According to a preliminary estimate, Lithuania's GDP was up 8.4 % y-o-y in the third quarter of 2003 and 8.1 % in January-September. Strong growth has continued in most sectors and has been driven by both domestic and external demand.

Industrial production was up 20 % in 3Q03 and 15 % y-o-y in January-September. Production and distribution of electricity climbed 28 % y-o-y. Of the key sectors, manufacturing of furniture (up 28 %) and food and beverages (10 %) increased most in January-September. Refined oil production rose slightly from the corresponding period in 2002. As in the other Baltic countries, the textile sector suffered from weak demand in Western Europe. In addition, some of the textile production has already been transferred to countries offering cheaper labour. Rapid growth continued in retail trade, thanks to strong domestic demand. Trade was up 12 % y-o-y in January-August and 18 % in July-August. Freight volumes in the ports and railways continued to increase in the third quarter as well. Over the last weeks, however, oil transportation has decreased.

In October, consumer prices were 1.4 % lower than a year ago.

Current account deficit remains under control

In the third quarter, exports were up 7 % and in January-September 8 % y-o-y. In January-September, exports of refined oil increased 10 % y-o-y and amounted to 19 % of all exports. Exports of furniture were up 39 % y-o-y, electrical machinery and equipment 19 %, and fertilisers 15 % y-o-y. Exports to Russia declined and their share in exports was 11 %. Lithuania has benefited particularly from an increase (11 %) of exports to other EU acceding countries. Despite the slowdown in the EU area, Lithuanian exports increased to most EU countries.

The current account deficit has remained rather small in Lithuania due to moderate import growth. In 3Q03, the deficit amounted to 3 % of estimated GDP. In January-September, the deficit was about 5 % of GDP. FDI net inflows were sufficient to cover about half of the gap. Imports (up 5 % y-o-y in Jan-Sept) have been boosted mainly by investments. In the first nine months of 2003, imports of capital goods rose 12 % and consumption goods 5 % y-o-y.

2004 budget submitted to parliament

The state budget foresees an increase in revenues of 23 % to LTL 11.7 billion (€3.4 billion) in 2004. Expenditures will increase 26 %, mainly as a result of the upcoming EU membership, which will increase co-financed investments and subsidies to agriculture. The budget deficit would be 3.3 % of GDP. The budget assumes 6.2 % GDP growth in 2004.

In the first half of 2003, the public sector deficit was 0.6 % of GDP. For all 2003, however, the deficit is expected to approach the forecast of 2.4 % of GDP.

Many privatisation projects still in the pipeline

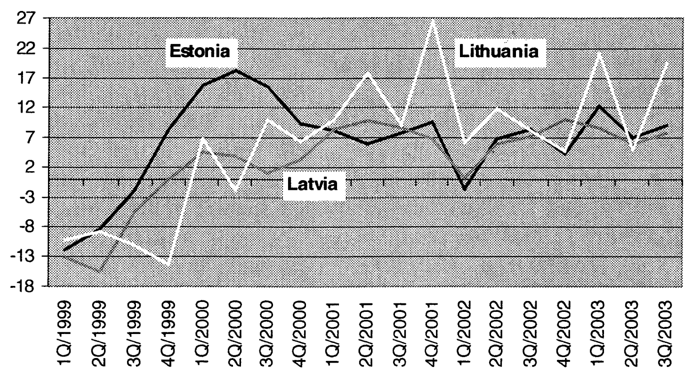
In the first ten months of 2003, Lithuania's income from privatisation projects amounted to LTL 330 million (€94 million). The biggest deals were the majority stake sell-offs in alcohol companies **Stumbras** and **Vilniaus Degtine** and in the shipping company **KTL**. The privatisations of two power distributors (**VST** and **RST**) and the electrical power generator **Mazeikiu Elektrine** are under way.

Many large projects, however, have been delayed. The negotiations on selling a 34 % stake in the gas company **Lietuvos Dujos** to the Russian Gazprom has taken more than a year. In October, the Lithuanian government finally accepted Gazprom's upwardly revised bid of LTL 91 million but the agreement has not been signed yet. Negotiations on selling two other alcohol companies, **Alita** and **Anyksciu Vynas**, were also prolonged due to uncertain information about the bidders. The privatisation of the shipping company **LJL** was complicated as one of the bidders sued over the procedure in court. New plans to privatise **Lithuanian Airlines** are in preparation as the first try to sell the company failed last spring. The State Property Fund is also planning to sell stakes in **the stock exchange** and **the securities depository**. In addition, the government has negotiated with the EBRD about a deal in which the bank would become a shareholder in oil company **Mazeikiu Nafta**.

EU monitoring report rather positive

The Commission's regular report found only few issues of serious concern in Lithuania. Lithuania was asked to amend its laws concerning the mutual recognition of professional qualifications and increase resources to control its fishing fleet. Resources in public administration and the judiciary should be increased so that they would have sufficient capacity to implement the *acquis* and manage structural funds. Overall, corruption is still a source of concern in public administration. The Commission encouraged Lithuania to form a comprehensive fiscal strategy and take measures to reduce unemployment and advance pension reform.

