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**Feature Articles**

*Corruption in the Baltic States: New Empirical Evidence*

*Labour Markets in Hard-Peg Transition Countries*

Baltic  
Economic  
Trends



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## Editor

Alf Vanags

Baltic International Centre for Economic Policy Studies (BICEPS), [alf@biceps.org](mailto:alf@biceps.org)

## Staff writers

Estonia: Raul Eamets, email: [Eam@ec.ut.ee](mailto:Eam@ec.ut.ee)  
Andrus Oks, email: [andrus@mtk.ut.ee](mailto:andrus@mtk.ut.ee)  
Viktor Trasberg, email: [Viktor@ec.ut.ee](mailto:Viktor@ec.ut.ee)  
Urmas Varblane, email: [varblane@mtk.ut.ee](mailto:varblane@mtk.ut.ee)

Latvia: Anete Pajuste, email: [anete.pajuste@hhs.se](mailto:anete.pajuste@hhs.se)

Lithuania: Giedrius Blagnys, email: [blagnys@takas.lt](mailto:blagnys@takas.lt)

## Editorial and production team

Anatole Faykin, Jody Lanfrey, Lena Levin  
Romans Pancs, Mariana Ruiz-Alvarado

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# Editorial

Welcome to the second issue of BET for 2002. In addition to the usual economic updates of the three Baltic states we offer two special reports. The first report, by Rudolfs Bems of the Stockholm School of Economics, uses the World Bank/EBRD developed Business Environment and Enterprise Performance Survey (BEEPS) to undertake an analysis of corruption in the Baltic states. BEEPS permits a distinction to be made between administrative corruption (loosely interpreted as the corrupt implementation of existing legislation) and state capture (which can be interpreted in terms of the extent to which law-making is corruptly influenced by private interests). The survey shows that Latvia is noticeably high in the state capture league, while Lithuania has high levels of administrative corruption. Estonia has moderate levels of both but all three have high average levels as compared with, say, EU countries.

The second report is by a team of IMF economists and offers an interesting survey of labour markets in the three Baltic states plus Bulgaria. This choice of countries was motivated by the fact that all four have pegs to hard currencies, with the consequence that adjustment to macroeconomic shocks must rely on flexible labour markets rather than exchange rate changes. Bulgaria is an interesting comparator also on the grounds that with respect to GDP per capita it is close to both Latvia and Lithuania. The IMF team find that despite considerable reallocation of labour, unemployment remains high in all three Baltic countries. Unemployment is also high in Bulgaria but the degree of restructuring and labour reallocation has been considerably less. This perhaps suggests simple GDP per capita comparisons may be insufficiently informative about the underlying economy to link Latvia and Lithuania with Bulgaria.

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Alf Vanags  
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[alf@biceps.org](mailto:alf@biceps.org)

Alf Vanags  
Editor



# Corruption in the Baltic States: New Empirical Evidence

**Rudolfs Bems**

Stockholm School of Economics, email: rudolfs.bems@hhs.se

## Introduction

Not a week passes without news of another corruption scandal in the Baltic states. Even the preparations for such an important international event as the 2006 Ice Hockey World Championship in Latvia have recently been tainted with accusations of illicit procurement, such that the very hosting of the event is now in doubt, with all the consequential loss of investments and tourism revenues.

It is sad but perhaps it should not come as a surprise. There have been huge changes in the ownership structure over the last decade. More than 60 percent of the economic activities in each of the three countries now come from the private sector, yet only 12 years ago all economic activities were under state control. This has made for vague boundaries between what is public and what is private. At the same time, governance practices have not kept up with this rapid change and in many cases Soviet era perceptions of the role of the state and of Soviet-type management still prevail. The 'phenomenal' success of some of the new powerful firms, the wealth of their owners, the Soviet era ties between managers and statesmen as well as the speedy privatization process have all contributed to the emergence of an environment where corruption can flourish.

Why is corruption such an important issue? It could be that corruption is simply a product of underdevelopment; instead of fighting corruption, maybe resources should be spent on stimulating economic development. Once the country succeeds in developing, corruption will gradually disappear. However, recent economic research suggests the opposite. There is a growing body of empirical evidence documenting a significant causal relationship between extent of corruption and quality of governance on the one hand, and economic and social development on the other.<sup>1</sup> Among other things, this research shows that corruption undermines successful implementation of reforms and that is it the poor who suffer most from it.

A wide range of corruption indicators confirm the seriousness of the problem in the Baltic states and transition economies in general. They reveal that perception of corruption in Central and Eastern Europe, including the Baltics, is at the same level as in Latin America or the Middle East and North Africa. Moreover, in the CIS it is among the highest in the world.<sup>2</sup> However, just knowing the extent of corruption does not allow us to successfully fight it. We need to learn more about its causes in each of the countries and its effects on different layers of society. Only then can the right policy advice be formulated.

## The BEEP survey

With the goal of policy formulation in mind, the World Bank and the European Bank of Reconstruction and Development undertook the Business Environment and Enterprise Performance (BEEP) survey during 1999 and 2000. Its aim was not only to measure the perception of corruption, but also to reveal the mechanisms through which different forms of corruption work in transition countries.

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<sup>1</sup> For a survey see Kaufmann, Kraay and Zoido-Lobaton (1999).

<sup>2</sup> See World Bank (2000).

Most importantly, the BEEP survey allows us to distinguish between two forms of corruption: state capture and administrative corruption. "*State capture* refers to the actions of individuals, groups, or firms both in the public and private sectors to *influence* the formation of laws, regulations, decrees, and other government policies to their own advantage as a result of illicit and non-transparent provision of private benefits to public officials. *Administrative corruption* refers to the intentional imposition of distortions in the prescribed *implementation* of existing laws, rules and regulations to provide provision of private gains to public officials."<sup>3</sup>

The respondents to the BEEP survey were companies and the subjects covered in the survey, apart from corruption, included company performance, financial development, assessment of the business environment, and provision of public services. With its wide range of data about the companies, the survey allows us to examine how different firms are affected by corruption and to compare these micro level effects with the impact of corruption at the aggregate level of the economy.

The BEEP survey offers several other advantages over previous studies that measure corruption perceptions. Firstly, it covers 22 transition economies and nearly 4,000 firms. Secondly, in all countries the same questionnaire was used, and was completed through face-to-face interviews with the top-level representatives from the companies. To further increase the validity of cross-country comparisons, in all sample countries (except Latvia and Albania) the same private firm, A.C.Nielsen, was contracted to implement the survey.

Thirdly, a lot of effort was put in obtaining a representative sample of firms for each country in terms of the origin of the firm, the size of the firm and the location of the firm.<sup>4</sup> Unfortunately for a comparison of the Baltic countries, Lithuania is the only country where the representativeness of the sample is questionable, since no state owned companies and too few large and medium size companies were included in the sample. The composition of the BEEP survey sample for the Baltic states is presented in Table 1.

Finally, where possible, numerical cardinal estimates of problems were used (e.g. share of revenues spent on unofficial payments) as opposed to subjective assessments of the extent of the problem. These estimates allow us to measure the margin of error of the respondents' answers.

**Table 1: The sample composition of the BEEP survey**

Country	Total number of firms	Origin			Size		
		<i>De Novo</i>	Privatized	State	Small	Medium	Large
Estonia	132	73	26	25	59	59	14
Latvia	166	88	25	33	70	76	18
Lithuania	112	84	26	0	93	16	3

## Results of the survey

Next, we present selected results of the BEEP survey for the Baltic states. The focus is put on revealing the extent of state capture and administrative corruption in Estonia, Latvia and Lithuania. We will identify the differences between the three countries and, when instructive, compare them with the

<sup>3</sup> Quote from the World Bank (2000), pp. xv-xvii.

<sup>4</sup> For a detailed description of the implementation of the BEEP survey see Hellman et al. (2000a).

other transition economies.

### *State capture*

The BEEP survey paid particular attention to identifying the phenomenon of state capture and measuring its impact at the micro and macro levels of the economy. To measure the impact, respondents were asked to assess the extent to which sale of parliamentary votes, presidential decrees or other similar activities affect the company's business. Answers to this question are summarized in Table 2.

**Table 2: Impact of state capture (% of firms affected by sale of ...)\***

Country	Parliamentary legislation	Presidential decrees	Central bank	Criminal courts	Commercial courts	Party finance	State Capture index <sup>†</sup>	Classification
Estonia	14	7	8	8	8	17	<b>10</b>	Low
Latvia	40	49	8	21	26	35	<b>30</b>	High
Lithuania	15	7	9	11	14	13	<b>11</b>	Low
CEE <sup>+</sup>	18	16	15	16	16	20	<b>17</b>	
CIS <sup>†</sup>	25	21	32	19	21	19	<b>23</b>	

\* Firms were asked whether state capture in each dimension had no impact, minor impact, significant impact or very significant impact on their business. The table reports the proportion of firms reporting significant or very significant impact of state capture in each dimension.

\* Calculated as unweighted average of the six component indices.

† Calculated as unweighted average.

In each of the six dimensions of potential state capture, except capture of the central bank, Latvia exhibits very high scores. The impact of state capture in Latvia appears to be high not only in comparison with Estonia and Lithuania, but even when compared with the average impact of state capture in the CIS. The state capture index for Latvia was fifth highest in the whole sample of 22 transition economies, trailing only to Azerbaijan, Moldova, Russia, and Ukraine. As a consequence, Hellman et al. (2000b) assign Latvia to the group of 'high-capture' economies.<sup>5</sup>

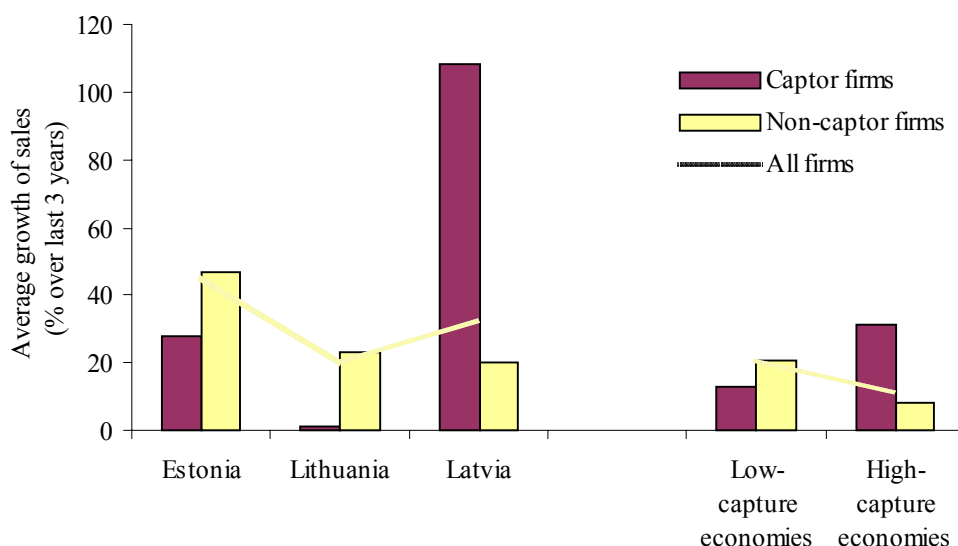
To further investigate these results, the survey allows us to identify the firms that are involved in state capture.<sup>6</sup> A typical captor firm in the sample for the Baltics, as for the rest of the transition economies, was a *De Novo* firm. Captor firms constituted 14 percent of all sample firms in Latvia and Lithuania and 5 percent in Estonia, suggesting that the impact of states capture is not proportional to the number of captor firms. We can use the data on firms' performance and firms' assessment of provision of public goods by the government to investigate the private benefits and social costs of state capture. First, we compare the reported growth of sales over the last three years between the captor and non-captor firms. The average growth figures for the two types of firms, as well as the whole sample of firms are presented in Figure 1.

We see that captor firms enjoy considerably higher growth of sales in Latvia than in Estonia and Lithuania, while growth rates for non-captor firms in Latvia are the lowest among the Baltic States. Also, in Estonia and Lithuania, captor firms on average have lower growth of sales than non-captor

<sup>5</sup> Based on the state capture index values Hellman et al. (2000b) divide all the transition countries into 'low-capture' and 'high-capture' economies. Ranked in ascending order of the index value the 'low-capture' group includes Uzbekistan, Hungary, Slovenia, Armenia, Belarus, Estonia, Czech Rep., Lithuania, Poland, Kazakhstan and Albania. The 'high-capture' group includes Romania, Slovak Rep., Georgia, Croatia, Bulgaria, Kyrgyzstan, Latvia, Azerbaijan, Moldova, Russia and Ukraine. Although the division of countries into 'high-capture' and 'low-capture' economies is somewhat arbitrary, there is a considerable variation in the 'state capture' index and a big gap in this index appears between Albania and Romania.

<sup>6</sup> The captor firms were identified on the basis of the following question: "How often do firms like yours nowadays need to make extra payments to public officials to influence the content of new laws, decrees and regulations?" Firms responding with "sometimes" or higher frequencies were classified as captor firms.

**Figure 1: Private benefits and social costs of state capture\***



\*Firms were asked if the company's sales changed in real terms over the last three years. In case of a positive answer firms were asked by what percentage have sales increased or decreased.

firms, but in Latvia the situation is the opposite. The same pattern emerges when we compare the much larger samples of all 'low-capture' and 'high-capture' economies.<sup>7</sup> This indicates that the business environment created by governments in 'high-capture' economies offers considerable private gains to state capture.<sup>8</sup> In contrast, in 'low-capture' economies captor firms are at a disadvantage, since they have lower growth of sales than other firms.

A comparison of protection of property and contract rights across captor and non-captor firms leads to similar conclusions. Captor firms in Latvia report a considerably higher increase in protection of their property and contract rights over the last three years than non-captor firms. In Estonia and Lithuania there is no difference between captor firms and non-captor firms in this respect. Thus again, state capture, by providing more security for property and contract rights, offers advantages to the captor firms in Latvia.

When we look at the data for all transition economies, results indicate that 'high-capture' countries, such as Latvia, incur considerable social costs from state capture. In Figure 1, such costs are represented by the lower growth of sales for all firms in 'high-capture' economies as compared with the 'low-capture' economies. Firms in 'high-capture' economies also feel less secure about their property and contract rights (Hellman et al. (2000b)). These results suggest that in 'high-capture' economies costs that non-captor firms incur from state capture considerably outweigh the concentrated benefits to captor firms. Hellman and Kaufman (2001) further argue that because captor firms can block any policy reforms that might eliminate their private gains, "state capture has become not merely a symptom but also a fundamental cause of poor governance." The capture economy is then trapped in a vicious circle of weak governance and tight control by the few increasingly powerful firms.

However, in the sample of Baltic firms there is no indication that all firms (or even non-captor firms) feel less secure about their property and contract rights in Latvia, than in Estonia and Lithuania. Also, the growth of sales for all sample firms in Latvia is higher than in Lithuania and also higher than the

<sup>7</sup> For explanation of 'low-capture' and 'high-capture' economies see footnote 5.

<sup>8</sup> By using an instrumental variables based statistical test for the sample of all transition economies Hellman et al. (2000b) conclude that the causality in this relationship runs from state capture to high growth rates of sales.

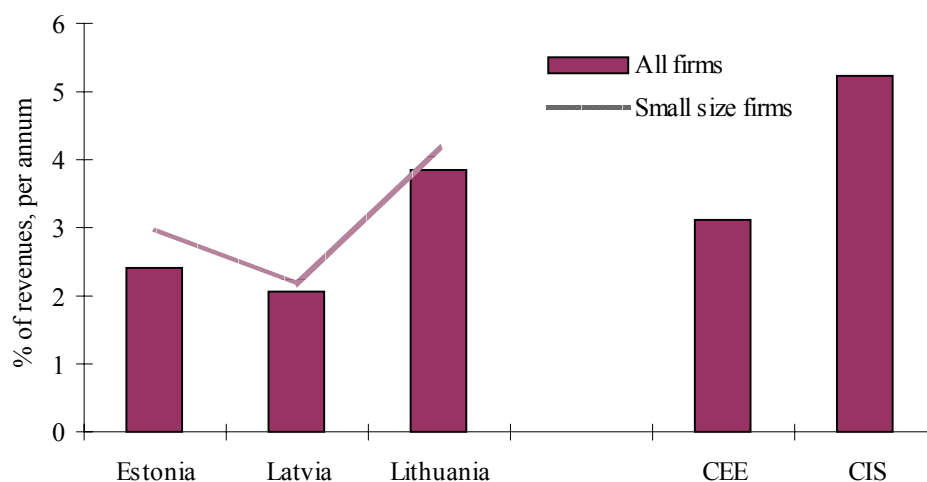
average growth of sales in all 'low-capture' economies (see Figure 1). Moreover, despite its high degree of state capture Latvia continues to experience high GDP growth and a steady pace of economic and social reform. Thus the evidence on the social costs of state capture in Latvia is mixed.

Understanding the implications of the BEEP survey results for state capture in Latvia is a complicated task, which is worth pursuing in future research. One possible interpretation of the situation could be that at the aggregate level large private gains from state capture in a small country, such as Latvia, can outweigh the costs that imposed on the rest of the economy. Furthermore, the close ties between captor firms and the government might induce more compliance in tax payments and induce other 'socially responsible' behaviour from the side of the captors. Yet, one should also remember that the private benefits from state capture accrue to the few captor firms and corrupt government officials and, consequently, the economic development in Latvia might come at the expense of increasing income inequality. To sum up, much more than the private gains and direct social costs should be taken into consideration when evaluating the effects of state capture.

#### *Administrative corruption*

Methods for measuring perception of administrative corruption and comparing it across countries are well developed. The BEEP survey used these conventional methods and asked firms what percentage of their revenues is spent on unofficial payments to public officials. Respondents' answers to this question are summarized in Figure 2.

**Figure 2: Measuring administrative corruption (unofficial payments as % of revenues)\***



\*Firms were asked, on average, what percentage of revenues do firms like yours typically pay per annum in unofficial payments to public officials: 0%; less than 1%; 1-1.99%; 2-9.99%; 10-12%; 13-25%; over 25%. The categories were imputed to median value in each category except the last, where the lower bound of the interval was taken.

The results indicate that in comparison with other transition economies, administrative corruption in Latvia and Estonia is at a moderate level, while in Lithuania it is considerably higher. One potential explanation for this difference could be the lack of medium and especially large size firms in the Lithuanian sample. To correct for this potential sample bias Figure 2 also shows the unofficial payments for small size firms only.<sup>9</sup> The results from this additional investigation indicate that, although small size firms do suffer more from administrative corruption than medium and large size firms, the level of administrative corruption is still considerably higher in Lithuania than in Latvia and Estonia.

<sup>9</sup> The BEEP sample does not allow us to compare the levels of unofficial payments for medium and large size companies, as there are too few observations for Lithuania.

To identify the sectors of the government that are most prone to administrative corruption, the survey asked respondents to estimate the share of payments that are paid to different government branches. The results of the responses to this question are presented in Table 3.

**Table 3: Average proportion of bribes spent on each government sector (%)**

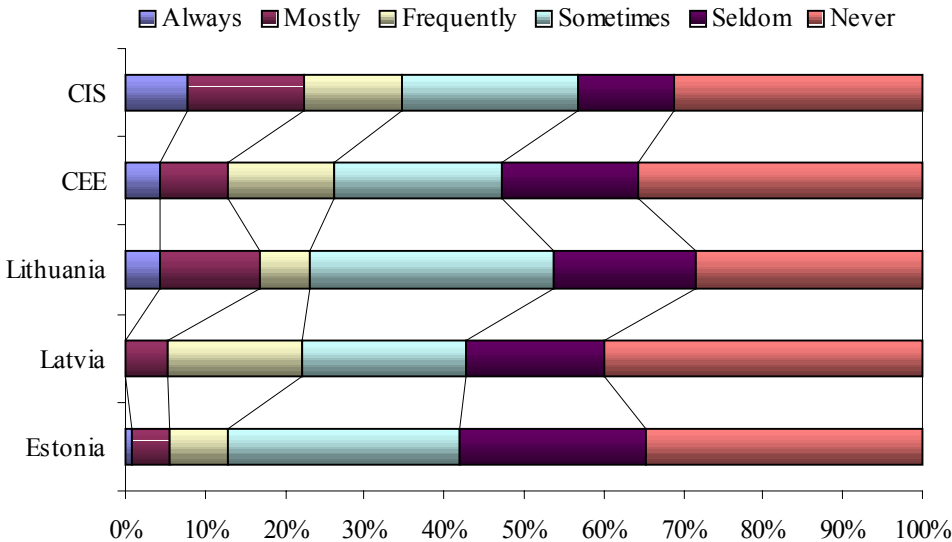
Country	Connection to public services	Licenses	Taxes	Government contracts	Customs	Courts	Health/fire inspectors	Influence legislation	Other	Total
Estonia	2.0	26.5	6.4	34.5	15.2	2.5	4.2	5.9	2.8	100
Latvia	6.7	10.9	9.1	10.8	14.0	5.7	4.0	3.4	35.4	100
Lithuania	14.0	8.5	16.3	5.0	15.1	8.7	17.6	4.3	10.6	100

For Estonia and Latvia a similar pattern emerges, as in both countries most bribes are paid for government contracts, during customs transactions, and for the acquisition of licenses. However, it should be noted that in Latvia the largest category is “other”. The customs department is also an important generator of bribe payments in Lithuania, although the other troubling sectors there are health and fire inspectors, taxes, and connection to public services. This difference between Lithuania and the other two Baltic States does not change when we look only at the sample of small size firms.

The BEEP survey data allows us to investigate in more detail the size of unofficial payments for government contracts. Firms were asked to estimate the fraction of the contract value that is offered in unofficial payments to secure contracts from the government. The average payments for the sample firms in Estonia, Latvia and Lithuania were correspondingly 5.2, 4.3 and 4.3 percent of the contract value.

In addition to estimating the amount of revenues spent on bribes, the extent of administrative corruption in the BEEP survey was also estimated by measuring the frequency of bribe payments. The respondents were asked to estimate how often firms need to make extra unofficial payments in general and to particular government sectors. The results for frequency of payments in general are summarized in Figure 3.

**Figure 3: Frequency of bribery\***



\* Firms were asked "Is it common for firms in your line of business to have to pay some irregular additional payments to get things done?"

Results indicate that 40 percent of firms in Latvia pay no bribes at all. The same numbers for Estonia and Lithuania are 34.7 and 28.4 percent. The highest frequency of payments among the Baltic states is again in Lithuania, although the difference here becomes much less pronounced, when we compare only the small size firms. The breakdown of payment frequency by government sectors suggests a pattern similar to the one presented in Table 3.

Overall, the survey data reveal that in comparison with the rest of the Central and Eastern Europe administrative corruption is a relatively small problem in Latvia and Estonia. In Lithuania administrative corruption is higher than the average level in the Central and Eastern Europe. In contrast to the other Baltic states a considerable fraction of bribe payments in Lithuania go to health and fire inspectors and for connection to public services, such as electricity and telephone.

