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Feature Articles

From Liberalisation to De-liberalisation: Estonian Multi-track Trade Policy Since the Early 1990s

How Costly Is It For The Bank Of Latvia To Support a Credible Fix?

Ethnic Russians in Baltic Labour Markets: Preliminary Evidence on Wages and Unemployment

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BALTIC ECONOMIC TRENDS, 2001, No 3

Editorial

Welcome to the third issue of *Baltic Economic Trends* (BET) for 2001. The special reports of this issue are devoted to diverse topics – trade policy in Estonia, the credibility of the Latvian currency, and the impact of ethnicity in Baltic labour markets.

Magnus Feldmann and Razeen Sally offer an account of the genesis of Estonia's uniquely liberal trade policy and point out that more current developments, especially the process of EU accession, will have the effect of an imposed 'de-liberalisation'. Viktors Stebunovs examines a number of indicators of the credibility of Latvia's peg to the SDR unit, concluding that on a number of occasions, most notably in the aftermath of the Russian crisis, the Bank of Latvia's commitment to the peg has been seriously tested. The peg has survived but intervention has been quite costly. In our third special report Ken Smith surveys the evidence on the labour market status of ethnic Russians in the post-Soviet Baltic states. Ken concludes that in both Latvia and Estonia the evidence points to the emergence and persistence of unfavourable wage differentials and unemployment differences against ethnic Russians that cannot be explained by normal economic factors. In Lithuania there appears to be no general 'wage discrimination' against ethnic Russians but they (and ethnic Poles) are hit harder by unemployment than are ethnic Lithuanians.

Magnus Feldmann is of Estonian/Finnish/Swedish family background. He has degrees from Oxford and the London School of Economics and is currently on the Political Economy PhD programme at Harvard. His research interests are the political economy of trade and macroeconomic policy making, especially in transition economies.

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Viktors Stebunovs is a graduate of the Analytical Economics Programme of the University of Latvia. He has also studied at Queen Mary, University of London and Aarhus University, Denmark and is currently a Muskie Scholar on the MA programme at Binghamton University, New York.

Ken Smith spent several years in the Baltic States, in Vilnius, Riga and Tartu. He is currently at the economics department of Millersville University, Pennsylvania. Ken has published in the *Economics of Transition* and is the leading western scholar of labour markets in the Baltic states.

The updates of economic developments in the three Baltic countries have a slightly revised format in this issue playing more emphasis on analysis and looking forward to future developments.

. Projected themes for future BET issues:

- . Foreign direct investment
- . Migration
- . EU accession and the Baltic currencies
- . Competition policy
- . Regulation

Special reports are intended to provide in-depth analysis and discussion of policy related issues. They may be the results of original research, or they may be written specifically to address a policy theme. In some cases reports are commissioned, but BET also welcomes submissions.

If you have an article that you believe might be suitable as a special report you are welcome to submit it. Submitted reports should be 3000-4000 words long and written in English. They should be sent (two hard copies) to

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BET would also be very happy to devote some issues to themes created by guest editors. If you have a theme within which you believe you can generate a small group of high quality papers please contact me at:

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Editor

From liberalisation to de-liberalisation: Estonian multi-track trade policy since the early 1990s¹

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Introduction

Estonian trade policy in the transition has been exceptional, standing out from other ex-socialist reformers. Estonia did not opt for gradual, reciprocal liberalisation as part of international trade agreements, but went all the way to free trade rapidly and on its own. By 1993 Estonia had the most liberal trade regime in Europe. Bilateral, regional and multilateral trade policy tracks followed or complemented the unilateral opening, which had been decided on in 1991.

Now Estonia is on the threshold of EU accession, when Estonia will have to adopt the Common External Tariff as well as the non-tariff protection of the EU. Indeed, Estonia has recently implemented so far moderate agricultural tariffs against third countries (with which it does not have free trade agreements), marking the beginning of a “de-liberalisation” phase that will accelerate with EU accession.

These developments raise a number of questions. First, how did the exceptional free trade regime come about? Second, how was free trade sustained throughout the 1990s and what role did “multi-track” trade policy (the bilateral, multilateral and regional tracks) play in this? Finally, what are the implications of impending EU membership for trade policy? De-liberalisation is surely an issue that will feature in Estonia’s accession referendum, now expected in 2003.

Estonian trade policy in the 1990s

Following independence, Estonia’s Soviet trade regime was dismantled fast but was not replaced by a complicated tariff system. The commitment to liberalise international trade completely was made before the first national budget was passed. This was an important reason why fiscal arguments for protection could be avoided. Customs duties were applied on a few peripheral items (furs, cars, yachts, motorcycles, sea- and snow-scooters; an export duty on vintage cars), but even these were repealed in 1997 (Purju, 1996: 21). The average weighted tariff was 1.4 per cent by the end of 1993 (down to zero by 1997). It should be noted that agricultural protection was abolished as part of the package. In 1991, more than 200 items were covered by export quotas and licences; by the beginning of 1993, only five were still in force (all subsequently abolished by 1995) (Purju, 1996 20-22, WTO, 1999: 14-15).

Table I illustrates the extent of Estonian import liberalisation in a comparative context. Its trade regime compares favourably with all other transition countries. Neighbouring Latvia and Lithuania, for instance, maintain protection, especially on agricultural imports. With foreign trade amounting to about 186 per cent of GDP, Estonia also ranks amongst the most open economies in the world.

¹ This article draws on Feldmann, 2000, and Feldmann and Sally, 2001. A more comprehensive bibliography and detailed analysis can be found there.

Table I: Estonia's trade liberalisation in a comparative perspective

Country	Average weighted tariffs, %, 1999	Trade to GDP ratio, 1999
Estonia	0	186.0
Bulgaria	15.1	87.7
Czech Republic	6.8	128.6
Hungary	13.3	137.6
Latvia	5.3	120.6
Lithuania	4.5	89.9
Poland	11.6	48.9
Romania	23.8	62.1
Slovakia	12	134.5
Slovenia	10.6	112.6
EU	5	74.5

Source: IMF *World Economic Outlook 2000*

Unilateral liberalisation has been accompanied by bilateral, regional and multilateral trade policy developments. Since the early days of transition, negotiating free trade agreements (FTAs) was a key priority for decision-makers (see Table II for a list of all the FTAs). What makes the Estonian case stand out is that the FTAs were concluded *after* unilateral liberalisation; market access was not used as a bargaining chip by the Estonian negotiators. Moreover, given unilateral free trade across the board, there was no differential between preferential and other tariff rates. This was also a unique feature of Estonia's trade policy regime, at least in the European context. Internationally, Estonian unilateral free trade can be bracketed with trade policies in Hong Kong and Singapore.²

Multilaterally, Estonia became a member of the WTO in 1999. Accession negotiations were perhaps unexpectedly complicated. With the EU's Common External Tariff in mind, Estonia wished to bind tariffs in the WTO far above applied rates of 0 per cent – an unprecedented situation for a WTO accession negotiation. Negotiations concluded with MFN tariff bindings of just over 6 per cent on industrial products and just over 17 per cent on agricultural products. The preparations for EU accession created difficulties in audiovisual services as well. Finally, WTO accession required addressing some of the trickier non-border issues in trade policy, such as intellectual property protection, technical barriers to trade, sanitary and phytosanitary measures, and anti-dumping actions (Feldmann and Sally, 2001: 19ff.).

Table II: Estonia's Free Trade Agreements

Country	Signed	In force/applied since
Ukraine	24 May 1995	14 March 1996
Czech Republic	19 April 1996	12 February 1998
Slovakia	29 May 1996	13 March 1998
Turkey	3 June 1997	1 July 1998
Latvia and Lithuania	13 September 1993	1 April 1994
Poland	5 November 1998	1 January 1999
Slovenia	26 November 1996	1 March 2001
Hungary	4 November 1998	1 March 2001
European Communities	18 July 1994	1 January 1995
EFTA	7 December 1995	1 October 1997
Turkey	3 June 1997	1 July 1998
Faroe Islands	27 November 1997	1 December 1998

Source: Estonian Ministry of Foreign Affairs homepage, www.vmi.ee

² Singapore has maintained protection in some services sectors, although a substantial liberalisation programme is in train. See *WTO Trade Policy Reviews of Singapore, 2000*, and *Hong Kong, 1998*.

In recent years the regional (EU) track of trade policy has become predominant. The early FTA with the European Communities was superseded by an ambitious and more comprehensive Association Agreement (also known as the Europe Agreement), which came into force in early 1998. The Europe Agreements provide the basis for the transition countries' integration into the EU. The imperative of EU integration has been an important factor in bringing about so far rather low agricultural tariffs (3.3 per cent in import weighted terms) against third countries, which were introduced in January 2000. The introduction of these tariffs marks the beginning of a new "de-liberalisation" phase in Estonian trade policy, where EU-style protection is gradually being introduced.

In terms of policy outcomes there has been a fundamental transformation of Estonia's foreign trade geography. A decade ago trade with the West was negligible. Now over two thirds of foreign trade is conducted with the member states of the European Union (see Table III for the list of the main trading partners); Finland and Sweden play a particularly important role, which is also reflected in their positions as the two biggest foreign investors (accounting for about 70% of total FDI inflows in the 1990s).

The political economy of unilateral free trade

In this section we analyse the emergence of free trade in Estonia by looking at the political economy factors that contributed to it. We focus on a number of exogenous factors and three political economy variables – interests, ideas and institutions.

A number of exogenous factors at the outset of transition contributed to an environment where liberalisation could be seen as a likely option. First, the fact that the Estonian economy had been sealed off from world markets meant that some liberalisation would be an inevitable part of transition to a market-based economy; total closure could hardly be an option. Second, the collapse of the Soviet and COMECON markets in the early 1990s created an urgency to seek alternative import and export markets. Third, the small size of Estonia, a country of just under 1.5 million people, contributed to a common-sense appreciation that international trade and foreign direct investment are important bedrocks of economic activity. Fourth, the security imperative of reorienting economic links from Russia, underpinned by historic links to the West, is worth noting. In this way trade policy became part of a more general state-building exercise. Finally, the deep economic crisis involving severe shortages and hyperinflation, coupled with the political challenges of re-establishing independence, created a unique window of opportunity for radical reforms.

However, it should be pointed out that none of these exogenous factors were dramatically different in the other Baltic States; but only Estonia went all the way to unilateral free trade. We therefore need to examine how these exogenous factors affected the three political economy variables – interests, ideas and institutions – to see what made the Estonian case stand out from the rest of the transition world.

Table III: Main trading partners (January – October 2000)

	Exports	% of total	Imports	% of total
1	Finland	31.2	Finland	28.7
2	Sweden	20.4	Sweden	9.8
3	Germany	9.3	Germany	9.8
4	Latvia	7.1	Russia	8.7
5	United Kingdom	4.6	Japan	6.3
6	Denmark	3.5	Italy	2.9
7	Lithuania	2.9	Latvia	2.7
8	Netherlands	2.5	Denmark	2.5
9	Norway	2.4	United Kingdom	2.3
10	Russia	2.0	United States	2.2

Source: Statistical Office of Estonia, www.stat.ee

The severe economic crisis at the outset of transition meant that interest group activity by protectionist (and other) lobbies was very weak. In this period of “extraordinary politics” lobbying activity temporarily ceased, as interest groups were primarily concerned with survival (Balcerowicz, 1995). Additional policy-induced factors also helped to reduce interest group activity in favour of protection. A sharp real devaluation contributed to cushioning the effect of the dramatic liberalisation by giving import-competing domestic producers some breathing space. The dissolution of collective farms and the privatisation of old state enterprises further added to the weakening of interest groups, which would have been likely to resist the move to free trade. Agricultural interests in particular were less well represented in Estonia than for example in Latvia.³ Estonia’s inherited industrial structure – mainly light industry as opposed to more heavy industry in Latvia – may have made reforms easier and reduced interest group pressure. These factors can at least partly account for the differences between Estonia’s bold move to free trade and Latvia’s more conventional trade policy regime, where more gradual liberalisation and sectoral protection have co-existed.

In the realm of ideas, there was a solid consensus in favour of neo-liberal economic thinking. The old system of central planning had been thoroughly discredited, and there was a strong sense that a dramatic shift was needed. A number of pro-independence groups had been engaged in intensive discussions on economic policy reform in the five years preceding independence, and a plan for economic autonomy (known as IME) was launched as early as 1987 (Taagepera, 1993, Laar, Ott and Endre, 2000). This helped build up a head of steam for later reforms, notably the move to free trade and the establishment of the currency board in 1991/2. The first Laar government (1992-95) then pushed through a whole range of further market liberal reforms, including a flat income tax, the beginning of large-scale privatisation, and full current and capital account convertibility. The move to free trade was thus part of a market-liberal reform package designed to bring about a swift transformation of the economy.

The strength of these ideas, and especially the support for free trade, can at least partly be explained by some of the exogenous factors discussed above, like the size of the economy and the security imperative of reorienting to the West. However, a strong “home-grown” consensus in favour of reforms developed earlier and reached deeper than elsewhere in the transition world. Indeed, the degree of domestic political support for external liberalisation and the free-trade zeal of Prime Minister Mart Laar in particular made Estonia stand out among its neighbours and in the wider region. Remarkably, there was no dramatic shift in the cross-party political support for free trade during the 1990s, despite many changes of government and some pressure in the mid-1990s for the restoration of agricultural protection.⁴

³ For a comparison of Estonia and Latvia, see Feldmann, 2000.

⁴ See the discussion about the 1995 election and its aftermath in Feldmann and Sally, 2001: 16.

The institutional framework – the decision-making setting for trade policy – was also an important factor. As economic transition coincided with the re-establishment of political independence, most institutions of a nation-state had to be created literally from scratch. This led to an overhaul of the political establishment and to the rise of a new generation of young, hitherto inexperienced politicians and civil servants. For example, Mart Laar was only thirty-two years old when he became prime minister in 1992. Trade policy was administered by a small group of equally young officials without prior experience in the Foreign Economic Policy Department of the newly established Ministry of Foreign Affairs (MFA). This new generation of civil servants, untainted by the Soviet past and without training in the reciprotarian practice of international trade negotiations (i.e. negotiating the exchange of export concessions in mercantilist fashion), were critically influential in the radical move to free trade. In contrast, Latvia and Lithuania had equally extraordinary initial conditions, but the shakeout of the old guard in the key ministries (especially in Lithuania) was not nearly as sweeping as it was in Estonia.

Since then the MFA has been the lead ministry on all trade policy tracks (unilateral measures and bilateral, EU and WTO negotiations) and has enjoyed a significant degree of administrative autonomy throughout the transition period. More recently the role of other ministries, particularly the ministries of agriculture and economics, has been growing due to the increasing complexity of trade policy in the light of WTO and EU commitments. On the whole, technocratic management underpinned by solid political support has been a crucial factor in implementing free trade and in maintaining policy continuity under changing administrations. Latvian and Lithuanian trade policies, in contrast, have seen their fair share of political and interest group interference, particularly in favour of agricultural protection (Feldmann, 2000).

As the preceding discussion illustrates, the unconventional unilateral move to free trade was conditioned by many factors – circumstances, interests, ideas and institutions. In other transitional countries, different circumstances, interest group opposition, insufficient domestic support of free trade, and a less advantageous decision-making setting, all conspired to prevent a wholesale unilateral move to free trade. Even in neighbouring and comparatively liberal Latvia, there was much more reliance on conventional reciprotarian trade policy. Estonia was exceptional in not resorting to mercantilist haggling over export concessions.

We now turn to “multi-track” trade policy and its effects on the unilateral free trade regime.

Multi-track trade policy I: Free trade, FTAs and WTO accession

In most countries, international negotiations and agreements tend to be used as an external device for securing market access abroad, and delivering trade liberalisation at home. As trade liberalisation in Estonia was not brought about through international negotiations – unconventionally, free trade preceded international negotiations – some interesting implications for multi-track trade policy management follow.

The Estonian FTAs served a number of important purposes. First, in the absence of GATT/WTO membership, Estonia could have been refused MFN treatment by most major (or potential) trading partners. Getting freer access to export markets was thus an important complement to the unilateral opening. As Estonia had implemented unilateral free trade, other countries could not gain any further market access by concluding an FTA with Estonia, although it might of course provide some guarantee against future protectionism. As often happens, political factors

were important in bringing about the FTAs. Most other countries – especially the Nordic members of EFTA and the EU – viewed the FTAs with Estonia as a means of showing political support for a reforming country that had recently regained independence.

Second, by providing market access the FTAs helped to accelerate the reorientation of international trade flows. It may also have had a positive effect on investment flows. Much of manufacturing FDI into Estonia consists of investments into export-oriented firms that are vertically integrated by means of intra-firm trade with (mostly Swedish and Finnish) mother companies. For example, leading Estonian manufacturing firms such as Elcotec do subcontracting work on mobile phone parts and cables for Nokia in Finland and Ericsson in Sweden. Free trade agreements are likely to have been important for such investment decisions, as they depend on open international markets.

Third, in the absence of comprehensive domestic legislation, the FTAs provided an initial legal framework to regulate free trade. This also helped to lock in the unilateral reforms. International commitments make domestic regime reversals more costly and difficult. Therefore, the FTAs contributed to the credibility of the unilateral free trade regime.

All of these arguments – market access, reorientation, legalisation and lock-in – apply with even greater force to WTO membership. The main advantage of the WTO is non-discrimination. In Estonia's case, WTO membership guarantees non-discriminatory (especially MFN) treatment from others, and obliges it to adhere to the same rules. This complements Estonia's hitherto non-discriminatory unilateral free trade regime. In addition, WTO membership provides an even more comprehensive legal framework for international trade than is the case with the FTAs. It also helps to build up national trade policy competence by focusing attention on some more complex non-border measures of trade policy. Finally, WTO accession provides Estonia with an important seal of approval for its trade policy reforms.

The Estonian case therefore shows that the bilateral and multilateral trade policy tracks can be used to underpin unilateral liberalisation, rather than being a stumbling block to it.

Multi-track trade policy II: EU integration

The EU accession process is expected to culminate with full EU membership in a few years. EU accession will affect practically all aspects of economic policy, and we do not attempt to make an overall cost-benefit analysis. Instead we focus on the impact of EU integration on unilateral free trade. Does EU integration, like the FTAs and WTO membership, provide an additional lock-in of unilateral reforms, or should it be seen as a reversal?

