BANK OF FINLAND
Institute for Economies in Transition

BALTIC ECONOMIES
The Quarter in Review
1 • 1999

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ESTONIA

Economic growth slows

While Estonia was among the fastest growing transition economies last year, growth has been slowing. In the first three quarters, GDP grew by 5.4% from a year earlier. However, in the third quarter, growth slowed to 1.7% from the same period the previous year. To some extent, the slow-down in economic growth has been a conscious aim of the Estonian authorities. In the autumn of 1997, measures were taken to dampen extremely rapid growth by tightening fiscal and monetary policies. The effects of these policies coincided with the Russian crisis a year later.

The crisis in Russia has hit Estonian food producers hardest, as a large share of their output has gone to Russia for several years now. Industrial production grew by only 1.5% in 1998, compared to 13% a year earlier.

There are, however, signs that towards the end of 1998, exports to Russia started to recover. In spite of the developments in Russia, cargo transit through Estonian ports showed an increase of more than 30% last year.

Inflation normalizing

Estonia's inflation rate came down considerably during last year. In December, 12-month inflation reached a low of 6.5%. Among the factors contributing to the slow-down were relatively tight fiscal and monetary policies and drops in both domestic and foreign demand.

According to preliminary information, the consolidated government budget recorded a deficit of 0.3% of estimated GDP in 1998. Compensation payments to depositors of a failed bank and remuneration paid to farmers for crop failures were the main causes for the larger than planned budgetary expenditure.

Current account deficit remains a problem

The huge current account deficit is one of the major worries in the Estonian economy. The situation has, however, been improving lately. Despite the negative effects of the Russian crisis, Estonia managed in the third quarter to squeeze the deficit below 8% of GDP. Thanks mainly to a growing service account surplus, the cumulative deficit for January-September declined to 9.5% of GDP from 12% in 1997. Both exports and imports continued their rapid growth, although at a decelerating pace.

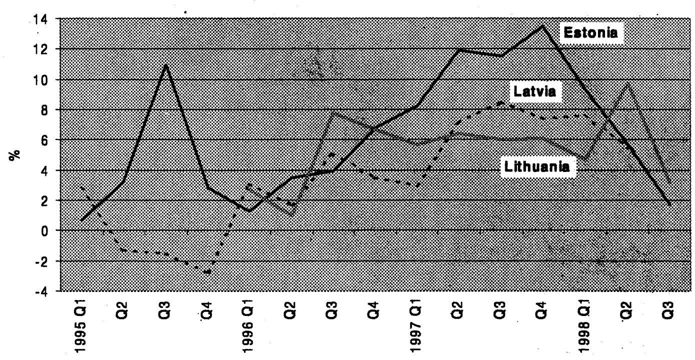
Banking sector consolidation proceeds

The Estonian banking sector has developed with remarkable speed since the start of economic transition owing to the rapid liberalization of markets, limited state involvement, and openness to foreign capital. These conditions have made Estonia's largest banks attractive to foreign investments. A bidding war between two Swedish banks over stakes in the biggest bank in the Baltics, Hansapank, ended in November with Swedbank holding almost half of the bank's shares. The other Swedish bank, SEB, settled for a one-third stake in Ühispank, Estonia's second largest bank.

At the same time, consolidation of the sector proceeded by mergers and closures of smaller banks, brought about by the central bank's tighter capital requirements and the financial difficulties of certain banks. In October, the Estonian central bank was compelled to rescue the country's third and fourth largest banks, which were thereafter merged. As a result of these developments, the Estonian banking sector now consists of just five domestic banks, and one foreign branch. Estonia started 1998 with eleven domestic banks.

The Russian crisis has also affected the banking sector. Last year proved generally disappointing for the banks, with only one, Hansapank, showing a small profit. Combined losses in the sector amounted to 7.5% of total assets.