## Conclusions

Corruption in the three Baltic states can be summarized in the following way: (i) Estonia exhibits a moderate level of administrative corruption and a moderate level of state capture, (ii) Latvia exhibits a moderate level of administrative corruption but a high level of state capture, (iii) Lithuania exhibits a high level of administrative corruption but a moderate level of state capture. These results agree with other estimates of perception of corruption, which show that in Latvia and Lithuania corruption is a bigger problem than in Estonia, but do not discriminate between different types of corruption.<sup>10</sup>

The contribution of the BEEP survey is to allow us to distinguish between problems with corruption in Latvia and Lithuania and make country-specific recommendations for fighting corruption. In the case of Latvia, emphasis should be put on transparency in government ties with the private sector, so that political parties represent all of their constituents and not merely the interests of particular businesses. The extent of state capture would also decrease if there was more competition among firms in the marketplace. At the same time, to fight administrative corruption Lithuania should focus on improving the quality of public administration and making government officials more accountable for their actions. Of course, further reforms are also needed in Estonia, since in comparison with the EU corruption levels in Estonia are still relatively high.<sup>11</sup>

Finally a word of caution is in place. Firstly, this survey looks only at firms although, surely, other individuals and groups are also involved in corruption. Thus one should expect that this survey underestimates the actual extent of corruption in transition economies. Secondly, like all other corruption surveys, BEEPS measures the perceptions of respondents and not the actual incidence of corruption.

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Hellman, J., G. Jones and D. Kaufmann, (2000b), "Seize the State, Seize the Day," The World Bank, Policy Research Working Paper No. 2444, September.

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<sup>10</sup> For example see the Corruption Perception Index from Transparency International ([www.transparency.org](http://www.transparency.org)) and the corruption index in Kaufmann et al. (1999). According to the Corruption Perception Index from Transparency International, corruption in Lithuania improved in 2000 and 2001, while in Latvia corruption has remained at the same high level throughout the 1999-2001 period.

<sup>11</sup> For more detailed discussion on strategies for combating corruption see World Bank (2000).

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# Labour Markets in Hard-Peg Transition Countries

Susan George, Erik Lundbäck, Luc Moers, Hélène Poirson, and Jerald Schiff  
International Monetary Fund (IMF), email: lmoers@imf.org<sup>1</sup>

## 1 Introduction

This article examines labour market developments and policies in the four countries – Estonia, Latvia, Lithuania, and Bulgaria – that have pursued transition to a market economy in the context of a hard exchange rate peg.<sup>2</sup> For each of the countries examined here, the extent to which ongoing reforms continue to generate growth, as well as the degree to which economic gains are broadly shared among the population, depends to a significant degree on the functioning of the labour market. Further, as each of these countries has chosen a pegged exchange rate, it is particularly important that the domestic labour markets be flexible, to help ensure that these economies can adjust to exogenous shocks and maintain their competitiveness on world markets.

The Baltic countries have established fully functioning market economies, but Bulgaria, which started later on its programme of reforms, has made strong progress in recent years (See Figure 1 on EBRD transition indicators). In each case, however, official unemployment has failed to come down from levels well above those of most industrial countries. This paper seeks to explain both the differences in labour market performance across the four countries and the common constraints to better unemployment outcomes. Our analysis suggests, in particular, that:

- (1) More rapid structural reform has been associated with better employment and wage outcomes;
- (2) Still high unemployment rates reflect in part skill mismatches as well as a lack of geographic mobility;
- (3) Significant restructuring likely remains to be implemented in several of the countries, so that unemployment may decline only over the medium term.

Section 2 reviews and analyzes developments over the course of transition in key labour market indicators, including employment, unemployment and wages. Section 3 describes key legal and institutional factors in the four countries – such as the system of unemployment insurance, minimum wage, role of unions and active labour market policies – and examines the extent to which they help to explain similarities and differences in developments across the countries. Finally, section 4 summarizes the findings of the article and discusses policy implications.

## 2 Developments in Employment and Wages

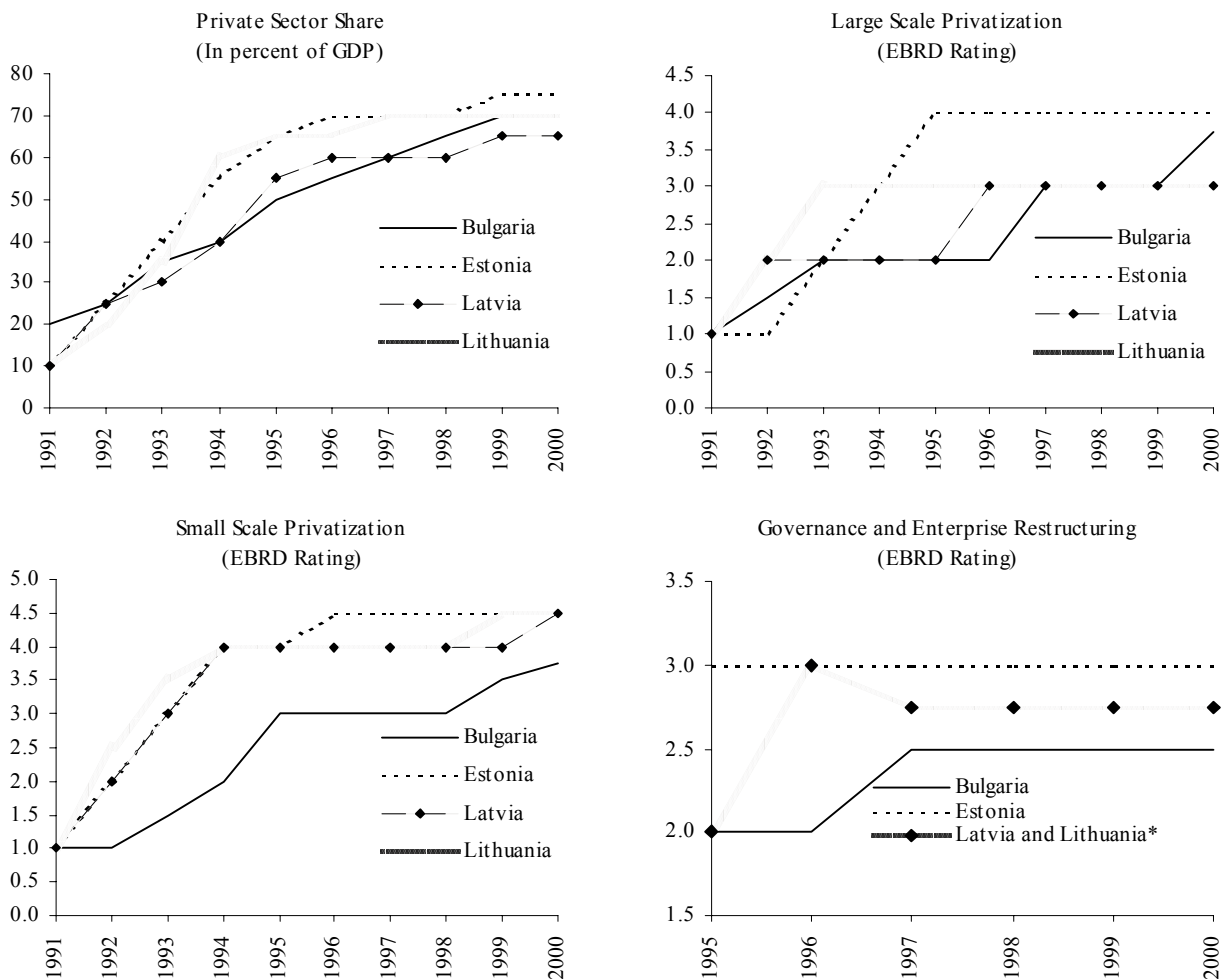
Models of labour markets in transition typically portray the transition process as characterized by job shedding in the public sector and, with some delay, job creation in the private sector, with increased unemployment as a temporary outcome. The public sector sheds labour during transition both be-

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<sup>1</sup> Corresponding author. The views expressed in this article are those of the authors and do not necessarily represent those of the IMF or IMF policy. Alexandra Merlino provided excellent research assistance. Comments by Raul Eamets and many IMF colleagues are gratefully acknowledged without implicating them. The article is based on information until June 13, 2001, when a more extensive version of this article was completed as IMF Country Report 01/100 (available from the IMF website).

<sup>2</sup> Estonia and Bulgaria operate currency boards pegged to the euro. Lithuania also operates a currency board, pegged to the dollar until the switch to a euro peg on February 2, 2002. Latvia's exchange rate is pegged to the SDR.

**Figure 1. Progress in Transition in Central and Eastern Europe, the Baltic States and Bulgaria, 1991-2000**



Source: EBRD Transition Report 1995-2000.  
 \* Same rating for Latvia and Lithuania.

cause public enterprises are privatized and because rationalization and associated layoffs are taking place within the state sector. At the same time, job creation in the private sector reflects privatization as well as the creation of new private sector firms and employment. However, the latter takes time, because the private sector does not develop instantaneously, and because matching individuals and jobs can be costly; as a result, unemployment rises (e.g. Burda, 1993; Boeri, 2000).

It would also be expected that, at least initially, labour market participation and employment would fall, and real wages would decline. Over time, these processes could be expected to reverse themselves as job creation in the new private sector picks up steam. The labour market experience of the four countries has been broadly similar, and generally in line with these expectations, although the unwinding of the initial negative consequences has taken considerably longer than expected.

### Population and Labour Force Participation

Reflecting emigration, a decline in the birth rate and an initial fall in life expectancy, populations declined during the decade of the 1990s by between 6 and 9 percent in Latvia, Bulgaria, and Estonia (See Tables 1-4). Latvia and Bulgaria experienced particularly large net emigration of about 5 percent of the population, primarily in the first years of transition. While some of this may have been a

response to worsening economic conditions, a majority of Latvians and Estonians emigrated to their countries of origin in the Commonwealth of Independent States (CIS), while more than half of the Bulgarian emigrants were ethnic Turks who emigrated to Turkey. In Lithuania, by contrast, emigration was small, and the overall population declined only marginally.

In all four countries, labour force participation and participation rates have declined substantially, helping to at least contain increases in unemployment.<sup>3</sup> In this, the experience has been broadly similar to other transition economies. Labour force participation has declined by 11 percent in Bulgaria,<sup>4</sup> about 15 percent in Latvia and Estonia, and 3 percent in Lithuania, where the population decline was far less dramatic. As a result, participation rates in all four countries have declined as well and, at between 41 and 49 percent, are low relative to Western industrial countries.

The decline in participation rates has had several causes. First, pension systems – in particular loose rules for disability and early retirement – have increased the number of pensioners, serving as a de facto safety net for many older workers who may have lacked the skills required by the new private sector (see section 3). Second, some workers became discouraged in their attempts to find a job, and dropped out of the labour force altogether. Third, some of the decline may reflect an attempt to acquire new skills needed in a market economy, e.g. via increased participation in higher education. Fourth, the decline in measured participation may reflect the fact that unreported economic activity is important. Finally, the decrease may reflect a response to the lifting of requirements to work typical of the Soviet system.

### **Trends in Aggregate Employment**

Employment has declined sharply during the last decade in all four countries, with much of this fall in the initial years of transition, broadly similar to the experience in transition economies in general. The scale of the employment loss was, however, much larger in Latvia, Estonia, and Bulgaria, than in most other countries (with the exception of Hungary) of Central and Eastern Europe (CEE) and the recovery in employment more delayed.<sup>5</sup> The larger and more persistent decline of employment in the Baltics and Bulgaria than in many other CEE economies may reflect in part a larger initial output loss. In Latvia, Estonia and Bulgaria, the number of officially employed individuals declined by about one quarter during 1990-99, largely in the initial years of transition.<sup>6</sup> In contrast to Latvia, employment in Estonia and Bulgaria has continued to decline, albeit more slowly, in the period since 1995.<sup>7,8</sup> Lithuania has seen a slower reduction in employment in line with its more gradual fall in participation, with employment falling by 11 percent over the 1990s, virtually all of which took place in the first half of the decade.

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<sup>3</sup> An individual is participating in the labour market if he or she is either employed or out of work and actively seeking a job.

<sup>4</sup> Based on Labour Force Survey data for 1993-99.

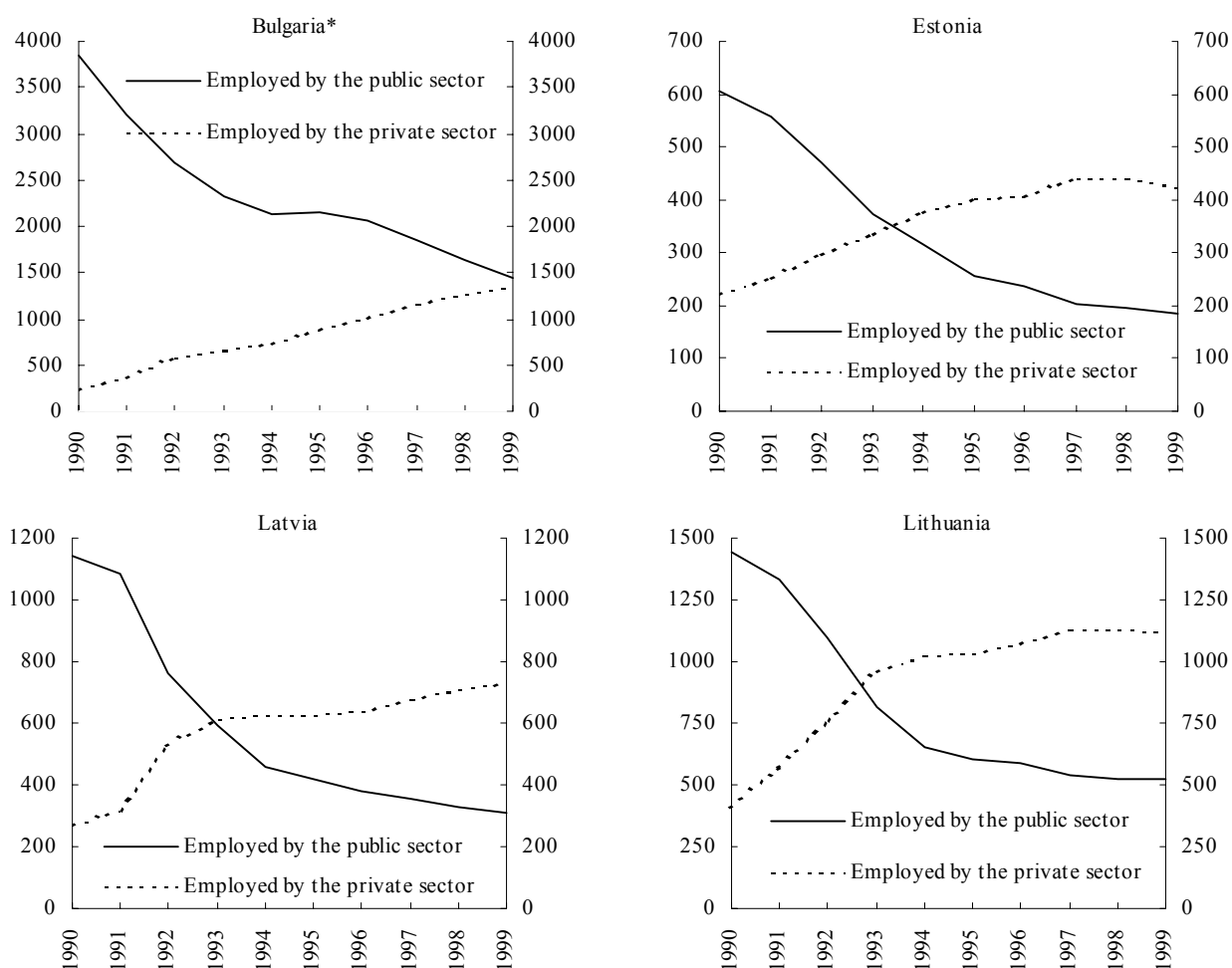
<sup>5</sup> Employment fell by some 9 percent in Poland and the Czech Republic during 1990-93, and by 14 percent in Slovenia during 1990-96, whereas in Hungary it dropped by a quarter over the same period (Garibaldi et al., 2000).

<sup>6</sup> Employment data for Estonia in Table 2 have a break at 1995, reflecting a shift in data collection procedures from enterprise reports to labour surveys. According to an alternative data source (United Nations Economic Commission for Europe) the employment decline in Estonia during 1990-95 was 22 percent.

<sup>7</sup> This is in contrast to much of CEE, where employment started to recover or level-off as early as 1994 (Poland, Czech Republic) or since 1997 (Hungary, Slovenia).

<sup>8</sup> Employment in Estonia increased in the 4th quarter 2001 for the first time in the transition period. See the Estonia Update of this issue of *BET*. Ed.

**Figure 2. Bulgaria and the Baltic Countries: Public and Private Employment, 1990-99 (in thousands)**



Source: country authorities.

\* Data from 1993 onward not comparable with previous years; see table 2.

Employment in the public sector has declined quite rapidly, falling by more than half. In Latvia, some 400 thousand public sector jobs were lost between 1992 and 1997, either through privatization or actual labour shedding – about half of the starting total – and about 200 thousand private sector jobs created, either through privatization or the formation of new private firms (Figure 2). The share of employment in the private sector has increased from 40 percent in 1992 to 70 percent in 1999. The other Baltic countries have seen similar developments, and the proportion of private sector employment is similar to other CEE countries. In Bulgaria, by contrast, only 22 percent of the workforce was employed in the private sector in 1993, reflecting a slower pace of reform, although by 1999, this figure had risen to almost 50 percent.

It appears that much of the switch from public to private sector employment reflects real labour-shedding in the public sector and private job creation, rather than simply privatization of state-owned enterprises.<sup>9</sup> While it is difficult to make a precise estimate, in all four countries, more than half of the public sector job loss (on a net basis) took place during 1992-94, well before the privatization process took off. Similarly, nearly half of the new private sector jobs were created during this period.

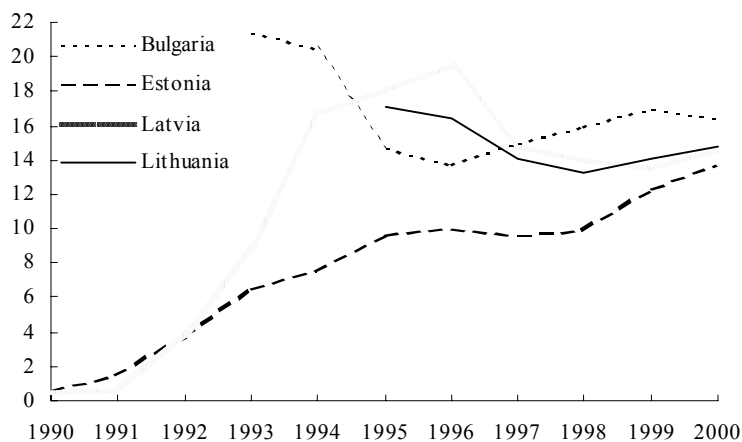
<sup>9</sup> This tentative finding is consistent with empirical results for transition economies. See e.g. Bilsen and Konings (1998) for Bulgaria, Hungary and Romania.

The acceleration of private job creation has not yet been sufficient to bring unemployment rates down significantly. Data indicate that people at both the younger and older ends of the age distribution have had particular difficulties finding jobs, supporting the view that skill mismatches have been an important determinant of levels of employment. In Estonia, for example, particularly large declines in employment over the decade have been observed in the age categories 15-24 and 50-69 years, where employment rates declined by about one third between 1990 and 1999 (Table 6).<sup>10</sup> The decline in employment for these two groups is mirrored in the high unemployment rate for the young, and the sharp rise in the number of retired persons. These trends, which can also be seen in the other countries, likely reflect skill problems – the young lack work experience and the education and vocational training systems are insufficiently responsive to market demands, while the old acquired skills under communism which are obsolete.

### Developments in Unemployment<sup>11</sup>

Despite the emergence of a vibrant private sector in the Baltics and more recently Bulgaria, the unemployment rate has been slow to complete the expected inverted-U shaped path. Unemployment in the Baltics increased until 1995-96, when it reached almost 20 percent in Latvia, 17 percent in Lithuania and 10 percent in Estonia. In Bulgaria, unemployment peaked in 1993 at 21 percent (Figure 3).<sup>12</sup> The initial rise in unemployment was as expected, due to the first round of privatization and restructuring which led to state sector enterprise closings and the hardening of budget constraints in remaining state enterprises. As in other transition countries, the private sector was not able to absorb these workers immediately, despite the sharp decline in participation.

**Figure 3. Bulgaria and the Baltic Countries, Unemployment, 1990-2000 (in percent)**



Source: Authorities labor force survey.

<sup>10</sup> The most recent figures which show an increase in Estonian employment also show that employment has increased in the 50-69 age group, See the Estonia Update of this issue of *BET*. Ed.

<sup>11</sup> Unemployment data come from several sources, corresponding to more or less broad definitions of unemployment. For all four countries, the national employment office compiles and publishes data on those individuals who register as unemployed ("official unemployment"). This understates true unemployment for well-known reasons. Alternative estimates of unemployment based on labour force surveys seek to measure the unemployed as all individuals not currently employed and seeking employment, consistent with the definition utilized by the International Labour Organization (ILO). While such data are conceptually preferable, they are available on a less frequent basis, and for a shorter time series, than official unemployment data. Thus this article makes use of both sets of data.

<sup>12</sup> These data are compiled by national authorities according to ILO definitions. However, the similar definitions do not necessarily ensure full comparability across countries.

Unemployment has remained at a fairly high plateau in the Baltic countries, significantly higher than both other CEE countries and most industrial countries. In Estonia, the unemployment rate was virtually constant over 1996-98 before rising in response to the Russia crisis. Latvia's experience has followed the expected path more closely, although the unemployment rate has not declined below 14 percent. Lithuania's unemployment fell to just over 13 percent in 1998, but has risen since. Bulgaria's experience has been quite different, with unemployment falling steadily from 21 percent to 14 percent during 1993-96, before rising in reaction to the economic crisis of 1996-97 and subsequent external shocks and economic restructuring. Following the Russia crisis in August 1998, unemployment rates rose in all four countries, though recently they have tended to decline again.

The failure of unemployment to decline to average industrial country levels is difficult to explain by reference to labour market policies, as these appear to be quite flexible (see section 3). At least part of the explanation lies in the lack of relevant skills, including language skills, as well as a lack of geographic mobility. High levels of long-term unemployment (45 to 52 percent had been unemployed for more than one year in 1999, excluding Lithuania) suggests that the ranks of the unemployed are to a great extent filled by individuals who are unable to function successfully in the post-transition labour market. In Lithuania, by contrast, the percentage of long-term unemployment is only 13, in part reflecting the sharp increase in the number of unemployed following the Russia crisis, some of whom may only now be entering the category of long-term unemployed. While these long-term unemployment rates are similar to those of other CEE countries<sup>13</sup>, they are of a different order of magnitude than, for example, the United States and Korea, where less than 10 percent of unemployed are long-term unemployed. Moreover, a large share of the long-term unemployed are without unemployment benefits, which contributes to increased poverty.

Other features of the unemployment picture include:

- Unemployment rates show substantial regional variation (see below).
- The highest levels of unemployment are experienced by young workers; despite low participation rates, those between 15-24 years of age experienced unemployment rates of 26 percent in Latvia, 28 percent in Bulgaria, 22 percent in Lithuania and 16 percent in Estonia, in 1998.
- Ethnic minorities have experienced relatively high levels of unemployment. In 1998, minority official unemployment rates ranged from 14-20 percent in the Baltics, compared with a range of 3-9 percent for ethnic Balts. In part, this reflects language skills, in particular for Russian speakers in the Baltics.
- Semi-skilled and unskilled workers are over-represented among the unemployed. They have suffered the brunt of the labour shedding, and often have found themselves without the appropriate skills for the newly available jobs.