EU accession establishes guaranteed free trade with Estonia's most important trading partner. It could also be viewed as an insurance policy against wholesale reversal of a relatively liberal trade regime, with EU policies providing a benchmark – although such a reversal could not be considered as very likely in any case. However, in practice EU integration is in many ways turning out to be a deliberalisation process, for Estonia has to shift from almost complete free trade to EU-style protection across a range of sectors.

Upon accession Estonia will have to align itself fully with the EU's Common Commercial Policy, including protection against third countries. The recent imposition of agricultural tariffs against third countries is just the beginning of this process. Indeed, Estonia is under pressure from the EU to

extend this protection further (Ministry of Economics⁵ and BOFIT, 2000: 1). Estonia will also have to adopt the whole set of EU trade policy instruments. The most obvious element of this is the Common External Tariff with its 10,794 tariff lines – ranging from 0 to about 1000 per cent, with tariff peaks and tariff escalation on sensitive products, especially agriculture, textiles and clothing. In addition, various EU policies of non-tariff protection, such as anti-dumping measures, trade-distorting subsidies and import quotas (especially on iron, coal and steel), will have to be adopted.

Moreover, EU accession is likely to undermine some of Estonia's FTAs – most notably the agreement with Ukraine, which is particularly far-reaching. All of this is likely to lead to trade diversion and higher prices for certain goods, especially food, coal and steel (Varblane, 1999 and 2000).

Overall, it is clear that Estonian-style free trade is inconsistent with EU membership. The simple, transparent and non-discriminatory classical liberal framework of the 1990s will be replaced by a more complex and opaque EU trade policy regime. On the trade front adopting EU norms will impose costs on Estonia; and it is open to question whether significant benefits from accession in terms of improved market access (i.e. going beyond the Europe Agreement) will be forthcoming. However, a full cost-benefit analysis of EU accession would have to weigh these costs against other economic and political benefits, including security externalities. Trade policy has clearly not been among the prime motivating factors for EU accession.

Conclusion

Estonian trade policy in the 1990s illustrates that free trade is an exceptional, but still feasible policy option at the turn of the millennium. Our political economy analysis of circumstances, interests, ideas and institutions shows that many factors contributed to this policy outcome.

We have also examined the relation between unilateral free trade, on the one hand, and bilateral FTAs, WTO accession and EU accession, on the other. Since unilateral free trade preceded multi-track trade policy, FTAs and WTO membership have acted as lock-ins for unilateral liberalisation in addition to providing market access. With EU accession Estonia will need to adopt the EU's tariff and non-tariff protection in full. This can be seen as a complete reversal of the trade policies practised so far. Not least, this de-liberalisation process also means that Estonia is about to lose one element of its uniqueness in last decade – its brand name as the "Hong Kong of Europe".

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How costly is it for the Bank of Latvia to support a credible peg?

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Introduction

Latvia's national currency (the lats), pegged since 1994 to the IMF's Special Drawing Rights (SDR) basket,¹ is often regarded as a "symbol of stability". However, it has not always enjoyed high credibility, as on several occasions the Bank of Latvia has had to defend the currency. Still, the peg has survived and the Bank of Latvia's prestige has grown.

Unfortunately, there is a downside to this success story. Supporting the fixed exchange rate when faced with devaluation pressure is costly to the central bank, since the foreign exchange reserves have a significant opportunity cost. Such reserves could instead be invested in US Treasury bills, which are liquid and safe. At the same time, by having large foreign exchange reserves at its disposal the central bank enhances the credibility of its exchange rate policy. If the credibility of the central bank is well established, devaluation pressure is less likely, and therefore the costs of maintaining a fixed exchange rate may be significantly reduced.

It is the task of the central bank to take these costs into account before acting. However, since the SDR is not traded directly in world currency markets, the policy actions of the Bank of Latvia are not very transparent to the general public. It is not easy for the general public to verify whether the peg holds at any given moment. Even if exchange rates in the local currency market are consistent with the announced policy, the public observes only the outcome of the interaction of market forces and the central bank. The general public cannot directly infer whether the exchange rate is stable due to a balance of supply and demand in the foreign exchange market, or whether it is a consequence of a costly central bank intervention.

The above suggests that it may be of interest to examine the credibility of the lats peg as perceived by local foreign exchange market participants, i.e. by the best-informed group of economic agents, and to estimate how costly it has been for the Bank of Latvia to sustain the peg.

This article looks at three alternative measures of credibility of lats peg: the implicit exchange rate, uncovered interest rate parity and market pressure index. Then, we make some estimates of the costs of Bank of Latvia interventions and draw some conclusions.

The implicit exchange rate

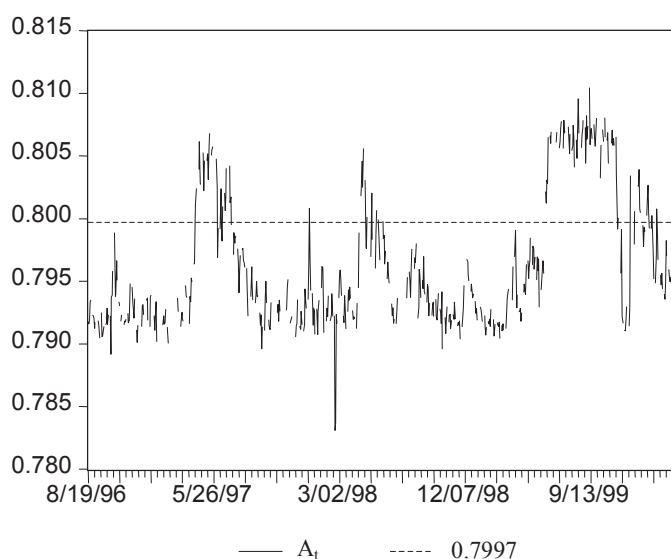
A fixed exchange rate regime requires the central bank to intervene in the foreign exchange market when the market rate departs from the peg or a band-target zone around the peg. Since the SDR consists of a basket of currencies and is not directly traded in world markets, interventions by the

¹ SDR is an artificial currency unit defined as a basket of national currencies that includes U.S. dollar, Euro, Japanese yen and Pound sterling.

Bank of Latvia must take place in another currency. Typically the currency of intervention is the USD. At any moment in time, the prevailing exchange rate of the lats against the SDR can be calculated from actual market exchange rates of the basket currencies. This calculated rate is defined here as the implicit exchange rate (A_t). If the peg of the lats is credible, the implicit rate should, on average, equal the official peg value of 0.7997 LVL per unit of SDR. Prolonged deviations in the implicit exchange rate from 0.7997 would suggest demand and supply imbalance and possibly a lack of credibility of the peg.

Calculations of A_t on daily basis for the period from 1996 to early 2000 are shown in Figure 1. A value of A_t below 0.7997 implies that the market value of the lats is higher than the peg and A_t above 0.7997 implies that the market value of the lats is below the peg.

Figure 1. The implicit market LVL/SDR exchange rate



Source: Author's calculations

Figure 1 shows that, most of the time, the implicit exchange rate has stayed below the rate set by the bank. Since there have never been serious expectations of appreciation of the lats, this is best interpreted in terms of an upper intervention margin set by the Bank of Latvia.

However, there are three distinct periods when A_t was above 0.7997 LVL/SDR, which can be interpreted as episodes of loss of credibility of the peg. In particular, one of these episodes coincides with the Russian crisis of August 1998, when devaluation of the rouble and the fall of Russian GDP had a significant adverse impact on the economic fundamentals of Latvia, thus creating devaluation pressure and potentially undermining the peg's sustainability.

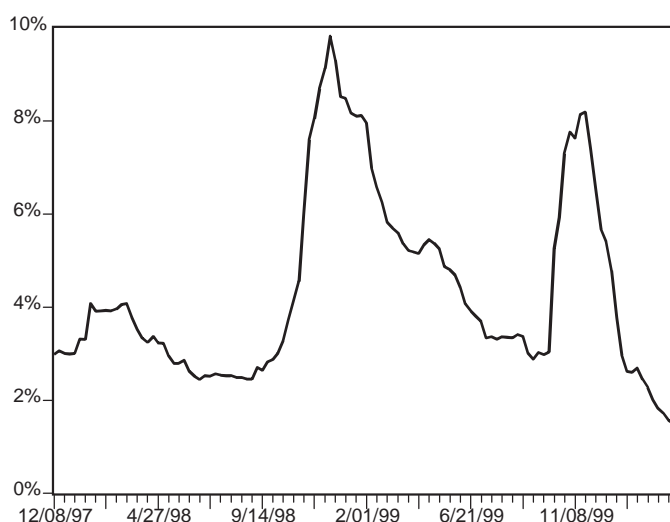
Formal econometric tests (reported in the appendix) suggest that we cannot reject the hypothesis of long-run equality of the implicit exchange rate and the official peg. However, these results still allow for episodes of diminished credibility accompanied by central bank interventions.

Uncovered interest parity

Examination of uncovered interest parity (UIP) offers evidence about credibility from another angle. UIP can be used to estimate the expected realignment of the exchange rate, which is often used as a proxy for the credibility of the peg. In case of Latvia, the UIP condition asserts that domestic market interest rates and world interest rates paid on assets that are perfect substitutes, but denominated in the lats and SDR respectively, should be equal. Thus any differences in the two interest rates correspond to an expected realignment of exchange rates. However, if assets are not perfect substitutes then an interest rate differential may still arise even in the absence of realignment expectations.

Figure 2 plots the expected realignment of the lats based on the 3-month Riga inter-bank interest rate and 3-month SDR interest rate on a similar asset² for a period from 1997 until early 2000. Until the Russian crisis of August 1998 the interest rate differential fluctuated at around 3%. This differential could reflect imperfect asset substitutability, or perhaps small but persistent devaluation fears, or a combination of these. Right after the crisis the differential did not jump immediately, but climbed gradually and reached 10% four months after the crisis. Presumably, economic agents were slow to estimate the adverse consequences of the crisis and to revise their beliefs. Still the substantially wider gap in the interest rates suggests an increase in expected realignment and thus a loss of credibility of the peg.

Figure 2. Expected realignment of the lats based on UIP



Source: Author's calculations

The market pressure index

Another measure of devaluation pressure is the foreign exchange market pressure index, which is constructed as a weighted average of the market interest rate, changes in the implicit exchange rate and (the negative of) foreign reserve changes.³ This index is widely used in empirical studies devoted to currency crises. However, it is not universal: its application involves an implicit assumption that the theoretical model underlying the index should be a standard currency attack model.⁴

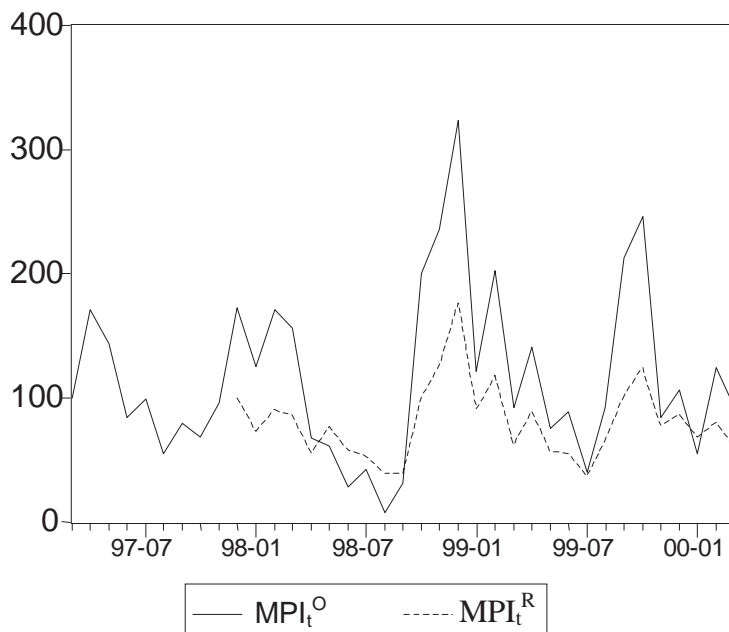
²The IMF calculates a market SDR rate based on money market rates of currencies comprising the basket.

³ The weights were chosen to equate weighted variances of the three variables.

⁴ Flood R.P. and Marion N.P. (1998)

Two market pressure indices are constructed here: one based on the over-night inter-bank interest rates (MPI^O) and the other on the 3-month inter-bank offer rate (MPI^R). Figure 3 shows that the two indices have evolved quite similarly over the sample period. The graph also suggests that market devaluation pressure was actually decreasing in the months before the Russian crisis of August 1998. Seemingly, the Russian crisis and its adverse impact caught market participants off guard. This finding is consistent with the behaviour of the expected realignment indicator in Figure 2.

Figure 3. Foreign exchange market pressure index



Source: Author's calculations

MPI^O and MPI^R jumped sharply right after the crisis, indicating a run on the currency and it took nearly 10 months for the indices to return to pre-crisis levels. This is consistent with the reports from the Bank of Latvia, according to which in the second half of 1998 the market exchange rate LVL/USD was close to the intervention border, on many occasions forcing the central bank to intervene. Overall around 96 million USD were spent on interventions in the course of 1998.

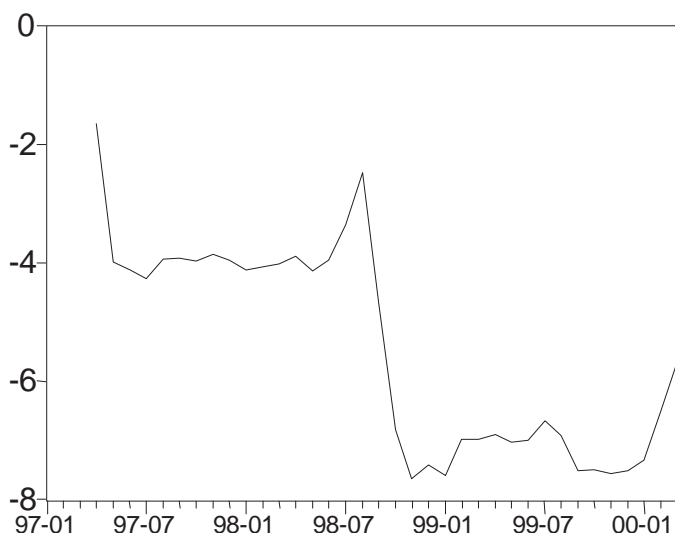
The Russian crisis proved the capability of the monetary authority to withstand severe devaluation pressure, and provided a chance to demonstrate its commitment to the exchange rate regime. However, the question remains as to how much the interventions cost.

The cost of intervention

In order to evaluate how costly it is for the Bank of Latvia in terms of foreign exchange reserves to sustain the peg, we estimate the reserve elasticity (h) with respect to the implicit exchange rate. Estimates of the elasticity can be obtained by simple econometric techniques (see appendix).

We calculate a sequence of estimates of the elasticity starting from the beginning of 1997. Increasing the sample month by month produces the results presented in figure 4. The sequence of estimates has a structural break around August 1998 and again a year later. Before the Russian crisis the reserves were less elastic, with the estimate of elasticity fluctuating around -4%, while after the crisis the estimate increased and remained for more than a year at around -7%.

Figure 4. The sequence of the elasticity estimates, %



Source: Author's calculations

How might we interpret the elasticity estimates? Before August 1998 a 1% increase in the monthly average of the implicit exchange rate (A_t) induced a 4% decrease in the reserves. After August 1998 the same 1% increase induced a 7% decrease in reserves. Or, to put it more intuitively, after the Russian crisis the Bank of Latvia had to use 7% of its foreign exchange reserves to fight a 1% depreciation of the market exchange rate. Evidently, reserves are highly responsive to foreign exchange market developments. This, of course, means that under devaluation pressure it is expensive in terms of reserves to sustain the peg. However, in the event of appreciation pressure, i.e. persistent excess supply of foreign exchange, reserves can also be quickly accumulated.

According to the Bank of Latvia, it spent 74 million USD on interventions in 1994, 68 million USD in 1995, and 96 million USD in 1998. In 1996 and 1997 the intervention balance was positive and the net amount of foreign currency purchased by the Bank of Latvia was correspondingly 148.5 million USD and 97.6 million USD. These numbers are consistent with the behaviour of the implicit exchange rate (A_t), which suggests an excess supply of foreign reserves in 1996 and 1997 (see figure 1). Annual reports of the Bank of Latvia do not disclose the data on interventions in 1999 and 2000. However, there is a way to circumvent unavailability of data on interventions in 1999. Multiplying the estimate of elasticity with the monthly average change of the implicit market LVL/SDR exchange rate for each month gives us the percentage of the foreign reserves spent or acquired while intervening. Then, knowing the level of the foreign reserves, we can obtain the nominal balance. This procedure gives an estimate of 36 million USD of reserves spent in 1999.

To calculate the total cost of interventions, we also need to take into account the opportunity costs. We assume that the foreign reserves that were spent or accumulated during the 1994-1999 period could be invested instead in US T-bills with a 4.5% return at the end of each year. This implies that at the end of 2000 the accumulated cost of the interventions to sustain a peg amounted to 35.3 million USD, a considerable sum.

Conclusions

The aim of this article is not to draw a final conclusion about the desirability of a sustained peg for the lats. Besides the reserves lost in foreign exchange market interventions, there are many other important costs and benefits associated with a sustained exchange rate peg that are not covered here. The results presented here assess the credibility of the current exchange rate policy, and shed some light on the direct costs incurred by the Bank of Latvia in sustaining the peg of the lats. They should be seen merely as a piece in the puzzle of the optimal exchange rate policy.

So what conclusions can we reach based on the information that a foreign exchange market participant might have had over the period of our study?

- First, the peg underwent a period of overconfidence right before the Russian crisis. The movements in the implicit LVL/SDR exchange rate and the accumulation of reserves support this claim. Later, the implicit exchange rate was more volatile and stayed above the official rate set by the Bank of Latvia, suggesting high uncertainty in the market and a lack of credibility for the peg. The central bank was forced to spend reserves intervening in the foreign exchange market.
- Second, the expected realignment indicator and the market pressure index both suggest that the markets did not anticipate the Russian crisis and its contagious adverse effects. After the Russian crisis, it took a prolonged period of time (approximately one year) to overcome the nervousness in the foreign exchange market.
- Third, the estimate of elasticity of the foreign exchange reserves suggests that reserves are highly sensitive to the implicit exchange rate. This in turn suggests that central bank interventions are intense and costly, and that reserves are vulnerable to a loss of confidence.
- Finally, over the course of 1994-1999 sustaining the peg of the lats has cost the Bank of Latvia 35.3 million USD in terms of foreign exchange reserves. The trend is more alarming, as during the 1994-1997 period additional reserves were accumulated, but more recently (1998-1999) the Bank of Latvia spent 142 million USD in interventions. It is probable that the lats will again come under devaluation pressure at some point in the future. The question remains: will it be worth supporting the peg in the next crisis?