GDP in the Baltics, year-on-year growth



ESTONIA	1994	1995	1996	1997	1998,	as of
GDP, %-growth	-2.0	4.3	4.0	11.4	5.4	Q1-3/98
Industrial sales, %-growth	-3.0	2.0	3.4	13.0	1.5	
Inflation, %-growth, December-December	41.7	28.9	14.8	12.5	6.5	
Average wage, USD, annual average	134	208	248	256	284	Q1-3/98
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	4.8	10/98
Exports, USD million	1320	1854	1814	2298	1937	Q1-3/98
Imports, USD million	1681	2526	2835	3427	2822	Q1-3/98
Current account, % GDP	-7.2	-5.2	-9.2	-12.0	-9.7	Q1-3/98

Sources: Statistical Office of Estonia, Bank of Estonia

LATVIA

Production suffers due to the Russian crisis

The growth of the Latvian economy slowed considerably in 1998. In the third quarter, 12-month growth amounted to only 1.9%, compared with 5.4% in the second quarter. During the first three quarters, GDP increased by 4.9%. The deceleration is clearly evident in industry, where production in December declined by 13% from the previous year. During the whole of 1998, industrial production still showed an increase of 2%.

Cargo transit to and from Russia, especially Russian oil exports, are important for the Latvian economy. Last year, in spite of the Russian crisis, cargo handling in Latvian ports was up by 3%.

Inflation record exceptionally good

Latvia's inflation continued to decelerate towards the end of 1998. In December, 12-month consumer price inflation came down to 2.8%. With that figure, Latvia had one of the lowest inflation rates among all Central and Eastern European countries. Tight monetary and fiscal policies, with the consolidated government budget in surplus, continued in Latvia throughout last year and were instrumental in achieving the good inflation performance. In addition, the Russian crisis had a dampening effect on demand.

Current account deficit balloons

Latvia has traditionally had the smallest current account deficit in the Baltics. In 1997, it amounted to 6% of GDP. Last year, the deficit started to grow rapidly, reaching almost 10% of GDP during the first three quarters. In the third quarter alone, the deficit was 13% of GDP. Fast import growth was one of the factors behind the surge of the deficit. Also exports continued to grow, but at a slower pace than imports. Exports to Russia and other CIS countries were especially hard hit, while exports to the West continued their strong growth.

New government takes office

After almost two months of negotiations following the October parliamentary elections, a minority government was sworn in at the end of November 1998. The government consists of centrist parties, led by the Latvia's Way party which has participated in most governments during Latvia's new independence. The new government is not expected to introduce any major changes in reform policies. It has stated that one of its main tasks is to lead the country to negotiations on membership in the EU.

Certain structural reforms, in particular privatization, were delayed during the pre-election period and the lengthy government formation process. Now it is hoped that privatization gets going again. A few major deals are being prepared, including the sales of Latvenergo, the electricity utility, and LASCO, the state shipping company.

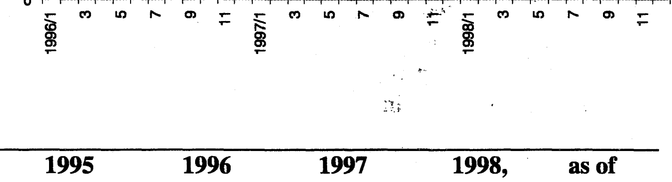
In conjuction with the parliamentary elections, a referendum was held on changing the citizenship law. Most voters favoured the amendments adopted earlier by the parliament. The amendments ease naturalization requirements set for non-Latvians. Passage of the amendments was seen internationally as an important step in improving the status of Latvia's ethnic minorities.

Latvians disappointed by EU assessment

In November, the European Commission published its regular reports on the 12 countries which have been approved for the accession process. In the report, the Commission commended Latvia for considerable progress in establishing market economy structures and for introducing EU-harmonized legislation during the past year. The Commission concluded that if the progress continues, membership negotiations can be opened during 1999. Nevertheless, the decision came as a disappointment to the government. The general opinion in Latvia was that Latvia had already reached a point in its reforms corresponding to that of Estonia's when it was admitted to membership negotiations.

In October, the World Trade Organisation (WTO) accepted Latvia into its membership after long negotiations. Latvia was the first Baltic country, and along with Kyrgyzstan, the first former Soviet Union republic to enter the organization.

Inflation in the Baltics, year-on-year growth



LATVIA	1994	1995	1996	1997	1998,	as of
GDP, %-growth	0.6	-0.8	3.3	6.5	4.9	Q1-3/98
Industrial production, %-growth	-9.5	-6.3	1.4	6.1	2.0	
Inflation, %-growth, December-December	26.3	23.1	13.1	7.0	2.8	
Average wage, USD, annual average	128	170	179	207	220	Q1-3/98
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	
Exports, USD million	1020	1367	1488	1839	1070	Q1-2/98
Imports, USD million	1321	1947	2286	2689	1533	Q1-2/98
Current account, % GDP	5.5	-0.4	-5.5	-6.3	-9.2	Q1-3/98

Sources: Central Statistical Bureau of Latvia, Bank of Latvia

LITHUANIA

Economy grows, but at a decelerating pace

Lithuanian GDP grew during the first three quarters of 1998 by 5.7% from the same period a year earlier. Since the summer of 1998, the pace has slowed down, mainly due to effects of the Russian crisis. In the third quarter, the growth was 3.2%.