Hidden unemployment and underemployment, which was important prior to transition, remained so in the early years of transition. In Latvia, for example, the number of underemployed-measured by full-time work equivalent of involuntary reduced work hours and unpaid leave-was significantly higher than the level of unemployment in 1992-93, and remained at nearly half of unemployment in 1999 (Table 7). Further, over the years 1995-99, the number of discouraged workers-those who have left the labour force after failed attempts to find work and so are not counted as unemployed-increased from an estimated 16 percent to 28 percent of the number of unemployed. In Estonia, similarly, the number of underemployed is about one third of the unemployed, while the number of discouraged workers is about one fourth as large as the pool of unemployed.

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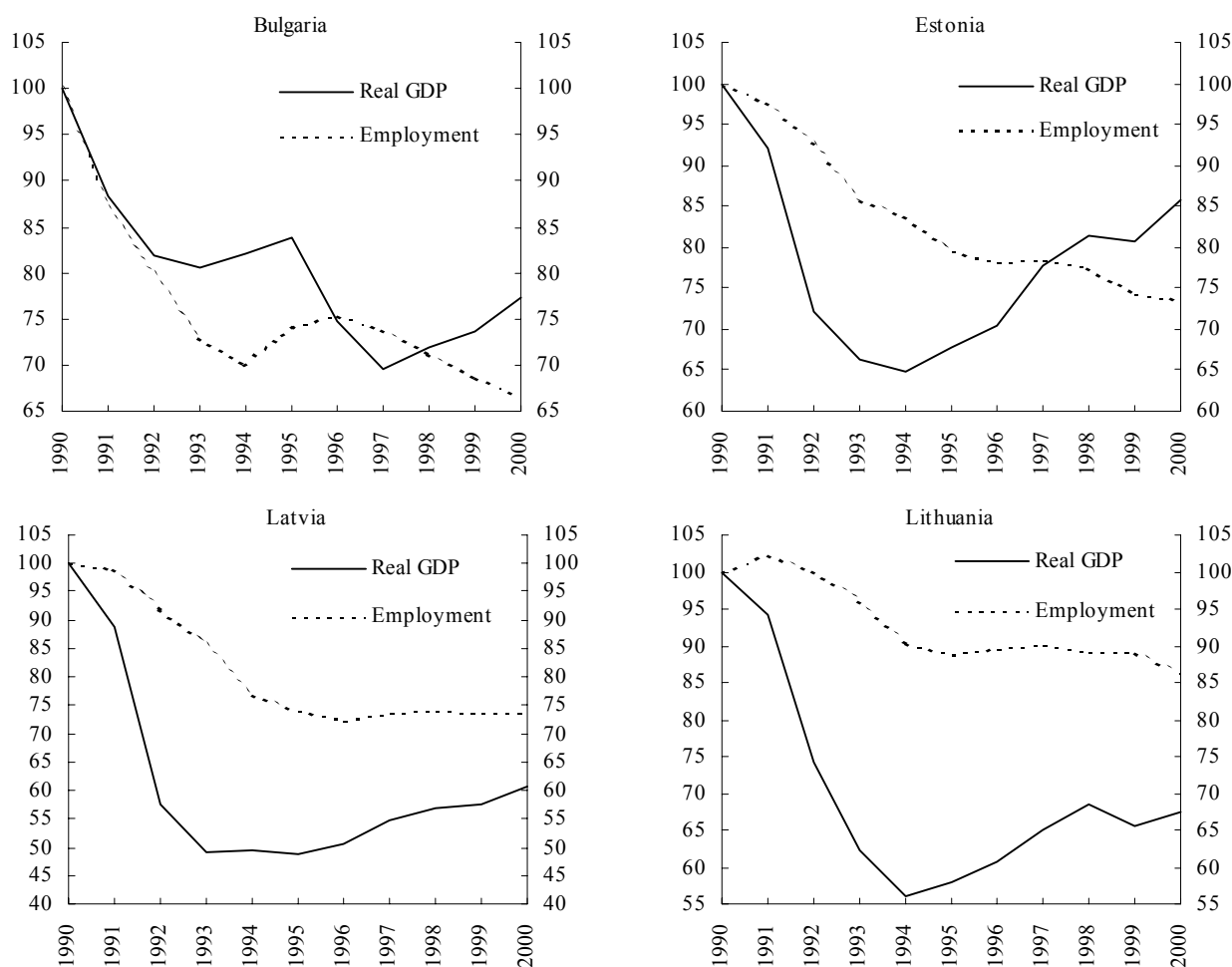
<sup>13</sup> In Hungary for instance, the share of long-term unemployed exceeded 50 percent of total unemployed by 1997, and in the Slovak Republic it nears 50 percent (EBRD, 2000).

## Economic Restructuring and Labour Market Developments

At the same time that labour participation was declining and unemployment rising, the early years of transition saw dramatic shifts in labour from contracting to expanding sectors of the economy. To a large extent, labour market flexibility has facilitated economic restructuring, but there is evidence that labour left behind in declining sectors – in particular agriculture – has become significantly less productive, and that significant further restructuring may be needed in several countries to ensure competitiveness.

The evidence suggests that early and strong structural reform has gone hand-in-hand with better labour market performance. For example, Estonia which privatized its state enterprises, opened up to foreign investment, and imposed hard budget constraints on enterprises quickly and decisively, has experienced relatively large reallocation of labour and significant improvements in labour productivity. While employment everywhere fell sharply in the early stages of transition, it did not – with the exception of Bulgaria – fall as rapidly as real output, at least as officially measured (Figure 4). As a result, labour productivity, measured by output per official worker, initially declined sharply in the Baltics, while rising moderately in Bulgaria. However, from 1992 in Estonia, and 1993 in Latvia, aggregate labour productivity has increased steadily. By 1999, productivity exceeded 1992 levels by 45 percent and 17 percent in Estonia and Latvia, respectively, albeit at significantly lower levels of employment. In Lithuania, where employment declined more slowly, productivity appears to have

**Figure 4. Bulgaria and the Baltic Countries: Real Gross Domestic Product and Employment, 1990-2000 (indices 1990 = 100)**



Source: country authorities; and Fund staff estimates.

remained below 1992 levels. In Bulgaria, after an initial 4 percent rise over 1991-95, labour productivity declined sharply by 14 percent during the 1996-97 crisis. Productivity has since begun to increase again, but remains below its 1992 level. These data suggest that the transition process may have some way to go before completion in at least several of the countries, and that further substantial restructuring at both macroeconomic and enterprise levels, and significant layoffs, may be in the offing.

### **Productivity and Industrial Restructuring**

In the Baltic countries, the sectoral composition of output has changed dramatically, with the share in GDP of manufacturing and agriculture declining sharply and the share of services increasing. In Bulgaria, by contrast, the decline in the share of industry in GDP has been much less marked, and the share of services declined until 1998 while the share of agriculture has increased slightly since 1994.

Economic restructuring has been made possible by a sizable reallocation of labour. In all four cases, the share of employment in manufacturing declined and that of services rose, but the magnitude of these changes varied substantially. Further, the role of agriculture has been quite different, reflecting in part the pace of economic restructuring. In particular, Estonia has been unique among the four countries in its ability to reduce agricultural employment and maintain employment in manufacturing. Conversely, Bulgaria experienced a sharp decline in the share of manufacturing and a steady rise in the share of employment in agriculture, suggesting that agricultural employment acted to some extent as a buffer for industrial labour shedding. Sectoral employment changes have generally been proportionally smaller than those for output, implying a decline in productivity, in particular in declining industries.

### **Developments in Wages**

Initially all four countries experienced substantial declines in real wages, which are estimated to have declined during 1990-92 by between 30 and 60 percent. While real wages have since grown steadily in Estonia and Latvia, they have only recently begun to rise back to pre-transition levels in Lithuania and Bulgaria.

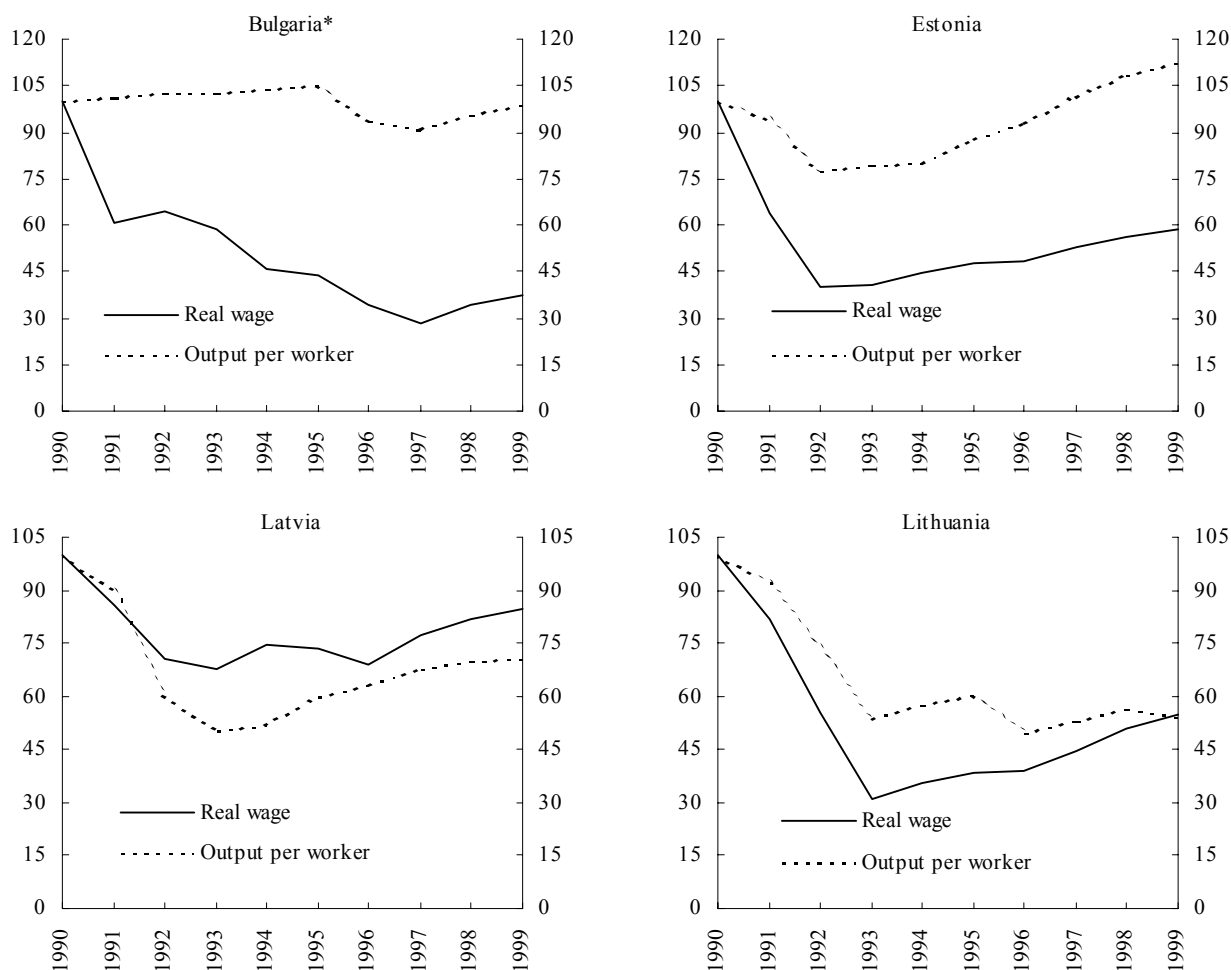
The relationship between wages and productivity has varied over time and across countries, with potential implications for competitiveness. Overall, output per worker has increased significantly faster than wages in Estonia, while the two have grown at similar rates in Latvia and Lithuania. In Bulgaria, the average real wage has taken the brunt of the adjustment throughout the transition, dropping by more than 50 percent up to 1997, significantly faster than productivity.<sup>14</sup> The turn-around in wages and productivity started only in 1998 with wages rising by about a third during 1997-99, four times as fast as productivity (See Figure 5). Perhaps more relevant for competitiveness, in both Estonia and Latvia, output per worker in manufacturing has grown significantly more rapidly than wages for the period as a whole, whereas for Bulgaria and Lithuania wages have grown roughly in line with productivity.

Declines in real wages, as a potential alternative to lower employment, are evidence of labour market flexibility. Of the Baltic states, Latvia has had the largest employment adjustment and the smallest real wage decline for the period as a whole (Figure 6; see also OECD, 2000.) In Bulgaria, by contrast, the initial sharp drop in real wages in 1992-97 was accompanied by only a limited employment decline over the same period. Within the CEEs more generally, there was also some evidence of a

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<sup>14</sup> The assessment of developments in private sector wages in Bulgaria as well as in most transition economies is hampered by the lack of comprehensive labour statistics. In particular, wages tend to be underreported in the private sector.

**Figure 5. Bulgaria and the Baltic Countries: Productivity and Real Wage, 1990-99 (indices 1990 = 100)**



Source: country authorities; and Fund staff estimates.

\* Wage data are for public sector up to 1995, and are an average of the public and private sectors from 1996 onward.

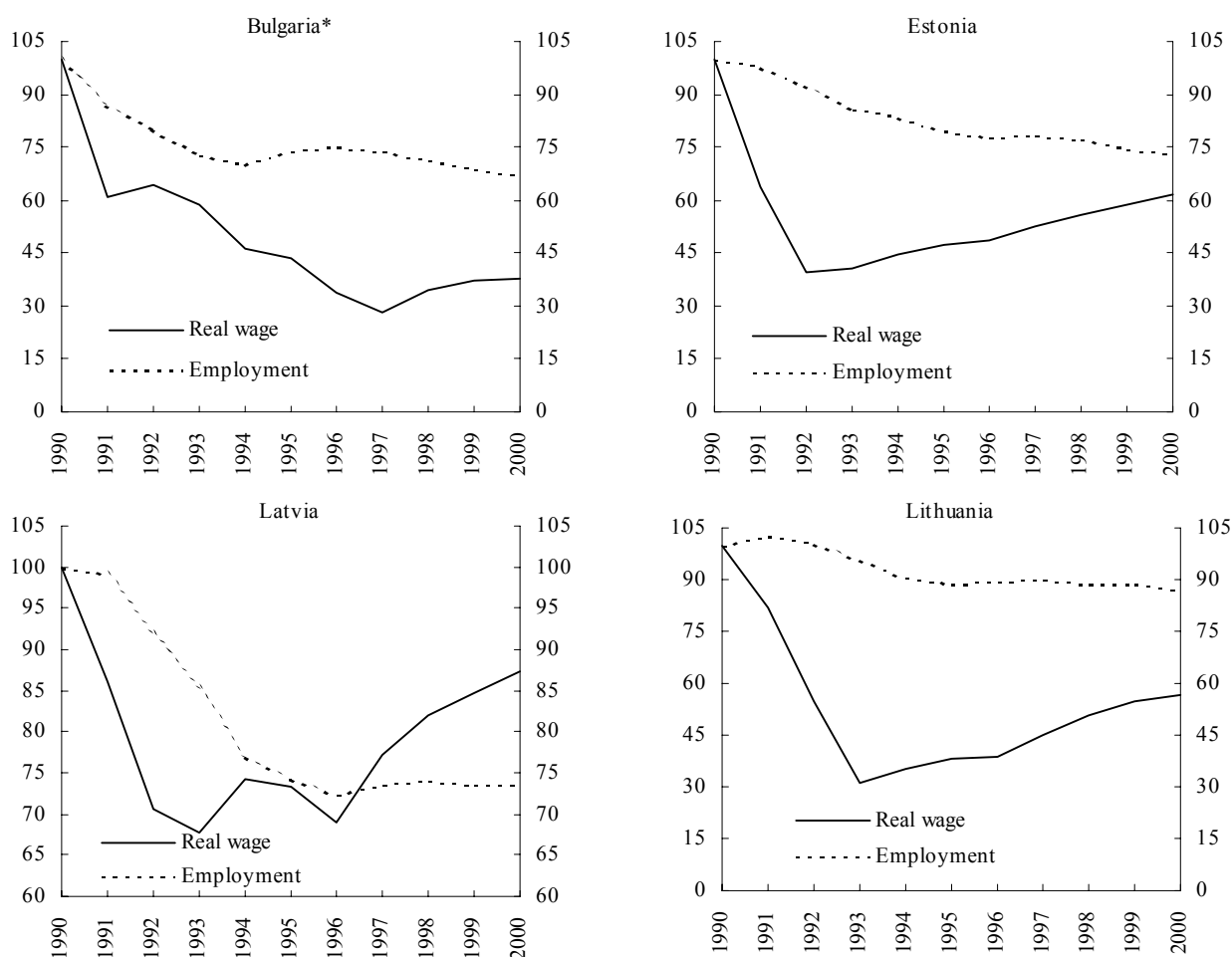
wage-employment trade-off during transition. There is little evidence of an impact of the 1998 Russia crisis on real wages in general, although there were significant adjustments in some affected industries. The transition process in most countries has resulted in a gradual but significant increase in wage dispersion and higher returns to education (e.g. Rutkowski, 1996).

Continued attraction of foreign direct investment and removal of remaining barriers to entry by new firms would appear to be keys to increasing wages while maintaining competitiveness. In this context, evidence suggests that, in the Baltics, foreign-owned enterprises pay higher wages than domestic ones, and new enterprises pay higher wages than those in operation since before the transition (OECD, 2000).

### Geographic Mobility and Regional Differences in Unemployment and Wages

All four countries are characterized by substantial regional variation in unemployment and wages, although only a few regions with relatively small populations can be said to have extraordinary problems (OECD, 2000). Living standards in rural areas are 20-30 percent lower than urban levels (more if only cash spending is counted), mainly reflecting differences in wages. Further, some rural regions are characterized by very low wages and high unemployment – southeastern Estonia, eastern Latvia (Latgale) and some parts of Lithuania (Alytus, in the South) and Bulgaria (Northwest and Northeast).

**Figure 6. Bulgaria and the Baltic Countries: Real Wages and Employment, 1990-2000 (indices 1990 = 100)**



Source: Authorities labor force survey.

The closing of a number of large enterprises in 'one company towns' as well as the decline in agriculture have led to high unemployment rates in some areas. The problem appears to be particularly important in Latvia, where unemployment by province ranges from near 30 percent, to less than 8 percent in Riga.<sup>15</sup> In Bulgaria, regional unemployment rates also vary substantially, from about 4 percent in Sofia in 1999 to 26 percent in Targovishte. In two regions of Estonia, unemployment rates exceed 20 percent, double the rate in Tallinn. Only in Lithuania is there just modest variation across regions, although such variation appears to have increased since the Russia crisis.

There has been surprisingly little movement of the population from high unemployment regions to those with low unemployment – in particular the capital cities – contributing to persistent high unemployment and significant long-term unemployment. Overall levels of migration between regions within the four countries are low.<sup>16</sup> For example, about 1 percent of the Estonian population and 2 percent of the Bulgarian population per year move between regions. More to the point, it does not appear that migration has been primarily motivated by labour market concerns. In Latvia, for example, fewer than 2,000 people migrated to Riga, on a net basis, during 1994-98, while net migration to Ventspils – a port city with robust growth – has been negative for each year in that period. By contrast, several of

<sup>15</sup> Data are difficult to compare across countries, as the number of regions varies considerably. The greater the number of regions into which data are disaggregated the more variability, other things equal, we would expect to find.

<sup>16</sup> The official data may underestimate real migration since some individuals may maintain their official residence while living and working elsewhere.

the regions with the highest unemployment, such as Rezekne, have experienced net inflows over the period. Similarly, Tallinn has experienced net outmigration during 1997-99. In Bulgaria, net emigration from Targovishte was zero, despite high unemployment.

The lack of labour mobility results, in part, from the high prices for new housing, and limited housing stock and turnover in urban areas. While housing markets are liberalized in all four countries, it has been difficult to obtain housing loans, or to use houses as collateral. This points to the importance of completing apartment privatization and further development of capital markets, including mortgages. In addition, migration from rural to urban areas may be limited by the high cost of moving relative to rural incomes, as well as the ability of the rural poor to meet consumption needs from private plots of land. The lack of mobility also likely reflects social norms developed during years of central planning and mismatches between the skills of the rural unemployed and the requirements for jobs in urban areas. It is plausible that as transition continues and employment opportunities increase, a rise in geographic mobility might result. The small size of the countries would, in particular, make daily or weekly commuting possible for many. Such activity could be encouraged by improved mass transit and transportation infrastructure (OECD, 2000).

### **3 Labour Market Policies and Institutions**

For the most part, labour market policies and institutions in the Baltics and Bulgaria are quite flexible, as required for the successful operation of a fixed exchange rate regime. Minimum wages, unemployment benefits, and pensions are unlikely to cause major incentive problems, because they are substantially lower than common wages. More generally, state interference with the labour market is limited. Active labour market policies, and other policies to increase labour mobility, have played only a minor role to date.

#### **Minimum Wages**

All four countries have set minimum wages at low enough levels that their potential adverse incentives have likely been moderate, certainly in the aggregate. Over the course of transition the minimum wage in the Baltics has been maintained at 25 to 45 percent of the average gross wage. In Bulgaria, the minimum wage began at a relative high level at the onset of transition, more than half of average gross wage in 1991, but is now around one third.

#### **Unemployment Insurance and Social Safety Net**

An adequate system of unemployment insurance (UI) can be a significant element of the social safety net and, if properly designed, can help move forward the process of economic restructuring. Without such a scheme in place, governments might be less willing to undertake reforms which might cause transitory unemployment and workers might be more willing to remain in less productive sectors, perhaps in part-time work. At the same time, overly generous benefit levels or duration, or eligibility requirements, may encourage unemployment beyond the optimal level and impose substantial fiscal costs.

In the Baltics and Bulgaria, UI has not been generous, so that it has likely not played a major role in prolonging unemployment. On the contrary, it could be argued that the narrow coverage and low level of benefits have left important holes in the safety net and perhaps slowed structural reforms in some cases. On the other hand, UI was typically more generous early on in transition, and pared down during later reforms, a policy path which could well be seen as quite rational.

Unemployment benefits (UB) in the four countries are substantially lower than common wages, with replacement rates of less than one third in the Baltics, and durations of one year or less in all four countries.<sup>17</sup> One potentially important characteristic of UI in all four countries is the low coverage rate (the percentage of registered unemployed receiving benefits), which has contributed to the incidence of poverty among the unemployed. In Latvia, for example, there has been a steady decline in the share of officially unemployed who receive benefits, from 81 percent in 1992 to 41 percent by end-1999, while Bulgaria experienced a decline in coverage rate from 54 percent in 1990 to 29 percent in 1999 (World Bank, 2000; OECD, 2000). This reflects relatively stringent eligibility requirements, low benefit levels, which reduce the incentive to register, and the high percentage of long-term unemployed, whose benefits have lapsed.

## **Pension Systems and Labour Markets**

Several aspects of a country's pension system can directly affect the functioning of the labour market. First, if a system generously allows for early retirement and disability retirement it will tend to reduce the supply of labour during transition. Second, the payroll taxes that typically finance pay-as-you-go pension systems distort labour market decisions, increase labour cost to the employer, and reduce labour supply. Third, to the extent that working pensioners lose pension benefits when they have earned income, they face a sizable implicit tax on those earnings, further distorting work decisions.