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Appendix

Modelling long-run credibility of the peg

The restricted co-integration model, which may be used to examine the long-run credibility of the peg, stems from the following. Given certain assumptions, eg credibility and financial integration, triangular arbitrage and interventions by the central bank should ensure that:

$$S_t = AS_t^* \quad (1)$$

where S_t is the LVL/USD exchange rate in the domestic market, S_t^* is an SDR/USD exchange rate, and A is the peg coefficient. Given the construct above, the exchange rates S_t and S_t^* should be co-integrated, ie there should be a long-term statistically significant relationship between these exchange rates.

In order to verify this long-term relationship a restricted co-integration test can be used. A co-integrating factor of the exchange rates will be set to 1 as to ensure that equality $\Delta S_t = \Delta S_t^*$ holds all the time. Equation 1 can be rewritten as follows using a logarithmic transformation:

$$\alpha_t = s_t - s_t^* \quad (2)$$

where α_t is an estimator of the logarithm of the peg coefficient, $\alpha_t = \ln(A_t)$, $s_t = \ln(S_t)$ and $s_t^* = \ln(S_t^*)$. Provided that the exchange rate s_t and the exchange rate s_t^* are integrated of the same order (I(n)), then the restricted co-integration null hypothesis states that the peg coefficient α_t is integrated of the order zero (I(0)) and the alternative hypothesis states that α_t is a unit root. Rejection of the null hypothesis indicates that the exchange rates are drifting apart over time, suggesting diminishing credibility of the domestic currency.

Since both excess supply or excess demand and central bank interventions affect the implicit exchange rate α_t , both of these factors should be accounted for in equation 2. An appropriate model apparently should come from the exchange rate band-target zone model family. An arbitrary alternative to exchange

rate band models might still be based on equation 2 but with some variable included that captures the scale of central bank activity in the foreign exchange market. Unavailability of such kind of data leads to an arbitrary model defined by equation 3:

$$\Delta\alpha_t = \mu + \gamma\alpha_{t-1} + \sum_{i=1}^{p-1} \varphi_i \Delta\alpha_{t-i} + \theta D_t + \varepsilon_t \quad (3)$$

where $p-1$ is the number of lags, D_t is complicated dummy variable that assumes the value 1 on a day of central bank intervention.

Provided that the exchange rates are integrated of the same order the null states that the generating mechanism of α_t is a unit root $H_0 : \gamma = 0$ with the alternative $H_1 : \gamma < 0$. Acceptance of the alternative hypothesis will indicate that the peg estimator α_t is integrated of order zero (I(0)) and thus the exchange rates are cointegrated with the co-integration factor being one. Equation 3 was estimated on daily basis for the period from August 1996 to March 2000.

Tests conducted before estimation showed that the exchange rates indeed are integrated of the same order. The results showed that the null-hypothesis $H_0 : \gamma = 0$ can be rejected at 5% or 2.5% levels of significance. The acceptance of the alternative hypothesis, however, does not demonstrate that the lats peg was credible at all times since the dummy variable D_t that is meant to capture central bank activity in the foreign exchange market is statistically significant.

Foreign reserve elasticity with respect to the peg estimator

In static terms the elasticity is defined as follows:

$$\eta = \frac{1}{R} \frac{dR}{d\bar{A}} \bar{A} = \frac{dr}{d\bar{\alpha}} \quad (4)$$

where η is the elasticity, R is the central bank's foreign reserves and \bar{A} is a monthly average of the peg estimator, consequently $r = \ln(R)$ and $\bar{\alpha} = \ln(\bar{A})$. Assuming time invariance of the constant elasticity, this regression equation gives an estimator for η :

$$r_t = \beta_1 + \beta_2 \bar{\alpha}_t + \beta_3 \tau + \varepsilon_t \quad (5)$$

where the regression coefficient, β_2 is interpreted as the elasticity η . Equation 5 was estimated on monthly basis for the period from January 1997 to March 2000. Foreign reserves r_t have a time trend, thus a time trend τ was introduced into the equation.

Ethnic Russians in Baltic labour markets: Preliminary evidence on wages and unemployment

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Introduction

As the Baltic States proceed with EU accession negotiations, an important issue is the political and economic status of certain groups such as women or ethnic Russians. While the status of women in the Baltic States is similar to that in many EU countries (as well as other transition economies and market economies in general), the presence of large minorities of ethnic Russians is a phenomenon unique to the Baltic countries.

The political problems of ethnic Russians in Estonia and Latvia are well documented. Both countries have large ethnic Russian minorities – nearly 30 percent of the population in both cases (UNDP 2000) – that have struggled to obtain citizenship and other political rights. Conversely, Lithuania has had a relatively easy time politically assimilating its comparatively small (less than 10 percent of its population) Russian minority. However the potential economic problems of ethnic Russians in the transitional Baltic economies have been less well investigated and reported. This is particularly true of Latvia and Lithuania.

This paper surveys existing analytical research on the status of ethnic Russians in Estonian and Latvian labour markets (I am not aware of relevant published research examining the Lithuanian labour market). Some preliminary evidence using contemporary Baltic Labour Force Survey (LFS) data for all three Baltic States is further discussed. The focus of the discussion is first on wages and then on unemployment. A final section presents some concluding remarks.

Ethnicity and Wage Differentials

Available evidence indicates that the relative standing in the income and wage distribution of ethnic Russians and ethnic Balts has changed sharply during the transition in both Estonia and Latvia. Evidence for Estonia (see Kroncke and Smith (1999) and Smith (2001)) indicates that Estonians and Russians received equal compensation (controlling for a host of human capital factors, demographic factors, regional considerations, and other economic factors) at the end of the Soviet period – 1989 and summer 1990. Conversely, ethnic Russians, clearly the dominant ethnic group in the Soviet Union as a whole, generally fared better in the overall income distribution than ethnic Latvians in Latvia (again controlling for a host of relevant factors – Smith (2001)). In the conventional economics literature, such unexplainable income or wage differentials are frequently provided as evidence of potential discrimination. Lithuania, like Estonia, had an income distribution that favoured neither Lithuanians nor ethnic Russians at the end of the Soviet period (Smith (2001)).

In Estonia, considerable evidence exists indicating that significant and unexplainable wage differentials appeared favouring ethnic Estonians during the transition. Using 1994 Estonian LFS data, both Noorkoiv et al. (1999) and Kroncke-Smith (1999) find significant wage differentials favouring ethnic Estonians relative to ethnic Russians. Both also control for a variety of factors that tend to influence wages.

One plausible explanation for the change between the Soviet and transitional periods is the migration of ethnic Russians back to Russia – particularly high-skilled Russians. However, both Noorkoiv et al. and Kroncke-Smith control for factors that economists generally relate to labour market skills including education, experience, occupation, and industry, and still the differential remains.

Another plausible explanation for the wage differential between ethnic Estonians and ethnic Russians is the absence of Estonian language skills among many Russians. Estonian is now the official language of Estonia, and many Russians lack the ability to speak, understand, or read Estonian functionally. However, the Estonian LFS includes a control for language ability. Kroncke-Smith find that the ability to speak Estonian does not significantly affect the earnings of ethnic Russians. Thus language ability does not seem to explain the large differential either.

Finally, evidence using a more recent 1997 Estonian LFS (Smith (2001)) indicates that the wage relationship between ethnic Estonians and ethnic Russians has stabilized in recent years.

Contemporary evidence from Latvia also indicates a major shift towards ethnic wage differentials favouring ethnic Latvians relative to ethnic Russians. Chase (2000) finds that, "...given their human capital characteristics, they (ethnic Russians) suffer earnings discrimination of between 5.5 and 7.3 percent." Smith (2001), using a more extensive set of controls, also finds large and significant wage differentials favouring ethnic Latvians in the Latvian labour market using May 1998 LFS data. Unfortunately available Latvian data does not allow one to control for the potential effects of emigration or language ability.

Very little evidence exists examining the Lithuanian labour market during transition. However, (Smith (2001)), indicates that the status quo of an absence of significant unexplained wage differentials established during the Soviet period is still in place. At least this is true when one looks at the Lithuanian labour market as a whole. The lack of an unexplained wage differential in Lithuania is also interesting as, at least anecdotally, it would appear that the emigration status of ethnic Russians and the lack of ability to speak the native language are similar to the situation in Latvia and Estonia.

In all three Baltic States, but especially Estonia and Lithuania, there is a significant, and to this point unexplained, difference in ethnic wage differentials between the capital cities and areas outside the capitals (see Table 1 at the end of the paper – regression results for the unified country samples are available in Table 1 of Smith (2001)). In all three cases ethnic Russians fare quite poorly within the capital city. Conversely, there is no evidence of unexplained wage differentials outside of Tallinn in Estonia, while ethnic Russians do significantly better than ethnic Lithuanians outside of Vilnius in the Lithuanian labour market. Only in Latvia is there evidence of wage discrimination against ethnic Russians both within and outside the capital city of Riga. This fascinating phenomenon concerning geographical ethnic wage differentials in Baltic labour markets certainly warrants further research.

Ethnicity and Unemployment

In all the former Soviet Union, significant unemployment is a relatively recent phenomenon, occurring only since the collapse of the Soviet regime. In all three Baltic States, Russians are having a relatively hard time finding and keeping jobs, with Russian unemployment rates considerably above ethnic Baltic ones. Again, on the available evidence, Russian ethnicity appears to be detrimental to finding gainful employment even when other variables such as region, human capital factors, and other demographic characteristics are accounted for.

In Estonia, recent figures place the Russian unemployment rate at over 14 percent or nearly double that of ethnic Estonians (Eamets (2001)). This relative unemployment situation also has been stable for a number of years. Eamets attributes the relative employment difficulty of ethnic Russians to language ability, the concentration of ethnic Russian employment during the Soviet period in industries that declined rapidly (particularly heavy manufacturing) during the transition, and the greater mobility – changing of jobs – of ethnic Russians.

Further, a potentially troubling aspect of Russian unemployment in Estonia has emerged in recent years. According to Eamets, while Russians were more likely to be unemployed in Estonia, due to greater mobility they generally had shorter spells of unemployment. However, the most recent evidence available from Estonian LFS data (1998) indicates that Russians now, on average, are suffering from longer unemployment spells than ethnic Estonians. In fact, the probability of an unemployed Russian being out of work for a year or more is nearly twice as high as the same probability for an ethnic Estonian.

The Latvian LFS points to relatively high unemployment in Latvia in May 1998 – considerably higher than in either Estonia or Lithuania. The overall unemployment rate in the Latvian LFS sample is nearly 16 percent. As in Estonia, Russians suffer from considerably more severe unemployment than do ethnic Latvians. The respective unemployment rates for Latvians and Russians are; 12.5 percent and 22.9 percent. Preliminary binomial logit regression results (available from the author upon request) indicate that even after accounting for age, education, gender, and location, ethnic Russians struggle to find and keep jobs in Latvia.

The reasons underlying this difference are still subject to examination. However, evidence using two other Latvian LFS data sets (November 1996 and November 1997) indicates that the relative difficulty ethnic Russians face finding employment in the Latvian labour market is persistent. Additionally, with respect to unemployment, ethnic Russians appear to face the same difficulties finding work whether in Riga or outside of Riga. Evidence concerning ethnicity and duration of unemployment in Latvia does not appear to exist.

At this point, only very basic evidence on unemployment in Lithuania is available. Using data from the May 1999 Lithuanian LFS suggests that non-Lithuanians may be at a disadvantage in finding work relative to ethnic Lithuanians. This appears to be true of the two larger minority ethnic groups in Lithuania – ethnic Russians and ethnic Poles. The respective unemployment rates for Lithuania as whole, ethnic Lithuanians, ethnic Russians, and ethnic Poles are: 10.9 percent, 10.0 percent, 16.5 percent, and 14.0 percent.

Thus, the raw unemployment numbers alone indicate a relative struggle for Russians to find work in the Lithuanian labour market even if they do appear to receive compensation equivalent to their ethnic Lithuanian counterparts once they do find work. A very simple logit regression (results also available from the author upon request) controlling only for gender, education, and ethnicity also indicates that all other ethnic groups in Lithuania (Russians, Poles, and primarily Belarussians and Ukrainians) are at a distinct disadvantage in finding work vis-à-vis ethnic Lithuanians. However, it should be noted that the regression results mentioned are very limited in scope. Additionally, explanations for these results, even if they hold up under more intense scrutiny, are currently lacking.

Concluding Remarks

Overall, the preliminary evidence regarding the status of ethnic Russians in Baltic labour markets paints a fairly bleak picture. In both Estonia and Latvia, evidence indicates Russians are at a severe wage disadvantage even if they manage to find work. Even in Lithuania where the overall wage situation between Lithuanians and Russians seems equal, ethnic Russians fare poorly in Vilnius where many Russians actually live. The wage situation may be particularly telling as it has been long accepted in the economics literature that unexplained wage differentials between ethnic groups and/or between genders present the strongest evidence of labour market discrimination (as opposed to, for example, employment or unemployment differentials).

In all three Baltic States, Russians face relatively severe unemployment. The reasons underlying the ethnic dimension of unemployment may be similar across the three countries; language ability and disproportionate training and employment of ethnic Russians under the Soviet regime in now depressed or defunct manufacturing industries. However unemployment in the Baltic States – particularly Latvia and Lithuania – is an under-researched issue.

As mentioned, the treatment of the ethnic Russian minority is a key issue in EU accession negotiations for all three Baltic States. A relevant question here is; should the apparent difficulties of ethnic Russians in Baltic labour markets be an issue of concern in accession negotiations?

In-and-of themselves, the problems of ethnic Russian minorities in Baltic labour markets probably should not be a stumbling block to EU membership. There is probably not an ethnically diverse democracy in the world where some ethnic minority or group of ethnic minorities does not suffer from labour market problems analogous to or worse than those faced by the Russian minorities in the Baltic States. More troubling than the problem itself is an apparent lack of interest by Baltic policymakers to acknowledge the problem. Clearly until the problem is acknowledged, it is difficult to implement a policy or set of policies to address the problem. An obvious difference between current EU members and the Baltic States is that current EU members do take steps to address the economic difficulties of apparently disadvantaged minorities.

To the extent efficacious policies are to be eventually enacted by the Baltic governments to better assimilate ethnic Russians into local labour markets, further research will be important. First and foremost, further research is necessary to gauge the magnitude of the ethnic dimension to wage and unemployment differentials and why they are different across the Baltic States (i.e. why does Lithuania, with a relative lack of ethnic political turmoil, appear to have a relatively small or nonexistent wage differential?).

Second, policy related research to address the problems of ethnic Russians is desperately needed. Questions to be examined might include:

- Could active labour market policies be used to address the needs of older Russian workers whose training and experience is limited to heavy manufacturing?
- Or, does the problem lie in inadequate training in Russian language schools with respect to the necessities of functioning in contemporary Baltic labour markets?
- Or, does the problem relate to a lack of avenues, such as courts addressing discrimination cases, through which ethnic Russians might deal with potential discrimination?

The presence and growth of minority difficulties in Baltic labour markets is a distinct indication that market forces are developing in the Baltic States. A key step in continued market development is to better understand the nature of these difficulties and develop institutions and policies to address them.

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Table 1 Ordered Logit Results (Dependent Variable: labour income)

Variable	Capital City			Outside Capital			Variable Definition
	Estonia	Latvia	Lithuania	Estonia	Latvia	Lithuania	
age	0.159*** (0.030)	0.109*** (0.024)	--	0.032 (0.025)	0.037** (0.017)	--	Age in years
age ²	-0.002*** (0.0004)	-0.001*** (0.0003)	--	-0.0005 (0.0003)	-0.0004** (0.0002)	--	Age * age
ten	--	--	0.038* (0.023)	--	--	0.043*** (0.011)	Years on current job
ten ²	--	--	-0.0002 (0.0007)	--	--	0.0001 (0.0004)	Ten * ten
exp	--	--	0.048*** (0.017)	--	--	-0.0008 (0.008)	Years total work experience
exp ²	--	--	-0.001 (0.0005)	--	--	0.0005 (0.0003)	Exp * exp
0=female 1=male	0.993*** (0.129)	1.146*** (0.100)	1.020*** (0.135)	0.895*** (0.091)	0.891*** (0.062)	0.719*** (0.067)	Gender
education	0.296*** (0.038)	0.327*** (0.033)	0.460*** (0.039)	0.374*** (0.029)	0.354*** (0.020)	0.480*** (0.019)	Level of education
urban1	--	--	--	0.390*** (0.128)	0.885*** (0.062)	0.862*** (0.090)	Largest city outside of capital
urban2	--	--	--	-0.494*** (0.183)	--	1.274*** (0.128)	2 nd largest city
urban3	--	--	--	0.464** (0.207)	--	1.232*** (0.146)	3 rd largest city
urban4	--	--	--	--	--	0.316** (0.151)	4 th largest city
hours (ft=1 est)	1.925*** (0.223)	0.020*** (0.003)	0.036*** (0.008)	2.259*** (0.173)	0.024*** (0.002)	0.027*** (0.003)	Hours per week worked
priv.=1 pub.=0	0.093 (0.134)	0.280*** (0.090)	-0.209 (0.141)	-0.370*** (0.094)	-0.345*** (0.058)	-0.930*** (0.075)	Dummy for private vs. public sector
native Balt	1.250*** (0.138)	0.517*** (0.105)	0.548*** (0.186)	-0.053 (0.117)	0.315*** (0.075)	-0.329** (0.164)	Ethnicity dummy
Belarus	--	-0.033 (0.225)	-0.594* (0.341)	--	0.026 (0.176)	0.259 (0.402)	“
Ukrainian	--	-0.239 (0.256)	0.588 (0.679)	--	-0.169 (0.227)	1.424*** (0.543)	“
Pole	--	--	0.183 (0.205)	--	--	-0.806*** (0.266)	“
Other	0.041 (0.217)	-0.006 (0.202)	-0.415 (0.652)	-0.091 (0.201)	0.076 (0.151)	-0.524 (0.449)	“
Log likelihood	-1243.0	-1931.7	-1419.1	-2546.0	-5039.3	-5959.4	
chi ² (k)	333.99***	309.88***	289.88***	497.38***	800.75***	1636.28***	

Notes: a) The data are from Labour Force Surveys conducted in each of the Baltic States. The data are gathered through individual interviews of a representative sample of the population; b) ** indicates significance at the 5% level and *** indicates significance at the 1% level; c) Ethnic Russians are used as the control ethnic group. Thus a positive number for “native Balt” indicates ethnic Balts tend to have higher labour incomes than do native Russians accounting for all other variables in the regression; d) The number 2 appearing after age, ten, and exp in the table indicates variable values are being squared, i.e., ten² = ten * ten.

