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BALTIC ECONOMIES
The Quarter in Review
1 • 2000

ESTONIA

Economic growth resumes

Optimism has returned to Estonia, as the repercussions of the Russian crisis are gradually overcome. The economy's decline halted in the third quarter of 1999, and in the fourth quarter, GDP started to grow from the previous year. In spite of the recent resumption, GDP growth was flat or negative for the whole of 1999. Authorities preliminarily estimate that Estonian GDP declined 1 % at most. Industrial output has recovered swiftly, with a 12-month growth of 7.5 % in December. Overall last year, industrial output contracted 3.9 % from 1998, because growth in the second half was insufficient to compensate for the drop in production at the beginning of the year.

Annual inflation fell to 3.9 % at the end of 1999 from 6.5 % a year earlier. The pace of inflation, however, picked up somewhat towards the end of the year due to recovering demand. According to monthly registration data, registered unemployment rose in 1999, reaching a record rate of 6.8 % in January 2000. The latest available labour force survey data, which includes also those unemployed not registered in labour offices, gives an unemployment rate of 11.7 % for the second quarter of 1999.

Budget deficit grew in 1999 ...

Estonia's fiscal policy has been extremely tight in the 1990s. Not only has it been the tightest among transition economies, but also stringent by Western standards. The highest deficit recorded before last year was in 1996, when it amounted to 1.9 % of GDP. This is a significant achievement for a country that is building state and economic administrations from the scratch, and simultaneously responding to compelling needs in the social sector, education, etc. In 1999, however, economic recession drove the general government budget deficit, according to advance information, to 4.7 % of GDP.

In mid-February, Estonia signed a precautionary stand-by agreement with the IMF, which will be discussed by the IMF's board in March. The agreement runs until September 2001 and amounts to USD 39 million. In the economic programme related to the agreement, a public sector deficit of 1.3 % of GDP is envisaged for the current year. The programme also sets target dates for the remaining privatisation and obliges Estonia to reduce its tax burden next year, reform its budget process and speed up pension system overhaul.

... but current account deficit temporarily declined

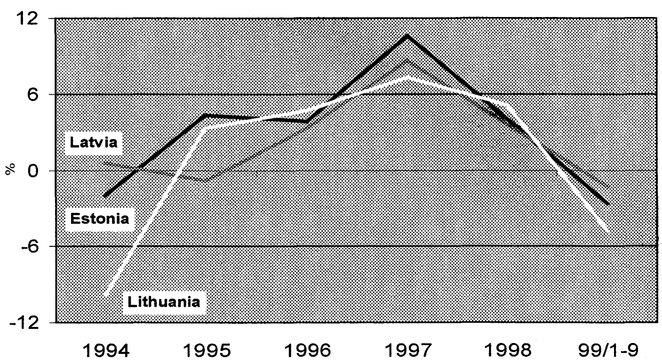
The recession was reflected in a drop of Estonia's trade and current account deficits as imports declined faster than exports during the past year. In 1998, Estonia's current account deficit equalled 9.2 % of GDP, a worrying level. In the first three quarters of 1999, the deficit dropped sharply to 4.6 % of the period's GDP.

The trade deficit was EEK 17.5 billion (USD 1.1 billion) in 1999. It was the smallest deficit in three years, amounting to 24 % of GDP. During the fourth quarter, however, the growth of goods imports picked up considerably, resulting in the largest quarterly trade deficit since the Russian crisis broke out in autumn 1998. Hence, it seems likely that the external deficit will again increase in tandem with the accelerating growth of the economy.

Banking sector also recovers

The Estonian banking sector posted a total profit of EEK 637 million (USD 41 million) in 1999, after a loss of almost EEK 500 million the previous year. The two leading banks, Hansapank and Ühispank were the most successful, with 1999 profits amounting to EEK 540 and EEK 101 million, respectively. Interest rates came down during last year from the high levels reached in the wake of the Russian crisis. At end-1999, the average interest rate of outstanding kroon loans was around 7 %. There are currently seven banks operating in Estonia. The banking sector is, however, highly concentrated, with Hansapank and Ühispank together managing around 85 % of all deposits and loans. Swedish banks are strategic shareholders in both banks.

