



## ESTONIA

### All time low inflation in April

Analysts believe Estonia's strong GDP growth continued in the first quarter of 2003. For example, industrial production was up 11 % y-o-y. Among the key sectors, manufacture of textiles and wood and wood products increased briskly. Many of the fast-growing smaller sectors, e.g. fabrication of metals and metal products, office machinery and computers, electrical machinery, as well as manufacture of medical, optical and precision instruments benefited from increased exports. Production fell in the chemical industry. Retail trade continued to enjoy brisk growth, thanks to lower unemployment, higher salaries and increased borrowing. The transport sector suffered from this winter's fierce ice conditions in the Gulf of Finland. The fast ferries between Tallinn and Helsinki, for example, only resumed service in mid-May. During January-April, cargo volumes at the Port of Tallinn were up just 1 % y-o-y.

Inflation slowed during the first months of 2003. In April, 12-month inflation dropped to a record low 1.3 % due to several factors. First, the hike in electricity prices implemented a year ago was excluded from the observation period. Second, prices of mobile phone calls, fuel, clothing and footwear fell in April. In addition, the rise in import prices was curbed by the euro's appreciation against dollar (the kroon is pegged to the euro). Analysts and the central bank, however, expect inflation to accelerate again in the summer.

### Current account deficit still widening

In the first quarter of 2003, Estonia's current account deficit increased to 18 % of estimated GDP. The high deficit was due to the widening trade deficit as import growth (16 % y-o-y) exceeded export growth (7 %). Import growth reflected increases in both investments and household consumption. The service sector surplus increased thanks to a rise in exports. Foreign direct investment and a €300 million eurobond launched by Hansapank financed the current account deficit. FDI inflows were dominated by a deal between AS Sylvester, Estonia's biggest sawmilling and wood procurement company, and Stora Enso.

Growth was somewhat stagnant in exports of wood and wood products and textiles. On the other hand, exports of electrical machinery and equipment were up 15 % y-o-y and furniture 14 %. Exports of many smaller sectors increased rapidly.

### IMF warns government on current account deficit

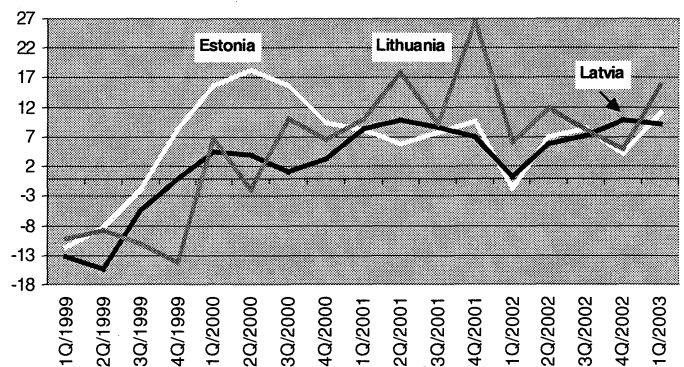
Estonia's new centre-right government started its work in April. The government is led by Juhan Parts, head of the Res Publica Party. The coalition government also includes the Reform Party and the People's Union. The government seeks to lower the income tax gradually from the current 26 % to 20 % by 2006. In addition, the untaxed share of monthly income would double. A supplementary budget with EEK 0.9 billion (€60 million) in spending was sent to parliament on May 7. The extra budget was made possible by higher-than-expected tax revenues.

IMF staff met the new government at the beginning of May. According to the IMF, prospects for the Estonian economy are favourable. However, the economy has become increasingly vulnerable due to the large current account deficit. To correct the imbalance, the IMF stressed the importance of fiscal policy in Estonia, where a currency board arrangement restricts the central bank's room for monetary manoeuvre. Thus, the Fund urged the government to save the fiscal surplus rather than implement a supplementary budget. The IMF also warned the government against a looser fiscal stance in coming years by hasty tax reductions.

### Fast-growing banking sector

At the end of March, total assets of Estonian banks reached EEK 88 billion (€5.6 billion). Deposits were up 16 % and the loan stock 23 % y-o-y. Loans to individuals grew fastest. As of end-March, loan quality remained good (share of non-performing loans 0.8 %) and the capital adequacy ratio of banks was high, 15.2 %.