ESTONIA

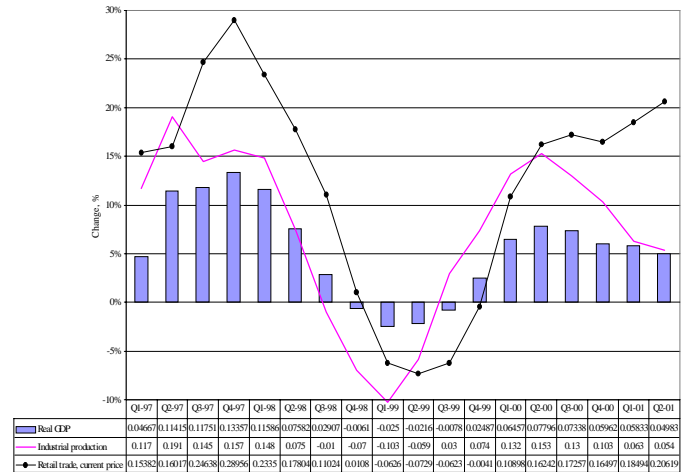
Overview of Developments and Prospects

Real GDP grew by 5.0 % in the second quarter of 2001, and industrial production by 5.4%, on a year-on-year basis (Figure 1), thus growth has been relatively high in the first half of this year. Industrial growth was driven mainly by fast-growing exports, but also by greater domestic consumption. However, in line with the world economic downturn, the Estonian economy appears to be gradually slowing down. In September industrial production rose by only 2.2 % on a y-o-y basis, largely due to the fall in Estonian exports after June 2001. In July exports were down 4.3 % compared to the previous year; in August they were down by 17.2% and in September by 9.5 %. Re-exports after inward processing have been especially weak, in particular telecommunications and electronic components as well as machinery.

The second quarter was also characterized by slow growth in private consumption and by little change in government sector expenditures (Figure 2). Consumption increased only 1.1% (partly explained by the fact that consumption was unusually high last year). On the other hand, retail sales surged in the first two quarters (up 18.5% and 20.6% compared with the same a periods a year ago) indicating continued high activity in consumer purchasing. This trend was supported by improved labour market conditions, higher wages and the aggressive expansion of large retail chains.

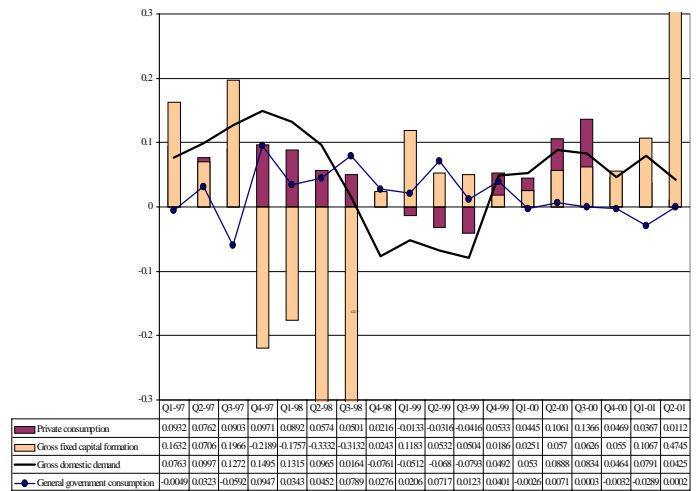
Gross fixed capital formation reached its highest level in 5 years “indicating the start of the expected recovery of investment activity”¹. Estonian large and medium size companies are pressing on with intensive restructuring and modernization of their technology, particularly to bring it in line with EU requirements.

Figure 1. Real GDP and index of industrial production (% change same period over previous year)



Source: Statistical Office of Estonia

Figure 2. GDP by expenditures, % from previous year, current prices



Source: Statistical Office of Estonia

¹ Ministry of Finance, Estonian Economy 2001Q2

In summary, the ongoing slowdown of the world economy began to affect Estonia after mid-2001. As a small and very open economy Estonia is quite vulnerable to the external environment. The slowdown in Finland and Sweden in particular is expected to have strong effects for next year's real GDP growth. Still, the fate of Estonia's economic growth in is likely depend on domestic developments. On the one hand, the government has been criticized for overestimating Estonian growth potential in the face of the global slump. On the other, it is widely anticipated that in a pre-election year government spending will rise, financed by an increase in the external debt.

Prices

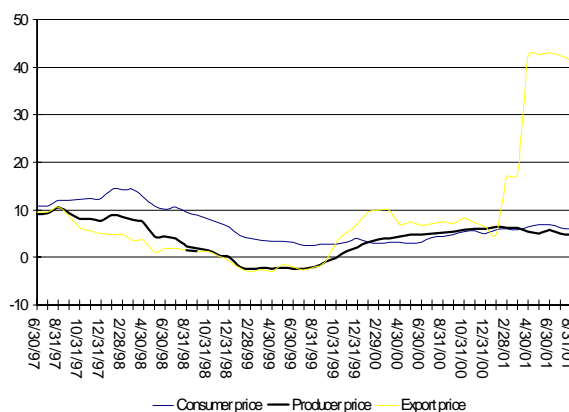
As expected, inflation peaked in June this year. The global economic downturn meant lower foreign demand and weaker price pressure for Estonia. Thus, in September import prices fell by one percent y-o-y and CPI growth dropped to 5.7% (see Figure 3). Even smaller figures can be expected in the future since the full impact of the recent international crisis has not yet been transmitted to the Estonian economy.

Producer prices moved to a lower growth path already at the beginning of 2001, for much the same reasons as the CPI did. However the hike in export prices, to around 30 % y-o-y, remains mysterious, as the only explanation offered is tied to Estonia's main exporter, Finnish-owned Elcoteq. However it seems doubtful that one company can have such an impact. Has Elcoteq increased its value-added so tremendously, or is the company using transfer pricing to take advantage of the Estonian tax system? Whatever the reason, the effects of the increase in the EPI are not expected to affect Estonia in general. However, the presence of this factor obscures developments for other exporters. The Estonian Statistical Office might consider disclosing additional information on this matter.

Labour

Although overall unemployment remains relatively high, labour market conditions have generally improved. Figure 4 presents employment and unemployment changes, comparing

Figure 3. Monthly growth of price indices (%)



Source: Bank of Estonia

yearly changes of quarterly data. After the Russian crisis in 1998, unemployment started to increase, reaching a peak in Q3 1999, when it was 30% higher than a year before. But this trend has been reversed in 2001 when unemployment fell as compared with the previous year. Moreover, employment rose in 2001 for the first time in recent years (Figure 5). Both developments are very positive. However, future prospects are not as bright, and unemployment is expected to climb as the world recession begins to bite.

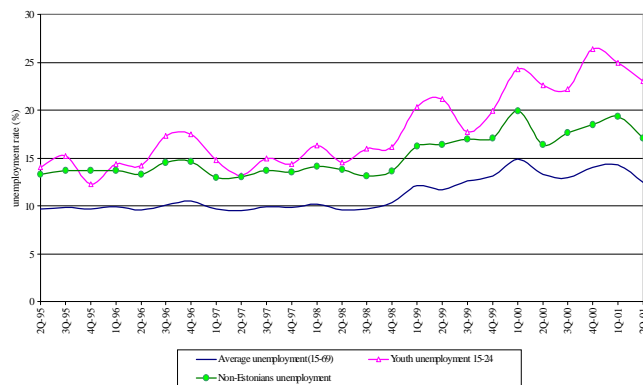
An important change in labour market legislation was the passing in November of the Gender Equality Act, planned to come into effect in 2002. This Act, prepared by the Bureau of Equality, prohibits both direct and indirect discrimination, and places an obligation on both private and public employers (besides other institutions) to advance gender mainstreaming. It defines and clarifies terminology, but does not define or create specific norms, so it is difficult to predict how the act will influence the employment situation. In Estonia, employment segregation by gender has tended to decline in the course of transition.

Foreign trade

The Estonian foreign trade situation has deteriorated rapidly since June of this year. The Estonian export boom, which started in late 1999, came to an end in Q3 2001. As noted above, exports in July were 4.3 % down on the previous year, in August down by 17.2% and in September by 9.5 %. Imports have also declined, but more slowly, producing a trade deficit 1.3 bn EEK bigger than in Q3 2000 (Figure 6).

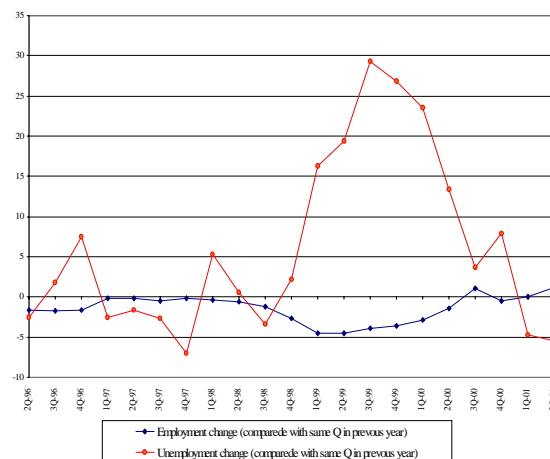
The major factor in this decline was a rapid fall in the volume of re-exports after inward processing. In the first half of 2001 re-exports made up 45 % of total exports. During the third quarter the share of re-exports dropped quickly. Most severely hit was production of telecommunication and electronic components together with machinery, which together made up around one-third of Estonian exports in the first half of 2001. However, in the third quarter these items were only 54 % of their level year ago.

Figure 4. Total unemployment, youth unemployment and unemployment of non-Estonians



Source: Statistical Office of Estonia

Figure 5. Employment and unemployment changes (compared with previous year same period)



Source: Statistical Office of Estonia

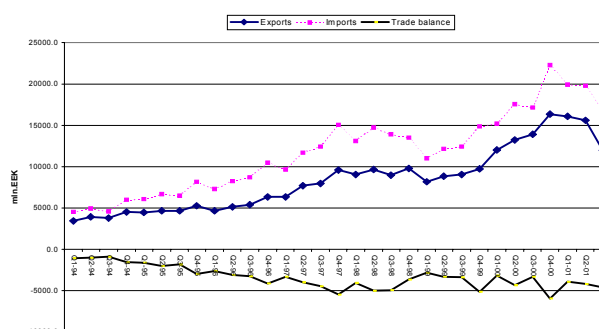
These developments indicate the integration of Estonia into the world economy and the increasing vulnerability of Estonian foreign trade as re-export orders are very closely linked to general macroeconomic conditions in major trade partner countries. Traditional export sectors like textiles or wood products have remained successful and have experienced stable export performance. Increased EU quotas and economic growth in CIS countries contributed to more than doubled food exports during January–September 2001 as compared with the same period a year ago.

The geographic structure of Estonian foreign trade has not changed much in the quarter, with the September EU share at 69% of exports and 61% of imports. The importance of Finland as a trading partner has stabilised at around 36% of total exports, but Sweden has lost some of its share as an export market – down from 20% to 13.8%. Germany and Latvia have maintained their shares as export partners with 6.5% and 6.8% respectively.

Foreign investment

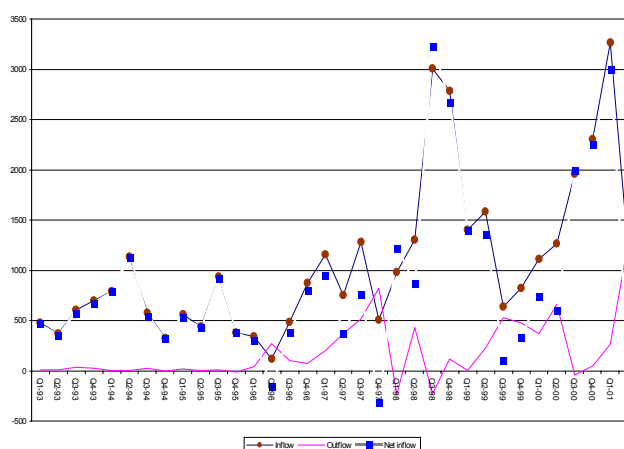
Since early 2000 Estonia has seen a substantial outflow of direct investments, reflecting the improved Estonian business climate. During Q2 2001 the outflow of FDI surpassed the inflow by 75 mn EEK (Figure 7). However, during the first half of 2001 the total inflow was 3 bn and outflow 1.5 bn EEK. The major destinations for Estonian FDI were Latvia and Lithuania, together comprising around 80% of the total. This interesting phenomenon partly reflects a growing interest of Estonian firms to do business in neighbouring countries. However, it is also in part merely a statistical phenomenon. Estonian investments in Latvia or Lithuania include investments from subsidiaries of Finnish or Swedish firms in Estonia. They represent typical inward/outward type investments, in which Estonia is used as a bridgehead to move further south into the other Baltic republics. According to research

Figure 6. Foreign trade (mn EEK)



Source: Statistical Office of Estonia and Bank of Estonia

Figure 7. Quarterly inflows and outflows of foreign direct investments (mn EEK)



Source: Statistical Office of Estonia and Bank of Estonia

carried out at Tartu University the share of this type of investor may be around 60-70 % of all Estonian investments abroad. The biggest outward investment during this period was acquisition by Hansabank of 99 % of Lietuvos Taupomasis Bankas.

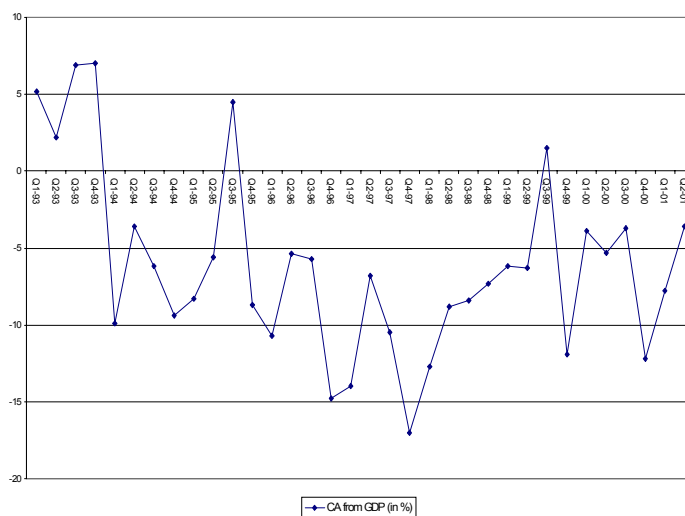
The inflow of FDI in Q2 2001 was around 1.2 bn EEK. The most active investors were from Finland, the US and Great Britain. The biggest share of the inflow of FDI was in the wholesale and retail sectors, followed by the manufacturing industry and the banking sector. FDI in the transportation industry fell by 0.8 bn EEK reflecting changes in the registration of Estonian Shipping Company ships owned by Norwegian investors.

The second quarter of 2001 was characterised by an improvement in the overall balance of payments of Estonia, from a deficit of 2.4 bn EEK in the first quarter to a surplus of 0.7 bn EEK. The decrease of the current account deficit, which formed only 3.6 % of GDP (Figure 8), accounted for much of this improvement. This is 1.7% better than a year ago and reflects an rise in the surplus on the services account. For Estonia, the second and third quarters typically are a period of improvement in the current account, and the results for 2001 confirm this tendency.

One striking feature has been the decline in the traditional surplus on the financial account. In Q2 2001 it was in surplus by 1 bn EEK, but in the whole first half of it was in deficit, by 329 mn EEK. This development reflects the growing outflow of FDI combined with the growing debt of credit institutions and other sectors.

The net investment position of Estonia at the end of Q2 2001 was negative by nearly 49.6 bn EEK, which is up 5.3 bn from a year ago. The total stock of foreign direct investments was 50 bn EEK and it has increased during the year by 10 bn EEK. The net external debt of Estonia was around 8 bn. EEK on 31.6.2001 or 9 % of expected GDP. During the last year the net external debt has remained the same and

Figure 8. Current account (% of GDP)



Source: Bank of Estonia

government sector debt has even fallen from 2bn to 1.78 bn. EEK. Therefore the net investment position of Estonia is rather stable.

Enterprise and banks

Interest rates for individuals dropped dramatically by 2.47 percentage points in September to 10.21% which induced a rise in loans by 435 bn EEK (Figure 9 and 10). This is surprising from the banks' side as deposits fell in September, but naturally, borrowers are willing to take advantage of lower interest rates (Figures 11 and 12). As a result the ratio of loans to deposits rose to 98.7%. Interestingly, domestic savings appear to be insensitive to interest rates, but seem to be determined by incomes. Lending grew by 23.4% y-o-y in September. The main borrowers were financial institutions and government (up +47% and +46% respectively); individuals increased lending by 31% but enterprises by a modest 5%. The successful introduction of the new pension system is expected to increase the domestic savings rate and consequently to promote financial deepening.

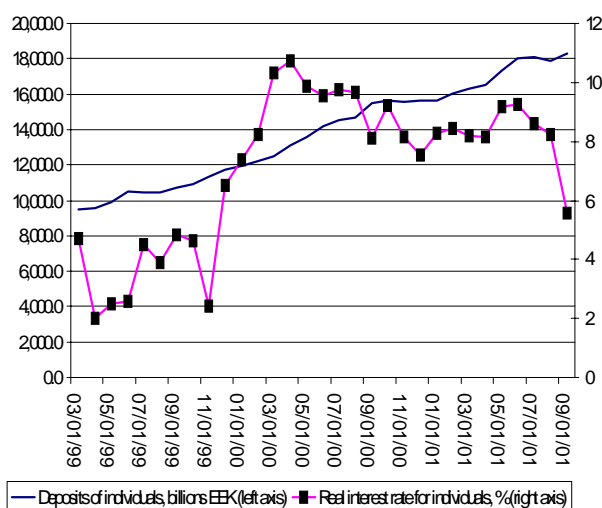
The budget

The key priorities of Estonian fiscal policy continue to be balanced budget arrangements, limitation of government expenditure and increasing the efficiency of the public sector.