Year-on-year changes in industrial production, %



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	6.8	7.9	H1/03
Industrial production in sales, % growth	5.3	5.0	3.3	8.2	-11.2	5.3	15.9	7.5	15.0	1-9/03
Inflation, % growth, end-year	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	-1.4	10/03
General government budget balance, % GDP	-4.5	-4.5	-1.8	-5.8	-8.2	-2.8	-1.9	-1.2	-0.6	H1/03
Gross wage, € period average	92	122	173	208	231	264	296	332	337	Q2/03
Unemployment, % (end of period, LFS data)			14.1	12.6	15.3	16.1	17.5	13.0	12.9	Q2/03
Exports, € million	2066	2687	3710	3537	2941	4403	5432	6235	5023	1-9/03
Imports, € million	2599	3393	4726	4893	4254	5602	6663	7667	5849	1-9/03
Current account, % GDP	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-5.3	-5.9	H1/03

Source: Statistics Lithuania, Bank of Lithuania.

Baltic Transition in Retrospect
by Pekka Sutela*

This is the final issue of BOFIT's *Baltic Bimonthly Review.* This is not due to a declining interest in Estonia, Latvia and Lithuania. On the contrary, interest remains strong in Europe as elsewhere. Starting next year, the Pan-European Institute of the Turku School of Economics and Business Administration plans to start their monitoring report on the area. We shall inform our readers when the first issue comes out. From our point of view, these countries graduate from being a topic of our specific interest to being part of the EU area. We therefore leave the analysis to others and continue concentrating upon Russia. In addition, BOFIT will next spring introduce a monitoring report on China.

Past successes...

Obviously, there is no doubt that the three Baltic countries constitute a very major success story. Quite simply, who could have expected?

Who could have expected fifteen years ago that Estonia, Latvia and Lithuania would not only escape the collapse of the Soviet Union almost unscathed, but would also become members of the EU and NATO in 2004? Who could have expected that three small nations, with only very limited and rather less than completely successful experience of independence behind them, would manage in little more than a decade the building of sovereign states with competitive, but generally consensual, political systems and an internationally recognised level of human rights?

And, most importantly for us, who could have expected that Estonia, Latvia and Lithuania would be among the most successful transition economies, whether measured by GDP growth and other qualitative indicators?

Well, the Estonians, Latvians and Lithuanians believed – and they were right to do so. Given the small size of the nations and their exposed geopolitical position, they knew that they had to succeed. Given the generally cloudy views of Russian prospects a dozen years ago, the Balts believed that to re-emerge as free and prosperous nations, they had to integrate with Europe and the Euro-Atlantic community as a whole as fast and as deeply as possible.

For these countries, the external policy anchor provided by accession to the EU, NATO and other such organisations was exceptionally important. The widely shared will to accept the requirements set by membership in these organisations has more than anything else shaped policies in these countries, making them more consistent, transparent and long-term than they would otherwise have been.

Equally important, there has been a willingness to adopt simple, straight-forward and market-consistent policy regimes. Examples range from currency boards to innovative tax reforms.

Also, the leaderships of these countries understood that Estonia, Latvia and Lithuania would be too small entities to bloom on their own. Deep integration with Europe, in particular North-Western Europe has been the goal from the beginning. Speedy and full opening up of the economies, fixed exchange rates, and often giving priority to foreign owners in privatisation have all been part of this agenda. It has worked very well, but this is a solution that is not available to all countries.

... should not lead to complacency

But for the Baltics – like for all countries, always – the real test is ahead. EU membership likely will bring some new foreign investment, perhaps in food industries, for instance, but basically the prospect of membership has already been factored into investment decisions. Now it is a matter of already established companies showing their endogenous ability to compete and be innovative. Like in accession countries generally, research and development expenditure remains meagre.

The competitive edge offered by low labour costs is wearing thin. Textile and other companies are already moving further to the east. There is always another country with lower costs.

The experiences of earlier EU enlargements show that countries may try and benefit from membership in very different ways. The worst alternative, fortunately highly improbable for the Baltics, is to rely on hand-outs from Brussels. Likely, Estonia, Latvia and Lithuania will find the way to draw benefits of different kinds. Also, they will each surely want to make a mark of their own in the evolving EU development agenda.

Even the administrative demands set by a full-scale involvement in EU practices will be a major challenge. Fortunately, at the same time such demands may help the Baltics remedy a recurring problem in investment environment assessments and competitiveness reports: the need for public sector reform.

The balance of global economic power is turning away from "Old Europe," towards the Pacific Rim, South Asia and perhaps Latin America. Old Europe will remain very rich, but it needs reform and new blood to regain vitality. Accession countries like Estonia, Latvia and Lithuania will be able to inject some of that. But at the same time they will also be in the position to utilise their position between the Old Europe and the core of the New one, Russia. Whether they will be able to do that, primarily depends on internal developments in Russia, as well as in Belarus and Ukraine.

Looking backward, one is gratified. Looking forward, one is optimistic. So, let's raise our glasses – whether they contain Baltic water, Viru Valge, Rigas Balzams or Kalnapilis beer – and cheer these three nations.

**Dr. Sutela is the head of BOFIT.*

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