Baltic Economic Trends

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Contents

Editorial

The economic updates of this issue all testify to the apparent good health of the three Baltic economies. The effect of the EU slowdown appears to have been minimal and in all three countries growth accelerated in the second quarter of 2002, while inflation has remained modest. However our first feature article by Rudolfs Bems of the Stockholm School of Economics (currently visiting Princeton) posts a warning that there are potential storm clouds lurking. This appears to be especially the case for Latvia where a combination of rapid credit growth, property boom and a widening trade deficit make Latvia especially vulnerable to exogenous shocks which could trigger financial panic and even devaluation.

Our second feature by Morten Hansen, of EuroFaculty and SSE Riga, and Romans Pancs, a Latvian graduate student at the London School of Economics, reports on research which suggests that in its labour market Latvia has made the transition to a normal market economy. They also offer the interesting result that the efficiency of the Latvian labour market, in the sense of matching job-seekers and vacancies, has improved in recent years. In contrast to developed Western countries where there has been a secular decline in matching efficiency.

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Alf Vanags
Editor

When will the next economic crisis hit the Baltic states? Sustainability of recent macroeconomic developments in Estonia, Latvia and Lithuania

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Introduction

Since the Russian crisis, the economies of the Baltic states have posted a remarkable performance. After a short-lived local crisis in 1999 all three countries experienced rapid growth in 2000 and 2001. Over this period the Baltic states were the fastest growing transition economies and among the fastest growing countries in the world. The economy of Latvia, which was the most successful among the three, grew by 14.9 percent during the two-year period, while Estonia and Lithuania grew by 12.5 and 9.9 percent, respectively. Moreover, this rapid growth trend is continuing into the first half of 2002.

This article looks at the driving forces behind Baltic states' GDP growth and at the implications for their external imbalances and capital investments. Furthermore, the article attempts to identify problems that are likely to arise in the near future.

Throughout the transition process, growth in the three Baltic states has been accompanied by a negative trade balance and by growing bank credit to the private sector. At times, when growth rates have been particularly high, trade imbalances and credit growth have tended to reach unprecedented levels. The current growth episode is no exception. In 2001, Latvia's trade deficit reached 20 percent of GDP and over the 2000-2001 period bank credit to the private sector increased by more than 70% in real terms.

In general, such a development process is in line with the predictions of standard economic theories. In order for the capital poor Baltic states to develop, they need to import capital from abroad. Once an appropriate level of capital stock is accumulated, countries will repay the imported capital to the foreign investors. In a similar way, economic growth requires a continuous increase in investments, which is facilitated by growing credit to the private sector.[1]

However, feasibility considerations and realistic future prospects put limits on current account imbalances that are sustainable and on credit growth rates that are in line with the developments in the rest of the economy. The same can be said about price increases in particular sectors of the economy. In order to correctly detect deviations from a sustainable development path, it is necessary to look at an integrated picture of the economy, one that includes the external sector as well as the local investment market. When deviations become too large, the economy is likely to experience 'painful' adjustments to a more sustainable development path.

[1] For further discussion of theoretical models see Bems and Jonsson (2002).

Much of the remaining article will focus on the case of Latvia, because at the moment the Latvian economy exhibits the highest growth rates of credit and its trade balance is the most negative. Yet, the discussion in the article is relevant for all three countries, since they have gone through a very similar development path in the past and are likely to develop in a similar manner in the future.

The structure of the rest of the article is as follows. The next section looks at external imbalances and discuses the prospects for their sustainability. In section two, we analyze the effects of bank credit growth in Latvia and, when relevant, also Estonia. This section also discusses the connection between external imbalances and credit growth. Section three looks at the issue of vulnerability and section four concludes.

External imbalances in the Baltics states

Since the early stages of transition the Baltic states have run increasingly large trade deficits. This trend has been temporarily reversed only after slowdowns or contractions in economic activity. Over the last five years the general trend in export and import growth has been very similar across the three countries (see Panel A in Figure 1). After a contraction caused by the Russian crisis in late 1998, growth rates of both exports and imports returned to positive by 2000 and were high during the 2000-2001 period. Although export growth exceeded import growth in Estonia and Lithuania during 2000 (see also Panel B in Figure 1), in 2001 and the first half of 2002 trade deficits again increased. In Latvia, the trend of increasingly negative trade balances started in 2000.

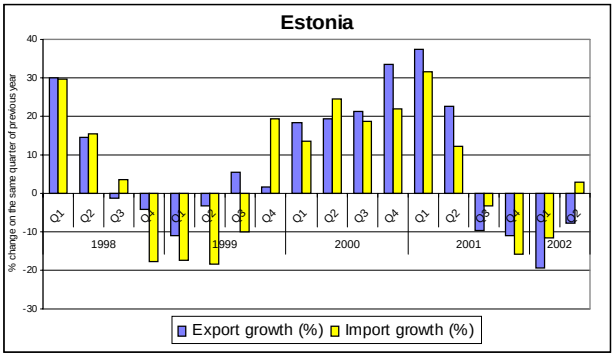
Panel B in Figure 1 shows developments in the balance of payments for the three countries. Although the positive balance on services, income, and transfers[2] helps to offset some of the deficit in merchandise trade, current accounts in all three countries follow closely the movement of the trade balance. Panel B in Figure 1 also shows us that so far each of the countries has sufficient capital inflows[3] to more than offset the negative trade balances. Only during 1999 in Lithuania did foreign reserves decrease.