In the first half of the 2001, government revenues were 14.4 bn EEK or 105.2% of planned revenues (Figure 13). The general government surplus was 308.2 million EEK or 0.3% of projected gross domestic product.

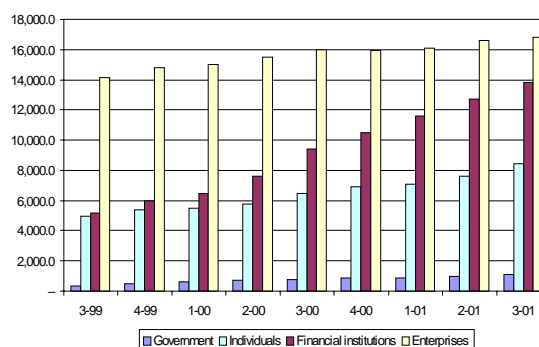
Most government revenues come from taxes, which were close to planned levels in the first half of 2001. Overall revenues were higher than expected due to larger income from government economic activities. High

Figure 9. Comparison of real interest rates and deposits for individuals



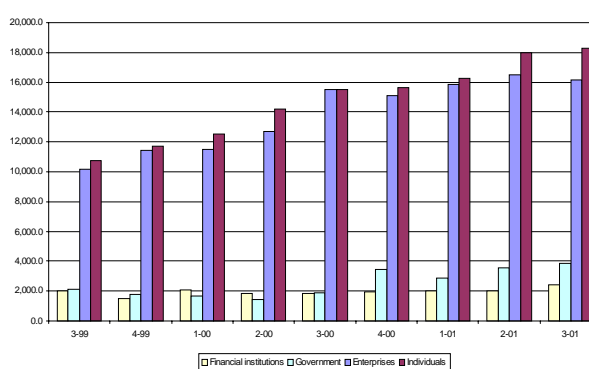
Source: Bank of Estonia

Figure 10. Decomposition of the loan portfolio, MN EEK



Source: Bank of Estonia

Figure 11. Decomposition of deposits in banks (mn EEK)



Source: Bank of Estonia

consumption levels drove up VAT revenues, while revenues from individual income taxes were lower than expected.

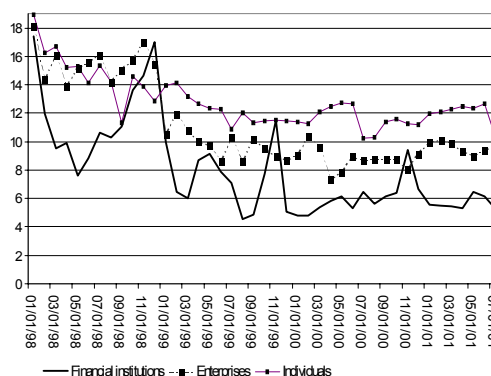
In order to support long-run economic growth the Government has declared its intention to pursue a conservative fiscal policy. But imminent parliamentary and local elections are creating pressure to boost spending in the next budget year. The Government has been criticized for its high growth estimate. There was a similar overestimation during the last election campaign in 1998, which led to a more than 4% budget deficit on the end of the 1999.

Money and the exchange rate

By the end of Q3 2001 the monetary base was 11% lower than a year ago (Figure 14). This reflects agents' decreasing demand for cash. At the same time broad money, M2, increased by 20%. The latter is the result of financial deepening (substantial increases in deposits). As the economy shifts to a lower gear, and somewhat more conservative credit activities are anticipated in the coming months, money growth will probably slow down. Already in the third quarter M2 grew only marginally as new reserve requirements by Bank of Estonia came into effect from 1 July. Banks must now cover one-half of the reserve with high quality foreign assets (previously this ratio was one-quarter).

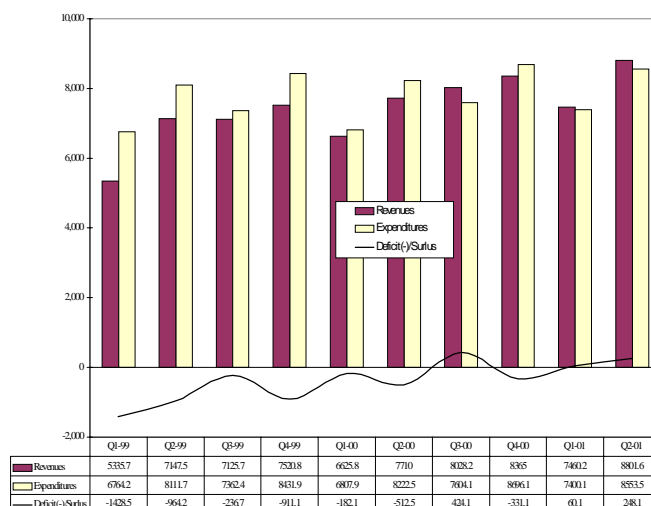
The real exchange rate vis-à-vis transition economies has been rather volatile again during the last quarter, caused partly by a weaker US dollar and partly by higher CPI in those countries (Figure 15). This has resulted in a loss of competitiveness by Estonian firms that could become a problem if the tendency persists. However, if the global situation does not worsen further, we will see only modest negative effects for Estonia. Estonian firms, which have proven their flexibility before, will be able to meet the challenge.

Figure 12. Interest rates (%)



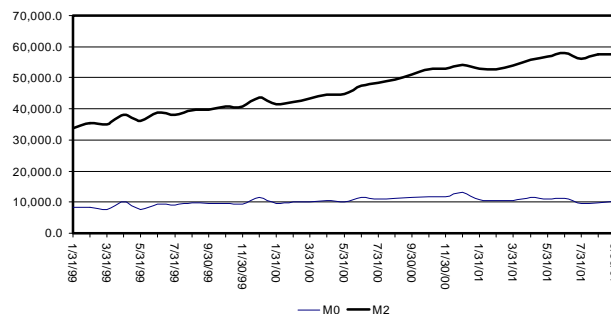
Source: Bank of Estonia

Figure 13. General government budget by quarters (mn EEK)



Source. Ministry of Finance and Bank of Estonia

Figure 14. Money supply (mn EEK)



Source: Bank of Estonia

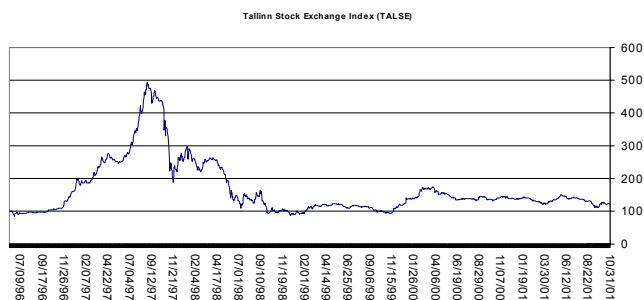
Financial markets

Some stocks on the Tallinn Stock Exchange (TSE), especially Estonian blue chips, Telekom, Hansapank and Norma, have shown similar reactions to the world's major stock markets, ie rapidly regaining initial losses after 11 September (Figure 16). Otherwise the situation is static. There has been a rise in the number of firms raising capital by issuing bonds, which has aroused the interest of investors as risk margins have been lowered.

The next anticipated big event is the TSE-HEX merger, when, starting from 28 January 28 2002 Estonian securities will be listed in Helsinki Stock Exchange's trading system. From that date TSE member firms will replace the current TSE trading system with the HEX trading system.

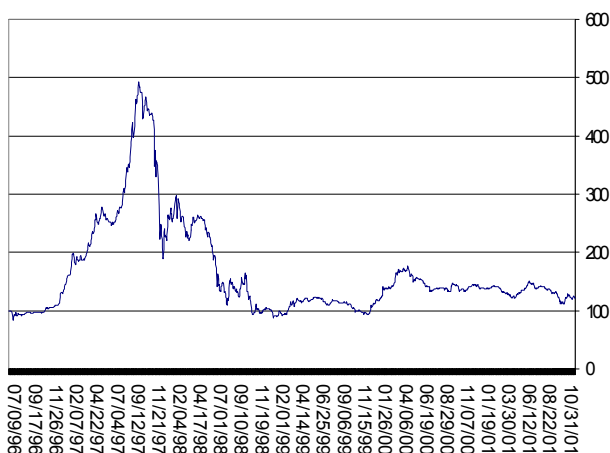
Although in general analysts are pessimistic, the merger gives grounds to hope for more IPOs of Estonian enterprises. We conjecture that in the medium-term perspective the "HEX's subsidiary in Tallinn" will be a place of substantial capital movements. One reason is that the merger offers increased shareholder protection and direct access to Finnish investors. There even exists the possibility for short-term capital gain given the current exaggerated pessimism of market participants.

Figure 15. The exchange rate (change in %)



Source: Bank of Estonia

Figure 16. Tallinn Stock Exchange index (TALSE)



Source: Bank of Estonia

Key Economic Indicators

	1998	1999	2000	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3
Population (mn. mid-year)	1.43	1.41	1.37					
Gross Domestic Product								
Nominal GDP (bn EEK)	73.54	76.33	85.44	21.60	22.18	21.49	25.22	-
Nominal GDP (bn USD)	5.23	5.20	5.03	1.25	1.23	1.25	1.39	-
Nominal GDP per capita (USD)	3659	3685	3675					
GNP per capita (USD at PPP)	7563	8190	-	-	-	-	-	-
Aggregate Growth Indicators								
Real GDP (%)	5.05	-0.70	6.88	7.34	5.96	5.83	4.98	-
Private consumption (%)	5.38	-0.78	8.19	13.66	4.69	3.67	1.05	-
Government consumption (%)	4.50	3.78	0.05	0.03	-0.32	-2.89	0.02	-
Gross fixed investment (%)	-21.95	6.09	4.91	6.26	5.50	10.67	47.45	-
Industrial production (%)	3.20	-1.65	12.82	12.98	10.27	6.33	4.92	7.87
Agricultural production (%)	-4.99	-8.21	-	-	-	-	-	-
Stabilization Indicators								
Consumer prices (avg. %)	10.58	3.30	4.01	4.44	5.38	5.89	6.71	6.05
Unemployment rate (avg. %)	9.88	12.30	13.68	12.80	13.90	14.20	12.40	12.00
Average nominal wages (EEK)	4100	4418	4876	4694	5279	5100	5775	5300
Average nominal wages (USD)	292	301	287	271	293	298	318	306
Budget balance (% of GDP)	0.04	-4.19	-0.10	2.35	-0.39	-0.31	1.94	-
Exchange rate EEK/USD (avg)	14.075	14.678	16.969	17.290	18.002	17.132	18.136	17.317
Exchange rate EEK/USD (end-period)	13.410	15.562	16.820	17.782	16.820	17.770	18.473	17.056
Trade and Balance of Payments								
Total exports fob (bn USD) ¹	2.68	2.52	3.32	0.81	0.92	0.94	0.87	-
Total imports fob (bn USD)	3.80	3.34	4.10	0.96	1.19	1.12	1.05	-
Trade balance (bn USD)	-1.12	-0.82	-0.78	-0.15	-0.27	-0.18	-0.18	-
Current-account balance (bn USD)	-0.48	-0.25	-0.32	-0.05	-0.15	-0.10	-0.05	-
Foreign Debt and Reserves								
Foreign debt (end-period. bn USD) ²	0.2	0.2	0.1	-	-	-	-	-
International reserves (end-per. bn USD)	0.81	0.86	0.92	0.77	0.92	0.74	0.75	0.77
Foreign Investment								
FDI inflows (bn USD) ³	0.573	0.303	0.401	0.128	0.110	0.191	0.066	-
Cumulative FDI inflows (bn USD) ^{3,4}	1.192	1.495	1.896	1.793	1.903	2.094	2.160	-
Portfolio investment (bn USD)	0.007	0.140	0.109	-0.002	-0.012	0.081	0.031	-
Monetary Growth								
M2. %	0.08	23.58	27.48	9.75	3.63	5.67	7.73	1.32
M3. %	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

¹ Converted to USD using the period average exchange rate.

² Not including external debt with a public guarantee.

³ Converted to USD using the period exchange rate.

⁴ Cumulative from 1993.

LATVIA

Overview of Developments and Prospects

Despite the economic downturn in the US and the general economic slowdown around the world, Latvia's GDP growth figures this year could not be better. In the second quarter of 2001, GDP increased by 9.2% as compared with the same period a year ago, and growth is expected to be at least 7.5% in the third quarter. Industrial production has also been growing, and capital formation increased by 9% on annual basis. The Finance Ministry's economic activity index, which combines a number of indicators, is also rising.

For the first half of 2001, as a whole GDP was up 8.8% as compared with the respective period last year. Retail trade (11.2%), transport, storage and communications (14%), manufacturing (10.6%), and commercial services (13.1%) were the key sectors driving growth.

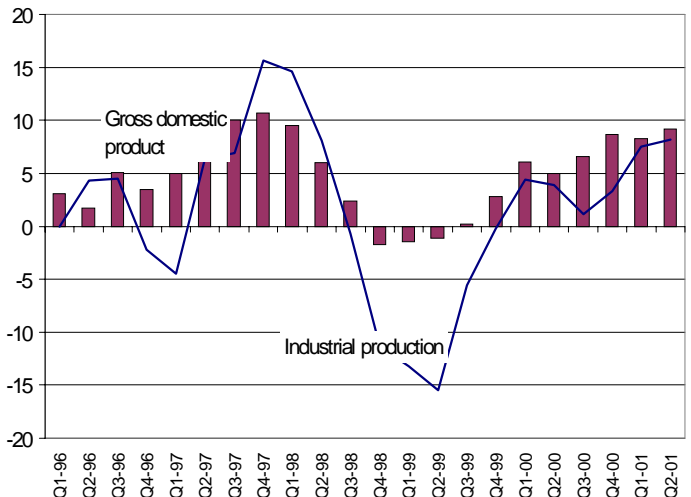
Retail sales of new cars were 8.8% higher than a year ago, a very positive sign given the antiquated age structure of cars in Latvia. On the other hand, the recent boom in new supermarkets makes one cautious; prices for commercial space will likely fall in the near future.

In November the International Monetary Fund (IMF) mission completed its annual consultations with Latvia and assessed the cooperation of Latvia as very successful this year. Nevertheless, a new memorandum of agreement was not signed because of serious disagreement over the 2002 budget deficit, which is planned to be 2.5% of GDP. This is significantly higher than the 1% of GDP stipulated under Latvia's cooperation memorandum with the IMF. The IMF believes that given the current macroeconomic situation in Latvia, the budget deficit should not exceed 1.4% of GDP. Discussions will recommence next spring.

The current account deficit, a problem common in transition economies, remains in the range of 6-7% of GDP. The Central Bank forecasts that this year's deficit will be about 6.5% of GDP.

With parliamentary elections coming next autumn Latvia is already experiencing a pre-election atmosphere, which can only intensify as the election

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



Source: Central Statistics Bureau of Latvia

nears. The decision of Central Bank Governor Einars Repše to start the creation of a new party "Jaunais Laiks", *New Era*, has already stirred controversy. Normally, this would not be anything extraordinary, but Repše has requested a one-off honorarium of one half a million LVL for himself and 0.9 mn LVL for the party as a precondition of proceeding with his mission. If these amounts are not raised (in mid-November around LVL 60 thsd had been donated) the donated money will be returned to the donors, and the party will not be established. In October/November, this "maybe" party had the strongest support in the opinion polls.

As part of the pre-election mood, the 2002 budget envisages spending increases for social needs – health care, and education. Integration into NATO and the EU have also been given high budgetary priority.

The continuing fall in unemployment (together with evidence from several recent surveys) suggests the emergence of a skilled labour shortage. It is something of a paradox in that in the US one sees mass redundancies, yet in Latvia, if economic growth continues at its current pace, the question of potential high-skilled labour immigration may become an issue.

The government has moved to encourage entrepreneurs by reducing corporate income tax, which currently stands at 25%. A reduction by 3% is planned for the beginning of next year and further cuts, down to 15%, are planned by 2004.

The Ministry of Finance is planning a new Eurobond issue for late 2001 to be managed by the French investment bank Paribas.

Prices

Consumer prices increased by 3.3% in the third quarter of 2001 as compared with the same period a year ago. Generally, there is a modest inflationary trend, which is quite natural in times of rapid economic growth. Time will tell whether the economy becomes overheated. Bearing in mind the worldwide economic downturn, this risk is probably not very high. Rather, we could even expect a slowdown in Latvian growth in the new year.

Consumer price inflation was driven by price rises for clothing and footwear, selected food products, and pharmaceuticals. Moreover, there was a steep rise in fees for education services, especially university tuition fees. Meanwhile, transportation services and gasoline prices did not change, and mobile phone rates fell.

Given current developments, it is likely that this year's inflation will not be below 3%, contrary to what was expected earlier.

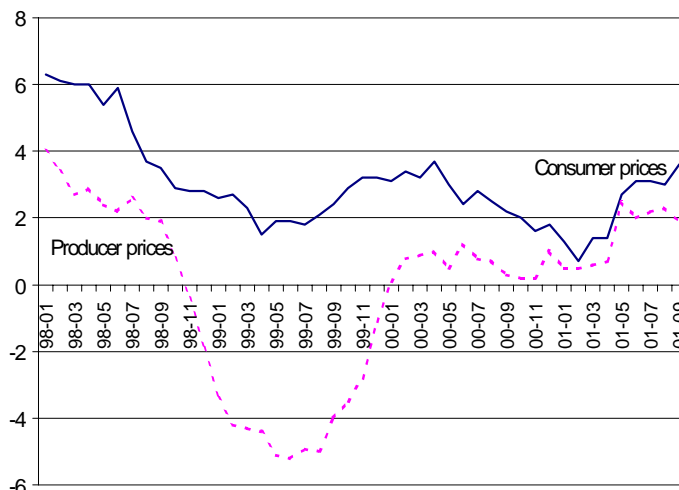
In the third quarter of 2001, producer prices increased by 2.2% as compared with the same period a year ago. So, this price index also shows an upward trend.

Labour

At the end of the third quarter (2001), the registered unemployment rate was 7.6% of the economically active population. This represents a small but continuing decrease as compared with the end of the first and second quarter figures – 8.1% and 7.8%, respectively.