Industrial production increased by 7% last year, which was by far the largest increase among the Baltics. The trend is down, however, as December showed a decline in production of almost 10% from December 1997. During the year, food production almost stagnated, while big increases were recorded in some sectors of machine building.

Inflation falls to new lows

Lithuanian inflation fell fastest among the Baltics in 1998 with consumer prices increasing by only 2.4%, compared to 8.4% the previous year. At end-1998, Lithuania's inflation was the second lowest (after Bulgaria) among transition economies.

For 1998, Lithuania had planned a consolidated government budget deficit of 1.6% of GDP. According to preliminary information, budget revenue slightly exceeded the planned figure, while no information on expenditure is yet available. For the current year, the consolidated government budget is planned to be in balance. This implies a considerable fiscal policy tightening in response to a large current account deficit and rapidly growing wages.

Current account deficit increasing further

As in other Baltic states, the external imbalance is one of the biggest problems facing the economy in Lithuania. In 1998, the current account deficit continued to grow, reaching 13% of GDP during the first three quarters. In the period January–November, the trade deficit grew by a quarter from the year before, with imports growing about twice as fast as exports.

Up until last year, Lithuania has not been very successful in attracting foreign direct investment. As a result, unlike in the other two Baltic states, a major part of the current account deficit has been financed by borrowing and portfolio investment, and not by foreign direct investment. The situation changed when the privatization of Lithuanian Telecom brought about a surge in FDI inflow in mid-1998. The large one-time increment is clearly visible in the international reserves of the central bank.

Structural reforms in Lithuania have proceeded slower than in the other two Baltic states. One reflection of this is the limited interest of foreign investors. The European Commission stated in its report in November that Lithuania has made progress in economic reforms, but further measures, especially in implementation of new laws, are needed before it can be invited to membership negotiations.

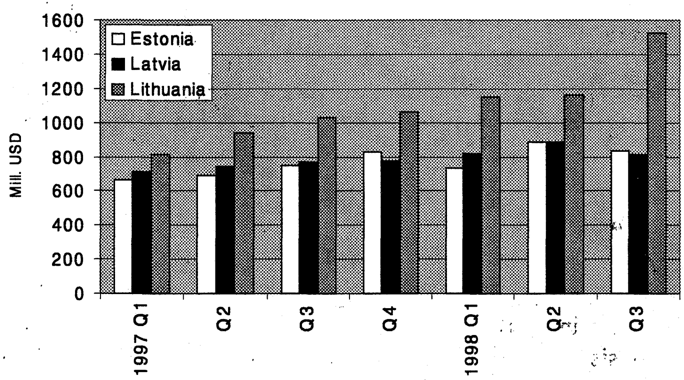
Currency board to stay in place

Lithuania's monetary system is based on a currency board arrangement, introduced in 1994. Since then, the litas has been pegged to the US dollar at four litas per dollar. Discussions on abolishing the arrangement have been frequent during the past few years, sometimes causing uncertainty about the future of the peg. In 1996, the government decided to gradually switch over from the currency board system to a conventional monetary policy regime with an active central bank. Preparations for that started the following year.

The need to secure credibility in a volatile international financial environment, however, delayed the implementation of the plan. Last autumn, the government and the central bank decided to postpone at least till the year 2000 the final phase of the plan, which would involve scrapping the currency board and possibly unpegging the litas from the dollar.

Lithuania has, together with the other Baltic states, been able to weather the recent disturbances in international financial markets. Official reserves of the Lithuanian central bank at year-end 1998 were sufficient to cover more than two months' worth of imports, which is considered adequate by international standards. The share was roughly the same for Estonia and Latvia.

International reserves of the Baltic central banks, USD mill.