Upon regaining their independence, the Baltic states inherited the pension system of the Soviet Union characterized by high replacement rates, multiple benefit and retirement rules, and extensive early retirement (Schiff et al, 2000). The Bulgarian pension system was similar. The pension systems became, over time, the most important de facto sources of welfare benefits to the growing number of unemployed and poor. In particular, the number of pensioners increased rapidly during the early years of transition, especially for those receiving disability pensions, as eligibility rules were explicitly or implicitly loosened.

Pension reforms in the Baltics and Bulgaria have generally moved toward limits on early retirement, increased retirement ages and closer links between contributions and benefits. These changes have aimed at ensuring the long-term sustainability of the pension system in the face of worsening demographic trends, and at limiting the adverse incentive effects of pay-as-you-go pension schemes. The four countries are moving toward a three-pillar system now, incorporating a compulsory fully-funded system and voluntary private pensions alongside the pay-as-you-go-pillar. These moves can be expected to further enhance labour market functioning to the extent that workers see their contributions to fully-funded pillars as individual investments as opposed to tax payments.

In all four countries, taxes on labour income are very high, with potentially important adverse consequences for the labour market.<sup>18</sup> All therefore plan gradual reductions in taxes on labour income, but this will be possible only as part of a broader medium-term strategy to reform the pension systems and reduce low-priority spending.

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<sup>17</sup> However Estonia has introduced a new UI scheme which will make its first payments in January 2003 and which has replacement rates of up to 50%. For details see *BET* 2002(1) pp22-23. Ed.

<sup>18</sup> Although analyses of the interaction of taxation on wages and employment often focus on payroll and personal income taxes, other forms of taxation may also be borne largely by labour, in particular in a small open economy, such as the Baltics and Bulgaria.

## **Labour Laws and Institutions**

All four countries have labour laws and practices that allow substantial scope for employers with regard to work practices and wage determination was deregulated early in transition, with the exception of typically rather low minimum wages.

Labour unions in the Baltics are rather weak. Their membership covers only about 10 percent of the workforce in the private sector in all three countries, although membership appears to be on the rise in Lithuania in response to recently increased unemployment. Wage bargaining takes place at the enterprise level throughout the Baltics. In contrast, union membership in Bulgaria is significantly stronger. Estimates of union membership range from about 30 percent<sup>19</sup> to more than 70 percent<sup>20</sup> of total employment. The role of unions tends to be strengthened by the greater reliance in Bulgaria on centralized bargaining and direct government involvement in labour negotiations. More decentralized bargaining at the local level could address high and persistent regional unemployment differentials. On the positive side, industrial relations are characterized by a high degree of cooperation and there is little evidence of strong wage pressure.

To date employment legislation in the Baltics permits employers to easily dismiss redundant workers. In Latvia, there is no mandatory severance pay and such pay is normally not included in the terms of employment. In Estonia, employers have the right to lay off a worker with a two-month notice, and even without notice in case of bankruptcy. Employers can generally select the workers they want to dismiss on the basis of productivity, although they must also take account of social factors such as family size, and they must pay severance benefits corresponding to 2-4 months of pay. Lithuanian municipalities have a formal possibility to stop dismissals, but this has rarely been used. The government of Bulgaria has taken some steps to enhance labour market flexibility and promote employment. Under amendments to the Labour Code approved in March 2001, contracts can now be terminated for economic reasons, and more flexibility in working hours is allowed. However, procedures for collective redundancies remain rigid and require difficult coordination with the trade unions, representing an obstacle to firm-level restructuring.

## **Active Labour Market Policies**

Active labour market policies (ALMPs) can play a useful role in providing job information, training, and income support to the unemployed, but experience has been mixed. In some cases taking part in active labour market programmes has led to either higher employment rates or shorter unemployment spells, but in other cases it has not led to appreciable improvements in job prospects. Public works programmes can be costly and, if not properly designed, provide disincentives for private sector employment. Such programmes also tend to have little net impact on reemployment probabilities due to large substitution effects in the case of subsidized employment and possible "stigma" effects in the case of public works programmes. Further, in transition economies, the ongoing restructuring process may make it more difficult to predict which skills will be required by private enterprises in the future. In any case, ALMPs are unlikely to have a major positive impact in the absence of an appropriate legal and institutional framework which allows labour market flexibility and mobility (see EBRD, 2000).

ALMPs play only a small role in the four countries. For example, expenditure on such activities accounted for only about 0.2 percent of GDP in Bulgaria. There are public employment agencies in all regions of each country but, as noted, many unemployed are not registered and, in any case, the

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<sup>19</sup> Figure cited by the Ministry of Labour.

<sup>20</sup> World Bank (2000).

agencies have limited capacity to serve large numbers of unemployed. Public sector job training and subsidized work have a modest role in Bulgaria, Latvia and Lithuania, and an even smaller one in Estonia.

#### **4 Conclusions**

This article has examined labour market developments in the four hard-peg transition countries, with a view toward understanding the persistent high unemployment experienced in each country. This unemployment cannot be explained by labour market institutions or policies, which are quite flexible. Indeed, labour market flexibility has been a key ingredient of restructuring, with large movements of workers from contracting to growing sectors of the economy. Neither can the unemployment be fully explained by a failure to proceed with needed structural reforms, as these countries have generally been successful in restructuring and reorienting their economies. However, the timing of observed trends in unemployment is quite closely related to the individual histories of structural reform, with sharp increases in recent years in Bulgaria and, to a lesser extent, Lithuania, following on belated hardening of budget constraints.

The high unemployment appears to reflect largely a mismatch between the skills of a significant pool of long-term unemployed, in particular in rural regions, and the needs of a growing private sector. In particular, language differences may help explain the higher unemployment rates among ethnic minorities. In addition, there has been a surprising lack of geographic mobility. These problems are clearly reflected in the relatively high and growing share of long-term unemployment in total unemployment, the persistent large regional differences in unemployment rates, and the concentration of unemployment among the young and unskilled. Older workers also tend to suffer from inadequate skills for the market economy, resulting in the sharp drop in employment rates for this group, and a rise in pension (disability) rolls in the initial years of transition.

Despite the significant levels of unemployment in all four countries, labour market developments suggest that the strongest and earliest reformers have had the best labour market performance as well. Thus, in contrast to the literature on optimal pace of transition (cf. Boeri, 2000), there is no clear evidence of a trade-off between speed of reform and unemployment costs except, perhaps, in the very short run. In particular, Estonia, which completed its privatization and imposed hard budget constraints throughout the economy quite early in transition, has experienced unemployment that, while still substantial, has been consistently lower than its Baltic neighbors, while job creation and productivity gains have been relatively strong. The ability of the Estonian economy to quickly move labour out of less productive activities, especially agriculture, appears to have played a large role in the overall strong performance of its economy. Bulgaria, by contrast, was significantly slower than the other countries in moving forcefully on structural reforms, but has still experienced unemployment rates that are comparable, or higher, than Latvia and Lithuania.

While there has been a substantial restructuring of the Baltic economies and Bulgaria during the course of the transition, further restructuring, on both a macro level and within enterprises, may need to take place. Reflecting this need, productivity levels in a number of industries and countries, appear to remain below pre-transition levels, in particular in declining sectors such as agriculture. As privatization is completed, new technologies are introduced, civil service reform proceeds, and job guarantees associated with privatized firms lapse, there will continue to be pressures which will make significant declines in unemployment difficult without robust new private sector job creation.

It is crucial, therefore, that all four countries continue policies aimed at encouraging investment and job creation. In this regard, the flexibility of labour markets is likely to be an important asset. Active labour market policies can also play a role, but should be carefully designed and targeted, and focused

on providing information and training rather than primarily public works and other public sector employment. In addition, reductions in taxes on labour income could increase job creation, although any such cuts would need to be made in the context of an overall medium-term fiscal framework. Further, as all four countries are characterized by low geographic labour mobility, policies should be developed to reduce rigidities in the housing market.

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## Statistical Appendix

**Table 1. Bulgaria: Summary of Labour Market Trends, 1990-99\***  
(In thousands, except where indicated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total population	8,718	9,632	8,540	8,472	8,427	8,385	8,341	8,283	8,230	8,191
Working age population †	4,822	4,793	4,757	4,736	4,741	4,745	4,749	4,750	4,750	4,753
Labour force participation	4,162	3,983	3,851	3,809	3,609	3,552	3,576	3,564	3,477	3,388
Participation, share of total population	47.7	41.4	45.1	45.0	42.8	42.4	42.9	43.0	42.2	41.4
Participation, share of working age population	86.3	83.1	80.9	80.4	76.1	74.9	75.3	75.0	73.2	71.3
Employment	4,097	3,564	3,274	2,995	2,869	3,032	3,085	3,030	2,921	2,811
Percent in private sector	5.9	10.1	17.7	22.4	25.5	28.8	32.7	38.2	43.6	48.2
Registered unemployed	65.1	419.1	576.9	626.1	488.4	423.8	478.8	523.5	465.2	610.6
Unemployment rate (registered)	1.7	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0
Unemployment rate (ILO definition)	...	...	...	21.4	20.0	15.7	13.5	13.7	12.2	14.0
Unemployment rate (survey)	...	...	...	21.4	20.5	14.7	13.7	15.0	16.0	17.0
Long-term unemployed	...	...	...	220.9	214.9	221.9	246.9	245.2	225.8	303.2
As percent of total unemployed	...	...	...	35.3	44.0	52.4	51.6	46.8	48.5	49.7
Wages (leva per month):										
Gross monthly wage (public sector)	...	0.9	2.0	3.0	4.7	7.3	13.4	135.5	194.8	221.4
Net monthly wage (public sector)	...	...	...	...	...	...	7.5	75.9	108.3	120.2
Gross monthly wage (economy-wide)	0.4	1.0	2.0	3.2	5.0	7.6	13.2	127.9	183.3	205.1
Real wage index (1995 = 100)										
Public sector	...	135.8	148.5	131.7	104.3	100.0	82.1	72.0	87.1	96.5
National economy ‡	229.5	139.9	147.9	135.0	105.8	100.0	77.9	65.4	78.9	86.1

Source: Central Statistics Bureau of Bulgaria.

\* Data on employment and labour force from 1993 onward reflects a change in the data source prompted from the labour survey.

† Working age population is defined as aged 15-59.

‡ Wage data are for public sector up to 1995, and are an average of the public and private sectors from 1996 onward.

**Table 2. Estonia: Summary of Labour Market Trends, 1990-99**  
(In thousands, except where indicated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total population	1,571	1,566	1,544	1,517	1,499	1,484	1,469	1,458	1,450	1,442
Working age population*	953	948	933	917	909	903	897	892	889	888
Labour force participation	832	820	795	758	749	727	718	718	710	700
Participation, share of total population	52.9	52.3	51.5	50.0	50.0	49.0	48.8	49.2	49.0	48.6
Participation, share of working age population	87.3	86.5	85.2	82.6	82.4	80.5	80.0	80.5	79.9	78.9
Employment	875	905	937	951	993	656	646	644	636	610
Percent in private sector	25.3	27.7	31.7	35.3	37.9	61.2	63.1	68.6	69.3	69.7
Registered unemployed	5.3	12.0	29.1	49.6	56.7	70.9	71.9	69.4	70.2	86.2
Unemployment rate (official)	...	1.1	1.3	1.8	1.5	2.1	2.6	2.7	2.7	4.0
Unemployment rate (survey)	0.6	1.5	3.7	6.5	7.6	9.7	10.0	9.7	9.9	12.3
Long-term unemployed	...	...	5.8	13.9	22.5	22.5	39.8	31.8	33.0	39.5
As percent of total unemployed	...	...	19.9	28.0	39.7	31.7	55.4	45.8	47.0	45.8
Wages (kroons per month):										
Gross monthly wage (public sector)	...	...	461	899	1,498	2,149	2,754	3,256	3,848	4,418
Net monthly wage (public sector)	...	...	341	665	1,108	1,590	2,038	2,409	2,848	3,269
Gross monthly wage (economy-wide)	38	76	549	1,066	1,734	2,375	2,985	3,573	4,125	4,440
Real wage index (1995 = 100)										
Public sector	...	...	77.4	79.6	89.8	100.0	104.2	111.4	121.6	135.2
National economy	210.1	134.2	83.4	85.3	94.0	100.0	102.1	110.6	118.0	122.9

Source: Central Statistics Bureau of Estonia.

\* Working age population is defined as aged 15-59.

**Table 3. Latvia: Summary of Labour Market Trends, 1990-99**  
(In thousands, except where indicated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total population	2,673	2,668	2,657	2,606	2,566	2,530	2,502	2,480	2,458	2,439
Working age population*	1,503	1,499	1,487	1,484	1,457	1,436	1,441	1,432	1,424	1,439
Labour force participation	1,416	1,405	1,347	1,320	1,300	1,276	1,263	1,218	1,213	1,200
Participation, share of total population	53.0	52.7	50.7	50.7	50.7	50.4	50.5	49.1	49.3	49.2
Participation, share of working age population	94.2	93.8	90.6	89.0	89.2	88.8	87.6	85.0	85.1	83.4
Employment	1,409	1,397	1,294	1,205	1,083	1,046	1,018	1,037	1,043	1,038
Percent in private sector	19.2	22.5	41.0	50.8	57.5	59.6	62.5	65.6	68.3	70.0
Registered unemployed	7.6	8.6	31.3	76.7	83.9	83.2	90.8	84.9	111.4	109.5
Unemployment rate (official)	0.5	0.6	2.3	5.8	6.5	6.5	7.2	7.0	9.2	9.1
Unemployment rate (survey) †	0.5	0.6	3.9	8.7	16.7	18.1	19.4	14.8	14.0	13.5
Long-term unemployed ‡	...	...	...	2.7	14.8	137.4	156.7	113.8	94.0	83.9
As percent of total unemployed	...	...	...	3.5	17.7	59.7	63.9	63.0	55.5	51.7
Wages (lats per month):										
Gross monthly wage (public sector)	1.5	2.8	23.0	51.8	74.3	94.5	105.6	126.9	143.0	156.8
Net monthly wage (public sector)	1.2	2.3	19.2	43.2	62.0	77.2	83.7	93.1	104.1	113.6
Gross monthly wage (economy-wide)	1.4	2.6	21.5	47.2	71.9	89.5	98.7	120.0	133.3	141.0
Real wage index (1995 = 100)										
Public sector	129.1	111.1	91.1	93.5	102.8	100.0	93.8	105.6	113.7	121.8
National economy	136.2	117.2	96.1	92.3	101.1	100.0	93.8	105.1	111.6	115.3

Source: Central Statistics Bureau of Latvia.

\* Working age population is defined as aged 15-59.

† As reported in The Statistical Yearbook of Latvia, 2000, where additional information is used to calculate employment and total labour force.

‡ Official data 1993-1994, Survey data 1995- 1999.

**Table 4. Lithuania: Summary of Labour Market Trends, 1990-99**  
(In thousands, except where indicated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total population	3,708	3,737	3,747	3,737	3,724	3,718	3,712	3,707	3,704	3,701
Working age population *	2,269	2,264	2,254	2,243	2,238	2,237	2,235	2,234	2,237	2,244
Labour force participation	1,855	1,903	1,879	1,859	1,741	1,753	1,784	1,774	1,770	1,796
Participation, share of total population	50.0	50.9	50.2	49.8	46.7	47.1	48.0	47.8	47.8	48.5
Participation, share of working age population	81.8	84.1	83.4	82.9	77.8	78.3	79.8	79.4	79.1	80.1
Employment	1,853	1,898	1,855	1,778	1,675	1,644	1,659	1,669	1,649	1,648
Percent in private sector	22.3	30.0	41.0	54.0	61.0	63.0	64.7	67.5	68.4	68.2
Registered unemployed	2.3	5.3	24.1	81.1	65.7	109.0	124.5	104.5	113.7	148.7
Unemployment rate (official)	0.1	0.3	1.3	4.4	3.8	6.2	7.0	5.9	6.8	8.3
Unemployment rate (survey)	...	...	...	...	...	17.1	16.4	14.1	13.3	14.1
Long-term unemployed	...	...	...	...	...	...	...	15.2	15.2	19.3
As percent of total unemployed	...	...	...	...	...	...	...	14.5	13.4	13.0
Wages (litai per month):										
Gross monthly wage (public sector)	3	8	58	142	371	531	683	851	1,033	1,133
Net monthly wage (public sector)	...	...	...	110	286	393	516	631	760	827
Gross monthly wage (economy-wide)	3	8	58	166	325	491	618	778	930	1,013
Real wage index (1995 = 100)										
Public sector	241	197	133	64	98	100	103	118	136	148
National economy	261	213	144	81	93	100	101	117	133	144

Source: Central Statistics Bureau of Lithuania.

\* Working age population is defined as aged 15-59.

**Table 5. Bulgaria: Labour Market Survey Results, 1993-2000**

	1993	1994	1995	1996	1997	1998	1999	2000
Economically active population								
(in thousands)	3,809	3,609	3,552	3,576	3,564	3,477	3,388	3,272
As percent of population	45.0	42.8	42.4	42.9	43.0	42.2	41.4	40.2
Employed (in thousands)	2,995	2,869	3,032	3,085	3,030	2,921	2,811	2,736
As percent of population	35.3	34.0	36.2	37.0	36.6	35.5	34.3	33.6
<i>Of which:</i>								
Employees	2,655	2,592	2,695	2,717	2,606	2,531	2,437	2,364
Employers	50	47	55	61	59	69	70	68
Self-Employed	243	199	244	263	294	274	296	259
15-24	280	264	260	259	248	252	238	218
50-69	570	537	581	590	592	587	558	551
Urban	2,219	2,163	2,249	2,306	2,244	2,221	2,137	2,098
Rural	775	706	783	779	786	700	674	638
Male	1,599	1,532	1,610	1,637	1,616	1,554	1,500	1,453
Female	1,395	1,336	1,422	1,448	1,414	1,367	1,311	1,282
Unemployed (in thousands)	815	740	521	491	534	556	577	537
<i>Of which:</i>								
Urban	538	475	334	338	369	381	389	357
Rural	277	265	187	153	165	176	188	180
Male	421	393	270	258	279	298	313	288
Female	393	348	250	233	255	258	264	249
Share of Long-term unemployment								
Total	52.5	59.3	64.8	58.6	56.5	53.3	52.5	58.6
Youth	13.3	13.7	14.6	12.0	12.2	11.0	10.7	10.4
Other	39.2	45.6	50.2	46.6	44.3	42.3	41.8	48.2
Unemployment rate by education level								
Higher education	9.7	8.1	5.2	5.0	6.1	6.7	7.0	6.3
Semi-higher	8.6	8.8	5.1	6.1	7.2	7.0	6.0	8.0
Secondary vocational	16.5	15.8	11.2	11.6	12.6	13.3	14.0	15.5
Secondary general	22.2	20.7	14.2	13.8	15.3	15.7	19.0	14.7
Primary or lower	30.1	31.0	23.9	21.1	22.7	26.4	26.4	28.9
Unemployment rate by age								
15-24	47.0	44.9	37.7	33.5	36.0	36.0	36.7	34.2
25-49	17.7	17.3	12.2	12.1	13.0	14.0	14.9	14.5
50-64	15.8	14.9	9.3	8.5	10.3	11.6	13.7	14.0

Source: Bulgaria Labour Force Survey.

**Table 6. Estonia: Labour Market Survey Results, 1990-99\***

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Economically active population (in thousands)	832	820	795	758	749	727	718	718	710	700
As percent of population	76	74	72	70	70	69	68	65	64	64
Employed (in thousands)	826	808	766	708	693	656	646	648	640	614
<i>Of which:</i>										
Full-time work	798	779	734	672	652	605	586	600	586	566
Part time work	28	29	32	36	41	51	60	49	54	48
<i>Of which:</i>										
Underemployed	13	15	17	19	21	31	35	31	29	28
Employees	799	772	717	648	629	610	597	596	585	561
Self-employed	27	36	49	60	64	46	49	52	56	53
Employment rate (in percent)										
City	75.8	74.1	70.2	66.4	65.8	63.9	63.4	61.5	60.2	57.7
Countryside	73.0	71.0	68.1	63.8	62.3	56.8	56.1	52.5	53.4	51.5
Estonians	73.8	72.0	69.0	65.6	65.4	62.3	61.6	59.8	59.1	56.6
Non-Estonians	77.2	75.5	70.6	65.4	63.5	60.9	60.5	56.6	56.0	54.0
Male	81.6	80.5	77.4	73.0	72.2	67.9	67.0	65.8	64.2	61.2
Female	69.0	66.6	62.5	58.9	58.0	56.3	56.1	52.6	52.7	50.8
15-24 years	48.0	47.9	46.7	44.4	46.1	41.0	38.6	38.9	37.4	32.4
50-69 years	64.8	61.3	55.1	49.5	47.8	44.7	45.2	45.7	46.5	46.0
Unemployed (in thousands)	5	12	29	50	57	71	72	69	70	86
<i>Of which:</i>										
Long-term unemployed	...	...	5.8	13.9	22.5	22.5	39.8	31.8	33.0	39.5
Unemployment rate (in percent)	0.6	1.5	3.7	6.5	7.6	9.7	10.0	9.7	9.9	12.3
City	...	1.6	4.0	6.5	7.4	9.4	9.6	9.0	9.6	12.1
Countryside	...	...	3.0	6.6	8.0	10.6	11.1	11.3	10.5	12.9
Estonians	...	1.3	3.0	5.2	6.0	7.7	7.8	7.8	7.9	9.9
Non-Estonians	...	...	5.0	9.1	10.6	13.5	14.0	13.3	13.7	16.7
Male	...	1.4	3.9	6.5	7.3	10.6	10.7	10.1	10.8	13.6
Female	...	1.5	3.4	6.6	7.9	8.8	9.2	9.2	8.9	11.0
15-24 years	...	...	7.4	11.0	11.6	14.1	16.0	14.4	15.7	19.8
50-69 years	...	...	...	4.2	5.1	6.9	7.2	6.1	6.1	8.4
Economically inactive population (in thousands)	271	284	306	322	320	335	337	386	392	403
<i>Of which:</i>										
Discouraged	...	4	7	11	13	15	18	16	19	21
Retired	96	107	125	135	133	144	136	182	183	182
Studying or receiving additional training	86	85	84	87	85	82	88	89	96	106
Taking care of children or other members of family	48	52	52	46	44	45	44	42	41	41
Ill or disabled	25	27	29	31	33	37	40	44	43	44
Other reasons	13	11	10	13	12	12	11	12	10	9

Source: Labour Force Survey Data, Statistical Office of Estonia

\* 1989 – 1996: population aged 15–69; 1997 – 2000: population aged 15–74.