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	-2.6	1-9/99
Industrial sales, %-growth	-3.0	1.9	2.9	14.6	4.1	-3.9	
Inflation, %-growth, December-December	41.7	28.9	14.8	12.5	6.5	3.9	
General government budget balance, % GDP	1.3	-1.3	-1.5	1.9	-0.3	-4.7	
Average gross wage, USD, period average	134	208	248	256	283	293	1-9/99
Unemployment, % (end of period, registered)	5.1	5.0	5.5	4.6	5.1	6.5	
Exports, USD million	1320	1854	1814	2293	2680	2593	
Imports, USD million	1681	2526	2835	3419	3795	3593	
Current account, % GDP	-7.2	-5.2	-9.2	-12.1	-9.2	-4.6	1-9/99

Sources: Statistical Office of Estonia, Bank of Estonia, EBRD

LATVIA

Back on the growth path

Latvia's recession bottomed out in 1999. The GDP decline that started at the end of 1998 halted in autumn 1999. According to advance information from Latvian authorities, GDP remained at the 1998 level or showed slight growth in 1999. Industrial production decreased almost 9 % over the year, but at the end of the year, monthly production had already recovered to the 1998 level.

Last year was particularly difficult for Latvian agriculture. In addition to adverse weather conditions, the Russian crisis cut food exports to Russia, the main foreign outlet for Latvian produce. Production of cereal crops dropped 19 % while the number of cattle fell 14 % in 1999.

The rise in consumer prices slowed until autumn 1999, then started to accelerate together with the recovery of the economy. Even so, Latvia's annual inflation of 3.2 % at end-1999 was one of the slowest among transition economies.

Unemployment (as defined by the ILO) hit the post-Soviet high in the first quarter of 1999, reaching 14.7 % of labour force. In the third quarter, the rate was down to 13.9 %. Unemployment rate based on registrations, which is available monthly, also started to decline towards the end of the year.

Budget deficit declines

Last December, Latvia and the IMF reached an agreement on a stand-by credit facility. The facility will be available for 16 months and totals USD 45 million. The Latvian government has no plans to resort to the credit. In fact, Latvia concluded the agreement in part to demonstrate internationally IMF's support for the government's economic programme. The current precautionary stand-by credit arrangement is Latvia's fourth.

The economic programme on which the agreement is based implies the continuation of austerity policies started last year in the wake of the Russian crisis. The programme stipulates that in 2000, the Latvian public sector deficit must not exceed 1.9 % of GDP, which translates into almost zero growth in nominal expenditure from last year. Latvia managed to squeeze last year's deficit to 3.5 % of GDP after expenditure cuts in the autumn. Nevertheless, the 1999 budget deficit was Latvia's biggest since 1995.

The fiscal austerity package for the current year includes plans for a public sector wage freeze. Social and pension funds also will continue to be under pressure, due to relatively high unemployment and the fact that last year the government, in the face of public opposition, refrained from curbing pension outlays to the extent earlier planned.

Current account deficit still considerable

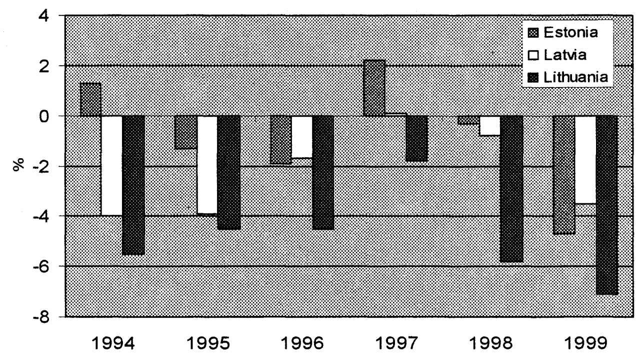
For the first time in Latvia's post-Soviet history, in 1999 total exports declined from the previous year. Exports to the West grew, but not enough to compensate for the significant fall in exports to Russia and other CIS countries. As imports fell more than exports, Latvia's current account improved somewhat, with the deficit equalling 10.7 % of GDP in the first three quarters of 1999. The deficit, however, increased during the year, implying a probability of growing imbalance now that the economy is again growing.