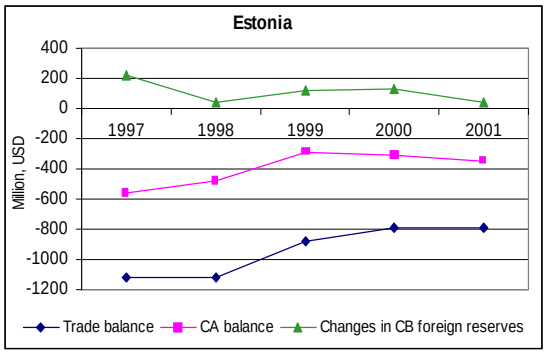
It is also important to look at the type of capital inflows that make the current account deficit in the Baltic states possible. A positive feature here is that a lot of capital inflows are in the form of FDI. These flows are the most favorable for the current position of the Baltic states, because FDI is hard to reverse once invested. Furthermore, foreign investors bear all the consequences for the future returns of the investment. Unfortunately, as Figure 2 shows, in comparison with 1998 levels, FDI inflows in the region are on the decline. At least partly this can be explained by the completion of the privatization process, which in earlier years attracted much of the FDI. Nevertheless, FDI remains the most desirable type of capital inflow, and the governments of Latvia, Lithuania and Estonia should put a lot of effort into creating a good environment for FDI even after the completion of privatization.

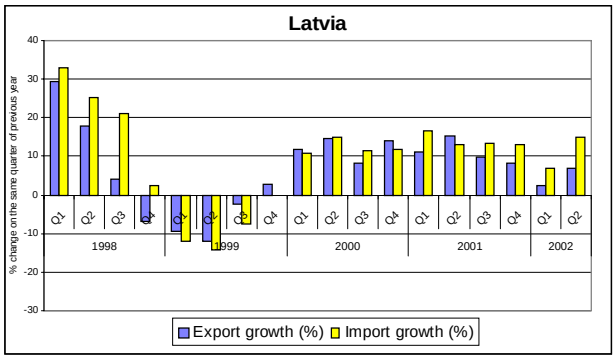
[2] In panel B this balance is equal to CA balance -Trade balance.
[3] Capital inflows in panel B are the difference between the changes in CB reserves and the CA balance.

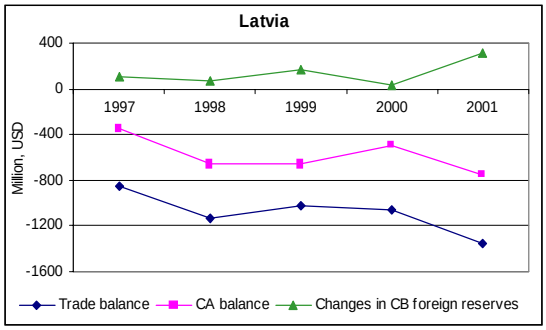
Figure 1. External sector imbalances in the Baltic states

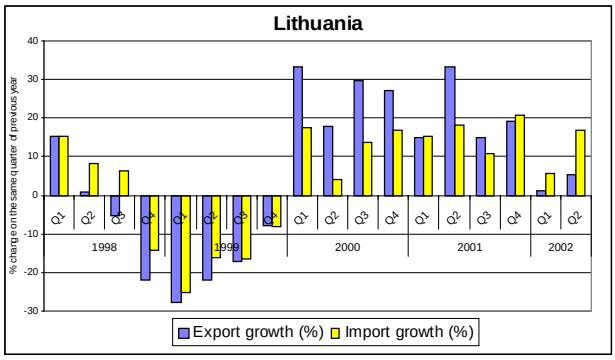
Panel A: Export and import growth **Panel B: Balance of payments**