**Table 7. Latvia: Labour Market Survey Results, 1995-99**

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
	Nov.	Nov.	Nov.	Nov.	Nov.
Economically active population					
(in thousands)	1,200	1,182	1,186	1,168	1,157
As percent of population *	67.6	59.8	59.7	58.8	58.2
Employed (in thousands)	973	966	1,015	1,007	990
<i>Of which:</i>					
On involuntary unpaid leave	4.3	3.6	3.0	2.0	1.4
Involuntary paid leave	0.4	0.4	0.4	0.2	0.2
Involuntary part time work	73.8	77.7	82.1	80.5	74.7
Jobseekers (in thousands)	227	217	171.2	161	167
As percent of economically active	18.9	18.3	14.4	13.8	14.5
Unemployment rate (in percent)	18.9	18.3	14.4	13.8	14.5
City	21.2	21.3	17.6	16.4	16.0
Countryside	12.9	10.8	6.9	7.4	10.7
Male	19.7	18.9	14.3	13.5	15.5
Female	18.0	17.7	14.6	14.1	13.3
15-24 years	30.1	29.0	24.9	25.5	24.6
50-69 years	19.8	16.4	12.3	10.7	10.9
Higher education	9.2	9.0	7.6	6.0	7.4
Primary/basic education	27.3	25.9	17.7	17.1	22.1
Without formal education	33.3	35.3	...	21.4	18.8
Economically inactive population					
(in thousands)	576	796	801	817	831
<i>Of which:</i>					
Discouraged	37	37	50	51	46
<i>Memorandum items:</i>					
Characteristics of jobseekers					
Percent under 24 years	23.6	21.9	22.0	22.3	20.9
Percent over 60 years	7.1	5.1	3.3	2.4	3.3
Percent male	55.7	54.4	51.4	51.6	56.4
Percent urban	81.3	83.7	85.9	84.1	78.7

Source: Central Statistics Bureau of Latvia, "Labor in Latvia: Labor Force Survey Data," various issues.

\* In 1995, age 15 to 69. Since 1996, age 15 and older.

**Table 8. Lithuania: Labour Market Survey Results, 1995-2000**

	1995	1996	1997	1998	1999	2000
Economically active population						
(in thousands)	1,979	1,938	1,828	1,843	1,862	1,794
As percent of population 15-69 yrs.	75.3	73.7	69.5	69.9	70.5	67.8
Employed (in thousands)	1,632	1,620	1,571	1,598	1,598	1,518
<i>Of which:</i>						
Employees	...	...	1,226	1,252	1,266	1,204
Employers and self-employed	...	...	287	275	259	253
Contributing family workers	...	...	57	67	68	55
Not stated	...	...	1	4	5	6
Jobseekers (in thousands)	347	317	257	245	263	276
As percent of economically active	17.5	16.4	14.1	13.3	14.1	15.4
Unemployment rate (in percent)	17.1	16.4	14.1	13.3	14.1	15.4
Urban	...	...	15.9	14.4	16.5	16.7
Rural	...	...	9.8	11.1	9.0	12.8
Male	...	...	14.2	14.3	15.6	17.3
Female	...	...	13.9	12.2	12.6	13.3
15-24 years	...	...	25.4	22.3	26.3	29
50-69 years	...	...	9.5	8.7	9.5	13.3
Economically inactive population						
(in thousands)	976	1,025	1,145	1,145	1,144	1,174
<i>Memorandum items:</i>						
Characteristics of jobseekers						
Percent under 24 years	...	...	25.5	21.7	23.3	20.8
Percent over 55 years	...	...	4.8	4.9	5.0	7.7
Percent male	...	...	53.3	56.0	57.1	57.7
Percent higher education	...	...	6.6	6.9	7.9	7.2
Percent college level education	...	...	22.2	20.1	20.6	21.7
Percent secondary education without vocational training	...	...	29.0	28.0	24.7	23.1
Percent secondary education with vocational training	...	...	15.4	20.1	22.7	22.2
Percent basic education without vocational training	...	...	16.3	13.6	13.3	14.9
Percent basic education with vocational training	...	...	6.6	8.2	8.7	8.7
Percent primary education	...	...	3.9	3.1	2.1	2.1

Source: Central Statistics Bureau of Lithuania, Labour Force Survey 1997-99.



# ESTONIA

1 EUR = 15.64664 EEK (fixed)

## Overview of developments and prospects

With GDP growth of 5.4% at constant prices, 2001 was generally successful for the Estonian economy. Somewhat surprisingly, growth was positive despite fears that slower growth in the major world economies would spill over and negatively influence the Estonian economy.

Domestic demand was the driving force of growth, with fixed capital formation leading the way. In the last quarter of 2001, domestic demand grew 4.6% as compared with the same period a year earlier. Private and government consumption grew by 4.5% and 2.7% respectively while fixed capital formation grew by a whopping 26.6% in that quarter.

Over 2001 as a whole, private consumption growth remained modest, reaching only 3.4%. Strong wage growth and positive developments in the labour market were offset by an increase in consumers' propensity to save, as shown by the growth of bank deposits.

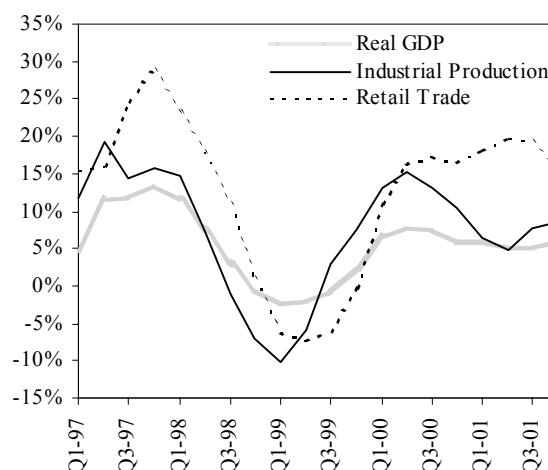
The conservative budget policy resulted in only a modest increase in government expenditure.

After two years of low investment activity, fixed capital formation increased 17.2% during 2001. A possible reason for such an investment boom might be the abolition a year earlier of corporate income tax on re-invested profits.

The Estonian industrial sector increased in constant prices by more than 8%, which is lower than in the year before, mainly due to declining subcontracts from main trading partner countries. Growth in the retail trade sector in 2001 was fast and stable, positively influenced by the good labour market situation, affordable consumer loans, and aggressive expansion of large retail chains.

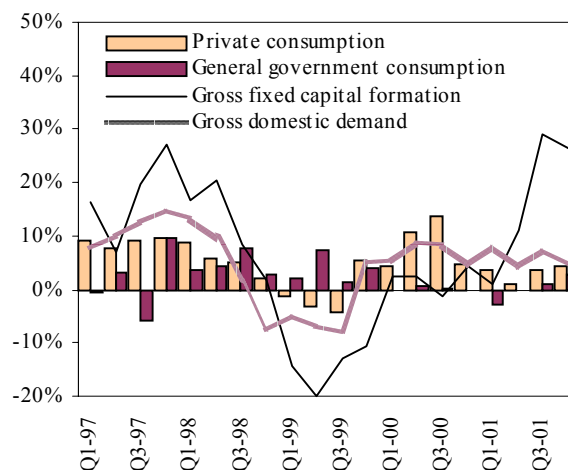
Weaker domestic demand means that the government expects a slowdown of growth in the first half of 2002, but projections for the second period anticipate faster growth due to the recov-

**Real GDP, industrial production and retail trade sales (% change same period over previous year)**



Source: Statistical Office of Estonia

**GDP by expenditures, % from previous year, current prices**



Source: Statistical Office of Estonia

ery in export demand in Estonia's main trading partners. Private consumption is also expected to grow because of continuing wage growth and improvement in consumer confidence.

Investment activity is expected to remain high in 2002, boosted by good profit figures in earlier years, record low interest rates, and attractive conditions for new FDI flows. Also, the EU accession process requires extensive investments in infrastructure and industrial modernization, which partly will be supported by EU structural funds.

### Prices

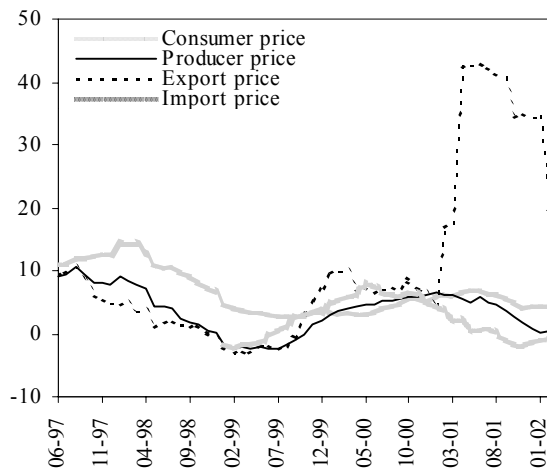
CPI inflation was 4.2% in the first quarter of 2002. This was somewhat surprising to us (as well as to most other analysts) since regular seasonal fluctuations pointed to a moderate decrease in inflation. Perhaps the bullish behaviour of domestic consumers has offset the regular seasonal effect.

Fluctuations in producer and import prices can be explained by the bleak situation in the world economy - the PPI has been virtually stagnant during recent months and the IPI has even decreased – by 1.15% year-on-year in January 2002. These movements represent good news for the Estonian economy. The staggering 18.8% increase in export prices year-on-year in the first quarter of 2002 is also good news.

### Labour

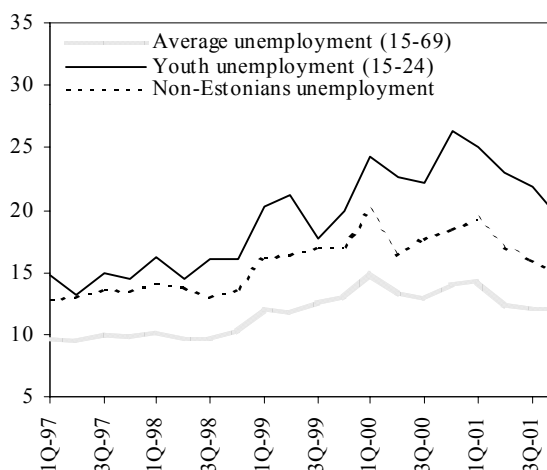
Data from the fourth quarter of 2001 confirm that labour market conditions have continued to improve in Estonia. The ILO unemployment rate declined to 12.1%. The average unemployment rate was 12.7% in 2001, which is 1.1 percent points less than in 2000. Another positive fact was that for the first time during the whole transition period (since 1989) average employment actually increased (by 4,800 persons). Thus, the employment rate increased from 58.0% to 58.8% but remains very low by Scandinavian standards. It is also interesting to note that the increase in employment came from increasing employment of older persons (50-69). Their average employment increased by 3,900 persons. This is a new phenomenon in Estonia and is con-

Monthly growth of price indices (%)



Source: Bank of Estonia

Total unemployment, youth unemployment and unemployment of non-Estonians



Source: Statistical Office of Estonia

firmed by other research results, which suggest that the time when only young people experienced changes in the labour market is over.

The unemployment rate declined for youths (by 7% compared with the last quarter of 2000) and for minorities as well.

Most analysts have forecast favourable economic developments for Estonia in 2002. This means that unemployment will very likely decline during the year. However, increasing labour productivity means that significant job creation will be needed to keep unemployment down. In general, job creation rates have been declining from the end of the 90s as compared with the early transition period.

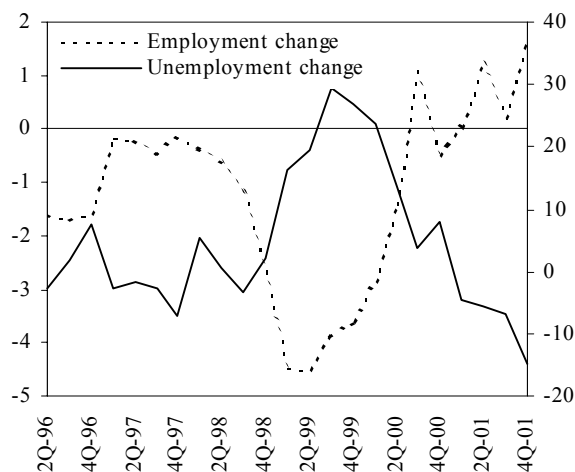
### Foreign trade

Interesting developments are occurring in Estonian foreign trade. At first sight, it seems that the deterioration of Estonian foreign trade situation continued into the first quarter of 2002. Exports in January were down by 23.8%, in February by 19.3% and in March by 16.2% as compared with the same period a year ago. Imports have also declined, but more slowly than exports, producing a larger trade deficit.

But the situation looks rather different if one analyses the dynamics of Estonian exports without the electronic equipment sector. In this case, instead of declining, the Estonian exports during the first quarter of 2002 actually grew by 4.7%. Therefore, the conclusion of a deep decline in Estonian exports does not hold in general. The most rapidly growing export groups as compared with the first quarter of 2001 were furniture (15.6%), plastics (27.3%) footwear (18%), and wood (4%). Exports of textile and food products have been stable compared with previous year.

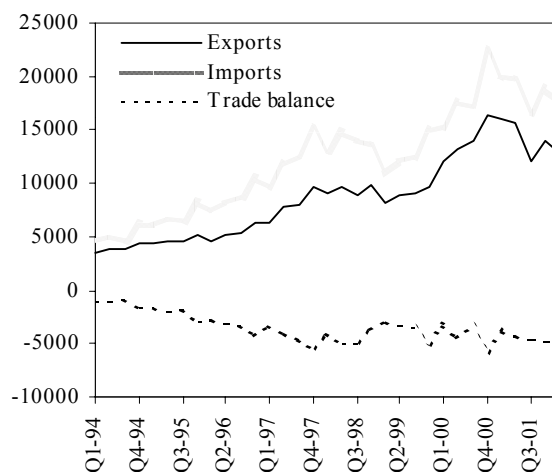
The situation inside electronic machinery and component sector (group 85 by Harmonised System) is also improving. In January 2002, the export of these products was only 30% of the level experienced in the same period a year ago. In February, the level grew to 44.6% and in March it reached 52.6% of the level a year ago. This positive trend, combined with the knowl-

**Employment and unemployment changes (compared with previous year same period)**



Source: Statistical Office of Estonia

**Foreign trade (mn EEK)**



Source: Statistical Office of Estonia and Bank of Estonia

edge that Estonian export price index has improved by nearly 19% as compared with the same period year ago, suggests that the Estonian export sector has managed to avoid serious difficulties. Stable exports in traditional sectors support the recovery in electronic components.

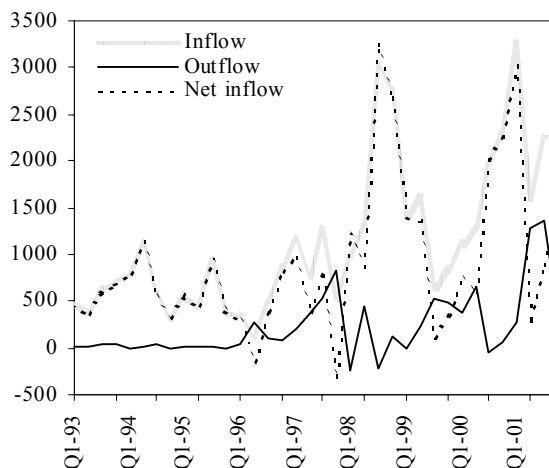
### Foreign investment

The fourth quarter of 2001 was characterised by an increase in the current account deficit to 11.6% of the GDP (from 5.9% in the third quarter). This is rather typical for the end of the year and is actually 0.6 percent points smaller increase than a year ago. By international standards, the current account deficit for the whole of 2001 was rather high - 6.4% of GDP. But in our opinion, in a transition economy context this is not surprising and not very dangerous. We have written before that in the process of interpreting the current account deficit in Estonia, it is often overlooked that an important part of the current account deficit is caused by the deficit in the balance of income. In the whole of 2001, this was 5.1 bn EEK. But it consists partly of the income earned by foreign investors from their firms in Estonia. As long as the income earned is reinvested, the same money will appear as an inflow of foreign direct investments in the financial account. This is particularly relevant for Estonia because re-invested profits do not attract corporate income tax. During the whole of 2001 reinvested capital by foreign investors formed 3.8 bn EEK. Therefore, the current account deficit partly reflects the positive development in firms which belong to foreign investors.

The 2001 FDI inflow set a new record level. During the whole year, the total inflow was 9.35 bn EEK, which is 1.2 bn more than in the previous record year of 1998. 32% of total FDI consisted of investments into share capital, 41% consisted of reinvestments into existing firms, and 27% consisted of loans to subsidiaries. The role of loans was smaller in 2001 than in the previous year and reinvestments played the major role.

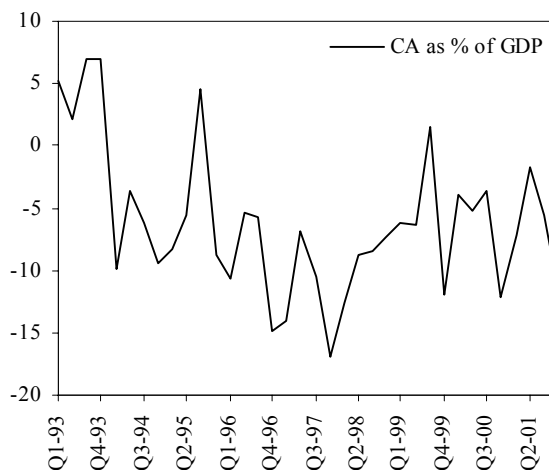
In 2001, another record also fell – Estonian outward direct investments reached 3.3 bn EEK, which is 1.7 times more than during 1997. The

**Quarterly inflows and outflows of foreign direct investments (mn EEK)**



Source: Statistical Office of Estonia and Bank of Estonia

**Current account (% of GDP)**



Source: Bank of Estonia

most important event in this field was definitely acquisition of Lithuanian Taupomasis Bankas by Hansapank, which accounted for half of the Estonian outflow.

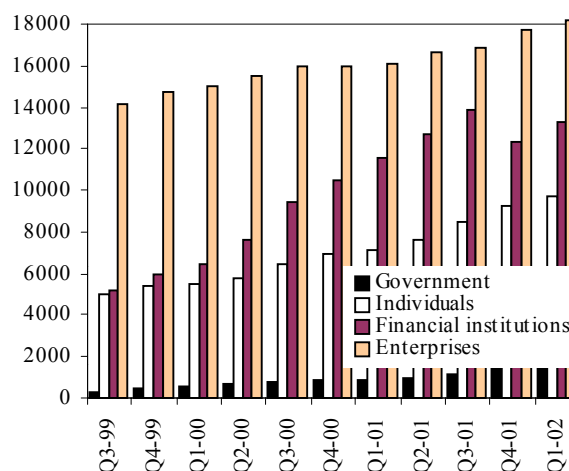
Since January 2002, Bank of Estonia has published monthly balance of payments (BOP) data. However, these monthly BOP figures should be treated with caution because many corrections are normally added later. During the first two months of 2001, the current account deficit was 2 bn EEK. The goods trade balance was heavily in deficit and the services trade balance was not able to compensate for it. The inflow of foreign direct investment was a strong 1.7 bn EEK, while the outflow was a moderate 0.3 bn EEK. During spring and, especially, during summer, the current account deficit is expected to decline and the service sector trade balance should cover the trade deficit. This is due to the growing revenues from passenger transportation, hotels and catering sector, combined with other services consumed by the approximately 5 million tourists from the neighbouring countries, especially from Finland.

### Enterprises and banks

The loan portfolio of Estonian banks has grown by 4.5% since the beginning of the year and the year-on-year rise in lending was 19.7%. The first quarter is not usually remarkably busy in lending activities (historically, loan portfolio growth has been around 2%), so this could be an indication of an expanding loan market in recent months. This was true for the financial institutions, which increased their borrowing by 7.3% in the first quarter, and perhaps for individuals, whose borrowing experienced a 4.8% increase. Of course, movements in the case of financial institutions can be rather volatile and dependent on a few big contracts. The borrowing of the corporate sector rose by a modest 2.7% and government borrowing remained at the same level.

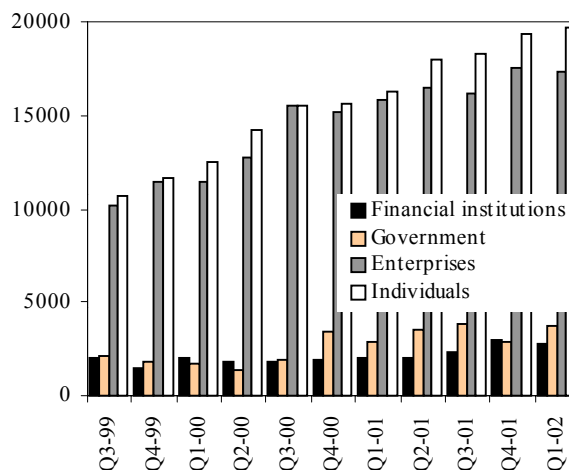
Some signs of a slowdown in banking activities can be observed by looking at the deposits – increase of deposits from the beginning of the year was just 2%, while the annual growth was 17.6%. Again, the first quarter is historically slow, but the year-on-year growth in formation

**Decomposition of the loan portfolio (mn EEK)**



Source: Bank of Estonia

**Decomposition of deposits in banks (mn EEK)**



Source: Bank of Estonia

of new deposits is almost half of the rate a year ago. Deposits by financial institutions and the government rose by 40.4% and 30% respectively, but as their share of overall deposits is small, this could not compensate for slow growth of deposits by individuals and enterprises (20.5 and 9.4% respectively). Although lending increased more than deposits, the situation is still not worrisome as deposits exceed loans by 900 mn EEK.

Fluctuation of interest rates even by as much as 5 percentage points in consecutive quarters is not surprising in case of financial institutions, as similar behaviour has been observed historically. This is probably because a few big transactions and possibly profit transfer inside banking groups tend to dominate the market. However, some peculiar behaviour of interest rates for enterprises was observed during the first quarter. In February, the interest rate fell by 1.49 percent points to 7.8%, which is the lowest level since June 2000, but then rose back to 9.2% in March.

### The budget

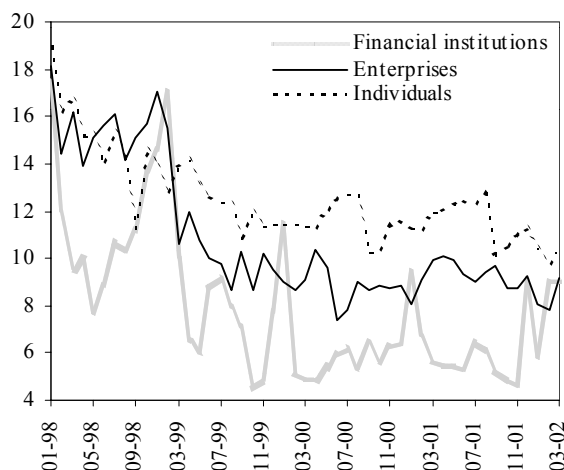
2001 was only the second time in the last decade when government revenues have exceeded its expenditures. The consolidated government sector budget surplus was 396 mn EEK, which represents 0.4% of GDP. (File Budget 2)

Government spending was 9.1% higher than in 2000 or 34.5 bn EEK. At the same time, revenue was 36.9 bn EEK or 11.8% more than a year earlier.

87% of total revenues came from taxes, which increased by 9.4%. Social tax and turnover tax yielded more than expected, while revenue from personal income tax was lower than expected. In general, tax revenues were buoyant because of wage growth and positive employment developments.

