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Institute for Economies in Transition
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BALTIC ECONOMIES
The Quarter in Review
4 • 1999

ESTONIA

Recession reaching an end?

Certain positive trends have surfaced in the Estonian economy during recent months. Although gross domestic product contracted 2.3 % year-on-year in the second quarter of 1999, the drop was considerably smaller than the -5.6 % registered in the first quarter. In the second half of the year, the situation has improved further. Latest data on industry record growth for the first time this year, with industrial sales in September up by 3 % from a year earlier. During January-September, the decline in industrial sales amounted to 7.2 %.

For the current year as a whole, the Estonian Central Bank forecasts zero GDP growth or a contraction of up to 1.5 %. Growth is expected to gather momentum next year for which the Ministry of Finance foresees a GDP growth rate of 4 %. Annual inflation is expected to be around 4 % next year, implying some acceleration form the current rate of 2.8 %.

Current account moving closer to balance

Throughout this decade, the share of the EU in Estonia's foreign trade has risen considerably at CIS countries' expense. The trend has continued after the Russian crisis, but due to a large drop in trade with CIS countries rather than a huge rise in trade with the West. Estonia's exports to the CIS were down 50 % in the first half of 1999 from a year before, while exports to the EU were up 8 %. During that period, the EU's share in Estonia's exports grew 10 percentage points to 62 %. Similar developments can be observed in the other Baltic states.

Estonia's current account deficit, 9 % of GDP in 1998, has declined since. In the first half of this year it equalled around 5.5 % of GDP. The Estonian Central Bank estimates the deficit will stay at this level for the rest of the year.

Return to tight fiscal stance planned

The current year will form a clear exception in Estonia's traditionally good fiscal record, as the general government budget deficit will according to estimates reach 4 % of GDP. Besides recession, domestic politics have played a role. In the run-up to the spring 1999 parliamentary elections, the budget relied on overly optimistic growth prognoses to justify higher expenditures.

For 2000, Estonia aims – as required by law – at a balanced budget that would leave expenditure at roughly this year's level. Estonia and the IMF started in spring negotiations on a new precautionary stand-by arrangement after the expiration of the previous agreement. The negotiations have been drawn out by differing views on the scale of austerity measures required to correct the budget imbalance. Negotiations resumed in autumn and the conclusion of the new agreement is now foreseen for December. Estonia has never drawn funds under its stand-by agreements and also this time has stated its intention to use the arrangement only as an indication of the country's commitment to IMF-supported economic policies.

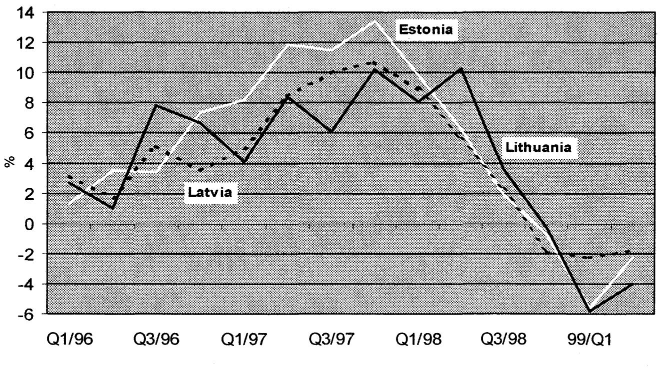
Local elections signal no changes

The local elections held in October reinforced the position of the three parties that form the ruling right-wing government coalition. The major opposition party, the centre-left Centre Party fared also well. This was the first time permanent residents without citizenship, mainly those belonging to the 35 % non-Estonian (primarily Russian) minority, were allowed to participate in local elections without prior registration. Even so, the election turnout was low: 49 % of all eligible voters and only 43 % among permanent residents.

WTO membership to enter into force

In October, the Estonian parliament ratified the charter of the World Trade Organisation. Estonia becomes the third former Soviet Union republic after Kyrgyzstan and Latvia to enter the organisation. The parliament also introduced a system of import duties in Estonia by approving a law that allows setting duties on products imported from countries outside the EU.

On-year change in Baltic GDP



ESTONIA	1994	1995	1996	1997	1998	1999,	as of
GDP, %-growth	-2.0	4.3	3.9	10.6	4.0	-3.9	H1/99
Industrial sales, %-growth	-3.0	2.0	3.5	15.2	2.3	-7.2	1-9/99
Inflation, %-growth, December-December	41.7	28.9	14.8	12.5	6.5	2.8	10/99
General government budget balance, % GDP	1.3	-1.3	-1.5	1.9	-0.3		
Average gross wage, USD, period average	134	208	248	256	283	300	1-6/99
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.6	9/99
Exports, USD million	1320	1854	1814	2293	2680	1787	1-9/99
Imports, USD million	1681	2526	2835	3419	3795	2393	1-9/99
Current account, % GDP	-7.2	-5.2	-9.2	-12.1	-9.2	-5.5	H1/99

Sources: Statistical Office of Estonia, Bank of Estonia

LATVIA

GDP contraction slows

While less severe than in Estonia or Lithuania, contraction of total production continued in Latvia throughout the first half of the year. Latvian GDP was down in the second quarter by 1.8 % and in the first half by 2 % year-on-year.