In order to protect domestic agriculture, hard-hit by the Russian crisis, Latvia resorted to import tariffs. Last June, a temporary 70 % import surcharge on pork was introduced. Starting from this year, the tariff was modified somewhat. In spite of the intra-Baltic free trade agreement, the tariff also applies to imports from other Baltic states. Estonia and Lithuania oppose the tariffs, which mainly affect their exports to Latvia. The European Union has also criticised the tariffs as they run counter to the stipulations of the Europe Agreement concluded between Latvia and the EU. Latvia and the EU are currently negotiating on the matter.

Latvia starts EU membership talks

In December 1999, Latvia, Bulgaria, Lithuania, Malta, Romania, and Slovakia were invited to membership talks with the European Union. Negotiations were officially launched in mid-February. Latvia aims at rapid negotiations in order to catch up with the first-wave countries, which have negotiated on membership terms since 1998. The formal goal of Latvia is to conclude its talks by January 2003. For the negotiations, the EU has divided its rules and practices into 31 topics, so called chapters. According to Latvian authorities, 15 chapters pose only minor problems, and Latvia is ready to start talks on them immediately.

General government budget balance



LATVIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	0.6	-0.8	3.3	8.6	3.6	-1.3	1-9/99
Industrial production, % growth	-9.5	-6.3	1.4	6.1	2.0	-8.8	
Inflation, % growth, December-December	26.3	23.1	13.1	7.0	2.8	3.2	
General government budget balance, % GDP	-4.0	-3.9	-1.7	0.1	-0.8	-3.5	
Average gross wage, USD, period average	128	170	179	207	226	218	1-11/99
Unemployment, % (end of period, registered)	6.5	6.6	7.2	7.0	9.2	9.1	
Exports, USD million	1020	1367	1488	1839	2012	1729	
Imports, USD million	1321	1947	2286	2689	3138	2957	
Current account, % GDP	4.8	-0.4	-5.5	-6.1	-11.1	-10.7	1-9/99

Sources: Central Statistical Bureau of Latvia, Bank of Latvia, EBRD

LITHUANIA

Economy – still down, but not out

Economic recession in Lithuania may be coming to an end. In the first three quarters of 1999, GDP fell by 4.8 %, but for the fourth quarter, the Bank of Lithuania estimates growth of 1.2 %. For the whole last year, a GDP drop of some 3 % is foreseen.

Industrial production was down almost 10 % in 1999, although the pace of decline decelerated towards the end of the year. The biggest decrease was recorded in oil refining which accounts for some 10 % of the Lithuanian GDP. Last year, the Mazheikiu Nafta oil refinery had problems with the supply of crude oil from Russia, its main supply source.

During the past two years, Lithuania has posted the lowest inflation among the Baltics and Central and Eastern European countries generally. In 1999, consumer prices rose only 0.3 %. The deep recession was one of the factors behind the stability of prices last year.

Joblessness reached an all-time high in January 2000, when the registrations-based unemployment rate climbed to 10.8 %. A year earlier, the rate was 7.7 %. A more accurate measure of unemployment, including those not registered in labour offices, is provided by labour force surveys carried out twice a year. The latest data, which are from November 1999, show an unemployment rate of 15.3 %.

Budget deficit record high

Last year's budget deficit amounted to about 7 % of GDP, which is considered high according to international standards. The figure includes the state budget and off-budget state funds, but not the municipal sector. While the recession was a main reason behind the budget failure, other strains were also present, including the state's obligation to contribute to the modernisation of the privatised oil refinery, Mazheikiu Nafta.