### Year-on-year growth of industrial production, %



ESTONIA	1995	1996	1997	1998	1999	2000	2001	2002	2003	as of
GDP, %-growth	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	5.8		
Industrial production, %-growth	1.9	2.9	14.6	4.1	-3.4	14.6	7.8	4.6	11.0	1-3/03
Inflation, %-growth, end-year	28.9	14.8	12.5	6.5	3.9	5.0	4.2	2.7	1.3	4/03
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		
Unemployment, % (end-year, LFS data)			9.8	10.2	12.9	13.9	11.9	11.3		
Exports, € million	1242	1395	2035	2415	2364	3580	3748	3677	902	1-3/03
Imports, € million	1728	2181	3036	3420	3137	4442	4630	4880	1262	1-3/03
Current account, % GDP	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5	-12.5		

Source: Statistical Office of Estonia, Bank of Estonia.

# LATVIA

## Transport sector suffers from cut in oil shipments

Despite difficulties in the transport sector, GDP growth apparently remained brisk in the first quarter of 2003. Both domestic and external demand supported growth. In January-March, industrial output was up 9 % y-o-y. Production rose in nearly all industrial sectors. The important wood industry did well. Among the smaller sectors, manufacture of metal products, furniture, electrical machinery and equipment, and rubber and plastic products increased significantly. Strong growth also continued in retail trade (13 % y-o-y). Tourism benefited from a 15 % increase in the number of foreign tourists.

The outlook somewhat worsened in the transport sector due to a decline in crude oil transshipments. The Russian oil pipeline monopoly Transneft halted crude oil transshipments via oil pipeline to Ventspils at the beginning of 2003. The block will continue at least until the end of June. Ventspils Nafta has cured the situation somewhat by increasing transport of crude oil and oil products via rail. In January-April, Ventspils Nafta handled 4.4 million tonnes of oil and oil products, 39 % less than in the corresponding period in 2002. In addition, transport of other products via Ventspils increased and the other major ports of Latvia – Riga and Liepaja – augmented their transshipments. The total amount of cargo handled in January-April in the three biggest Latvian ports decreased only 5 % y-o-y, while railway cargo increased 22 %.

Latvia posted the highest inflation rate among the Baltic countries in April as 12-month inflation rose to 2.5 %. The acceleration was due to a rise in prices for clothing and housing. The Latvian central bank expects annual inflation to remain around this level in 2003.

## Strong growth in exports and imports

In the first quarter of 2003, the value of Latvian exports increased 17 %, while imports rose 22 % y-o-y. Among key exports, base metals and metal products increased 45 %, textiles 25 %, chemical products 23 %, and wood and wood articles 18 % y-o-y. Export growth to the EU remained strong (22 %) partly due to the low figure in 1Q02. Exports to CIS countries were up 11 %. The fastest rise in imports was in mineral products (92 %), a reflection of high oil prices.

Due to the fast growth of imports, the trade deficit increased from the 1Q02. Thus, despite the increase of the current transfers from EU, the current account deficit increased to about 5 % of estimated GDP in January-March. While FDI inflows declined slightly from 1Q02, they were nearly sufficient to cover the deficit in January-March.

## IMF demands enhanced fiscal prudence

The IMF concluded its annual Article IV consultations with Latvia in April. The IMF praised Latvia's good economic