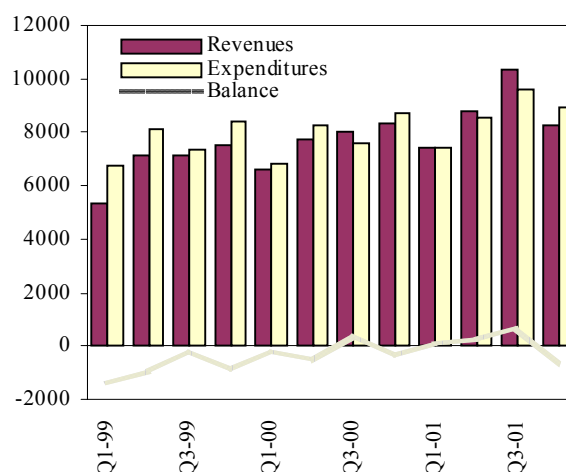
As part of the EU accession process, government expenditure will increase. Extensive funds will be needed for environment purposes, for infrastructure, for agricultural and social requirements, and for pension reform. Since the government has a commitment to a limited and

### Interest rates (%)



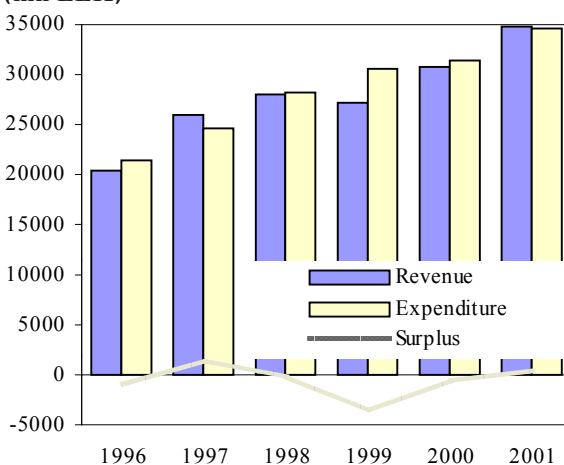
Source: Bank of Estonia

### General government budget (mn EEK)



Source: Ministry of Finance and Bank of Estonia

### Budget revenues and expenditures, 1996-2001 (mn EEK)



Source: Ministry of Finance and Bank of Estonia

balanced budget policy, coping with greater obligations means, first of all, the need to increase spending efficiency.

### Money and the exchange rate

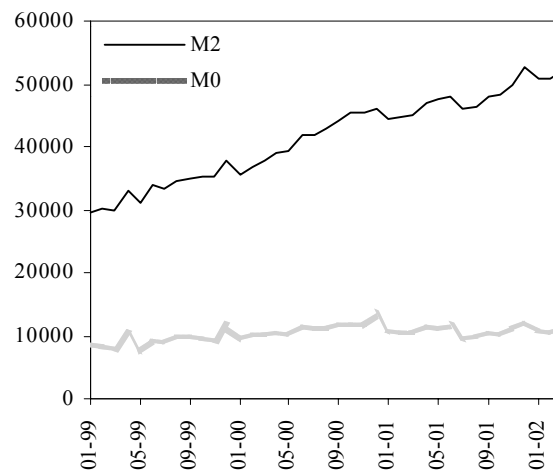
M2 fell in the first quarter of 2002 because of changes in reserve requirements imposed by the Bank of Estonia. The new set up allows banks to invest some of their reserves (previously held at the central bank) in safe foreign assets. This is technically a change in measurement, but it causes a breakpoint and makes it difficult to handle the time series analytically, at least in terms of levels. To avoid such problems, the Bank of Estonia has recalculated the historical data using the new principles. The growth rates of monetary aggregates should not be affected by this move.

The real exchange rate was virtually stable in February – only a 0.2% increase on the year-on-year basis. The strengthening of the Euro during the last couple of months means tougher conditions for Estonian companies in case of dollar denominated trade as we suggested in the previous issue.

### Financial markets

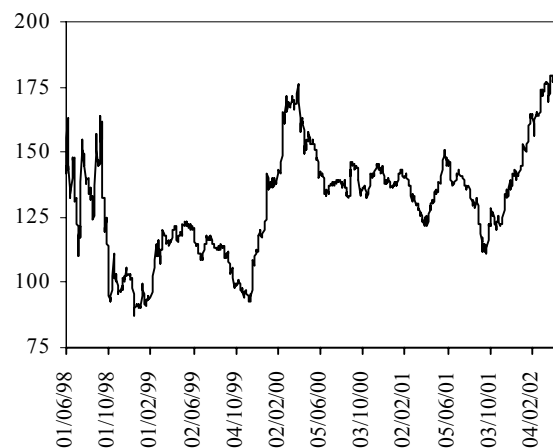
The merger of the Tallinn Stock Exchange (TSE) and the Helsinki Stock Exchange (HEX) appears to have been a success. The resulting higher stock prices (72.8% increase in TALSE in the last seven months, 32.3% during this year) and somewhat higher trading volumes are direct evidence of that. In addition, there are five new member firms in the TSE, four of which are from Finland and one is the internationally well-known Credit Suisse First Boston (Europe). We expect to see higher correlation with the world's leading stock indexes as well as with the other emerging markets' stock indexes in the area in the coming months, since the main source of recent price increases (TSE-HEX merger) has been most probably exhausted by now.

Money supply (mn EEK)



Source: Bank of Estonia

Tallinn Stock Exchange index (TALSE)



Source: Bank of Estonia



# Key Economic Indicators

	1998	1999	2000	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1
<b>Population</b> (mn. mid-year)	1.43	1.41	1.37					1.36	
<b>Gross Domestic Product</b>									
Nominal GDP (bn EEK)	73.54	76.33	85.44	22.18	21.49	25.22	24.21	24.36	-
Nominal GDP (bn USD)	5.23	5.20	5.03	1.23	1.25	1.39	1.40	-	-
Nominal GDP per capita (USD)	3659	3685	3675						
GNP per capita (USD at PPP)	7563	8190	-	-	-	-	-	-	-
<b>Aggregate Growth Indicators</b>									
Real GDP (%)	5.05	-0.70	6.88	5.96	5.83	4.98	5.03	5.74	-
Private consumption (%)	5.38	-0.78	8.19	4.69	3.67	1.12	3.60	4.50	-
Government consumption (%)	4.50	3.78	0.05	-0.32	-2.89	0.02	0.99	2.66	-
Gross fixed investment (%)	22.14	-13.26	2.09	4.96	2.68	11.87	28.95	26.57	-
Industrial production (%)	3.20	-1.65	12.82	10.27	6.33	4.78	7.56	7.80	1.90
Agricultural production (%)	-4.99	-8.21	-	-	-	-	-	-	-
<b>Stabilization Indicators</b>									
Consumer prices (avg. %)	10.58	3.30	4.02	5.38	5.89	6.71	6.05	4.38	4.30
Unemployment rate (avg. %)	9.88	12.30	13.68	13.90	14.20	12.40	12.00	11.90	11.20
Average nominal wages (EEK)	4100	4418	4876	5279	5100	5775	5300	5879	5721
Average nominal wages (USD)	292	301	287	293	298	318	306	337	322
Budget balance (% of GDP)	0.04	-4.19	-0.10	-0.39	-0.31	1.94	2.87	1.89	-
Exchange rate EEK/USD (avg)	14.075	14.678	16.969	18.002	17.132	18.136	17.317	17.466	-
Exchange rate EEK/USD (end-period)	13.410	15.562	16.820	16.820	17.770	18.473	17.056	17.692	17.800
<b>Trade and Balance of Payments</b>									
Total exports fob (bn USD) <sup>1</sup>	2.68	2.52	3.32	0.92	0.95	0.87	0.71	0.79	0.72
Total imports fob (bn USD)	3.80	3.34	4.10	1.19	1.12	1.05	0.93	1.06	1.00
Trade balance (bn USD)	-1.12	-0.82	-0.78	-0.27	-0.18	-0.18	-0.22	-0.27	-0.28
Current-account balance (bn USD)	-0.48	-0.25	-0.32	-0.15	-0.09	-0.03	-0.08	-0.16	-
<b>Foreign Debt and Reserves</b>									
Foreign debt (end-period. bn USD) <sup>2</sup>	0.2	0.2	0.1	-	-	-	-	0.1	0.1
International reserves (end-per. bn USD)	0.81	0.86	0.92	0.92	0.74	0.75	0.77	0.82	-
<b>Foreign Investment</b>									
FDI inflows (bn USD) <sup>3</sup>	0.573	0.303	0.392	0.128	0.191	0.085	0.151	0.128	-
Cumulative FDI inflows (bn USD) <sup>3,4</sup>	1.192	1.495	1.887	1.892	2.083	2.168	2.319	2.447	-
Portfolio investment (bn USD)	0.007	0.140	0.076	-0.009	0.081	0.030	-0.014	-	-
<b>Monetary Growth</b>									
M2. % <sup>5</sup>	4.21	23.50	25.11	1.55	5.23	5.63	3.10	7.98	-

<sup>1</sup> Converted to USD using the period average exchange rate.

<sup>2</sup> Not including external debt with a public guarantee.

<sup>3</sup> Converted to USD using the period exchange rate.

<sup>4</sup> Cumulative from 1993.

<sup>5</sup> The definitions of monetary aggregates from 1993 and onwards have been changed.



# LATVIA

1 EUR = 0.582 LVL (June 2002)

## Overview of developments and prospects

The latest figures show that Latvian GDP growth in 2001 was 7.6%. This was the highest in Central and Eastern Europe and is an awesome result given the overall economic slowdown in the rest of Europe.

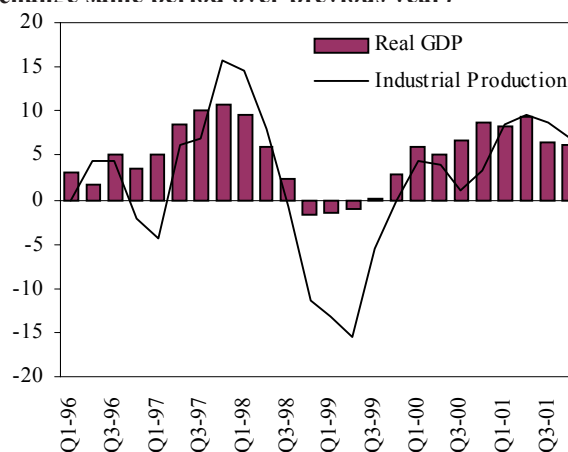
The fourth quarter results revealed a 6.3% annual increase in the GDP, which, although down from the high numbers of 8.3% and 9.3% experienced in the first and second quarters, respectively, was still a very good outcome. The main contributing sectors were: trade (+10.6% annually), transport, storage, and communications (+9.5%), manufacturing (+9.5%), and commercial services (+13.9%).

Nevertheless, the current economic situation in Latvia should be interpreted with caution. The high growth has been driven primarily by local consumption, often financed by borrowed money. There are certain other features that give rise for concern: the slow-down of export growth, rising unemployment (though this may be only a regular seasonal pattern), the widening trade deficit, the high current account deficit, and rising budget spending. In the event of an external shock (e.g. a sharp drop off in EU demand) these factors may combine to create a rather fragile economic situation in Latvia. The positive sign is that the level of saving has increased, with the volume of deposits up by 30% annually.

Modest export growth in the first two months of 2002, in our opinion, is a good predictor for the economic growth figures we may expect for the 1st quarter of 2002. We would be surprised to see the GDP growth above 4%.

The current account deficit in 2001, which reached 10% of GDP, was negatively influenced by the purchase, at the end of last year, of three new tankers by the Latvian Shipping Company ("Latvijas Kugnieciba") for a total cost of around USD 125 mn. The widening trade deficit has also intensified pressure on the current account.

Real GDP & Index of Industrial Production (% change same period over previous year)



Source: Central Statistical Bureau of Latvia

Increased budget spending is part of the pre-election environment and the fastest rising budget expenditure items are wages and salaries. According to the latest opinion polls, the new political party "Jaunais Laiks" (New Era), led by former Central Bank governor Repse, is in first place and its popularity continues to improve, although Repse's personal rating has fallen. The popularity of all the other parties has correspondingly decreased.

The sale of 32% of "Latvijas Kugnieciba" (LK) shares in a public auction for privatisation vouchers was successful with all 64.3 mn shares sold for a nominal price of LVL 1.11. But the debate on this privatisation continues. The primary issue being that a few large shareholders appear to have obtained the bulk of the shares offered in the voucher auction. The approved privatisation process of LK indicates that the next step is to offer a further 51% of shares on the stock exchanges (in Latvia and Scandinavia). We believe a majority shareholder will emerge; and there are signs pointing to local candidates.

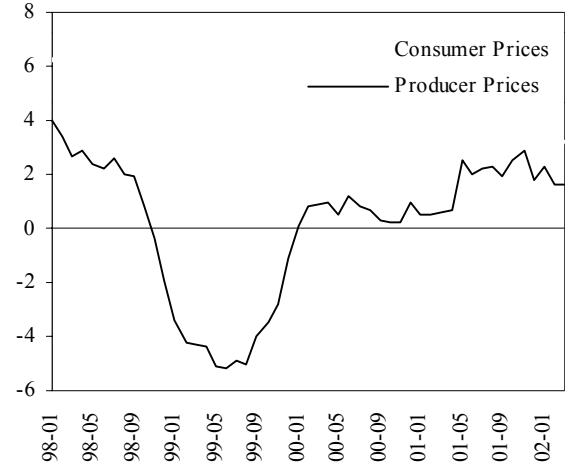
**Prices**

In the first quarter of 2002, inflation was 3.3% as compared with the same period a year ago, influenced by unusually high seasonal increases in food prices as well as continuous strong domestic demand.

The main price increases at the end of March 2002 as compared with a year ago were in the following sectors: food products (+7.2%), educational services (+6.7%), and medicaments and healthcare (+5.3%). Meanwhile, clothing and footwear (-1.4%) and communication services (-1.6%) prices decreased. The latter has been primarily driven by reduced mobile phone calling rates following an aggressive price policy by Tele2, one of the two largest mobile phone service providers.

In the last issue, we noted the surprisingly slow increase in administratively regulated prices (e.g. utilities, energy) of 0.7% year-on-year. We expect that these prices may soon begin to rise more rapidly. At the same time, we expect that

**Price indices (% change over same period previous year)**



Source: Central Statistics Bureau of Latvia

in general consumer prices will remain rather stable (around 3% inflation), because economic growth is slowing down. Moreover, the high number of supermarkets that have sprung up everywhere recently should sooner or later be reflected in some price competition.

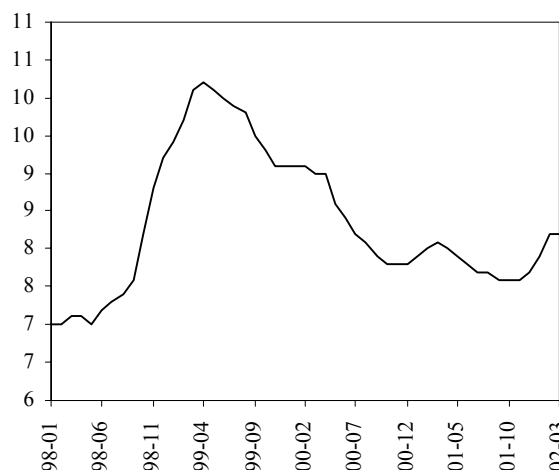
In the first quarter of 2002, producer prices increased by 1.8% as compared with the same period a year ago. We expect a further slowing down of growth in producer prices in the coming quarters.

### Labour

Registered unemployment has risen slightly during the first months of 2002. In the first quarter of 2002 it was 8.2% of the economically active population, as compared with 7.7% in the previous quarter and 8.1% in the respective period a year ago. This increase appears to be a seasonal tendency that has been observed over the last couple of years - unemployment in the first quarter tends to be higher than for the rest of the year. But again we should note that this effect is seasonal only if accompanied by good economic growth throughout the year. The next quarter will show whether the unemployment reverts to the previous below-8% level or continues to rise, which would be a signal that the economy may be moving into a downturn.

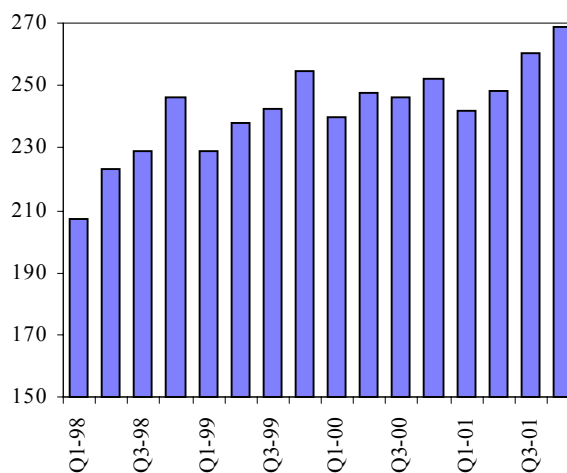
At the end of 2001, average gross monthly wages and salaries were LVL 169 (USD 269), which was up by 8% as compared with a year ago. This increase goes hand-in-hand with the good growth figures. According to officially reported wage levels, (that is excluding all kinds of irregular payments) the highest remuneration, as of October 2001, was for persons working in financial intermediation (LVL 385), public utility companies (LVL 235), and transport and communications (air transport led with LVL 435, water transport paid LVL 289 and post and communications paid LVL 276). Unsurprisingly, the highest reported wages are in regulated or more supervised industries. It indirectly tells us that unreported payments are more prevalent in unregulated sectors.

**Registered unemployment (% of economically active population)**



Source: Central Statistics Bureau of Latvia

**Average monthly gross wages and salaries (USD)**



Source: Central Statistics Bureau of Latvia

## Foreign trade

The trade deficit worsened significantly during 2001, reaching 20% of GDP. In 2001, exports increased by 11.1% (to USD 2bn) while imports rose by 13.8% (to USD 3.5bn) on a yearly basis.

Looking at quarterly data, we observe a quite striking pattern. The export volume in the fourth quarter of 2001 increased by only 8.2% on a yearly basis, while import volume increased by 13.1%. Thus export growth (year-on-year) has dramatically fallen from 15.2% in the second quarter of 2001 to only 4.2% in the first two months of 2002. Meanwhile, the speed of import growth has remained stable at around 13% and only in the first two months of 2002 have we observed some slowdown, when imports rose 9.8% on yearly basis. This pattern once again confirms that economic growth in Latvia has been driven by domestic demand.

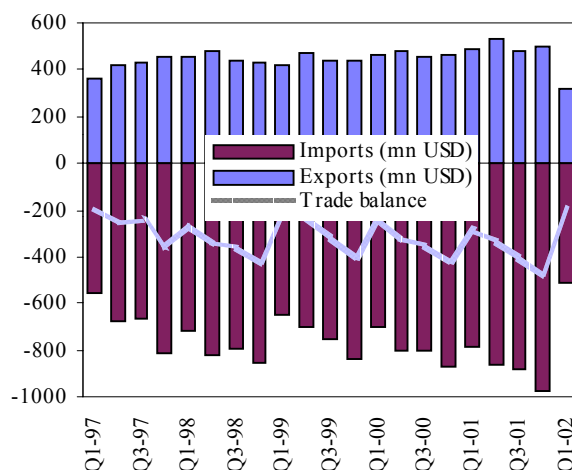
The main cause of the export slowdown has been the decrease in demand from the EU, Latvia's main export partner. The share of exports to the EU in the first two months of 2002 was nearly 70%, and to the CIS markets – 9.6%. Local producers have switched to Russian, CIS, and other Baltic state markets but this has failed to compensate for the decrease in the EU exports. Latvia's main export partners remain Germany, Great Britain, Sweden, Lithuania, and Russia.

The main export category remains wood and wood products, but its share in total export volume decreased from 37.4% at the end of 2000 to 34% at the end of 2001. The main reasons behind this are falling prices in the global markets combined with reduced demand.

## Foreign investment

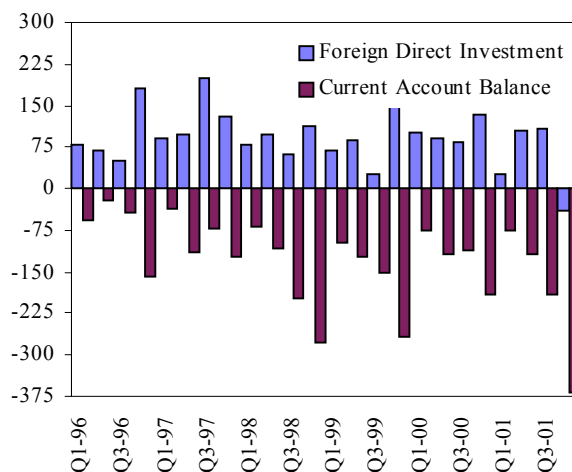
Revised figures show that the foreign direct investment (FDI) flow in 2001 was USD 200 mn, which is 50% lower as compared with a year ago. The apparently worse FDI outcome was not the result of massive flight by foreign investors but rather by special circumstances surrounding a specific deal by a domestic company. The net outflow of direct investment in December (-

**Exports, imports and the trade balance (mn USD)**



Source: Central Statistics Bureau of Latvia

**Foreign direct investment inflow and the current account balance (mn USD)**



Source: Central Statistics Bureau of Latvia

USD 39 mn) was caused by restructuring within an international financial group that involved the takeover of a non-resident owned enterprise by a local investor.

FDI during the first two months of 2002 was USD 90 mn, which is a rather positive sign. Most of the inflow came in form of investment in equity capital. The net outflow of portfolio investment during the first two months of 2002 amounted to LVL 5.8 mn.

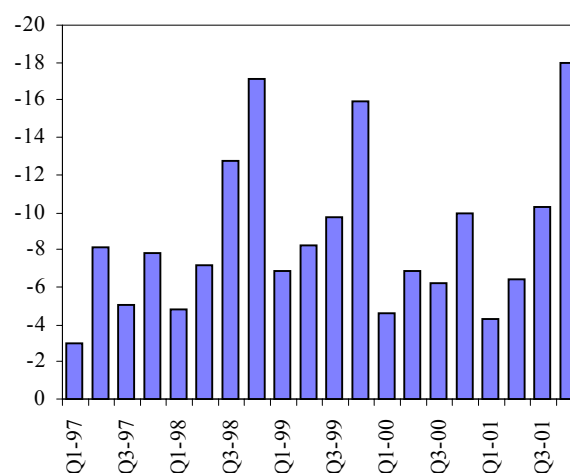
The current account deficit in 2001 reached USD 758 mn, which is around 10% of GDP. This outcome is partly the result of the purchase of three tankers by the shipping company "Latvijas Kugnieciba" in the last quarter of 2001 and is partly due to the widening trade deficit. The increasingly negative goods trade balance has not been sufficiently covered by a services trade balance surplus. FDI in 2001 covered only one fourth of the current account deficit. Net portfolio investment in 2001 amounted to LVL 82 mn.

Reducing the current account deficit remains a major challenge for the government. This indicator is closely followed by international observers and may be a possible stumbling block in future talks with international financial institutions, as well as with the EU.

### Enterprises and banking

The main event in the first quarter of 2002 was the sale of 32% of "Latvijas Kugnieciba" (LK) shares in a public auction for privatisation vouchers. The auction was successful and all 64.3 mn shares were sold for price of LVL 1.11, which is around 1.1 times the book value of company's equity and 8 times earnings. Even though the general evaluation of this event is positive in that this transaction has redeemed large amounts of remaining privatisation vouchers, there remain concerns. In particular, the public is concerned that a few large shareholders some of whom are connected to certain Ventspils enterprises and others with the "Tautas partija" (Peoples Party) have managed to obtain the majority of the shares on offer. The approved privatisation process of LK requires that the remaining 51% of LK shares will be offered on

Current account deficit (% of GDP)



Source: Central Statistics Bureau of Latvia

the stock exchanges (Latvia and Scandinavia) for cash (10% of the shares have been reserved for the state pension fund, 6% for employees and pensioners, and 1% as a private reserve).