The fall in Latvia's industrial output has decelerated. In September, industrial output was 1.1 % less than a year ago. For both Latvia and Estonia, September's favourable industrial output development partly reflects the low comparison figure of September 1998 – the month after the Russian crisis hit. During January-September, industrial production was 11.6 % below the level reached a year earlier.

The Latvian Central Bank estimates that GDP growth will resume in the second half and GDP will grow by 1 % in 1999. Annual inflation for the rest of the year would stay at the current level of 2.9 %. According to the government forecast used as a basis for next year's draft budget, GDP will grow by 3.5 % in 2000, while annual inflation will be around 3 %.

Current account deficit still considerable

The second quarter balance of payments figures came as a slight disappointment, as the current account deficit grew somewhat from the first quarter, amounting to 9.7 % of the period's GDP. The growth was due mainly to increased goods imports.

Latvia continues to earn considerable amounts of foreign currency from exports of transportation services, mostly oil transit from Russia. The Russian crisis did not affect transit deliveries significantly. In the first half of 1999, the surplus in Latvia's service account covered 30 % of the deficit in trade account.

Budget deficit to be curbed next year

The budgetary situation continues to be worrying. In spite of expenditure cuts by the parliament, the general government deficit will amount to 4.6 % of GDP at the end of the year according to government estimates.

In September, Latvia reached a preliminary agreement with the IMF on a new stand-by arrangement. According to Latvia's economic programme, the general government budget deficit next year will be squeezed to 2 % of GDP. A draft budget to that effect was approved in the parliament's first reading in October; the final reading will be held in December. In nominal terms, budgetary expenditures are reduced almost 3 % from the current year, while revenues increase about 5 %.

Lat survived pressure

Latvia's currency, the lat, experienced some pressure in summer and autumn due to negative fiscal and external account developments. The Central Bank was compelled to intervene in the market to defend the lat, which is pegged to the SDR. The pressure eased in October, and the need for the central bank to intervene has since diminished. Short-term money market rates, nevertheless, remain higher than in the spring.

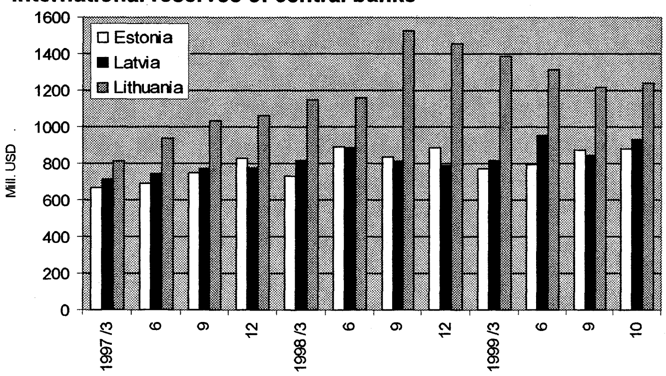
Latvia's credit rating continues to be rather good (e.g., S&P gives a sovereign rating of BBB), enabling the country to tap international credit markets at favourable rates. Latvia has issued two Eurobond loans this year. An EUR 150 million issue was offered in May and another worth EUR 75 million in September. The second loan was unplanned and it was taken to cover the shortfall of budget revenues.

Weaknesses in pension system emerge

In order to curb next year's budget deficit, Latvian lawmakers have drawn up excise duty hikes and expenditure cuts. Proposed amendments to the pension law have proven to be the most controversial of expenditure cuts.

The new pension system, created according to a Western model, was introduced at the start of 1997. Subsequently, several amendments increasing pension outlays were made, including an indexation clause added during the pre-election period last year. With insufficient pension fund revenues, state budget resources have been used to cover pension payments. In the summer of 1999, the parliament approved increases in the pension age from the current 57.5 for women and 60 years for men to 62 years for all. Pensions of working pensioners were also cut. The proposed changes caused dissatisfaction among the population. The opposition was not, however, able to turn down the amendments in the referendum organised on the issue in mid-November. The World Bank has criticised Latvia's erratic pension system changes, and a thorough appraisal of the entire system is needed to make it balanced.