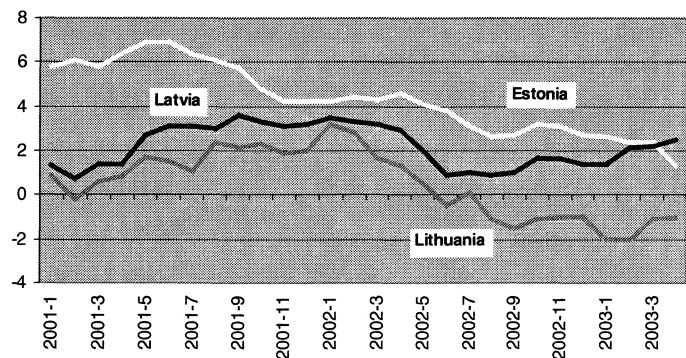
development over recent years and believes growth will continue in the medium term. However, the Fund expressed concern over persisting unemployment and the large current account deficit. The IMF also stressed the importance of prudent fiscal policy in preserving external balance. It expressed disappointment with Latvia's widening fiscal deficit at the end of 2002 and the deficit assumption of 3 % of GDP in the 2003 budget act. The Fund said it would welcome reductions of non-priority spending, better budget planning and improvements in the efficiency of spending. In addition, the IMF demanded improvements in local government fiscal discipline. The IMF also urged to delay further tax reductions until Latvia's fiscal performance has improved.

In the first quarter of 2003, Latvia had a fiscal surplus of LVL 14 million (€22 million). The surplus was due to brisk growth in tax revenues. The government has agreed preliminarily on a supplementary budget, which will increase spending by LVL 32 million this year. Most of the spending will be allocated to raising wages in health care and education. Traditionally, Latvia's budget deficits tend to grow towards the end of the year.

## Mortgage loans booming

At the end of March, the total assets of Latvian banks amounted to LVL 4.6 billion (€7.3 billion) or 3 % higher than a year earlier. Deposits increased 23 % overall, and the share of non-resident deposits was 51 %. In Latvia, over half of all loans are granted in foreign currency. The loan stock was up 32 % y-o-y at the end of March. Loans to private persons rose 79 % y-o-y. As in other Baltic countries, mortgage lending led growth. There are various reasons for the rapid growth in mortgage lending. First, interest rates have fallen. Second, thanks to the higher wages and decreased unemployment, more households have become eligible to get a mortgage from a bank. Finally, increased competition among banks has decreased interest rate margins.

## Annual inflation rates in the Baltic countries, %



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		
Industrial production, % growth	-6.3	1.4	6.1	2.0	-8.8	3.2	6.9	5.8	9.0	1-3/03
Inflation, % growth, end-year	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	2.5	4/03
General government budget balance, % GDP	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-2.1	-2.5	1.2	1-3/03
Gross wage, € period average	130	141	183	202	225	265	282	307		
Unemployment, % (end-year, LFS data)		19.5	14.1	13.7	13.2	13.3	12.9	11.6		
Exports, € million	1044	1172	1627	1796	1765	2237	2367	2570	669	1-3/03
Imports, € million	1486	1800	2377	2804	2725	3387	3862	4008	1077	1-3/03
Current account, % GDP	-0.4	-5.5	-6.1	-10.6	-9.7	-6.9	-9.7	-7.8		

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

## LITHUANIA

### Strong GDP growth continues in the first quarter

Preliminary figures indicate Lithuania's real GDP grew 9.1 % in the first quarter of 2003. The surprisingly high growth was partly the result of a slowdown in GDP growth in 1Q02. The Department of Statistics reported that strong growth was underpinned by growth in industry, construction, transport and communications. Growth in retail trade and in the hotel and restaurant sector was more modest.

Lithuanian industrial output rose 16 % y-o-y in the first quarter. Most industrial sectors saw rapid increases in production. Highest growth was registered in production of electricity, foodstuffs, refined oil, furniture, vehicles and related components, as well as machinery and equipment. In the transport sector, the national railway company reported a 16 % increase in freight traffic in January-April. At the same time, Lithuania's biggest port, Klaipeda, handled 12 % more cargo than it did a previous year. Growth in retail trade slowed somewhat at the beginning of the year. In the first quarter of 2003, the turnover of retail trade sector was 8 % higher than a year ago.

Annual deflation was 1.0 % in April. Lithuania's deflation is mainly due to a correction of last year's exceptionally high food prices back to the level of previous years. In addition, import prices have remained steady due to the appreciation of the euro against US dollar. The Central Bank of Lithuania expects 12-month inflation will rise to a level above 1.5 % by the end of 2003.