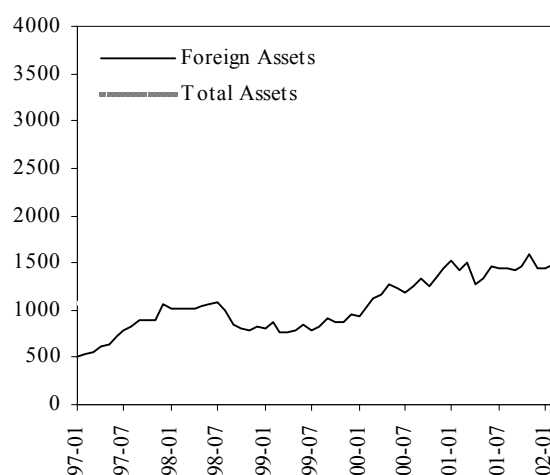
The Latvian banking sector continues to prosper. In the 1st quarter of 2002, total loans issued and deposits received increased by 6.3% and 10.1%, respectively. The annual rate of growth in loans has been above 40%. Loans to domestic enterprises and private persons, and particularly long-term loans, have led the way. There has been a considerable increase in mortgage loans. In the first quarter of the year, the weighted average interest rate on long-term loans in LVL decreased from 10.5% to 9.5% per annum.

The link between rapidly rising borrowing and strong domestic consumption is a worrying sign. It means that the consumption has been driven by borrowed resources, and in case of economic slowdown the real consequences could be correspondingly severe. A good sign is that deposits have increased in line with loans. For the moment, the banks appear not to experience any liquidity problems as indicated by the fact that loan rates have not increased in response to rising demand.

The assets of the Latvian commercial banks at the end of the first quarter of 2002 were USD 5.6 bn, which is a 7% increase as compared to the end of 2001. The total value of deposits was USD 4 bn. The total value of loan portfolios was USD 2.7 bn. The aggregate profits of Latvian banks in the first quarter of 2002 were USD 19 mn. The three largest banks (by asset value) are Parex Bank, Unibanka, and Hansabanka, jointly controlling 54% of the market.

The growth in mortgage lending has been a very positive factor for the insurance market. For example, life insurance premium income has risen by more than 20% annually, in part because of the requirement that in order to obtain a loan an individual must have life insurance (at least for the amount of borrowed money).

**Total assets and foreign assets of the banking system in Latvia (mn LVL)**



Source: Central Statistics Bureau of Latvia

## The budget

The state budget deficit in the first quarter of 2002 was LVL 14.8 mn. Budget revenues were LVL 437 mn (+10.2% on annual basis) and budget expenditures were LVL 452 mn (+11.3%). Budget revenues have benefited from an increase in value added tax collection (+14.7% during the first two months of this year) as well as in personal income tax (+13.9%). During the first months of the year, tax collection generally showed some improvement (revenues from all taxes grew), but increasing budget spending has offset this positive effect. The increase in wages and salaries of +11.5% led the expenditure side of the budget, which reflects the election year atmosphere.

The government has a 2002 planned budget deficit of 2.45% of GDP. This decision has been one of the main points of disagreement between the International Monetary Fund (IMF) and the Latvian government. The government is reluctant to take any strong stance because next year's budget will be the responsibility of a newly elected government in the autumn.

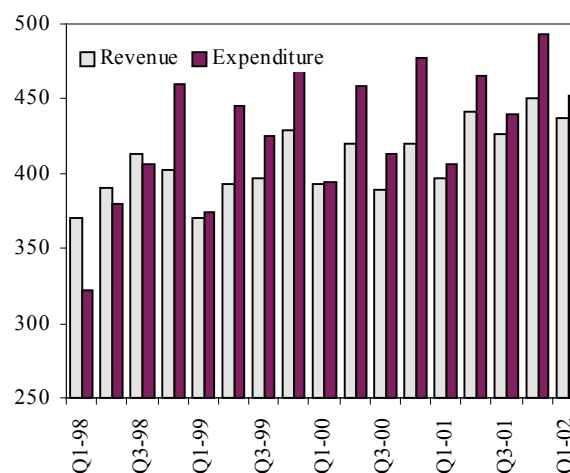
Increased spending on integration towards the EU and NATO, as well as the reduction in corporate income tax, can be regarded as positive reasons for a widening budget deficit. However, the government has been criticized for not having clear priorities on spending, as well as for lagging on tax collection improvement.

At the end of the first quarter of 2002, central government debt was LVL 0.7 bn (USD 1.1 bn), which is a 14% increase year-on-year. Of this, external debt amounted to USD 710 mn, a 30% annual increase. The increase in external debt resulted from an issue of EUR 200 mn worth of 7-year Eurobonds in November 2001.

## Money and the exchange rate

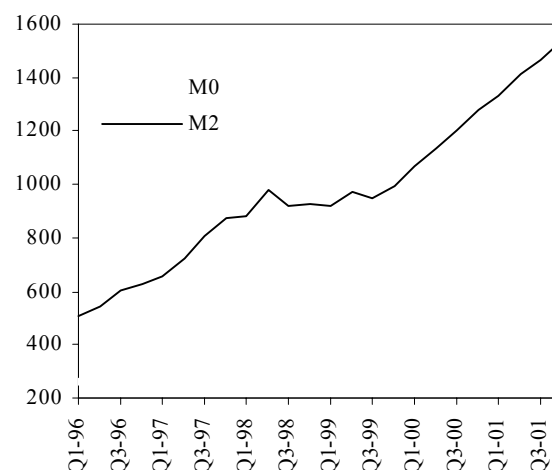
At the end of the 1st quarter of 2002, the monetary base (M0) was LVL 637 mn, representing a 17% annual increase. Broad money (M2) has increased by 24% and reached LVL 1.65 bn. Increased deposits (annual growth of 30%) in the banking sector caused the rise in M2.

Central government revenues and expenditures (mn LVL)



Source: Central Statistics Bureau of Latvia

Money supply (M0 and M2) at the end of period (mn LVL)



Source: Central Statistics Bureau of Latvia

During the first quarter of 2002, banking system liquidity was adequate and 3-month interbank offer rates fell below 5%. The good liquidity position was a result of the generally low demand for cash as well as the redemption of LVL 3 mn worth of 12 month T-bills.

International reserves at the Central Bank remain high. At the end of February 2002 they stood at USD 1.2 bn and covered around 121% of the monetary base.

This year so far, LVL/USD exchange rate has fluctuated in the range of 0.630 to 0.644. The lat depreciated against the dollar during the first two months of the year but the rate had returned to the 0.63 LVL/USD level at the end of April 2002. This latest movement has been driven by dollar's weakness in global markets.

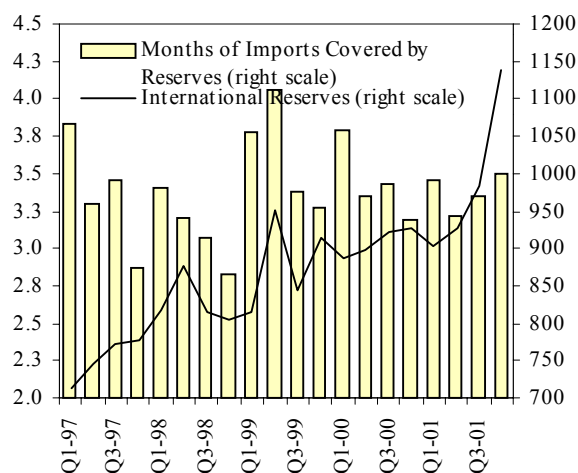
### Financial markets

Capital market turnover in the first quarter of 2002 was LVL 97 mn (of which 4.8 mn was in equities and 92.2 in debt securities). The equity market remains highly inactive. Trading in "Latvijas Gaze" (LG) stock dominated the trading volume in equities, accounting for 78% of total equity turnover. The share price of LG decreased by almost 20% in the first quarter, as a result driving down the value-weighted index (Dow Jones RSE) by 13.7%. The fall in the LG share price appears to have been driven by private investors who bought LG shares with privatisation vouchers and afterwards rushed to the stock exchange to sell their shares for cash.

Equity market capitalisation at the end of the 1st quarter was USD 574 mn with two main list shares - "Latvijas Gaze" and "Ventspils Nafta" - accounting for close to 80% of the whole market.

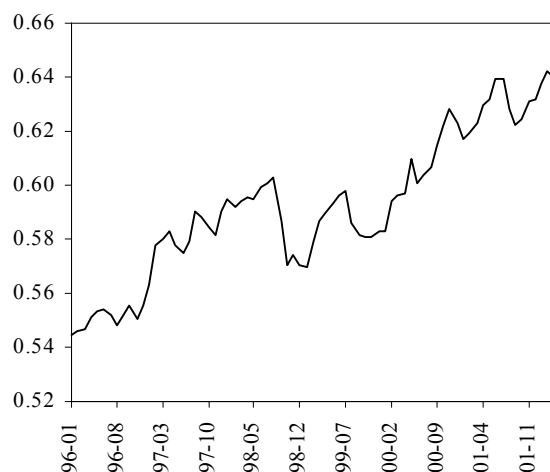
As a new addition, 51% of the Latvian Shipping Company (LK) shares are to be offered on the stock exchanges (in Latvia and Scandinavia). Theoretically, the listing of LK on Riga Stock Exchange would increase the overall equity capitalisation by at least USD 300 mn and potentially might give a boost to the stock market, but in practice this seems unlikely. We believe that LK will be acquired by large block

**Foreign reserves (mn USD) and months of imports coverage**



Source: Central Statistics Bureau of Latvia

**Average exchange rate for the period (LVL/USD)**



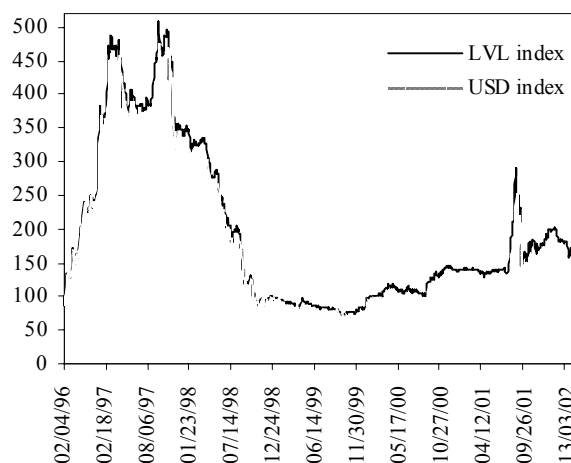
Source: Central Statistics Bureau of Latvia

investors (e.g. Itera, Ventspils Nafta, etc), which means that a significant chunk of shares will not trade on the market. Moreover, if there are any financial investors in that issue, they will most likely choose to trade on the Stockholm, Oslo, or Helsinki exchanges.

It is clear that Latvian companies do not regard the local stock exchange as a source for raising capital and it is very unlikely that they will ever do so. The predominant financing source in Latvia is debt, as we can see from the growth of loan finance. The only option that could attract activity from the few large companies that might search for external equity financing is to follow the Estonian experience, i.e. merge with (be taken over by) a European stock exchange, namely Helsinki.

We are waiting with great interest for the next steps of "Ventspils Nafta" (VN) in the near future. For the third year in row, the company has not paid dividends, even though net profits in 2001 were LVL 25.7 mn and the company sits on LVL 40 mn cash. Moreover, it has more than LVL 100 mn in "long-term" loans to related companies that can probably be recovered rather fast if necessary. This means that VN has about LVL 140 mn in cash under the mattress - a sum that would be enough to acquire around 65% of "Latvijas Kugnieciba" shares...

**Riga stock market index (DJRSE)**



Source: Central Statistics Bureau of Latvia



# Key Economic Indicators

	1998	1999	2000	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1
<b>Population</b> (mn. mid-year)	2.45	2.43	2.37						
<b>Gross Domestic Product</b>									
Nominal GDP (bn LVL)	3.59	3.90	4.33	1.21	1.10	1.18	1.18	1.29	-
Nominal GDP (bn USD)	6.09	6.26	7.13	1.95	1.77	1.86	1.87	2.05	-
Nominal GDP per capita (USD)	2486	2575	3010						
GDP per capita (USD at PPP)	5777	4294	4807						
<b>Aggregate Growth Indicators</b>									
Real GDP (%)	3.88	1.08	6.83	8.70	8.30	9.30	6.40	6.30	-
Private consumption (%) <sup>1</sup>	6.18	4.26	10.84						
Government consumption (%) <sup>1</sup>	22.64	4.18	7.38						
Gross fixed investment (%) <sup>1</sup>	59.61	0.06	17.50						
Industrial production (%)	2.30	-8.58	3.23	3.40	6.47	9.53	9.10	5.57	-1.10
Agricultural production (%)	-11.18	-2.25	-						
<b>Stabilization Indicators</b>									
Consumer prices (avg. %)	4.67	2.38	2.64	1.80	1.13	2.40	3.23	3.20	3.33
Unemployment rate (avg. %)	7.58	9.68	8.40	7.80	8.00	7.90	7.67	7.63	8.10
Average nominal wages (LVL)	133	141	149	156	150	157	164	170	162
Average nominal wages (USD)	226	241	246	252	242	248	260	270	253
Budget balance (% of GDP)	0.29	-3.43	-2.82	-4.81	-0.86	-1.95	-1.16	-3.33	-
Exchange rate LVL/USD (avg)	0.590	0.585	0.607	0.621	0.619	0.634	0.630	0.629	0.640
Exchange rate LVL/USD (end-period)	0.569	0.583	0.613	0.613	0.631	0.639	0.619	0.638	0.641
<b>Trade and Balance of Payments</b>									
Total exports fob (bn USD)	1.80	1.77	1.87	0.47	0.49	0.53	0.48	0.50	0.49
Total imports cif (bn USD)	3.19	2.94	3.18	0.87	0.78	0.86	0.88	0.98	0.81
Trade balance (end. bn USD)	-1.39	-1.17	-1.32	-0.41	-0.29	-0.33	-0.40	-0.48	-0.32
Current-account balance (bn USD)	-0.65	-0.64	-0.50	-0.19	-0.08	-0.12	-0.19	-0.37	-0.09
<b>Foreign Debt and Reserves</b>									
Foreign debt (bn USD)	0.41	0.62	0.57	0.57	0.55	0.54	0.56	0.72	0.71
International reserves (bn USD)	0.81	0.91	0.92	0.92	0.92	0.93	0.99	1.22	1.20
<b>Foreign Investment</b>									
FDI inflows (bn USD)	0.357	0.347	0.407	0.134	0.025	0.105	0.110	-0.039	0.131
Cumulative FDI inflows (bn USD) <sup>2</sup>	1.44	1.79	2.19	2.01	2.22	2.32	2.43	2.39	2.52
Portfolio investment (bn USD) <sup>3</sup>	0.041	0.273	-0.196	-0.108	-0.021	-0.133	0.007	0.228	-0.032
<b>Monetary Growth</b>									
M2 (%)	5.9	8.0	27.9	6.0	4.2	6.3	3.4	5.5	6.8

<sup>1</sup> Data revised.

<sup>2</sup> Cumulative from 1995.

<sup>3</sup> Methodology of calculation has changed from 1999.



# LITHUANIA

1 EUR = 3.4528 LTL (fixed)

## Overview of developments and prospects

Lithuanian GDP grew at 5.9% for the year 2001 as a whole, boosted by a 7.9% growth rate in the last quarter. This performance, which exceeded earlier expectations, was driven by strong export growth. In turn, export performance was stimulated by the accelerated recovery of demand in some of Lithuania's main trade partners, such as Russia and the Baltic countries, and by the export of oil products to Great Britain. On the other hand, after steady growth in earlier years, the share of exports destined for the EU has stabilised and now accounts for just under half of total Lithuanian exports.

Recent economic growth has created conditions that are favourable for further growth of investment. Nonetheless, some weaknesses remain. In particular, the current account deficit is still quite large and, as a small open economy, Lithuania remains vulnerable to external shocks.

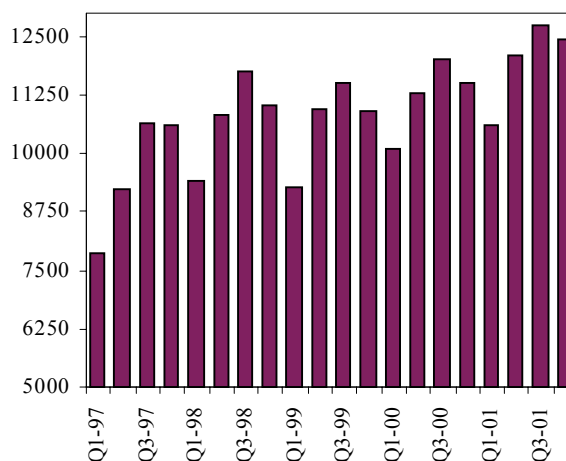
The rapid growth of imports at the end of 2001 worsened the trade balance and contributed to a current account deficit in the last quarter of 2001 of 10.1% of the quarterly GDP. Moreover, given the importance of refined oil exports, the failure to secure long-term crude oil contracts for the Mazeikiu Oil refinery creates some significant uncertainty for the future.

Additionally, greenfield investment remains low, suggesting that the financing of the current account deficit could be threatened once the privatisation process ends.

Despite the last quarter's performance, the yearly balance of payments has improved for two years in a row. A contributory factor has been the successful implementation of fiscal policy benchmarks as set out in the IMF Memorandum.

On the other hand, economic growth in Western Europe, North America, Poland, and other states economically closely related to Lithuania was slowing down in the 2nd half of the year. This

GDP at current prices (bn LTL)



Source: Statistical Office of Lithuania.

could gradually lead to structural changes in the development of the economy and perhaps limit the rate of economic growth in 2002.

The International Monetary Fund expects 2002 economic growth in the European Union countries to be 1.5% and global economic growth to be 2.8%. However, the euro-zone economies are expected to develop particularly slowly. In particular, Germany is expected to grow at only 0.75% in 2002.

Nevertheless, according to the Ministry of Finance forecasts, GDP growth in Lithuania in 2002 will be 4.4%. This projection implicitly assumes that economic development in Europe will be slow in the first half of the year but will gradually gain strength afterwards. Thus, the anticipated growth of both domestic and external demand is expected to contribute to economic growth in 2002.

It is anticipated that export dynamics in 2002 will not be as rapid as in 2001. Thus, in January 2002, exports actually declined by 1.1% in comparison with the same period last year. As mentioned above, it is expected that oil products development will continue to affect Lithuania's external trade balance. According to the IMF, oil prices will go down in 2002 and it is expected that this factor will contribute to a slowdown of Lithuania's export growth over the year.

However, consumption and investment are expected to grow significantly in 2002. Thus, household consumption expenditure is expected to grow by 5.6% in 2002 and gross domestic investment is expected to grow by 9.6%.

In the medium term, developments related to Lithuania's anticipated entry into the EU are expected to contribute to a rising trend in the growth rate. For these reasons, the Ministry of Finance forecasts that growth will be 4.9% in the year 2003, 5.3% in 2004, and 5.6% in 2005. Aggregate investment growth in 2003 - 2004 can be expected to increase the current account deficit, but this will later be offset by growing transfers from the European Union as well the continuing growth of exports.

## Output and aggregate demand

GDP was LTL 48 bn at current prices in 2001 (in the fourth quarter it was LTL 12 bn) and per capita GDP was LTL 13,800 (USD 3,450).

Export oriented industries played a major role in Lithuania's economy. Value added generated by all sectors of the economy, excluding agriculture and public sectors, grew by 7.9%. Agriculture and the public sectors together decreased by 6.9% and by 10.3% and 0.9% respectively (within the gross value added structure the share of declining sectors made up 13.1%).

Gross capital formation grew by 10.6% (20.9% in the fourth quarter). Exports of goods and services leaped 20.8%, while imports grew by 17.7%. Exports and imports grew 31.1% and 25.6% respectively in the fourth quarter.

Final consumption expenditure grew by 2.5% (1.6% in the fourth quarter). Over the year as a whole, public consumption declined (by -2.7%), but rose by 12.1% in the fourth quarter.

Preliminary estimates suggest that GDP in the first quarter 2002 increased by 4.1% as compared with the corresponding period in 2001 and totalled LTL 11 bn at current prices (LTL 6.9 bn at constant prices of 1995).

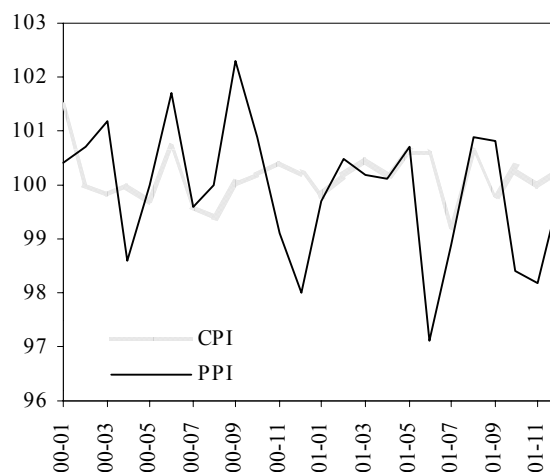
First quarter 2002 growth was generated by the growing production of agriculture, electricity supply, retail trade, and insurance services.

## Prices

Inflation remained low in 2001 with an annual rate of 2%, though this is up a bit as compared with 2000. In the fourth quarter, the consumer price index (CPI) increased by 2.1% as compared with the fourth quarter of 2000.

The price of industrial output (PPI) decreased by 5.3% in the fourth quarter of 2001 as compared with the same period in 2000, with construction costs decreasing by 2.2%. However, the prices of animal products increased by 16.2% in the fourth quarter of 2001 as compared with the same period of 2000. This influenced

**CPI and PPI (compared to previous month) – year 2000-2001**



Source: Statistical Office of Lithuania

the growth of average market prices of agriculture products by 3.4% in the fourth quarter of 2001 as compared with the same period of 2000.

Industrial prices in March 2002 went up by 1.9% from the month before, of which prices for mining and quarrying production increased by 7.5% and manufacturing by 2.1%. PPI in March 2002 was mostly influenced by an 11.8% rise in prices for refined petroleum products, specifically 11.1% for crude oil, and 1.2% for textile articles.

Inflation in March 2002 (March 2002 against March 2001) was 1.6% (in March 2001 against March 2000 it was 0.6%).

The consumer price index (CPI) in March 2002 against February 2002 was 99.3 (in March 2001 against February 2001 it was 100.5). Comparing with December 2001 it was 100.1 (in March 2001 against December 2000 it was 100.5).

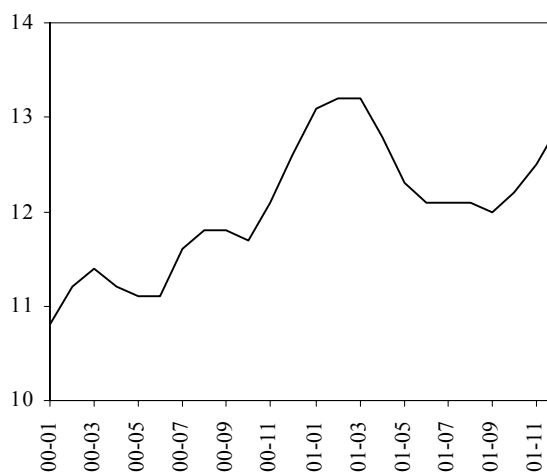
### Labour

Despite a growing economy, registered unemployment has not decreased and real wages have not increased. Lithuanian companies have adopted a cautious employment approach in the aftermath of the Russian crisis, with the effect that the registered unemployment rate was 13% at the end of the fourth quarter of 2001 as compared with 12.6% a year before. This meant that the number of registered unemployed was 224,000 at the end of December.