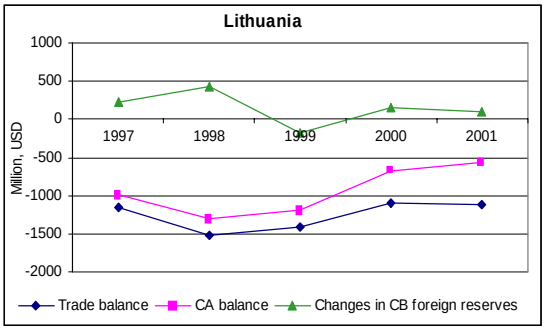










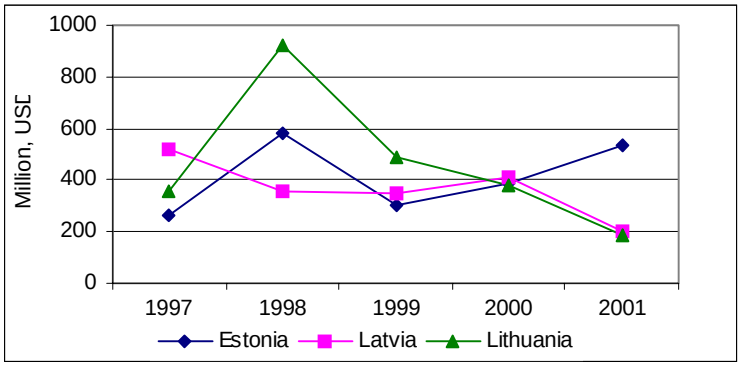


Why are the trade balances in the Baltics, and at the moment especially in Latvia, so negative and still widening? As already mentioned, economic development in the capital poor Baltic states requires the inflow of foreign capital, which makes it possible for local investments and consumption to grow and thus for economic activity (GDP) in the country to increase.[4]

At the moment, future prospects for the Baltic states appear bright and this is no doubt the driving force behind the recent GDP growth. Consequently, capital is flowing into the region and overall investment is on the rise. Also, bright future prospects and wider availability of credit has encouraged the local population to increase consumption expenditures.

[4] In the case of the Baltic states the need for foreign capital is additionally high, because of their low domestic savings rates.

Figure 2: Foreign direct investments in the Baltic states



However, such a level of foreign capital inflow is unlikely to be sustainable in the long run. There is a limit to how much capital can be invested in Latvia before it would become unreasonable to expect that the economy is still able to generate enough exports to repay the foreign investments in the future. Although by historical standards all three Baltic states already exhibit very high current account deficits, it is hard to predict what kind of deficits the markets will consider as unsustainable. The very small size of the countries and the encouraging future prospects might suggest that we have not yet approached the limit.[5]

If a limit is reached, some sharp adjustments in the local economy will have to be made. In essence such adjustments can be of two types. The first, already in action during the Russian crisis, is to decrease local consumption and thus demand for imports. This of course also slows down GDP growth. Such an adjustment mechanism can work, if the capital flow reversals are not too sharp. A more dramatic reversal in capital flows requires an increase in the interest rate to prevent capital flight. Unfortunately, experience from crises in the other regions of the world suggests that this is not a long-lasting solution. Usually, it results in a devaluation of the local currency and a banking crisis.[6]

Given these prospects it is important to make sure that the deficits are not seen as unsustainable and to foster the belief that eventually exports will grow faster than imports. To assess the sustainability of the current external imbalance for Latvia we need to look separately at the two reasons for capital inflows: the increase in investment and the increase in local consumption.

How wisely is the capital that flows into Latvia invested and will it generate the needed exports? The direct answer to this question will be discussed in the next section, when we look at bank credit and investments. More indirectly an assessment of the use of capital inflows can be obtained by looking at the indicators for corruption and the quality of governance in the region. In this respect, especially in Latvia and Lithuania, the picture is hardly encouraging.[7] At least a part of the capital inflows are affected by inefficiencies arising from corruption and poor administration. For example, there is am-

[5] For example, EU accession would imply an additional 140-170 million euro of capital inflows into Latvia in the first accession year alone.

[6] Devaluation can be thought of as a kind of a default solution to the problem, since a low enough exchange rate will always generate the necessary exports. The adjustment will also work through imports, since a lower exchange rate will automatically make imports more expensive.

[7] Results of the most comprehensive attempts to measure corruption and quality of governance reveal that Lithuania and especially Latvia has higher level of corruption and mismanagement than the most advanced transition economies, including Estonia. For more details see www.transparency.org or www.worldbank.org/

ple anecdotal evidence that in Latvia a fraction of 'aid' money (e.g. World Bank money provided for the development of infrastructure) goes into the pockets of the local authorities that administer it.[8] All this makes the future prospects of export oriented growth more questionable.

Rising local consumption is an important part of the development process, since the increases in investment and in the supply of goods and services cannot pay off without a corresponding increase in local demand. The less desirable consequence of this is that the increase of consumption also increases the demand for imports and thus widens the trade deficit. What determines consumption growth? First of all, consumption in Latvia is increasing because household income is increasing. Secondly, as people expect even better economic conditions in the future and consumer credit becomes increasingly available, they are willing and able to increase their consumption already today. Both of these developments are welcome, although the transfer of expected future consumption to the present should not be overdone. If consumption grows faster than the supply of good and services in the local economy, it is more likely to translate into demand for imports, which makes the 'external balance sustainability' issue more acute.

In addition to the above considerations, two more factors play an important role in determining a country's external position. First, the government budget deficit directly adds to the current account deficit. The government needs to keep this in mind. Secondly, an overvalued real exchange rate can lead to an even bigger trade deficit. However, at the moment neither budget deficits, nor overvalued exchange rates[9] seem to be a problem for the Baltic states.