There are some signs of an growing shortage of qualified labour. For example, according to a recent statistical survey, the portion of specialists among the unemployed has fallen significantly. Given that the economy develops at the current or slightly slower speed, new jobs will be established, creating an increased demand for workers. Of course, this does not imply that zero unemployment will prevail. There are still many workers with the "wrong" skills, ie, who are redundant in the current market situation. In several eastern regions of Latvia,

Price indices (% change over same period previous year)



Source: Central Statistics Bureau of Latvia

Registered unemployment (% of economically active population)



Source: Central Statistics Bureau of Latvia

unemployment remains above 20%. Not everyone is able or willing to re-train or to improve their qualifications, therefore high unemployment among certain professions and regions and the shortage of qualified labour force will very probably co-exist. What could be a solution to this labour shortage? For international companies, most probably it will be to "import" labour from their European or even US operations.

Average gross monthly wages and salaries were LVL 157 (USD 248) in the second quarter of 2001, representing a 5.3% nominal increase as compared with the same period a year ago.

Foreign trade

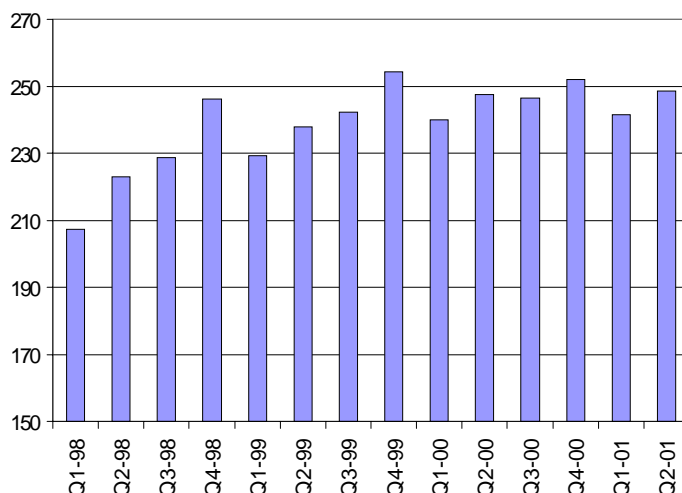
During the first eight months of this year, exports were up 12.4% and imports 14.3%, as compared with the same period a year ago. Export values reached LVL 0.8 bn (USD 1.4 bn) and imports – LVL 1.4 bn (USD 2.2). The negative trade balance was LVL 0.6 bn, which is slightly worse than a year ago when it was LVL 0.5 bn.

Trade relations between the Baltic countries continue to strengthen. The share of the other Baltic states in Latvia's foreign trade has increased by 20% for exports (reaching 13.8% of total exports) and by 25% for imports (14.6%). This pattern shows that Latvia's bilateral balance with its neighbours has worsened slightly and could be explained by faster economic growth in Latvia at the moment.

Exports to the EU have risen by 7% as compared with the previous year, but the share of the EU in Latvia's export volume has decreased somewhat. Given the emergence of economic stagnation in Europe, this pattern is likely to continue. The share of the CIS countries remains constant at around 9.5% of total exports.

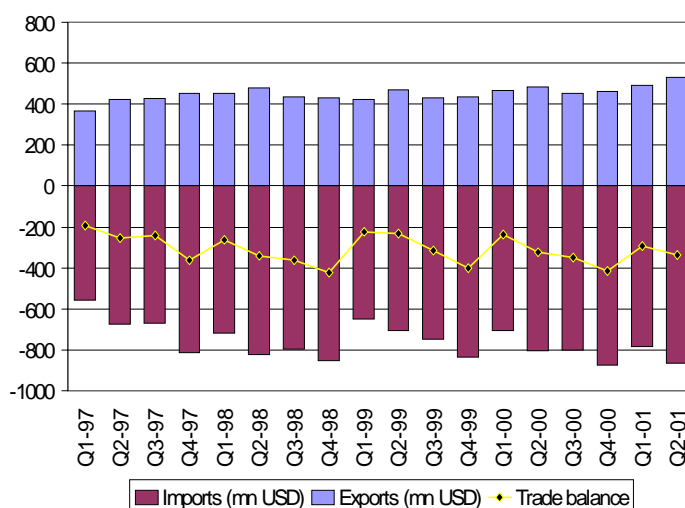
The main export category remains timber and wood products (35%), followed by textile products (14%), and metal products (13.4%).

Average monthly gross wages and salaries (USD)



Source: Central Statistics Bureau of Latvia

Exports, imports and the trade balance (mn USD)



Source: Central Statistics Bureau of Latvia

An increase in imports provides evidence that rising domestic consumption cannot be fully met by local goods. During the first eight months of 2001, the steepest rise of imports as compared with last year has been from Lithuania (27%), Estonia (22%) and Germany (20%). Meanwhile, imports from Russia have dropped by 9%.

Foreign investment

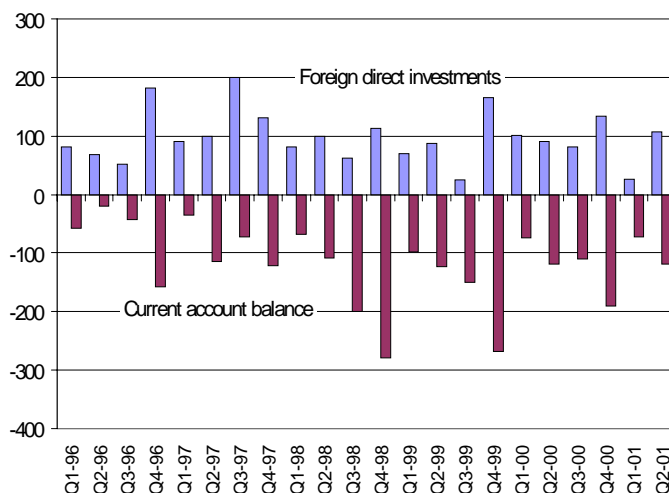
The second quarter of 2001 saw a significant increase in foreign direct investment (FDI). At USD 107 mn, it was 300% more than in the first quarter (USD 27 mn (revised figure)) and 19% higher year-on-year (USD 90 mn). During the first two months of the third quarter, FDI has already reached USD 102 mn, so the third quarter figure should be close to the second quarter. The accumulated FDI from 1994 to the end of August 2001 is around USD 2.3 bn or USD 945 per capita.

In the second quarter of 2001, the largest FDI contributors were Estonia (USD 27 mn), Denmark (USD 26 mn) and the US (USD 13 mn). The most attractive sectors have been financial intermediation, wholesale trade, manufacturing and transport, storage and communications.

The outlook for FDI development in the near future is unclear. On the one hand, Latvia's current economic performance makes the country very attractive for investors. On the other hand, the global economic crisis might hold back some potential investments. Moreover, the importance of an agreed memorandum with the IMF has a direct link to FDI, as many international organisations and companies follow IMF advice on the economic situation in a particular country. If agreement is not reached, there may be a negative impact on FDI.

The portfolio investment balance in the second quarter was negative, LVL 132 mn, ie, Latvian residents have invested more in foreign securities than foreigners invested in Latvian securities.

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



Source: Central Statistics Bureau of Latvia

The current account deficit widens each quarter. In the second quarter it reached LVL 75 mn (as compared with LVL 72 mn in the same period a year ago, and LVL 45 mn in the previous quarter). In the first two months of the third quarter it was already LVL 84 mn, almost double the amount in the respective period a year ago. Nevertheless, the deficit is fully offset by the high FDI inflow. Given the healthy GDP growth, we would support the central bank forecast that this year's current account deficit will not exceed 6.5% of GDP.

Enterprises and banking

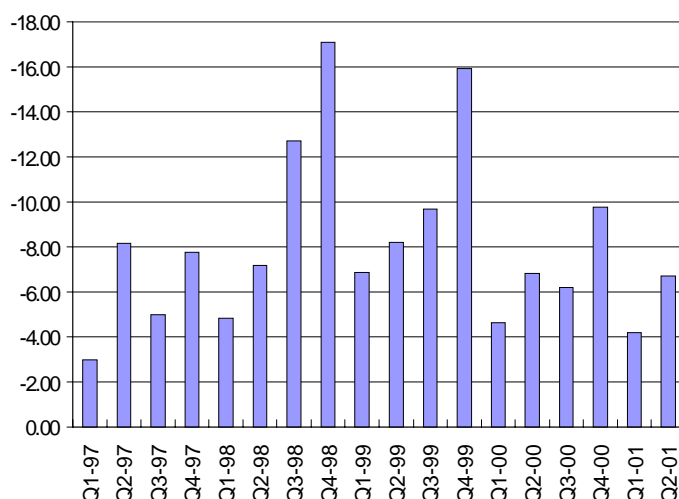
The total value of assets in Latvian commercial banks at the end of the third quarter 2001 was USD 5.1 bn, representing a 20% increase on an annual basis.

Despite a general upward tendency in loan rates, medium term loan rates fell slightly in the third quarter. However, a lats shortage in the market has exerted upward pressure on deposit rates. This pattern of interest rate development reveals that banks are cutting on margins and hoping to regain it in volume by increasing their loan portfolio. The rising profits of Latvian commercial banks, dominated by commissions and interest income, show that the strategy is paying off.

At LVL 1.4 bn (USD 2.2 bn) the volume of loans issued by Latvian banks in the first three quarters of 2001 was up by almost 30% as compared with the same period a year ago. The largest loan portfolio was held by Latvijas Unibanka, comprising 28% of all loans.

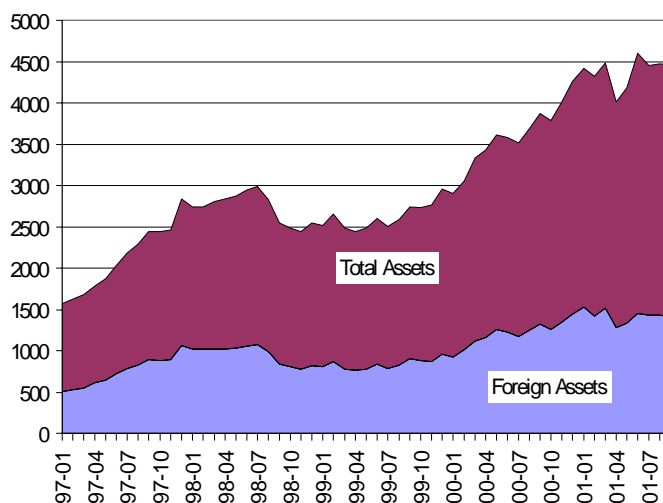
Uncertainty following the September 11 events in the US led to a decrease in total deposits and account balances. Deposits in local currency have remained stable, while balances in foreign currencies have fallen.

Current account deficit (% of GDP)



Source: Central Statistics Bureau of Latvia

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



Source: Central Statistics Bureau of Latvia

During the first nine months of this year, the aggregate profits of Latvian banks reached LVL 29 mn (USD 46 mn). The top three performers were Unibanka (profit of LVL 9 mn), Parex Bank (LVL 8.3 mn) and Hansabanka (LVL 4.6 mn).

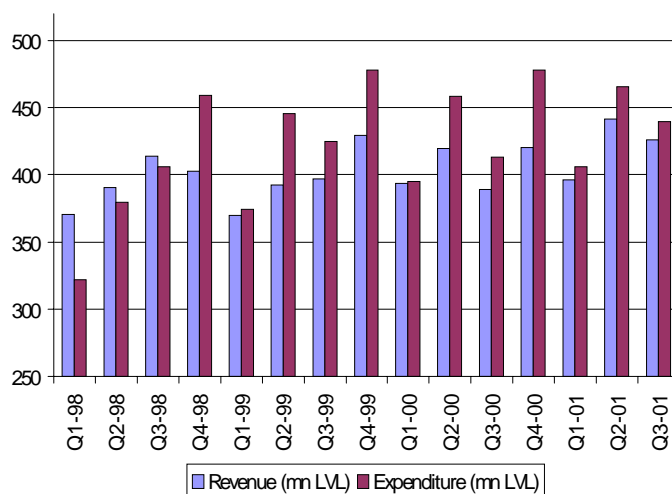
The budget

During the first three quarters of 2001, state revenues were LVL 1.26 bn (+5.2% year-on-year) and expenditures LVL 1.31 bn (+3.6%). So far, the pattern has been positive, ie, revenues are climbing faster than expenditures. However, a reverse pattern is planned for next year – the budget plan expects a 4.5% increase in revenues, but a 7.3% increase in expenditures.

For this year, the overall implementation of the budget plan has been very positive. It can be expected that the budget deficit will remain within 1.8% of the GDP, as anticipated. Tax collection of customs duties, personal income tax and corporate income tax is better than expected. There are still problems with social insurance contributions, value added tax and excise tax. The situation can be regarded as unsatisfactory, because two of the "problem taxes" – social insurance contributions and value added tax – generate the highest share of the state budget revenues. During the first nine months of 2001, social insurance contributions have increased by 3.5% year-on-year (budget plan expected 6.3%), and value added taxes – by 5.1% (estimated 9.2%). As for the most critical part, excise taxes have decreased by 2.3% year-on-year (estimated +13.5%).

Next year's budget plan is very much influenced by the coming elections and the positive mood about recent economic developments in Latvia. Ministers are trying to "buy" votes by boosting spending on education and healthcare. Budget revenue projections are very much based on the assumption that economic growth will continue and the global economic crisis will not affect Latvia. If the Latvian economy also slows down, budget revenues will be smaller than foreseen and the budget deficit will be even bigger than the planned 2.46% of GDP.

Central government revenues and expenditures (mn LVL)



Source: Central Statistics Bureau of Latvia

In an interesting fiscal move by the government, the Bank of Latvia is to be required to make an additional contribution of 15% of its profits to the national budget. This is described as payment for the use of state capital, and is on top of the normal 22% of next year's corporate income tax. The extra amount paid in by the central bank is intended to compensate for the reduction of the corporate income tax from 25% to 22% next year.

Money and exchange rate

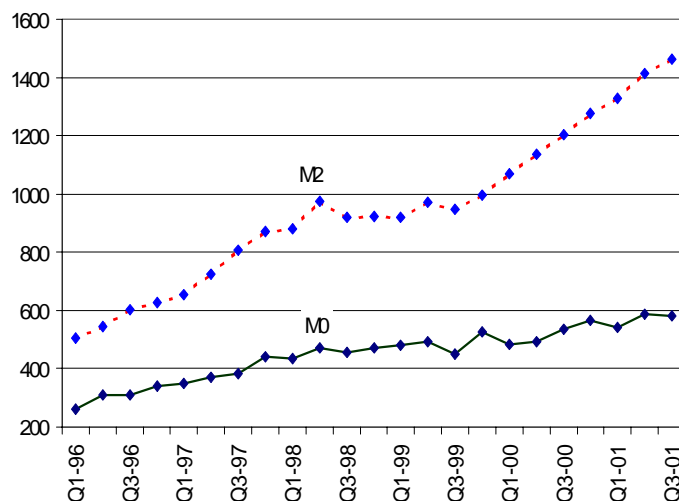
The monetary base M0 reached LVL 582 mn at the end of the third quarter of 2001, a 9% increase year-on-year. Meanwhile, broad money (M2) increased by 21% year-on-year (LVL 1.4 bn), reflecting increased savings in the form of deposits and account balances in the banks.

At the end of the third quarter of 2001, the foreign reserves of the Bank of Latvia were USD 987 mn, an increase of 11.4% year-on-year. The recent swell in reserves has been partly due to the intervention by the Central Bank to increase the availability of lats in the interbank market by selling lats for foreign currency. Reserves cover more than 3 months of imports and 104% of the monetary base.

Because of high loan activity there is a continuing shortage of lats in the interbank market. Overnight interbank offer rates fluctuate between 6 and 7%. The 3-months interbank offer rate is around 7%. At the beginning of the fourth quarter of 2001, short-term interbank rates fell slightly partly as a result of Central Bank intervention, and partly from an inflow of money as 2-year bonds reached maturity.

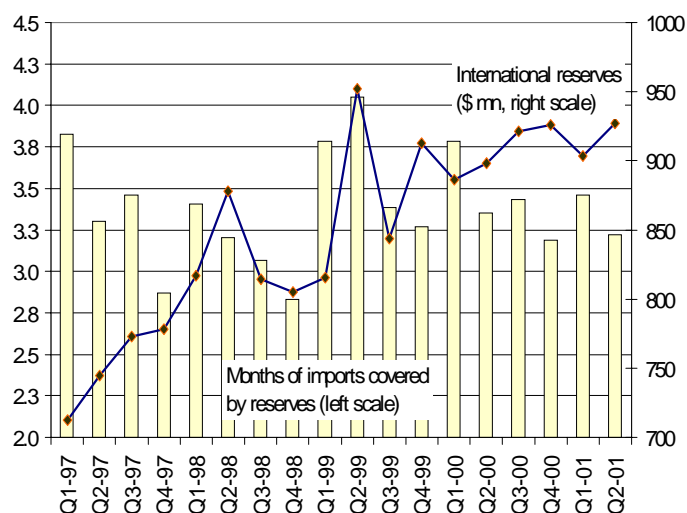
Primary auctions of short-term T-bills have not been any more successful in the third quarter than before. As already mentioned,

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



Source: Central Statistics Bureau of Latvia

Foreign reserves (mn USD) and months of imports coverage



Source: Central Statistics Bureau of Latvia

there is a lack of free lats resources, and the interest rates offered by the Ministry of Finance were too low.

During the third quarter, the situation in the currency market was influenced by the terrorist attacks against the US. Just after September 11, the Latvian market felt a wave of dollar sales, but that was a short-lived. The situation has stabilised and the dollar is back to its pre-attack level.