Employment in the major sectors of the economy in the fourth quarter of 2001 was as follows: manufacturing (about 18% of total employment), agriculture, hunting and forestry (about 17%), wholesale and retail trade (about 15%), and educational and training services (about 11%).

The largest employment falls over the year were observed in agriculture and forestry (a fall of about 16,000 or 6%), manufacturing (about 7,000 or 3%), and in health care and social sector activities (about 6,000 or 6%).

Registered unemployment (%)



Source: Lithuanian Labour Exchange

Average monthly gross wages in the fourth quarter of 2001 were LTL 1087.1, up by 1.8% over the previous quarter.

Earnings in the public sector were LTL 1128.4 and against the 3rd quarter 2001 were up by 2.5%, whereas those in the private sector were LTL 1047.0 up by 1% over the third quarter.

Average monthly gross earnings in the fourth quarter of 2001 as compared with the same period in 2000 were up by 1.3%. In the public sector the wage increase was 0.5% while in the private sector it was 3.0%.

### Foreign trade

Over the year 2001, Lithuania's exports developed rapidly, growing by 20.8% as compared with 2000. Over the same period imports grew by 17.7%.

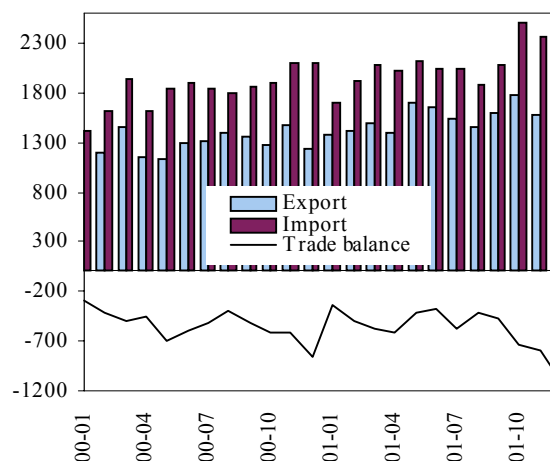
Total exports were LTL 18 bn, while imports were LTL 25.4 bn. Thus the trade balance was negative at -LTL 7.4 bn.

Lithuania's foreign trade structure in 2001 remained similar to the previous year's trade structure. The most important export partners were the United Kingdom (13.8%), Latvia (12.6%), Germany (12.6%), and Russia (11%), whereas the key import partners were Russia (25.3%), Germany (17.2%), Poland (4.9%), and Italy (4.2%).

The bulk of exports (47.8%) were destined for EU countries, while exports to the CIS made up 19.7%. The EU was also the source of 44% of Lithuania's imports (imports from the CIS countries had a share of 29.4%).

Exports to both EU and CIS countries (as compared with 2000) increased by 20% and 45.9%, respectively. Over the same period, imports from the EU countries rose by 18.4%, while those from the CIS countries went up by 8.1%.

Foreign Trade (mn LTL)



Source: Lithuanian Ministry of Finance

## Foreign investment

The stock of foreign direct investment (FDI) as of January 1st 2002 made up LTL 10.7 bn (up by 14.2% over the January 1st 2001, when it was LTL 9.3 bn). This implies that per capita FDI in Lithuania was about LTL 3,000.

The main investing countries were as follows: Denmark (LTL 2 bn or 18.6%), Sweden (LTL 1.7bn or 16.1%), Estonia (LTL 1.1 bn or 10.0%), Germany (LTL 1 bn. or 9.2%), and the USA (LTL 0.9 million or 8.3%).

Over 2001 FDI from Estonia increased by 80% and from Germany by 43%.

The bulk of investment was in the manufacturing industry (25.6% of total FDI), trade (20.4%), financial sector (19.9%), and communication services (14.7%).

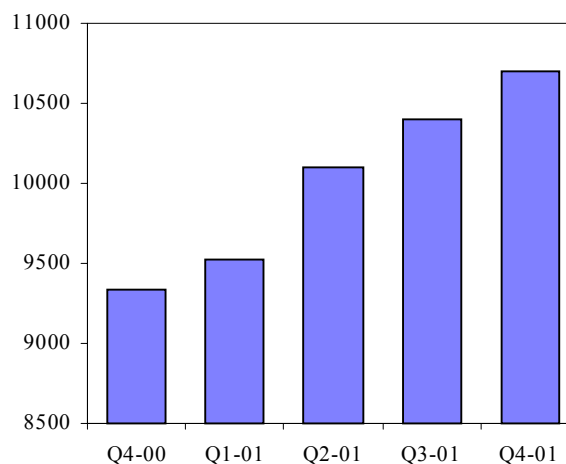
The biggest investment deals in 2001 were the sale of the state-owned stakes in AB Lietuvos Juru Laivininkyste (LISCO) (JSC Lithuanian Shipping Company) and AB Lietuvos Taupomasis Bankas (JSC Lithuanian Savings Bank) to Danish and Estonian investors. The Danish company DFDS Tor Line paid 190 mn LTL for a 76.36% stake in LISCO and undertook to invest a further 150 mn LTL in the company's development.

## Enterprises and banks

Lithuania's banking sector followed the growth path of the economy as a whole. At the end of 2001, there were 9 domestic banks operating under a license from the Bank of Lithuania. Also, 4 foreign bank branches and 5 foreign bank representative offices were active in Lithuania. As of January 2002, in six out of nine commercial banks foreign investors held more than one half of the share capital.

As of 1st January 2002, total assets of the commercial banks stood at LTL 15.3 bn, increasing over the year by LTL 2.25 bn (17.2%). Total loans granted to clients amounted to LTL 6.5 bn, increasing over the year by LTL 988 mn (17.9%); deposits totalled LTL 10.4 bn, increasing over the year by LTL 1.8 bn (21.2%). Individual deposits, part of total deposits, stood

Foreign direct investment (mn LTL)



Source: Bank of Lithuania

at LTL 6.4 bn, increasing over the year by LTL 1.3 bn (26.1%). Deposits in the national currency were LTL 5.7 bn, increasing over the year by 27.2%, while deposits in foreign currencies were LTL 4.7 bn, increasing over the year by 14.6%.

The share of loans in banking assets increased over the year from 40.6% to 41.3%. The largest loan portfolio growth was recorded in the last quarter of 2001 and especially in December. This growth development was related to changes in the Law on Profit Tax whereby the previous exemptions on invested profit were abolished. Thus businesses used their last opportunity to reduce their taxable profit through intensive investment. In addition, the share of long-term loans increased from 60% to 67%.

In contrast to 2000, when credit to state and municipal enterprises and local government institutions grew fastest, in 2001 loans to private companies and individuals grew fastest, by LTL 830 mn and LTL 143 mn, respectively, or by about 18%. This growth was much influenced by the expectation of changes in corporate profit taxation, since tax relief for corporate investment was to be abolished as of the beginning of 2002. Thus, the last quarter of 2001 represented the last chance to make use of these tax reliefs.

The quality of the loan portfolio improved over the year, influenced by the improved financial standing of some borrowers, the recovery in the domestic economy, and the write-off of bad loans and their transfer to non-systemic accounts.

The domestic banking system as a whole posted a loss of LTL 23.3 mn in 2001. Six banks and one foreign bank branch were profitable with an aggregate profit of LTL 115 mn, while three banks (AB Bank Hansa-LTB, AB Parex Bankas, and UAB Sampo Bankas) and three foreign bank branches (Merita Bank Plc Vilnius Branch, Norddeutsche Landesbank Girocentrale Vilnius Branch, and Vereins-und Westbank AG Vilnius Branch) incurred a total loss of LTL 138.3 mn.

Shrugging off the decline in the interest rate (from 5.2 to 4.3%), the majority of banks improved their results. However, most foreign bank branches have so far failed to achieve profitability in their operations.

### The budget

Budget revenues over the period of January 1st through April 1st were 2 bn LTL. This is some 1.2% or 25 mn LTL more than expected.

In March, total public debt decreased by LTL 20.2 mn and at the end of the month amounted to LTL 12,902.8 mn, thus standing at 25.2% of projected GDP.

As of March 31, direct state liabilities (loans received on behalf of the state) amounted to LTL 10.9 bn or 84.2% of total debt and contingent liabilities (state guarantees) were LTL 2 bn or 15.8% of the total debt.

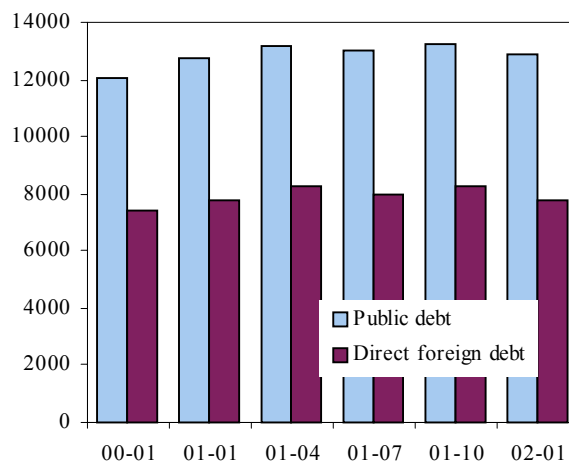
Direct foreign debt (loans received on behalf of the state) decreased by LTL 47.6 mn over the previous month and as of the end of March was LTL 7.8 bn or 60.3% of total public debt. In March, the state received LTL 7.5 mn under previous agreements. External lenders were repaid LTL 24.8 mn of loans. Furthermore, debt outstanding decreased by LTL 30.3 mn due to the changes in the currency exchange rate.

Direct domestic debt increased by LTL 79.1 mn and as of the end of March constituted LTL 3.1 bn or 24% of the total public debt.

In March, contingent foreign debt (state guarantees issued on loans in foreign currency) decreased by LTL 51.2 mn and amounted to LTL 1.9 bn or 14.9% of total public debt. During the month, the debtors received LTL 6.7 mn and repaid LTL 24.5 mn of foreign state guaranteed debt.

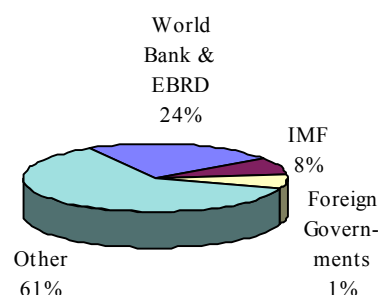
The government is targeting a fiscal deficit of 1.5% of GDP for 2002 and intends to run a balanced budget from 2003 onwards (excluding pension reform costs). Steps are in place to limit future spending pressures and a major tax overhaul is underway to strengthen revenues.

Public Debt (mn LTL)



Source: Bank of Lithuania & Lithuanian Ministry of Finance

Direct Foreign Debt by creditors as of 1 October 2001



Source: Bank of Lithuania

Of course, implementing pension reforms and further restructuring the energy sector will give rise to substantial expenditures, while the introduction of a new tax system could lead to lower fiscal revenues. At the same time, the savings and land restitution schemes represent a substantial contingent liability (about 7% of 2002 GDP) for the government.

But the risk that the government could experience temporary liquidity problems has been reduced markedly by the creation of a Reserve Stabilisation Fund. The Fund already contains LTL 1.1 bn (equivalent to 2.3% of GDP) and is expected to hold LTL 2 bn by the end of 2002, providing a large financial buffer.

### The exchange rate

Since the 2nd of February 2002, the peg of the litas has been switched from the US dollar to the Euro at the rate of 1 EUR = 3.4528 LTL, which was the implicit market rate on 1st of February.

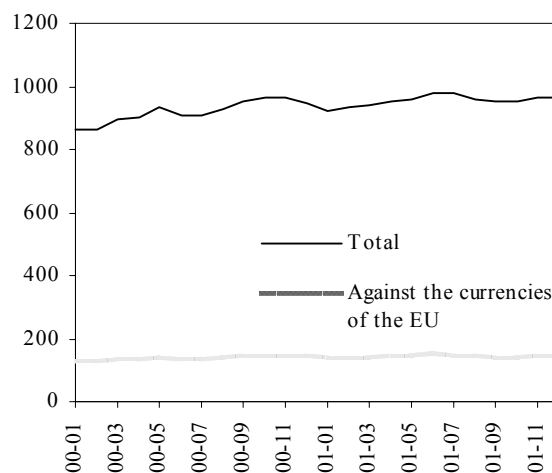
The nominal effective exchange rate of the litas, as calculated by the Bank of Lithuania, against the currencies of its main trade partners appreciated by 1.4% during the fourth quarter of 2001. Against the currencies of the EU countries the nominal appreciation was 1.7%, while against the currencies of the CIS countries it was 2.6%.

At the same time, the real effective exchange rate appreciated by 0.6%. Against the currencies of the EU countries the real value of the litas appreciated by 2.5%, while against the currencies of the CIS countries it depreciated by 1.7%.

### Money

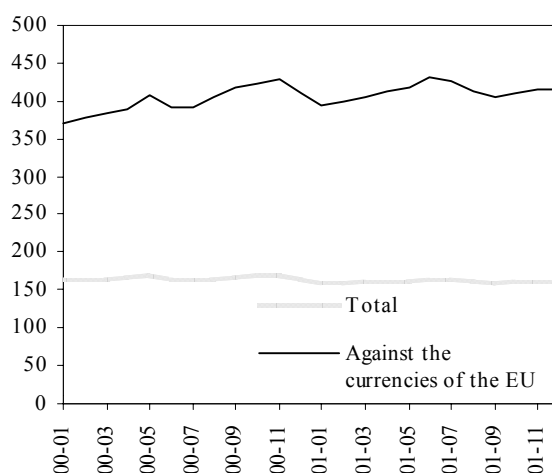
Over the fourth quarter of 2001 the monetary base increased by 13.3% and stood at 4.3 bn LTL at the end of December. The biggest portion (76.5%) was currency outside the Lietuvos Bankas (Central Bank). The reserves of the commercial banks in national currency made up 13.7% and required reserves in foreign currencies accounted for 9.8%.

**Nominal Effective Exchange Rate Indicates of the LTL (June 1993=100)**



Source: Bank of Lithuania

**Real Effective Exchange Rate Indicators of the LTL (June 1993=100)**



Source: Bank of Lithuania

Broad money, M2, amounted to 12.7 bn LTL at the end of December, representing growth of 8.4% over the quarter. The growth reflected an increase in the net foreign assets of the banking system, at the same time demonstrating greater confidence in the banking system.

M1 increased by 15.8%, while the amount of quasi money went up by 1% during the quarter.

The share of demand deposits increased, while that of foreign currency deposits and time and savings deposits both decreased, if compared to September. The amount of currency in circulation grew by 8.4% during the quarter.

### Capital markets

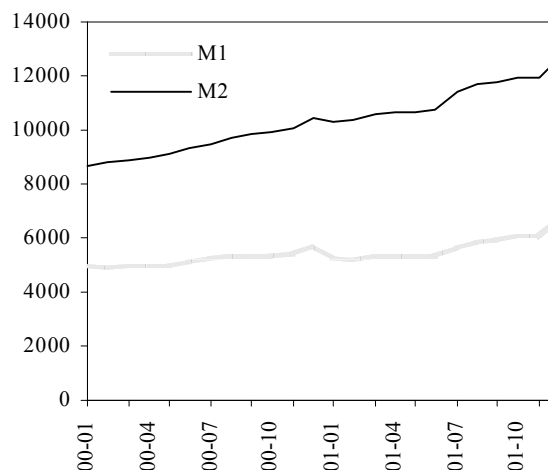
Eleven auctions of Government securities (GS) were conducted in the fourth quarter of 2001. The nominal values of Treasury bills and government bonds sold were LTL 160 mn and LTL 175 mn respectively. All issues were fully subscribed and the average T-bill yield was 4.6%, while the average Government bond yield was 6%.

Government securities turnover on the National Security Exchange of Lithuania (NSEL) was down by nearly 31% in the 4th quarter of 2001 as compared with the previous quarter. Prices for GS in the secondary market grew by 45.6 points during the quarter (the LITIN-VVP index was 2068.72 points at the end of December).

Total turnover on NSEL increased by 59.2%, while turnover in shares increased by 82.3% in comparison with the 3rd quarter.

During the reference quarter, the prices for shares in the companies included in the Official List grew by 28.3 points (the index LITIN was 321.51 points at the end of December), while the prices for shares that were traded most actively at the NSEL increased by 120.46 points (the index LITIN-10 was 1139.43 points at the end of December). The prices for all quoted stocks increased by 64.62 points (the index LITIN-G was 855.34 points at the end of December).

Money supply (mn LTL)



Source: Bank of Lithuania

Total capitalisation of NSEL was LTL 12.5 bn at the end of December, of which listed securities capitalisation was LTL 6.8 bn and unlisted securities capitalisation was LTL 5.7 bn.

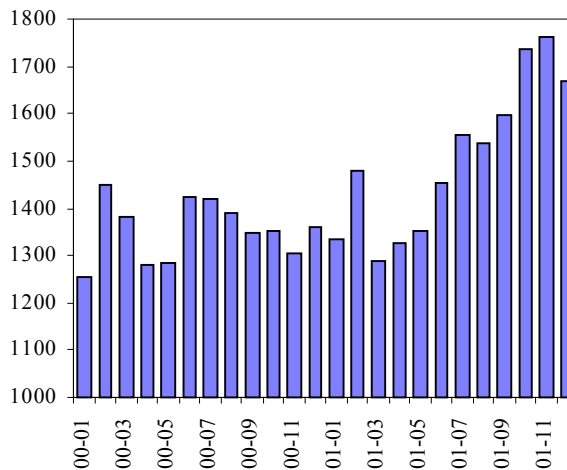
During the first quarter of 2002, share demand increased, considerably exceeding share supply twice in February, which led to the rise of all NSEL indices. The index LITIN increased by 15%, LITIN-G by 16%, and LITIN-10 by 2.75%.

This had an effect on the Stock Exchange turnover structure. As compared with the average value per session of the previous year, central market share turnover demonstrated the fastest growth (80%). In the total share turnover, trading volumes on the central market accounted for 42.5% (13% in 2001).

The total share turnover, amounting to LTL 117 mn, was larger than the first quarter trading volumes of the previous two years and accounted for 45% of the annual central market share turnover of 2001. Trading in securities by block transactions stood at LTL 324 mn, where tender offers and privatisation of state-owned property accounted for 30%.

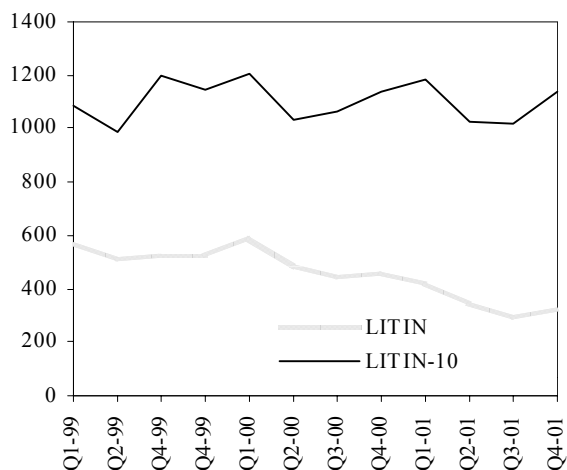
Stock Exchange capitalisation grew by 4.97% up to LTL 13.1 bn, and that of listed securities moved up by 8.85% to LTL 7.4 bn over the 1st quarter of 2002.

**International reserves (mn USD)**



Source: Lithuanian Ministry of Finance

**The LITIN and LITIN-10 index**



Source: National Stock Exchange of Lithuania



# Key Economic Indicators

	1998	1999	2000	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4
<b>Population</b> (mn. mid-year)	3.71	3.71	3.69	3.69	3.69	3.69	3.69	3.69
<b>Gross Domestic Product</b>								
Nominal GDP (bn LTL)	42.77	41.84	44.93	11.52	10.68	12.09	12.75	12.40
Nominal GDP (bn USD)	10.69	10.46	11.23	2.88	2.67	3.02	3.19	3.10
Nominal GDP per capita (USD)	2881	2820	3044	12488	11577	13106	13821	13442
GNP per capita (USD at PPP)	6283	6490	-					
<b>Aggregate Growth Indicators</b>								
Real GDP (%)	5.05	-4.19	2.64	3.65	6.39	6.74	8.22	7.90
Private consumption (%)	-1.81	0.78	3.77	1.3	-7.8	7.0	3.9	1.6
Government consumption (%)	3.99	15.98	-0.70	13.0	-19.2	23.8	-15.4	12.0
Gross fixed investment (%)	5.1	-11.8	-12.2	4.2	-32.0	23.5	23.8	n/a
Industrial production (%)	9.3	-9.6	8.8	14.5	6.0	8.3	2.0	3.8
Agricultural production (%)	n/a	-11.68	-1.78	-10.9	-14.0	-9.7	-6.2	-9.8
<b>Stabilization Indicators</b>								
Consumer prices (avg. %)	5.10	0.89	0.93	1.41	0.56	1.51	2.04	2.10
Unemployment rate (avg. %)	6.40	8.37	11.53	12.13	13.17	12.40	12.07	12.10
Average nominal wages (LTL)	1009	1075	1089	1113	1041	1067	1068	1087
Average nominal wages (USD)	252	269	272	278	260	267	267	272
Budget balance (% of GDP)	-1.26	-4.33	-0.97	-0.58	0.83	0.20	-0.05	-2.50
Exchange rate LTL/USD (avg)	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000
Exchange rate LTL/USD (end-period)	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000
<b>Trade and Balance of Payments</b>								
Total exports fob (bn USD)	3.96	3.15	5.20	1.30	1.40	1.55	1.56	1.20
Total imports fob (bn USD)	5.48	4.55	5.83	1.59	1.49	1.64	1.59	1.90
Trade balance (bn USD)	-1.52	-1.40	-0.62	-0.29	-0.09	-0.09	-0.03	-0.50
Current-account balance (bn USD)	-1.298	-1.194	-0.675	-0.254	-0.145	-0.138	-0.014	-0.300
<b>Foreign Debt and Reserves</b>								
Foreign debt (end. bn USD)	1.682	1.854	1.880	1.880	2.107	1.998	2.065	1.949
International reserves (end. bn USD)	1.460	1.242	1.180	1.359	1.287	1.455	1.598	1.661
<b>Foreign Investment</b>								
FDI inflows (bn USD)	0.926	0.486	0.374	0.114	0.133	0.207	0.107	0.066
Cumulative FDI inflows (bn USD) <sup>1</sup>	1.4325	1.9189	2.2926	2.2926	2.4260	2.6333	2.7405	2.6750
Portfolio investment (bn USD)	-0.043	0.508	0.418	-0.007	0.236	-0.039	0.030	0.480
<b>Monetary growth</b>								
M2 (%)	14.51	7.74	16.53	6.10	1.50	3.07	7.08	8.35

<sup>1</sup> Cumulative from 1996.