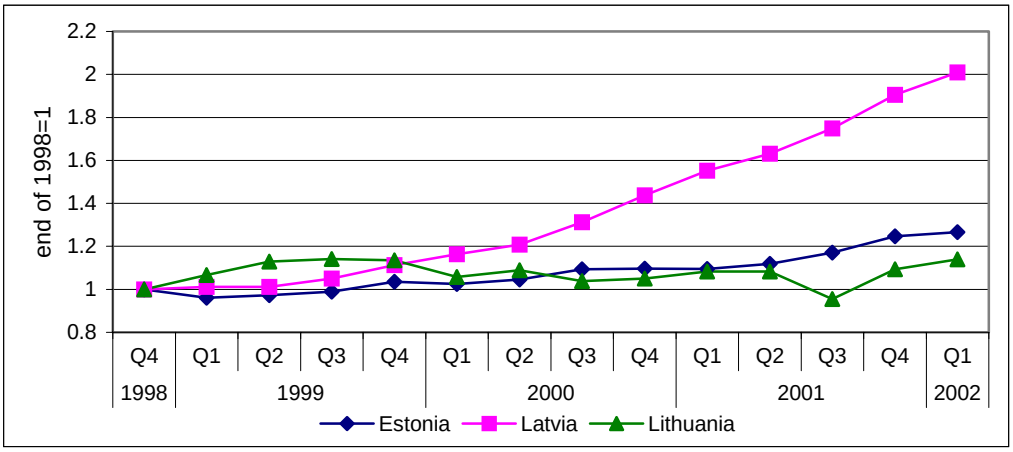
Bank credit and investments

Banking sectors in the three Baltic states have developed somewhat differently over the last decade. From the early stages of transition, bank credit played more important role in Estonia than in Latvia and Lithuania. In Estonia, banking sector activities, as measured by credit/GDP, have been increasing throughout the 90s, while in Latvia they increased rapidly from 1997 onwards (8.5% to 20.9%). In Lithuania, credit/GDP in 2001 was still below the levels it reached during 1995 and over the 1999-2001 period it has changed very little.[10] In 2001, the ratio of credit/GDP in Estonia, Latvia, and Lithuania was 27.2, 20.9 and 12.2 percent, respectively.

We can see a similar pattern of development by looking at the changes in the stock of credit in the Baltic states over the last 3.5 years (see Figure 3). In Latvia, the credit stock more than doubled over this period, while in Estonia and Lithuania the growth rates were considerably smaller.

[8] Of course, such 'stolen' money can still be invested productively.
[9] See Kazaks and Qin (2002).
[10] Credit/GDP measures are adjusted for nominal changes over time as well as for stock-flow differences. See Beck et al. (1999) for further details.

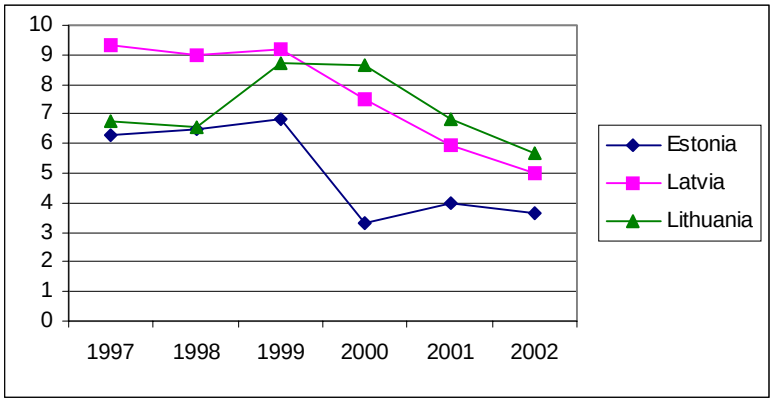
Figure 3: Growth of 'real' domestic credit to the private sector (CPI adjusted)



Another measure of banking sector development is the difference between lending and deposit rates (see Figure 4). Since 1999 we can see a decrease in this measure for all three countries, and in terms of levels Estonia is again ahead of the other two Baltic states.

An important recent development is the large equity investments by foreign banks in the banking sector of all three Baltic states. Among other things this means more and easier access to funds for both investment and consumption.

Figure 4: Difference between average lending and deposit rates on short-term loans and deposits in national currencies



We can conclude that banking sector activities are important and increasing in Latvia and Estonia, but less so in Lithuania. Credit market developments are especially important in the context of this article, since the credit market plays an increasing role in the allocation of investments and thus in determining the sustainability of the external imbalances, especially in Latvia and Estonia. Also, by making credit more accessible to consumers the credit market can influence the growth of consumption and demand for imports.

It is true that in the Baltic states credit markets still play a much less important role than in Western Europe, and thus their role in credit allocation is likely to increase in the future. At the same time, we need to realize that for several reasons development of such variables as credit/GDP has to stay in line

with developments in the rest of the economy. First, returns of many investment projects are directly dependent on the income levels in the economy. Second, at any point in time the economy, its institutions, and infrastructure can efficiently absorb only a limited amount of new investment, before decreasing returns kick in. Thus, credit growth can lead economic development, but it cannot run too far ahead of it for long.