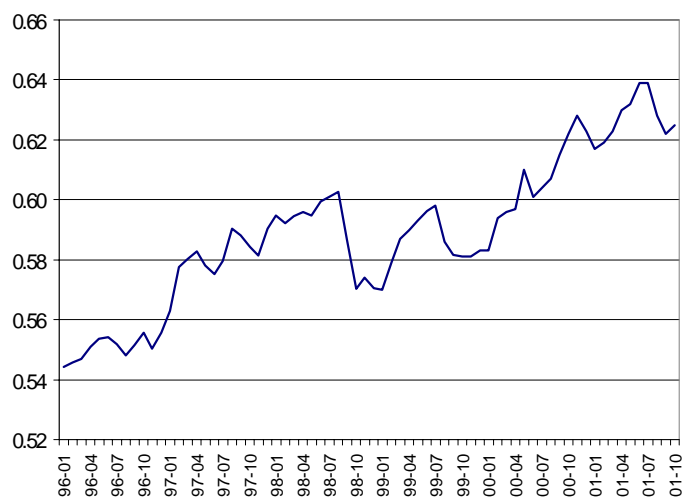
Financial markets

Total capital market turnover in the first nine months of this year was LVL 388 mn. Quarterly turnover was LVL 112 mn, LVL 166 mn and LVL 110 mn, for the first, second, and third quarters, respectively. Trading activity has been dominated by fixed income deals. During the period, activity in the debt market constituted 75% of total market turnover. The most popular debt market instruments were 2-year and 5-year government bonds.

Equity market turnover was LVL 4 mn, LVL 34 mn, and LVL 57 mn in the first, second, and third quarters, respectively. The high Q3 figure was dominated exclusively by the Latvijas Gaze share auction and subsequent trading in this stock. During the third quarter, the most active shares have been Latvijas Gaze and Ventspils Nafta. Equity market capitalisation at the end of the quarter was LVL 319 mn (USD 515 mn).

The government has decided to sell its remaining 3% stake in the gas company Latvijas Gaze by public auction. However, the method of payment will be privatisation vouchers with a maximum allowed number of shares per person/company of 200. This is another effect of the pre-election mood. The argument behind this method of payment is to allow the population to offload a huge amount of unused privatisation vouchers. Most of the remaining unused vouchers have been purchased on the market and accumu-

Average exchange rate for the period (LVL/USD)



Source: Central Statistics Bureau of Latvia

Riga stock market index (DJRSE)



Source: Central Statistics Bureau of Latvia

lated by a small number of companies and individuals, who plan to use them in this and the remaining auctions. This fact is not much stressed by the authorities. (clear now .. I hope). Moreover, it is naïve to believe that in the current stock market situation the general public will rush to acquire shares in a company which is by now totally controlled by two large share blocks – German Ruhrgas/ EON and Russian Gazprom/ Itera. Earlier this year, the government sold 2% of shares in LG for LVL 12.5 per share (July) and 3% of shares for LVL 6.1 per share (August). At the beginning of November, the LG price in the Stock Exchange was around LVL 6. Thus, by choosing privatisation vouchers as a method of payment, the state will lose around LVL 7 mn.

At the beginning of November, the European Bank of Reconstruction and Development (EBRD) finalised its purchase of 24% of insurance company Balta shares. As already mentioned in the previous issue of *BET*, earlier this year the Danish company Codan acquired 99.3% of Balta shares – 73.4% directly from the previous large shareholders and the rest through a share buy back offer to minority shareholders. Codan has now kept 51% of the shares, selling 24% to EBRD and 24% to a Danish Investment fund. According to Riga Stock Exchange information, EBRD bought 1.1 mn shares at a price of LVL 2.05 per share. However, Codan paid LVL 4.5 per share for all of its 99.3%. It seems that the outlook for the insurance market in Latvia has also become much worse. As a consequence of such imperfect timing Codan has made a loss of around LVL 2.5 mn in a rather short period of time.

Staburadze, one of the main list companies, is a clear example of how minority shareholders are ignored in Latvia. After the sale of Staburadze shares to an Icelandic entrepreneur Reynisson and some of his Icelandic partners, jointly they control more than 50% of company shares. Nevertheless, an attempt by the Finance and Capital Market Commis-

sion to force Reynisson to make a mandatory share repurchase from minority shareholders has failed. Reynisson holds 43% of shares and claims that these holdings are unrelated to the other Icelandic holdings. The case is awaiting further court hearings.

The Ministry of Finance has postponed its planned Eurobond issue until later this year in order to evaluate its impact on next year's budget.

Key Economic Indicators

	1998	1999	2000	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3
Population (mn. mid-year)	2.45	2.43	2.37					
Gross Domestic Product								
Nominal GDP (bn LVL)	3.59	3.90	4.33	1.08	1.21	1.08	1.12	-
Nominal GDP (bn USD)	6.09	6.26	7.13	1.77	1.95	1.74	1.77	-
Nominal GDP per capita (USD)	2486	2575	3010					
GDP per capita (USD at PPP)	5777	6220	-					
Aggregate Growth Indicators								
Real GDP (%)	3.88	1.08	6.58	6.60	8.70	8.30	9.20	-
Private consumption (%)	6.18	3.63	-					
Government consumption (%)	22.64	-9.32	-					
Gross fixed investment (%)	32.76	-2.65	-					
Industrial production (%)	2.30	-8.58	3.23	1.10	3.40	7.53	8.33	7.30
Agricultural production (%)	-11.18	-2.25	-					
Stabilization Indicators								
Consumer prices (avg. %)	4.67	2.38	2.64	2.50	1.80	1.13	2.40	3.23
Unemployment rate (avg. %)	7.58	9.68	8.40	8.07	7.80	8.80	9.80	10.80
Average nominal wages (LVL)	133	141	149	151	156	150	157	-
Average nominal wages (USD)	226	241	246	246	252	242	248	-
Budget balance (% of GDP)	0.29	-3.43	-2.82	-2.21	-4.81	-0.87	-2.05	-
Exchange rate LVL/USD (avg)	0.590	0.585	0.607	0.611	0.621	0.619	0.634	0.630
Exchange rate LVL/USD (end-period)	0.569	0.583	0.613	0.615	0.613	0.631	0.639	0.619
Trade and Balance of Payments								
Total exports fob (bn USD)	1.80	1.77	1.87	0.45	0.47	0.49	0.53	0.48
Total imports cif (bn USD)	3.19	2.94	3.18	0.80	0.87	0.78	0.86	0.88
Trade balance (end. bn USD)	-1.39	-1.17	-1.32	-0.35	-0.41	-0.29	-0.33	-0.40
Current-account balance (bn USD)	-0.65	-0.64	-0.50	-0.11	-0.19	-0.07	-0.12	-0.19
Foreign Debt and Reserves								
Foreign debt (bn USD)	0.2	0.4	0.3	0.6	0.6	0.5	0.5	0.6
International reserves (bn USD)	0.81	0.91	0.91	0.92	0.93	0.90	0.93	0.98
Foreign Investment								
FDI inflows (bn USD)	0.357	0.347	0.407	0.082	0.134	0.026	0.102	0.098 ¹
Cumulative FDI inflows (bn USD) ²	1.44	1.79	2.19	1.88	2.01	2.04	2.14	-
Portfolio investment (bn USD) ³	0.041	0.273	-0.196	-0.029	-0.108	-0.021	-0.133	0.007
Monetary Growth								
M2 (%)	5.9	8.0	27.9	5.8	6.0	4.2	6.3	3.4

¹ From July and August

² Cumulative from 1995

³ Methodology of calculation has changed from 1999

LITHUANIA

Overview of developments and prospects

The overarching objective of Lithuania's economic policies for 2001-2002, defined last summer as part of an exercise to identify assumptions and policy targets, is "to promote sustained economic growth and improved living standards through continued macroeconomic stability and further implementation of structural reforms necessary for an efficiently functioning market economy and enhancement of competitiveness".

With early accession to the EU and NATO as the main policy goals, the key elements of Lithuania's economic policy continue to be:

- to maintain the currency board arrangement as the cornerstone of macroeconomic stability;
- to continue further fiscal consolidation in order to support external viability; and
- to advance the remaining key structural reforms at a fast pace.

The Government's macroeconomic outlook for 2001-2002 envisages a continued recovery of growth, low inflation, and the maintenance of the current account deficit at a sustainable level. Economic growth is projected to accelerate from about 3.6% in 2001 to 4.7% in 2002.

Inflation is expected to be around 1% in 2001 and 3% in 2002. The current account deficit is projected to widen slightly to 6.7% of GDP in 2001, reflecting the pick-up of domestic demand from 2001, and to start to narrow again in 2002.

Over the medium term, macroeconomic policies will aim at boosting real growth rates to about 5-6% a year, maintaining inflation at around 2-3% (which is consistent with faster productivity growth than in trading partners), and gradually reducing the external current account deficit to below 6 % of GDP by 2005.

Several major privatisation projects are to be completed during 2001-2002, with the implication that foreign direct investment (FDI) is expected to increase significantly.

In fiscal policy the aim is to achieve a balanced budget position (excluding the cost of pension reform) by the time of EU accession (assumed to occur in 2004). This, together with further structural reforms, will underpin the projected medium term path of the economy. It is expected that a sizeable share of EU-related investment will be financed by EU transfers, and about half of the current account deficit will be financed by FDI inflows, contributing to a gradual reduction of external indebtedness and a strengthening of Lithuania's external position.

The budget deficit remains on course for its 2001 target of 1.4% of GDP. In July, the Seimas approved certain fiscal changes that aim at reallocating expenditure while keeping the budget deficit target unchanged. The revision increases both revenue and expenditure by LTL 80.3mn (0.17% of GDP).

Other changes in the tax system are planned. The aims are: to ease the tax burden so as to promote employment-generating growth and investment; to eliminate loopholes; to make the system more transparent; to strengthen municipal finance. The first phase of the tax reform will mainly focus on corporate income tax, personal income tax, and consumption taxes.

On the expenditure side a number of priorities and new commitments must be faced: the costs of EU and NATO accession, the legal commitments to finance education, the closure of the Ignalina nuclear power station, environmental protection, pension reform, improvements to social expenditure, and the clearance of remaining expenditure arrears.

The savings and land restitution programmes represent additional substantial obligations that can only be met over a long period of time. Hence, cash payments on their account will be limited to about 0.1% of GDP in 2001-2002.

Energy sector problems and closure of the Ignalina nuclear power plant are key issues that will affect Lithuania's economic situation, not just in the near future but over the next decade. The Ignalina question will appear very soon in Lithuania's EU negotiations with the start of negotiations on the energy chapter. There is pressure on Lithuania to close Ignalina, which produces about 73% of all Lithuanian electricity, before the term specified for its safe use expires because Western experts consider its Soviet RBMK model reactor designs inherently unsafe. The European Union (EU) and Nordic countries point out that the plant was built to the same design as Ukraine's Chernobyl, the site of the world's worst civilian nuclear accident in 1986.

Under its current national energy strategy and other laws, Lithuania is obliged to close down the first reactor at Ignalina by 2005, and to make a decision on the second reactor block there by 2004.

However, Lithuania has been investigating the possibility of postponing the decision on decommissioning the second reactor block. For example, during a visit in Brussels on 24 of July, Prime Minister Algirdas Brazauskas discussed the topic of Ignalina's closure with EU leaders. Before his visit Brazauskas stated "This isn't just a local matter, it's a regional problem, with the power plant itself close to the border with Latvia, we can't leave the entire city of Visaginas unemployed. This problem has to be addressed and solved".

The Brazauskas position has met with support in the Lithuanian Parliament. According to Ms. Kazimiera Prunskiene, the former Prime Minister and now an influential MP, "Lithuania has very serious arguments to postpone the decision on decommissioning of the second reactor block until the year 2015-2017".

Moreover, according to Mr. Leonas Asmontas, the Chairman of the National Association of Nuclear Energy and former Minister of Energy, Ignalina is much safer than the Sosnovy Bor

plant built on the Finnish-Russian border. Sosnovy Bor sells energy to Finland without meeting any resistance from the EU. According to other energy experts, the main reason for EU insistence on closing Ignalina is to protect the EU electricity market from the low cost of electricity, which it produces.

Nevertheless, the EU is insisting that Lithuania move quickly towards a decision on the second reactor. The Association Council between the EU and Lithuania, which oversees EU/Lithuanian relations, has “encouraged Lithuania to take further tangible actions towards the implementation of the closure commitments for the Ignalina NPP”.

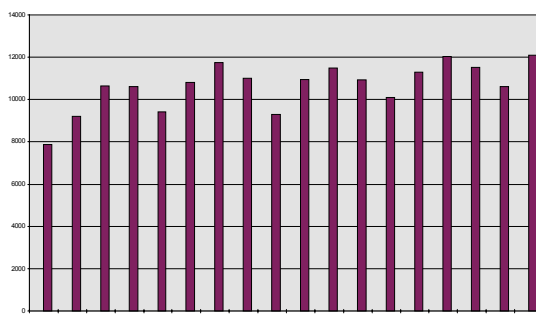
Governments of EU Member States have also expressed concern regarding Ignalina’s closure. The Netherlands regards it as one of the most important issues on the table in EU and Lithuanian relations, and have pledged 1.5 million USD to the nuclear power plant closure fund, while Luxembourg is planning to contribute 1mn USD.

Lithuania has drawn attention to the fact that funding of the closure is still not sufficient. Preliminary estimates for shutting down only first reactor block come to 530mn USD. A further 1bn USD will be needed to shut down the second reactor block. So far only 200mn USD has been pledged. Moreover, with the loss of 8600 jobs the social impact of the closure will also be very deep.

According to preliminary estimates GDP in Q3 2001 totalled LTL 13bn at current prices (LTL 8bn at constant prices of 1995) representing 5.1% real growth as compared with the corresponding period of 2000 (growth in the second quarter was 5.6%). GDP over the first nine months of 2001 was LTL 35.3bn and against the corresponding period of 2000 was up by 5.1%.

The GDP growth over the second quarter was driven by a 24.7% rise in mining and manufacturing industries, an 8.7% increase in

GDP at current prices (bn LTL)



Source: Statistical Office of Lithuania

financial intermediation services and a 4.7% growth in volumes of trade. These developments were the greatest factors contributing to the results of the first half of 2001 as a whole.

During the second quarter exports grew by 23% against the corresponding period of last year, which had a positive impact on GDP growth. Household consumption expenditure increased by 3.8% and government consumption expenditure by 3.6%. Fixed capital formation exceeded the volume of the 1st quarter, but against the corresponding period of last year it decreased by 5%.

Prices

Inflation remains low. In Q2 2001, consumer prices (CPI) increased by 1.3% compared to the same period of 2000.

The biggest price changes (June 2001 against June 2000) occurred in food products and non-alcoholic beverages (+ 4.5%), clothing and footwear (-4.4%), furnishings, household equipment and routine maintenance (-2.3%), education (+6.0%), hotels, cafes and restaurants (+2.9%).

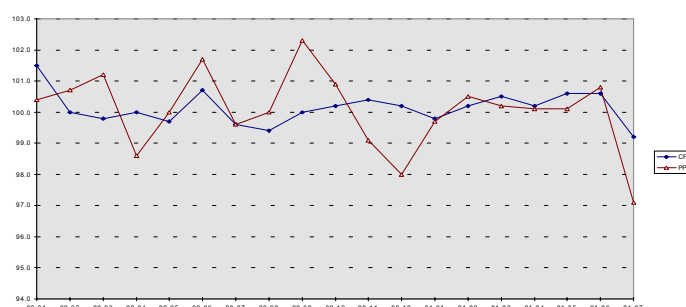
The price of industrial output (PPI) increased by 1.1% in Q2 as compared with the same period last year. Construction costs decreased by 0.5% in Q2, while the prices of animal products increased by 23.4% compared to the same period of 2000.

Labour

The registered unemployment rate was 12.1% at the end of Q2 as compared with 11.1% a year before.

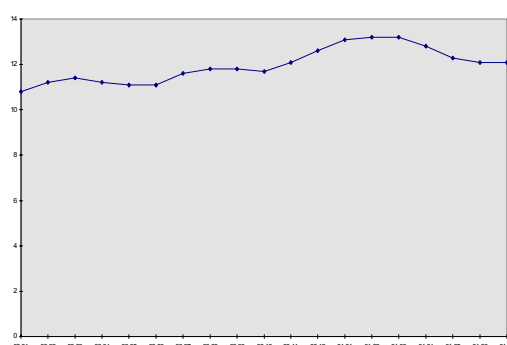
Over the year, employment decreased in several sectors. In agriculture, hunting and forestry, by approximately 30,000 (or 10%), in transport, storage and communications (by about 13,000 or 12%) and in manufacturing industry and trade (by 10,000 or 4%) respectively.

**CPI and PPI (compared to previous month)
year GDP at current prices (bn LTL).**



Source: Statistical Office of Lithuania.

Registered unemployment (%)



Source: Lithuanian Labour Exchange

Average gross monthly wages in Lithuania in the second quarter of 2001 were 1067 LTL representing an increase of 0.1% over the previous year.

Wages in the public sector were 1,106 LTL, or an increase of 0.8% as compared with the corresponding quarter of 2000 while in the private sector they were 1,028 LTL, in a decrease of 0.1%.

Foreign trade

The situation in world markets has had mixed effects for Lithuania. Economic development in the EU slowed down in Q2 2001 (with EU GDP growth at 2.4 % in Q1 and 1.7 % in Q2). Meanwhile, economic growth in Russia remained relatively high (4.9 % growth in Q1 and 5.1 % in Q2). Global oil prices weakened significantly. All of these factors influenced the development of Lithuania's foreign trade.

Lithuanian exports over January-July 2001 amounted to LTL 10.6bn, and imports amounted to LTL 13.9bn. Thus the trade balance was negative at minus LTL 3.3bn. Over January-July 2001 against the same period of 2000 exports grew by 23.1% (or LTL 1.98bn), whereas imports rose by 14.6 per cent (or LTL 1.8bn).

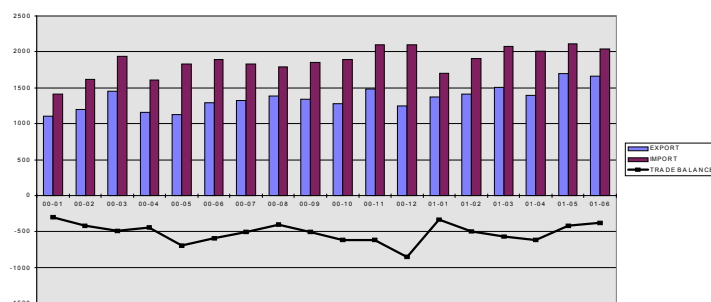
The most important export partners were Latvia (15.1%), the United Kingdom (14.8%), Germany (13.5%) and Russia (8.7%), whereas for imports they were Russia (28.7%), Germany (15.8%), Poland (4.6%) and Italy (4%).

Mineral products imports increased by 27.4% as compared with the second quarter of 2000 and formed the largest share of total imports (23.1%).