### Export growth decreases trade deficit

Exports grew 21 % and imports 11 % y-o-y in 1Q03. The export growth was broadly based. In January-March, the exported amount of refined oil increased almost 60 % y-o-y as oil supplies from Russia returned to normal levels. The refinery margin was also particularly high in the first months of 2003. Exports of electricity, metals and metal products, as well as vehicles and related components, grew rapidly. Textile exports lagged, growing only 4 % y-o-y. As a result of redirecting refined oil exports to a Swiss company, Switzerland became Lithuania's most important export country in the first quarter of 2003. For the same reason, the share of exports going to EU countries declined from 52 % to 41 %. The value of exports to CIS countries declined 10 % y-o-y in 1Q03. The main reason for the decline was the appreciation of litas against the US dollar.

The increase of exports of many re-exported products after inward processing increased imports of intermediate consumption commodities by 23 % in January-March. For example, imports from Russia increased 38 % due to an increase in crude oil supplies. Imports of investment commodities were up only 1 % and consumption commodities declined 6 % y-o-y.

As a result of the rapid export growth, Lithuania's trade deficit shrank substantially in the first quarter. Thus, despite a decrease in the service balance surplus, the current account deficit remained modest at around 1 % of estimated GDP. FDI inflows exceeded the current account deficit.

### Booming banking sector

Lithuanian banking sector is relatively smaller than its counterparts in Estonia or in Latvia. However, after the end of the privatisation of the sector about a year ago the banking system in Lithuania seems to have become more efficient. At the end of March, the total assets of the Lithuanian banks amounted to LTL 17 billion (€ 5 billion). At the same time, the total amount of domestic credit was 8 % higher than a year ago. Loans to the private sector grew at a blazing rate of 33 % y-o-y. Households and most economic sectors increased their borrowing considerably. The capital adequacy ratio of Lithuanian banks was 14.7 %. The amount of non-performing loans has considerably fallen over recent years. At the end of March, the share of non-performing loans was 4.8 %.

### Lithuanians vote for EU membership

In the national referendum held May 10-11, EU membership received a higher-than-expected endorsement with 91 % of voters supporting membership. The turnout rate was 63 %, clearly surpassing the threshold of 50 % needed to make the referendum valid.

### Banking sector in the Baltic countries, end of March 2003

	Estonia	Latvia	Lithuania
<b>Number of banks</b>	7	22	14
<b>Total assets, bn €</b>	5.6	7.3	4.9
% of GDP	80	80	30
<b>Loans to the private sector</b>			
% of GDP	50	32	14
y-o-y %-change	22	50	33
share of loans in foreign currencies, %	83	55	51
<b>Deposits, y-o-y % change</b>	16	23	9
<b>Share of non-performing loans, %</b>	0.8	1.9	4.8
<b>Capital adequacy ratio</b>	15.2	13.8	14.7

Source: Central banks, Latvian Financial and Capital Market Commission

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		
Industrial production in sales, % growth	5.3	5.0	3.3	8.2	-11.2	5.3	15.9	7.5	15.7	1-3/03
Inflation, % growth, end-year	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	-1.0	4/03
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		
Unemployment, % (end-year, LFS data)			14.1	12.6	15.3	16.1	17.5	13.0		
Exports, € million	2066	2687	3710	3537	2941	4403	5432	6235	1708	1-3/03
Imports, € million	2599	3393	4726	4893	4254	5602	6663	7667	1828	1-3/03
Current account, % GDP	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-4.8	-5.3		

Source: Statistics Lithuania, Bank of Lithuania.

\* Base year for GDP pricing in 1996 – 2002 changed from 1995 to 2000.

# Information Technology Industry in the Baltic States

by Marja Nissinen\*

Reflecting their information society and knowledge economy strategies, the Baltic States prioritise technology intensive branches of industry. They hold ambitions to become international players in the IT market. Latvia, for instance, has set the goal of becoming a leading software service exporter in Eastern Europe by 2010.

Despite the shared vision, the IT industries in the Baltics have differentiated profiles with their specific strongholds. Estonia is most advanced in mobile technologies and wireless solutions; Latvia possess the biggest outsourcing capacity; Lithuania offers the best availability of programmers as well as some interesting software products.