There are several sectors in the economies of the Baltic states, especially Latvia and Estonia, in which currently issued credits are likely to run into trouble, when the time comes for their expected returns to be collected. Also, rapid credit growth may directly increase the demand for imports and thus worsen the trade deficit. This, in turn, can backfire with loss of external confidence.

One such worrisome sector is the real estate market and the bank loans that are connected to it. In terms of received credit, the real estate sector is the fastest growing in all three Baltic states and over the last several years this sector has experienced a boom of its own. However, returns from investments in real estate developments and credit for housing are tied down by the income of the population. And income growth in the Baltic states has been in line with GDP growth. For example, the average gross income in Latvia increased by 12.8 percent over the last two years. Another issue is mortgage loans, which in Latvia more than doubled in 2001. When issued during a real estate boom such loans can be a problem, since later banks may have trouble collecting the expected value from sale of the collateral.

Consumer credit has also been growing rapidly. In Estonia and Latvia it grew by 85.5 percent and 65.9 percent, respectively, in 2001 alone. Yet the returns from these loans are again bound by the income of consumers, which is growing much more slowly. Besides the repayment concerns, the rapid growth of the consumer credit is also likely to increase the demand for imported goods with all its negative consequences.

Another troubling observation is that the wholesale-retail trade sector has received the biggest share of recent investments and is also the fastest growing among the big investment sectors in Latvia. In comparison with the manufacturing sector, in 2001, the wholesale-retail trade sector received 23.1 percent of all investments, while manufacturing received 17.8 percent. Also, the amount invested in the wholesale-retail trade sector was a 31.4 percent increase over the previous year, while in manufacturing the same figure was 17.7 percent. This raises doubts about the possibility of export driven growth in Latvia in the future. Although it is the fastest growing sector, expansion of wholesale-retail trade is not what will turn around the negative trade balance in Latvia. On the contrary, rapid development in this sector is likely to make the trade balance even more negative by encouraging import consumption.

Overall, the allocation of investment resources through banks plays an important role not only in determining the overall level of economic activity in the Baltic states, but also in determining the sustainability of the current negative external positions. Thus in Latvia, where bank credit growth rates have been much higher than in Estonia and Lithuania, the trade balance has also deteriorated much faster.

Vulnerability

The issue of vulnerability is distinct from the above discussion of sustainability. An economy whose external position is not in balance, such as Latvia, Estonia, or Lithuania can find itself in an economic crisis for reasons that are beyond its control. And, as the country becomes more open, it also becomes more vulnerable to such exogenous crisis. Furthermore, for a highly-out-of-balance Latvia, the external shock that can cause a crisis does not have to be especially big.
We can think of several such external developments that the Baltic states should keep in mind. Persist

ent recession in the EU is likely to negatively affect exports from Baltic states and thus worsen the trade balance. At the end of 2001 and during 2002, all three Baltic states have already experienced the effects of economic showdown in the EU. Estonia has been the hardest hit, but export growth slowed down also in Latvia and Lithuania. When mixed with rapid growth at home, such an external shock can be particularly dangerous, since import growth is not directly affected by it.[11]

Another possible shock is a change in the Baltic states' future economic prospects, such as a non-accession to the EU. This can have very severe consequences, including a downwards revision of the trade and CA deficits that are considered sustainable by market participants and sharp reversals in capital flows.

A country's vulnerability to external shocks increases with the level of financial development, since it becomes easier for investors to withdraw capital. In fact, one of the suggested explanations for the success with which Baltic states have withstood the different crises in the 90s, is that their financial sectors have not been developed enough to allow the external shocks to affect the local economies and to allow speculators to take advantage of the external imbalances.[12] As the banking sector in the Baltics continues to develop and becomes more integrated with world financial markets, this is likely to change.

The vulnerability of the economic situation in the Baltic states is another argument against a very rapid credit expansion in the banking sector. If the country is hit by an exogenous shock, the outlook for many apparently profitable investments will change. A banking sector in the middle of a credit expansion will then have a harder time facing the shock and avoiding a bank crisis.

The 1997 Asian crisis offers a good example of the negative effects of exogenous shocks. That crisis was in large measure based not on unsustainable imbalances or bad policies, but on investor panic and the vulnerability of Asian countries to such a panic.[13] The Baltic states at the moment are just as vulnerable.

Conclusions

It is rather unlikely that economic development in the Baltic states will continue at the current pace without setbacks. We are likely to experience 'corrections' that will put credit growth in line with developments in the rest of the economy. Trade deficits are also likely to be corrected. Hopefully, export growth will pick up before such corrections occur or, in a worse case scenario, corrections will take place through decreased demand for imports, and the most severe solutions, such as devaluation, will not have to be used.

An important point to bear in mind is that there is not so much that the government can do about this. It is an inherent part of a fast development process. Still, there are some minor things that can help. First, to avoid a further worsening of the current account, the government should have at least a balanced budget during the years of rapid economic growth. Second, government institutions should not advocate a 'worry-free' future, since this gives the wrong signal to local consumers, especially consumers still unused to a market economy. Third, banking sector supervision should be based on realistic future prospects and forward-looking indicators. This is in contrast to the often-cited very low bad debt level in the banking sector of Latvia, which in the middle of 2002 was a mere 2.6 percent. If a negative shock hits the economy, this indicator is unlikely to be of any use.