Lithuania's budget policy has traditionally been the most lax of the Baltics, tolerating public sector deficits of at least 4 % of GDP per year throughout most of the 1990s. This year's budget law, however, implies a considerable tightening of fiscal policy as it envisages a general government budget deficit of only 2.8 % of GDP.

To attain the target, the Lithuanian government has introduced several cost-cutting measures. Nevertheless, Lithuania's state finances continue to face difficulties. In January, budget revenues fell far short of plan and the government is in arrears to farmers for produce bought last year. Moreover, there have been delays with pension payments, caused by the depletion of the social security fund.

In mid-February, Lithuania finished negotiation with the IMF on a new stand-by credit arrangement to support Lithuania's economic policies. The precautionary arrangement covers 15 months and amounts to USD 80 million. The economic programme that forms the basis of the arrangement includes the stringent budgetary outline, adopted by the parliament for the current year. In addition, also institutional measures are dealt with. The government is expected, among other things, to reconsider import tariffs set on agricultural products after the Russian crisis and publish more detailed information on the Mazheikiu Nafta privatisation deal.

Foreign trade declines

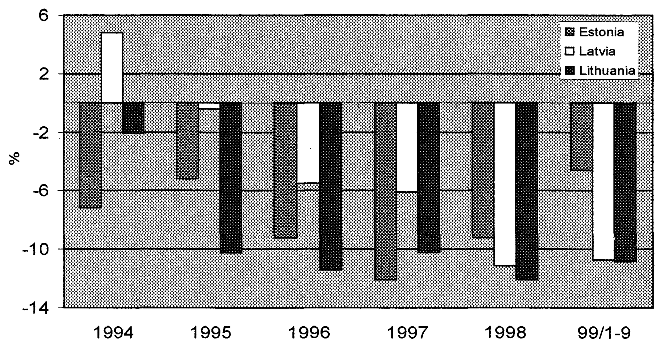
Since 1995, Lithuania has run very high current account deficits, equalling over 10 % of GDP. In the course of last year, the deficit started to decrease as the recession depressed domestic demand. Imports turned into decline, while the fall in exports continued for the second consecutive year in 1999. During the first three quarters, current account deficit amounted to almost 11 % of GDP.

Overall, Lithuania's exports to Russia and the other CIS countries in 1999 were down by 60 %, while imports from those countries declined 22 %. Russia's share in Lithuania's exports was 7 % last year, down from 17 % the year before.

Banking sector concentration intensifies

Lithuania' banking sector consists of 15 banks. The sector is concentrated around four large banks, which together manage some 85 % of the sector's total assets. Two of these banks are state-controlled and slated for privatisation. The other two big banks, Vilniaus Bankas and Hermis, merged in February, forming the biggest bank in Lithuania. The new bank, Vilniaus Bankas, controls around 40 % of the banking sector's assets and is the second largest bank in the Baltics after the Estonian Hansapank.

Current account balance, per cent of GDP



LITHUANIA	1994	1995	1996	1997	1998	1999,	as of
GDP, % growth	-9.8	3.3	4.7	7.3	5.1	-4.8	1-9/99
Industrial production, % growth	-26.6	5.3	5.0	3.3	7.0	-9.9	
Inflation, % growth, December-December	45.1	35.7	13.1	8.4	2.4	0.3	
General government budget balance, % GDP	-5.5	-4.5	-4.5	-1.8	-5.8	-7.1	
Average gross wage, USD, period average	81	120	155	196	239	293	
Unemployment, % (end of period, registered)	4.5	7.3	6.2	6.7	6.9	10.0	
Exports, USD million	2020	2706	3413	4192	3962	2996	
Imports, USD million	2220	3404	4309	5340	5480	4791	
Current account, % GDP	-2.1	-10.2	-11.4	-10.2	-12.1	-10.8	1-9/99

Sources: Lithuanian Department of Statistics, Bank of Lithuania, EBRD

Baltic privatisation compared

by Seija Lainela*

Most industrial enterprises now in private hands

The Baltic states are well advanced in privatisation. Estonia, in particular, is a leader among transition economies both in terms of the speed and scope of its state asset divestiture.