International reserves of central banks



LATVIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.6	-2.0	H1/99
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-11.6	1-9/99
Inflation, % growth, December-December	26.3	23.1	13.1	7.0	2.8	2.9	10/99
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8		
Average gross wage, USD, period average	128	170	179	207	226	235	H1/99
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	9.5	10/99
Exports, USD million	1020	1367	1488	1839	2012	1296	1-9/99
Imports, USD million	1321	1947	2286	2689	3138	2125	1-9/99
Current account, % GDP	4.8	-0.4	-5.5	-6.1	-11.1	-9.1	H1/99

Sources: Central Statistical Bureau of Latvia, Bank of Latvia

LITHUANIA

Recession continues

The problems facing the Lithuanian economy seem to be more serious than those of its Baltic neighbours. The repercussions of the Russian crisis emerged in Lithuania later than in Estonia and Latvia, in part due to state support for enterprises after the Russian crisis in 1998. The subsequent decline has, however, been deep. Lithuania's GDP decreased 4 % in the second quarter of this year after a 5.8 % drop in the first quarter. During January - September, sales of manufacturing production dropped 7.3 % from the previous year. In October, the decline deepened again and sales were 14 % lower than a year earlier.

In mid-November, the Ministry of the Economy revised its GDP projection for the current year downward. It now forecasts a decline on the order of 2 % instead of its earlier estimate of a 1 % decline. The draft budget for 2000 is based on estimated GDP growth of 3.8 % and annual inflation of 4.1 %.

Budget gap widens ...

It has already become evident that this year's budget will record the highest deficit ever. The Lithuanian parliament reduced budget expenditure by 6 % in October, but that did not improve the situation significantly. It is estimated that the general government budget deficit may by the end of the year surge to 7 to 10 % of GDP (excluding privatisation receipts). Further cuts equalling some 15 % of budget expenditure are currently planned.

Difficult decisions remain to be made concerning next year's budget, the draft of which is in the parliament. In the draft, state budget expenditures exceed in nominal terms this years level (after the 6 % cuts) by about 10 %, and deficit would be well above the IMF's recommended 2 % of GDP. Following the IMF's advice, the government proposes that the parliament discontinue the savings restitution programme launched earlier to compensate depositors for the loss in value of savings that took place due to the decade's first years' rapid inflation. The IMF has also warned that financing obligations the state took over in connection with the privatisation of the state-owned oil-concern will burden the budget excessively. Lithuania and IMF are currently negotiating a new stand-by arrangement.

... along with the current account deficit

The slow-down in economic growth has not brought about a sustained fall in the current account deficit. During the second quarter of 1999, exports declined faster than imports and the deficit grew to 14.2 % of GDP, after dropping to 9.6 % in the first quarter.

Lithuania's international competitiveness has suffered from the strong dollar. The litas has been pegged to the dollar since 1994, and speculation about a devaluation in connection with a possible change of the litas peg has become a recurring theme with currency traders. In October, the central bank announced it would not change the peg of litas next year to a euro-dollar basket as previously announced. Instead, the litas will be pegged directly to the euro in 2001. Until then, the modified currency board arrangement will remain in force.

These difficulties have lately caused pressure on the litas, and interest rates have surged in the autumn.

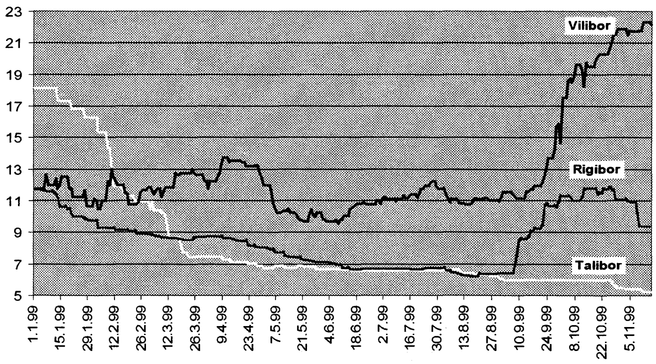
Governmental crisis caused by privatisation deal

One of Lithuania's biggest privatisation deals, the sale of Mazheikiu Nafta, the national oil company, was concluded in late October after almost two years of negotiations. The investor, USA-based Williams International, bought a 33 % stake in the company. Prime Minister Rolandas Paksas resigned in protest to the deal, claiming it put too big a financial burden on the state budget. The concluded agreement stipulates that the Lithuanian state must contribute USD 344 million in the reconstruction of the refinery.

The deal also had a political flavour. Russia is the sole supplier of crude oil to the refinery, and a major Russian oil company, Lukoil, has been interested in acquiring a stake in it. A few times this year, Russia cut crude supplies to the refinery in an apparent protest against selling the company to a US investor.