LITHUANIA	1994	1995	1996	1997	1998,	as of
GDP, %-growth	-9.8	3.3	4.7	6.1	5.7	Q1-3/98
Industrial production, %-growth	-26.6	5.3	5.0	0.7	7.0	
Inflation, %-growth, December-December	45.1	35.7	13.1	8.4	2.4	
Average wage, USD, annual average	81	120	155	196	252	
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	
Exports, USD million	2020	2706	3413	4192	3194	Q1-3/98
Imports, USD million	2220	3404	4309	5340	4244	Q1-3/98
Current account, % GDP	-2.1	-10.2	-9.2	-10.2	-13.0	Q1-3/98

Sources: Lithuanian Department of Statistics, Bank of Lithuania

The effect of Russian crisis on the Baltic countries

by Iikka Korhonen*

For obvious reasons, Russia has been a very important trading partner for all Baltic countries. In Latvia and Lithuania it has been the leading trading partner, and in Estonia Russia has been among the top three countries. (This despite the fact that Russia has levied higher customs duties on Estonian goods. Estonian producers have responded by rerouting some of their exports through other countries, which means that the official statistics underestimate the size of exports to Russia.) However, during 1998 Russia's relative importance began to wane, and after the August crisis exports to Russia have plummeted.

The table presents Baltic exports to Russia for 1997 and the first eleven months of 1998. One can easily see how exports to Russia have decreased both in absolute and relative terms. Beyond this, the Baltic countries have also been hit by knock-on effects from economic problems in two other large CIS countries, namely Belarus and Ukraine. Especially in Lithuania's case, these two countries have been quite important. In 1997, Belarus and Ukraine accounted for 19% of Lithuania's exports.

Because the Russian market has been so important it is clear that the drastic reduction in Russian demand represents a large macroeconomic shock to all Baltic countries. The deceleration in Baltic GDP growth was already apparent in the figures for the third quarter of 1998, and this year's growth forecasts are generally lower than last year's growth. For example, the IMF forecasts GDP growth in Latvia of 5%, in Lithuania 4% and in Estonia 3.6%.

Uneven impacts

The effects of declining exports to Russia have been distributed quite unevenly. In all countries, food producers had relied heavily on exports to Russia. Currently, many Baltic foodstuff companies are struggling. For example, the largest fish processing plant in Estonia has gone bankrupt. Food exports are quite hard to reorient to other markets because so many countries restrict food imports.

The Russian crisis has meant that growth in the value of exports has been significantly lower than earlier. As the Baltic countries have all suffered from large external imbalances, some commentators have feared that the current slowdown in exports might aggravate the problem further. However, at least in Estonia the trade deficit has decreased during the autumn. Imports have declined as domestic demand has slumped. In Latvia and Lithuania, the trade deficit has continued to increase, although not at the same pace as before.

Russia's share of exports in the Baltic countries

	1997		1-11/ 1998	
	USD (millions)	% of all exports	USD (millions)	% of all exports
Estonia	550	18.8 %	381	13.3 %
Latvia	350	21.0 %	207	12.4 %
Lithuania	944	24.5 %	635	17.9 %

Financial sectors suffer mostly from indirect effects

Although the trade relations between the Baltic countries and Russia have been extensive, Baltic banks (with a few unfortunate exceptions) were not overly exposed in Russia. At the outbreak of the August crisis, the central banks of Estonia and Lithuania reported that their banks had invested only approximately 1 per cent of their assets in Russia. In Latvia, however, the situation was different and much more difficult. Of the banking system's consolidated assets over eight per cent had been invested in Russia. The Bank of Latvia was forced to close one small bank, and there was a run on the fourth largest bank, although it managed to stay liquid.

While the direct effect on Baltic banking systems has been modest, it is obvious that banks have been hurt by the general economic slowdown in the Baltic countries. Many large banks posted losses in 1998, or at least their profits declined substantially. Further effects on the results of the banks depend on the overall economic conditions. If Baltic companies are able to reorient at least part of their former Russian exports to other – mainly Western European – markets and/or Russian markets recover somewhat, Baltic banks should recover fairly quickly. If the overall economic recovery is slower, it will be reflected in banks' profits. During the past few months foreign banks have bought significant shares in the largest Baltic banks, and this should provide additional stability to Baltic banking systems.

Prices on the Baltic stock markets have been mostly on a downward trend during the last year or so, as have Russian stocks, but there is no statistical evidence that daily movements in the Russian stock prices affect Baltic stocks, with the possible exception of Latvia. Therefore the direct effects through this channel are also quite small.

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BALTIC ECONOMIES
The Quarter in Review
8 February 1999

ISSN 1456-4963

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