[11] This is confirmed in Panel A of Figure 1, which shows that with exception of one quarter in Estonia and one quarter in Lithuania, from the second half of 2001 onwards import growth rates have exceeded export growth rates in all three Baltic states.
[12] See Sutela (2001).
[13] See Radelet and Sachs (1998).

Finally, we see setbacks in development processes in all developing countries (e.g. Asian countries, Latin American countries, other Eastern European countries). However, these setbacks are not all bad and often they represent needed adjustments. The factor that determines successful development is the speed with which a country recover from a crisis. Furthemore, a fast enough recovery often makes the crisis worthwhile. For example, some of the Asian countries have resumed fast growth since their crisis, as has Russia since its crisis. Also, the Russian crisis helped Baltic countries to re-direct exports towards EU. On the other hand, Argentina has been devastated by its recent crisis and is unlikely to recover anytime soon. Thus, the Baltic states should always be prepared for a crisis and make sure that they can recover from it fast.

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Has the Latvian Labour market become more efficient? Evidence from the Beveridge curve and the matching function[1]

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1. Introduction[2]

The paper is concerned with the process whereby the unemployed find a job and employers manage to fill vacancies and how the process depends on institutions. This process can be more or less efficient- if jobs are more easily found and vacancies are filled more quickly – the labour market is regarded as being more efficient. The Beveridge curve, which measures the equilibrium relationship between unemployment and vacancies, and the matching function, which measures the number of new hires from unemployment in a given period, are natural tools to use in an investigation of the impact of institutions and frictions on labour market outcomes.

The research reported here relates to the Latvian labour market, where the institutional change has involved nothing less than the transition from designation of workplaces to potential job-seekers in the Soviet system towards a search and hire market environment. The aim is two-fold: firstly, to investigate whether the Latvian labour market has 'normalised', that is behaves much like any other market economy labour market, and secondly, to see whether in the process the Latvian labour market has become more efficient in matching job-seekers to vacancies. The evidence suggests that indeed it has become more efficient, which is in contrast to developed market economies where labour market efficiency appears to have declined in recent decades.

The empirical investigation is centred on the period around and after the Russian crisis of 1998, which serves as a negative shock shedding light on the economic mechanisms at work by ensuring some variability in unemployment and vacancy rates.

2. A short overview of the Russian crisis of 1998 and the Latvian labour market

In August 1998 Russia devalued the *rouble*, defaulted on treasury bills (GKO) and on interest payments to several Paris Club creditors. Within a year the rouble price of Latvian *lats* (LVL) had risen more than four-fold. The rouble devaluation had a catastrophic impact on Latvian exports to Russia heralding the end of Russia as Latvia's most important trading partner.

[1] This research was supported by a grant from the CERGE-EI Foundation under a programme of the Global Development Network. All opinions expressed are those of the authors and have not been endorsed by CERGE-EI or the GDN.
[2] The authors would like to thank Linda Sproge, Central Statistical Bureau of Latvia and Ilze Berzina, Latvian State Employment Service, for helping to provide data on vacancies and matches as well as Alf Vanags, Baltic International Centre for Economic Policy Studies (BICEPS), for helpful comments and suggestions.

The Russian crisis represented a classic negative demand shock. Latvia enjoyed very high growth rates throughout 1997 and into 1998, but following the crisis growth slowed in the 3rd quarter of 1998 and in the 4th quarter of 1998 and the two first quarters of 1999 growth was negative. From 2000 growth rates have again been high.

In the labour market the unemployment rate (registered) hovered at around 6 -7% from 1995 through to second quarter of 1998, it then increased for ten months in a row. The following twenty months (until December 2000) saw unemployment rates decrease. It should be noted that the unemployment rate based on Labour Force Survey data has consistently been about twice as high as the official rate and that there are very large and persistent regional disparities in unemployment.

The Russian crisis, thus, represents a natural experiment to investigate the mechanisms at work in the reallocation of resources, including in the labour market.

3. Interpreting the Beveridge curve and the matching function

GDP and unemployment responded textbook-wise to the negative economic shock of the Russian crisis. But have other key economic relationships responded equivalently? This section attempts to investigate graphically the relationship involving unemployment and vacancy rates, namely the Beveridge curve. Although not exactly neglected, the Beveridge curve has been somewhat overlooked due to heavy emphasis on the Phillips curve. Blanchard and Diamond (1989), in their seminal paper, consider this wrong: "The Beveridge relation comes conceptually first and contains essential information about the functioning of the labor market and the shocks that affect it".