Mineral products (mostly refined oil products) with a share of 27.4% were also the largest export category in Q2. Their value grew by 97.8% compared with the same period last year.

The increased trade of mineral products was a result of increased utilisation of production capacity at the Mazeikiai oil refinery plant.

Foreign Trade (mn LTL)



Source: Lithuanian Ministry of Finance

Foreign investment

FDI inflows in the second quarter of 2001 were LTL 829 mn. Much of this was generated by the privatisation of the shipping company LISCO and of the Lithuanian Savings Bank. Foreign direct investment flows in the first half of 2001 made up LTL 1.4bn, and proceeds from the sale (privatisation) of property made up LTL 346mn, ie 25.4% of total investment flows. Compared to the first half of 2000, total foreign direct investment flows were up by LTL 0.6bn (76.8%).

The main investors were: Denmark (LTL 1.9bn or 19.0%), Sweden (LTL 1.5bn or 14.9%), the USA (LTL 1bn or 9.7%), Germany (LTL 0.9bn or 8.9%) and Estonia (LTL 0.8bn or 8%).

The main receiving sectors were: manufacturing industry (28%), trade (20%), financial intermediation enterprises (18%) and communication services (16%).

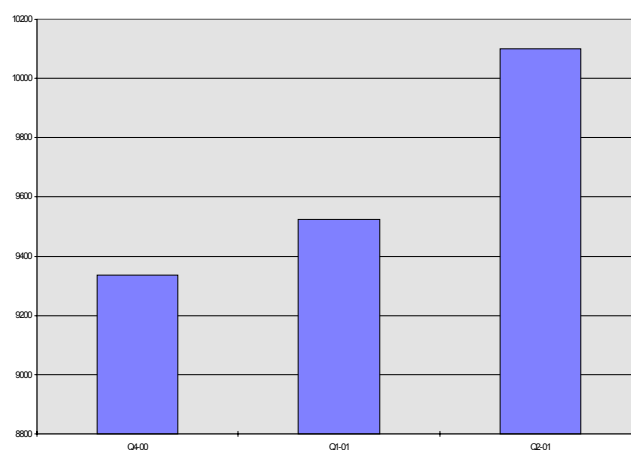
Accumulated foreign direct investment as of 1 July 2001 made up LTL 10.1bn (USD 2.5bn), of which LTL 1.7bn (USD 0.4bn) were long-term and short-term loans extended by foreign direct investors. Per capita FDI was LTL 2,744 (USD 686).

Enterprises and banks

Banking proved very profitable in the first half of 2001 when the total profits of the commercial banking system were LTL63.1mn (as compared with just LTL 368,000 in the first half of 2000). Eight Lithuanian banks and two foreign bank branch offices made profits totaling LTL 69.7mn, while losses of LTL 6.6mn were experienced by two banks and foreign bank branch offices.

Despite a fall in its profits, Lithuania's biggest bank - Vilniaus Bankas - earned 57.4% of the banking sector's total profit. Its decline was compensated for by the successful

Foreign direct investment (mn LTL)



Source: Bank of Lithuania

operation of the other two big banks, JSC Lithuanian Savings Bank and the Lithuanian Agricultural Bank.

In the first half of this year, bank interest income grew by 9.2% as compared with last year. However, the share of income from interest payments decreased due to the rapid growth of income from services and commissions, which during the first half of this year exceeded that of last year by 130%. The cost structure of the banks did not change significantly.

Loans remain the biggest component of bank assets, accounting for roughly 41%. The tendency for the share of long-term loans to grow was confirmed when the Q2 long-term loan share grew from 62% to 65%. The main alternative to loans is investment in securities. Bonds dominate the securities portfolio, which accounts for 21% of bank assets.

In recent years, the fastest growing liabilities have been deposits of private customers (comprising 48% of total balance sheet liabilities). The share of liabilities to banks and other credit and other financial institutions has fallen correspondingly.

The expanding share of foreign investors in bank equity continued in the second quarter of this year. Acquisition of 90.73% of JSC Lithuanian Savings Bank by the Estonian Hansapank meant that the foreign-owned share of bank equity jumped from 58% to 76%.

Credit unions are a tiny but growing sector of the Lithuanian financial sector. During the second quarter of 2001, 1,131 new members joined credit unions. Their capital stock increased by LTL 374800 while assets grew by 19.5% to LTL 22.9mn, or 0.17% of the total assets of the banking system. The largest four credit unions accounted for 37.4% of the total assets of credit unions.

Loans granted by credit unions during the last quarter increased by 39.1% to LTL 14.3mn. On 1 July 2001, 18 credit unions had made special

allocations for loans (LTL 123,400). During the second quarter of 2001, deposits in the credit unions grew by 20%, reaching LTL 16.7mn.

Profits in the first half of this year were LTL 256,000, of which 126,000 was earned in the second quarter (as compared to a LTL 55,000 loss in Q2 last year). Twenty eight credit unions were operating profitably in the second quarter, whereas eleven experienced some loss.

The budget

Revenue payments were 3.1bn LTL (USD 0.8bn) during the first six months of this year, some 25mn LTL less than planned. Revenues for June came to 493mn LTL, some 18mn LTL short of the monthly target. As of June 30, expenditure exceeded revenue by 470.6mn LTL. The 2001 budget is planned with a deficit of 906mn LTL, so overall the 2001 budget seems to be on track.

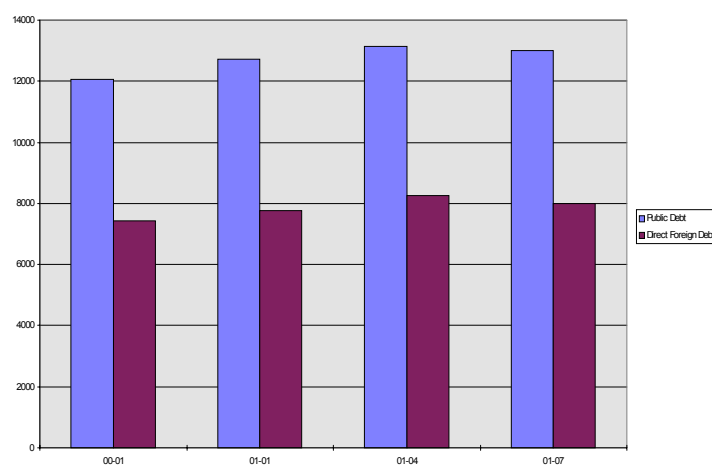
A total of 395 entities worth 406mn LTL (USD 101.5mn) were privatised in Lithuania during the first half of 2001. Some 83.8% of first-half privatisation proceeds came from the sale of state-owned shares in Lithuanian Shipping Company (LISCO) and Lietuvos Taupomasis Bankas (Lithuanian Savings, or LTB). In June of this year, 67 entities were sold for 14.9mn LTL, including 5.2mn LTL worth of state property and 9.7mn LTL of municipal property

The public debt stood at LTL 13bn on 30 June 2001 representing an increase by LTL 159 mn (1.2%) in the second quarter.

As of 30 June 2001, domestic debt totalled LTL 2.9bn, of which LTL 2.8bn was direct debt. Long-term liabilities accounted for 71% of direct domestic debt. During the quarter under review, direct domestic debt grew by 0.5%.

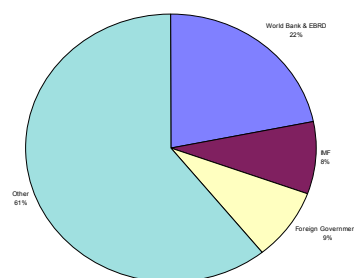
Foreign debt stood at LTL 10bn on 30 June 2001 of which direct debt was LTL 8bn. Securities and long-term loans accounted for 55% and 45% respectively of direct foreign debt. Over the quarter, direct foreign debt shrunk by 3%.

Public debt (mn LTL)



Source: Bank of Lithuania & Lithuanian Ministry of Finance

Direct foreign debt by creditors as of 1 July 2001



Source: Bank of Lithuania

The exchange rate

The Litas (LTL) has been pegged to the dollar at a rate of 1USD=4LTL since 1994.

However, as of 2 February 2002 the Euro (EUR) will be the anchor currency, and the official exchange rate of the Litas will be established on the basis of the Euro and the US dollar (USD) exchange rate that prevails in the currency market on 1 February 2002.

The rate of the Litas against the Euro that will come into effect as of 2 February 2002 will be calculated by multiplying the US dollar and Euro exchange rate, as announced by the ECB on 1 February 2002, by four (ie by the current exchange rate of the Litas against the US dollar).

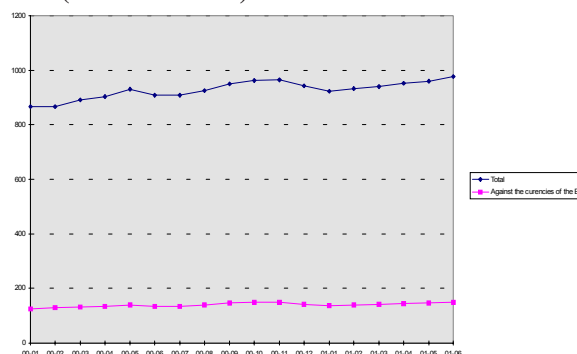
The Bank of Lithuania's calculated nominal effective exchange rate of the Litas against the currencies of its main trade partners appreciated by 3.8% during the 2nd quarter of 2001. Against the currencies of the EU countries the nominal appreciation was 6.3%, but against currencies of the CIS countries the Litas depreciated by 2%.

At the same time the real effective exchange rate appreciated by 2.8%. Against the currencies of the EU countries the Litas appreciated by 6.5%. Against currencies of the CIS countries the real value of the Litas depreciated by 1.7%.

Money

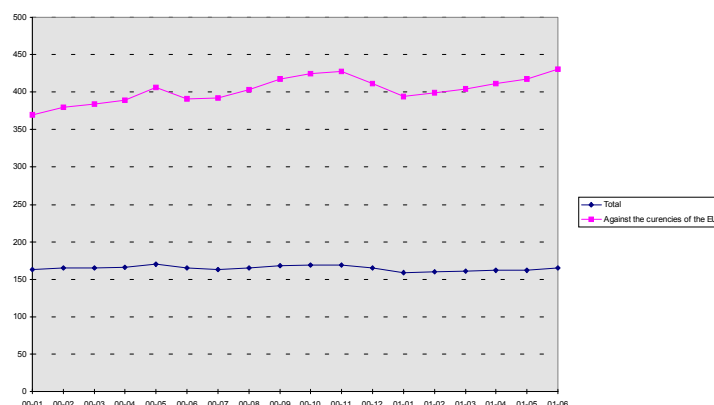
Reserves increased by LTL 701.1mn in Q2 and by LTL 473.5mn during the first half of 2001. The growth of reserves during Q2 was influenced by privatisation proceeds that were transferred from the commercial banks to the central bank as well as by the fact that during the quarter the Bank of Lithuania (LB) pur-

Nominal effective exchange rate indicates of the LTL (June 1993=100)



Source: Bank of Lithuania

Reall effective exchange rate indicates of the LTL (June 1993=100)



Source: Bank of Lithuania

chased USD 35.8mn more from commercial banks than it sold to them. At the end of the quarter, import coverage by net international reserves (excluding gold) was 2.6 months (2.7 months at the start of the year).

The monetary base increased by 4% over the quarter to LTL 3.8bn at the end of June. The biggest portion (74.7%) of the monetary base was currency outside the LB. Broad money M2 amounted to LTL 10.9bn at the end of June, representing a rise of 3.1% over the quarter. M1 increased by 3.3%, while the amount of quasi-money went up by 2.8%.

Deposits made up the bulk of M2 and their share increased during the second quarter. The share of time and savings deposits and foreign currency deposits increased, while the share of demand deposits decreased, as compared with March. The amount of currency in circulation grew by 3.8%.

Capital markets

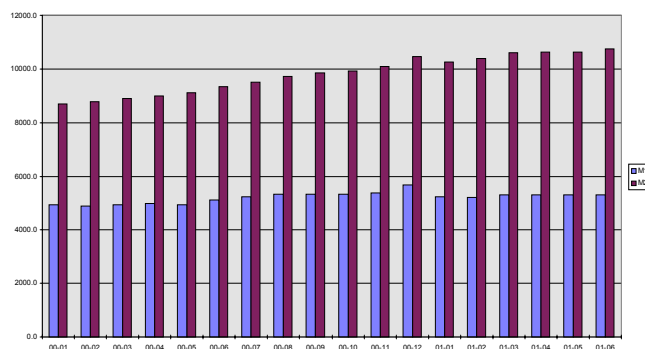
In the second quarter, 15 auctions of Government securities (GS) were conducted. The nominal values of the Treasury bills and government bonds sold were LTL 180mn and LTL 200mn respectively. All issues were fully subscribed, and the average T-bill yield was 5.95%, while the average Government bonds yield was 7.41%.

Government securities turnover on the National Security Exchange of Lithuania (NSEL) decreased by 21.8% in Q2 2001 as compared with Q1. The prices for the GS in the secondary market grew by 42.54 points during the quarter (the LITIN-VVP index was 1982.82 points at the end of June).

Total turnover on NSEL decreased by 9.1%, turnover in shares increased by 30.7% in comparison with Q1.

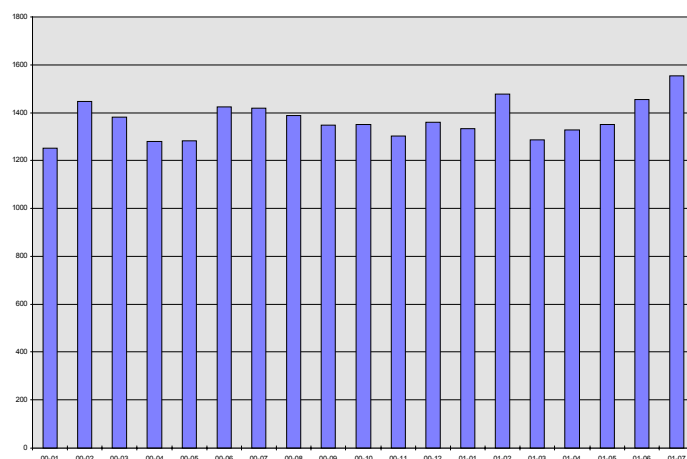
During the quarter, the prices for shares in the companies included in the Official List fell by 76.82 points (the index LITIN was

Money supply (mn LTL)



Source: Bank of Lithuania

International reserves, (mn USD).

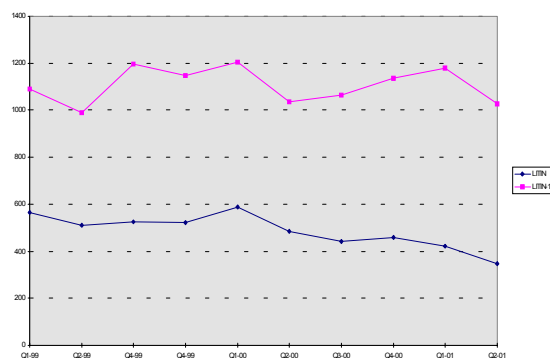


Source: Lithuanian Ministry of Finance.

346.13 points at the end of June). The prices for shares that were traded most actively at the NSEL dropped by 152.42 (the index LITIN-10 was 1027.41 points at the end of June). The prices for all quoted stocks declined by 97.59 points (the index LITIN-G was 909.69 points at the end of June).

Total capitalisation of NSEL was LTL 13.6bn at the end of June, of which listed securities capitalisation was LTL 6.5bn, while unlisted securities capitalisation was LTL 7.0 bn.

The LITIN and LITIN-10 index.



Source: National Stock Exchange of Lithuania.

Key Economic Indicators

	1998	1999	2000	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3
Population (mn. mid-year)	3.71	3.71	3.69					
Gross Domestic Product								
Nominal GDP (bn LTL)	42.77	41.84	44.93	12.03	11.52	10.68	12.09	-
Nominal GDP (bn USD)	10.69	10.46	11.23	3.01	2.88	2.67	3.02	-
Nominal GDP per capita (USD)	2881	2820	3044					
GNP per capita (USD at PPP)	6283	6490	-					
Aggregate Growth Indicators								
Real GDP (%)	5.05	-4.19	2.64	3.10	3.65	6.39	6.74	-
Private consumption (%)	-1.81	0.78	3.77					
Government consumption (%)	3.99	15.98	-0.70					
Gross fixed investment (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Industrial production (%)	-5.45	9.28	16.16	10.23	-8.72	-21.22	-18.86	-17.36
Agricultural production (%)	n/a	-11.68	-1.78	12.50	-10.90	-14.00	-9.70	-
Stabilization Indicators								
Consumer prices (avg. %)	5.10	0.78	0.95	0.90	1.30	0.10	1.30	1.80
Unemployment rate (avg. %)	6.40	8.37	11.53	11.73	12.13	13.17	12.40	12.07
Average nominal wages (LTL)	1009	1075	1089	1099	1113	1041	1067	-
Average nominal wages (USD)	252	269	272	275	278	260	267	-
Budget balance (% of GDP)	-1.26	-4.33	-0.97	-1.75	-0.58	0.83	0.20	-
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
Trade and Balance of Payments								
Total exports fob (bn USD)	3.96	3.15	5.20	1.37	1.30	1.40	1.55	-
Total imports fob (bn USD)	5.48	4.55	5.83	1.48	1.59	1.49	1.64	-
Trade balance (bn USD)	-1.52	-1.40	-0.62	-0.11	-0.29	-0.09	-0.09	-
Current-account balance (bn USD)	-0.325	-0.306	-0.224	-0.026	-0.254	-0.145	-0.138	-
Foreign Debt and Reserves								
Foreign debt (end. bn USD)	1.682	1.854	1.880	1.943	1.880	2.107	1.998	2.065
International reserves (end. bn USD)	1.460	1.242	1.180	1.349	1.359	1.287	1.455	1.598
Foreign Investment								
FDI inflows (bn USD)	0.926	0.486	0.374	0.121	0.114	0.133	0.207	0.207
Cumulative FDI inflows (bn USD) ¹	1.4325	1.9189	2.2926	2.1785	2.2926	2.4260	2.6333	-
Portfolio investment (bn USD)	-0.043	0.508	0.418	0.071	-0.007	0.236	-0.039	-
Monetary growth								
M2 (%)	14.51	7.74	16.53	5.56	6.10	1.50	3.07	7.08
M3 (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

¹ Cumulative from 1996