The contribution of the IT sector to the national economy is still relatively modest in the Baltics. In 2001, the sector's ratio of value added to GDP accounted for around 4 – 5 % in each country, but this share is growing gradually. Investments in the Estonian IT industry accounted for 3 – 4 % of GDP in 2001. The annual growth rates of the IT market have varied around  $\pm 20\%$  in recent years. The Information Society Development Committee of Lithuania estimated the value of the Baltic IT market by segment in 2002 as follows (in million euros): software around 0.90, hardware more than 230, and services less than 150. The turnover of Lithuania's top twenty IT companies totaled 218 million euros in 2002.

The Baltic industrial associations assess that national information technology and telecommunications (ICT) sectors employ around 10,000 people in each country. The number of software specialists, who can be acknowledged as programming professionals, is smaller. According to a bold estimation, there might be 12,000 competent software developers in the Baltics altogether, but some question this estimation. The top 25 IT companies in Latvia employ over 3,000 professionals.

The total number of IT companies is assessed to be about 200 in Lithuania. In Latvia, respectively, the number of software companies is around 100, while the total number of ICT companies climbs to some 500. The corresponding figures for Estonia are 100 – 150 and 250 – 300.

## The Largest IT Service Firms, 2002 (in thousands of euros)

	Service revenue	Growth 02/01	Service of total	Total revenue	Growth 02/01
Microlink	19,584	23 %	32 %	61,200	4 %
Dati	14,918	38 %	100 %	14,918	38 %
Exigen	8,748	8 %	99 %	8,800	8 %
Alna	7,340	18 %	32 %	22,675	-9 %
IT Alise	5,359	32 %	78 %	6,880	46 %

Source: Prime Investment, May 2003.

Small companies, employing up to ten or twenty people, predominate the Baltic IT industry. This lack of depth weakens the capacity to receive large-scale projects. A narrow spearhead of large firms competes for major contracts

in each country. The leading IT companies by country are the Estonian Microlink (680 employees), the Latvian Dati (more than 400 employees), and the Lithuanian Alna (more than 200 employees).

Baltic IT companies mainly provide customised solutions or outsource their services rather than develop "green" software products of their own. Locally developed accounting and financial management products are sold mostly in the domestic market, where their heyday was in the 1990s. One of the few internationally successful software products is the Latvian GRADE, a graphical modelling tool for complex business and technology systems, which is used by Siemens among others.

Companies focusing on system development and integration belong to the most successful ones in the past years. The strong emphasis placed on e-government and e-business, especially e-banking, has created opportunities for developers of major infrastructure systems and innovative mobile technologies in Estonia. Latvia advertises the following competence areas: software re-engineering, implementation services for enterprise resource planning, advanced B2B internet solutions, CASE tools, payment card systems and localisation software. Lithuania's largest IT exporters are specialised in programming services, banking and telecommunications solutions, and business management system installation.

The most commonly used programming languages in the Baltics are SQL, C++, Visual Basic and Java. Typically used technologies are based on relational database systems that involve a client-server architecture or on the internet environment. The major domestic customers come from financing, telecommunications, public administration and increasingly manufacturing.

The main export markets of the IT industry are located in Western industrialised countries, especially in the Nordic countries, Germany and the United States, although the Baltic neighbours and Russia are also among the target regions. Lithuanians joined the Latvian Information Systems Cluster project this year, which means that the two countries aspire to building a pan-Baltic IT cluster.

In the future, the Baltic IT industry should focus more on research and development. However, companies first have to build up capital. A threatening shortage of the highest level specialists with postgraduate degrees constitutes another challenge.

*\*The author is a senior researcher at VTT technology studies. The article is based on a study "The Baltics as a Business Location for Information Technology and Electronics Industries" published in 2002 as a VTT research note Number 2169. The whole study is available at [www.vtt.fi/trr](http://www.vtt.fi/trr).*

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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](mailto:bofit@bof.fi)  
Web [www.bof.fi/bofit](http://www.bof.fi/bofit)

Editor-in-Chief Tuuli Koivu

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