The Beveridge curve is the equilibrium relationship between contemporaneous job vacancies and unemployment, reflecting the segmentation and frictions of the labour market. It is an equilibrium of the following process. Each month a certain number of new hires from unemployment occurs. For this to be the case, there should have been some unemployed and some unfilled vacancies, which have been matched during that month. It is likely that not all picky jobseekers were able to find a suitable job and likewise some vacancies could need more than a month to identify the right applicant. Intuitively, it is easier to find a job if there are many vacancies and it is easier to fill a vacancy if there are many applicants – and thus unemployed. Consequently, a given monthly number of hires could be a search equilibrium result consistent with low unemployment but many vacancies or high unemployment and few vacancies and numerous intermediate cases. The Beveridge curve, thus, depicts the combination of vacancies and unemployed (or their rates), which gives rise to a fixed number of hires during a period.

The Beveridge curve summarises how, in equilibrium, unemployment and vacancies may coexist. This may be due to skills differences, so that an excess demand for one type of labour may coexist with an excess supply of another type of labour. In Latvia the huge lack of geographical mobility produces another source of mismatch between demand for and supply of labour. In addition, lack of information or an inefficient dissemination of information concerning available jobs may result in the coexistence of job vacancies and unemployment.

The search process in a labour market can be interpreted as the production of matches (hires from unemployment), where vacancies and jobseekers can be interpreted as inputs to the 'production process'. In aggregate, the process can be described by the matching function – a counterpart of the production function. The Beveridge curve then will be an analogue of an isoquant in production, that is, it represents the different combinations of unemployment and vacancies that generate a given number of matches. The Beveridge curve is therefore expected to be downward sloping in unemployment-vacancy space.

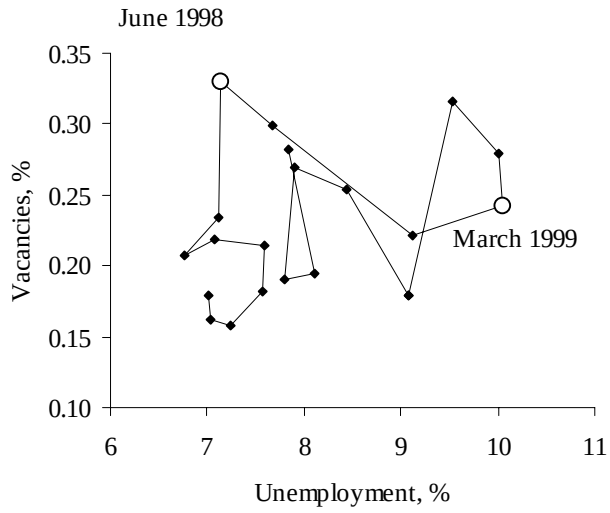
Following Blanchard and Diamond (1989), two types of shocks affecting this relationship may be mentioned: Shocks to economic activity when the rate of job destruction differs from the rate of job creation. This causes shifts in the Beveridge curve in a counter-clockwise direction (with unemployment on the horizontal axis). On the other hand reallocation shocks, which reflect changes in the intensity of reallocation of labour from one sector to another, induce outward (or inward) movement of the Beveridge as both job destruction and job creation increase (or decrease). Shifts in the Beveridge curve are not inconsistent with simple production function-type interpretation of the matching function, it is just that other factors affecting matching may be at work. The literature for Western Europe and North America has consistently found a secular deterioration of matching efficiency.

The Russian crisis constituted a negative activity shock to the Latvian economy with a subsequent reallocation shock. It caused an immediate drop in GDP and employment, which then recovered following the reorientation of production and exports towards Western Europe.

4. The aggregate Beveridge curve for Latvia

Figure 1[3] displays the aggregate Latvian Beveridge curve for June 1996 through June 2001. With GDP growth increasing during 1997 the rate of vacancies went up due to a higher demand for labour but with minimal impact downwards on the unemployment rate. The rate of vacancies peaked in August 1998, just before the Russian crisis. Then, as the crisis hit, the unemployment rate increased rather sharply while the rate of vacancies fell. This is fully consistent with what can be expected from a negative economic shock. As unemployment peaked in April of 1999 it seems that it became more easy to fill vacancies. As the unemployment rate fell again, reflecting the rather quick reversion to high economic growth, the demand for labour was again high, reflected in a higher rate of vacancies. Currently, the Latvian Beveridge relation seems to have reverted to where it was before the Russian crisis.