In Estonia and Latvia, open tenders and direct sales to strategic investors have been the preferred approaches to privatising medium-size and large enterprises, because they aim at securing the long-run viability of enterprises. For large enterprises, once a strategic owner has been found, public auctions and offerings are used to divest the remaining state ownership. Estonia has always had liberal attitude towards foreign participation in privatisation.

Estonia's privatisation process was virtually complete by 1996, so currently only a few industrial enterprises remain for divestiture. Latvia's large-scale privatisation started in practice in mid-1990's only. Nevertheless, much of the process has been completed by now.

Lithuania chose a different strategy, launching a voucher-based mass privatisation programme as early as 1991. This approach tended to favour enterprise insiders, i.e. employees and managers. Mass privatisation was abandoned in mid-1990's in favour of direct sales and tenders. Since 1997, medium- and large-scale privatisation has gathered speed, thanks to the increased number of enterprises slated for privatisation and more advantageous conditions proposed for buyers. Even so, the current list of enterprises to be privatised still contains several hundred companies.

Privatisation methods and business environment matter

Open tenders and direct sales tend to instil better corporate governance and stronger financial position in enterprises than mass privatisation or insider deals. The presence of foreign investors with greater management experience and access to financing (factors typically in short supply in transition economies) also enhances development of the enterprise sector.

These factors were important reasons for the change in Lithuania's privatisation policies, which earlier had emphasised mass privatisation and restricted foreign ownership. The power shift after the 1996 parliamentary elections induced greater openness towards privatisation. Since then foreign ownership has become increasingly significant, although it is still less important than in Estonia and Latvia.

The creation of new private enterprises is also important in building a well-functioning market economy. New enterprises absorb workers made redundant by privatisation and restructuring of state enterprises, hence smoothing the transition socially. The emergence of new enterprises has been especially notable in Estonia, where the institutional setting is considered favourable for entrepreneurs. In Lithuania, red tape and frequently changing business regulations constitute major hindrances.

Functioning bankruptcy legislation is also essential in imposing financial discipline on the enterprise sector and enhancing the operation of markets. Again, Estonia is at the forefront among transition economies in establishing stringent and effective bankruptcy procedures.

All these factors have contributed to Estonia's success. It has the lowest unemployment rate in the Baltics, and has weathered the effects of the Russian crisis rather well. Lithuania, the other extreme of the Baltic states, still has much to do to enhance the functioning of its markets.

Infrastructure's turn

As Baltic privatisation has entered its last phase – sell-off of large infrastructure enterprises – the process has again become more contested and time-consuming. Currently, the most important sectors up for divestiture are transportation (the Baltic economies are heavily involved in cargo transit to and from Russia) and energy.

In Estonia, the biggest enterprises slated for privatisation include the Estonian Railways, the oil-shale-burning power stations in Narva and the port of Tallinn. Although their privatisation has been put off for some time already, it is hoped that the railways at least will be sold this year.

Latvia made little progress last year in privatisation due to a lack of consensus on privatisation methods and disagreements between politically powerful industrial groups. The sell-off of the two largest remaining infrastructure enterprises – the shipping company LASCO and parts of energy producer Latvenergo – should happen this year.

In Lithuania, privatisation of one of the two state-owned banks is foreseen this year, and the sell-off of the other is under preparation. Restructuring of Lithuania's heavily subsidised energy sector is long overdue. The government has approved plans for the splitting and partial sell-off of the national gas and power companies. Political resistance to privatisation of state-owned assets is strong, and the opposition has demanded a halt to the process until after the parliamentary elections in autumn 2000.

Privatisation in the Baltics has now reached utilities production and other monopolised sectors, making the creation of an efficient regulatory framework for securing competition and fair pricing necessary. Guided by relevant EU regulations, this work now proceeds in all countries.

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