Lithuania's new government – the third this year – was approved by the parliament in November. Like its two predecessors, it is formed by conservative parties that together command a majority in the parliament. The government is headed by Prime Minister Andrius Kubilius. The government's main goals remain the same as those of the two previous governments, namely accession to the EU and NATO. The new government program stresses the importance of pursuing tighter fiscal policies.

3-month interest rates
Estonia: Talibor, Latvia: Rigibor, Lithuania: Vilibor



LITHUANIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.8	H1/99
Industrial production, % growth	-26.6	5.3	5.0	3.3	7.0	-7.3	1-9/99
Inflation, % growth, December-December	45.1	35.7	13.1	8.4	2.4	-0.3	10/99
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-6.0		
Average gross wage, USD, period average	81	120	155	196	239	266	1-8/99
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	8.4	9/99
Exports, USD million	2020	2706	3413	4192	3962	2425	1-9/99
Imports, USD million	2220	3404	4309	5340	5480	3790	1-9/99
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-12.1	H1/99

Sources: Lithuanian Department of Statistics, Bank of Lithuania

EU accession and Baltic transition

by Seija Lainela*

Politics outweigh economics in EU enlargement

Over the past year, general opinion in the European Union has increasingly favoured enlargement on a wide front, evidencing that political considerations have come to outweigh economic concerns. This shift became apparent in October 1999, when the European Commission recommended extending membership negotiations to all applicant countries that fulfil the political criterion – sustainable democracy. Hence, all 'second wave' countries[1] except Turkey will quite likely be invited to membership talks at the European Council meeting in Helsinki in December 1999. When the six 'first wave' countries[2] were invited to negotiations, economic criteria carried far greater weight.

Baltics receive positive evaluations

The Commission regularly monitors political and economic developments in applicant countries, as well as how closely their legal and institutional systems approximate EU rules and practices. The results are published in annual progress reports. The October 1999 report presents, with some reservations, a rather positive picture of the Baltic states.

As regards macroeconomic development and the functioning of markets, Estonia continues to rank with Hungary, Poland, and Slovenia as the best-performing applicant countries (the Czech Republic also makes it into this good-performer category). The Commission's October 1999 report also promoted Latvia to this group of good performers. Latvia is the only 'second wave' country to gain such distinction, mainly due to its considerable progress during the past year.

The Commission also notes that Lithuania failed to proceed as rapidly as had been expected, in part due to the fact that Lithuania was hit harder by the Russian crisis than its two Baltic neighbours. Lithuania has traditionally been more dependent on trade with the CIS than Estonia or Latvia. Lithuania also chose to loosen its fiscal policies to dampen the effects of the crisis, which then led to large internal and external imbalances.

The reports state that Estonia and Latvia should be able to "withstand competitive pressure and market forces within the EU" in the medium term. Lithuania should also be able to do that if it implements planned reforms.

The report singled out Latvia for its progress in legal reforms and institution building. The vigorous reforms in Latvia were likely driven by deep disappointment within the country after the Commission's 1998 progress report, which recommend against starting of membership negotiations, in spite of Latvia's success with reforms.

Estonian and Lithuanian achievements in legislative and institutional reforms during the past year were somewhat mixed, with good performance in some fields and slow-going in others. The Commission was pleased with the Lithuanian government's decision to decommission one of the Ignalina nuclear power station's two reactors by 2005. The Chernobyl-type nuclear power station has been a problematic issue in Lithuania's accession to the EU.

EU accession has boosted reforms

Accession to the EU has proven important for the applicant countries from the point of view of their transition to a market economy. Accession offers the countries a clear economic and political target for transition and motivates them to keep going with their reforms. EU legislation also gives a framework for the creation of coherent legal systems in transition economies.

The Baltic states serve as excellent examples on these positive effects. After Latvia and Lithuania were left outside the 'first wave' group of accession countries in 1997, we saw a redoubling of their reform efforts. The EU's tough line showed the EU was serious in expecting applicants to execute their reforms. In contrast, the October 1999 recommendation of the Commission on starting membership negotiations with all countries fulfilling the political criteria could be a dangerous signal to applicants that some aspects of their reform efforts can be relaxed.

Membership criteria must be clear

Indeed, as political considerations are given greater weight in membership decisions, the monitoring of economic reforms in applicant countries becomes more important. A clear distinction needs to be made between political goals and economic criteria. Politically coloured interpretations of economic data serve no one. While some of the criteria (such as the ability to withstanding the competitive pressures within the single market) are difficult to define exactly, it is nevertheless crucial that the economic criteria for membership be unambiguous as possible and the same for all.

**The author is an economist at BOFIT.*

[1] Bulgaria, Latvia, Lithuania, Malta, Romania, Slovakia
[2] Cyprus, Czech Republic, Estonia, Hungary, Poland, Slovenia

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