Figure 1. Aggregate Beveridge curve June 1996 - June 2001



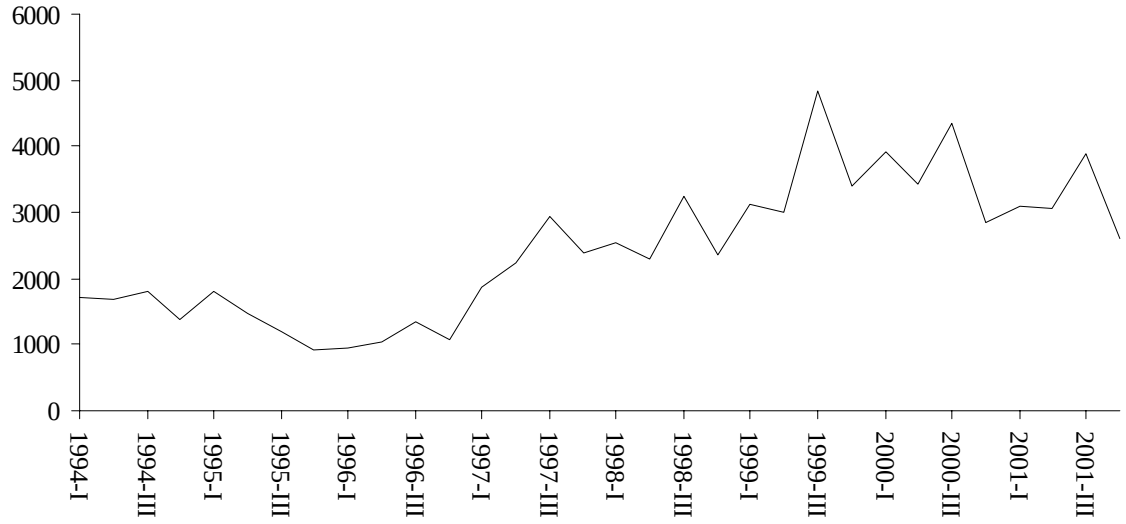
[3] The unemployment rate, calculated by the Central Statistical Bureau of Latvia is official unemployment, end of period, as a percentage of the labour force whereas the vacancy rate is number of vacancies, end or period, as a percentage of the labour force. Vacancies are collected by the Latvian State Employment Service.

Thus, not only did GDP development and unemployment respond to the Russian crisis as expected, but on a deeper level the Latvian economy also responded normally, in this case via easily interpretable movements in the Beveridge curve. Still, the plotted Beveridge relationship is a far cry from a well-behaved isoquant. This is because the number of hires could not have stayed constant during the observed period, and, indeed, did not. Moreover, there could be variables, other than jobseekers and vacancies, which also had a bearing on the resultant number of matches. To cope with these additional factors, it is convenient to resort to the concept of the matching function.

5. Estimation of a matching function for Latvia

The final level of analysis concerns estimation of a matching function for Latvia. In estimation, the unemployment rate used is registered unemployment at the end of the quarter. Vacancies are end of quarter unfilled vacancies. Matches measure the number of new hires from unemployment during a quarter. Hence a potential problem of misspecification arises. Unemployment and vacancies are both stock variables while matches is a flow variable. The pool of unemployed should be the right variable for measuring job seekers but total vacancies over a quarter would be a more appropriate variable than end of quarter vacancies[4]. Reporting of vacancies in Latvia is mandatory, unlike in USA and Western Europe, which contributes to the credibility of Latvian data. The data period employed is 1994-I – 2001-IV. Data before 1994 are notoriously unreliable, since unemployment in the early days of transition was severely understated. There are thus 32 quarterly observations. Quarterly series on matches, unemployment and vacancies are provided in Figures 2, 3 and 4 respectively.

Figure 2. Matches (hires from unemployment), 1994-2001



[4] The Latvian State Employment Service has started collecting the series of total vacancies but did not do so until 2000.

Figure 3. Registered unemployment, 1994-2001

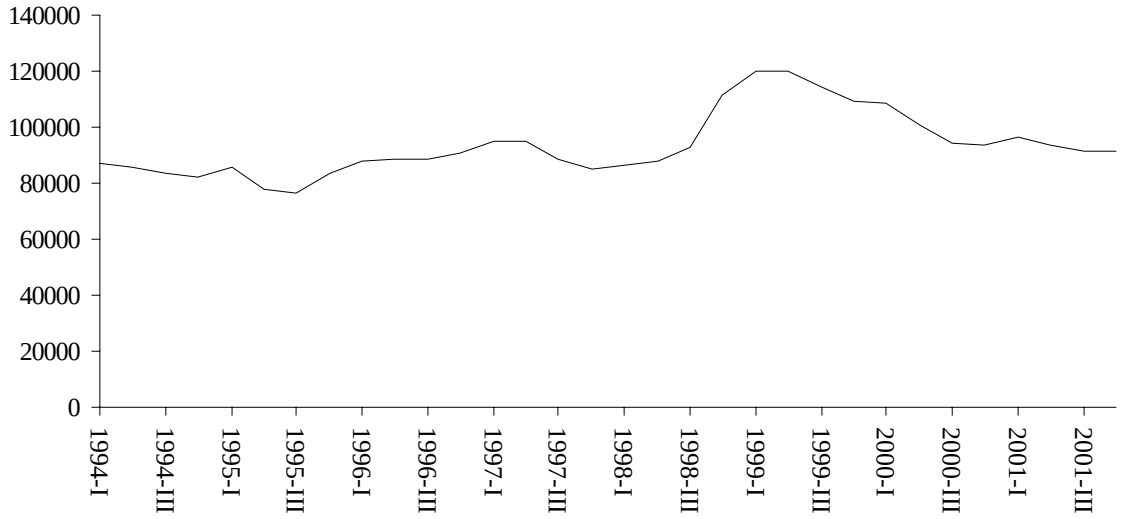
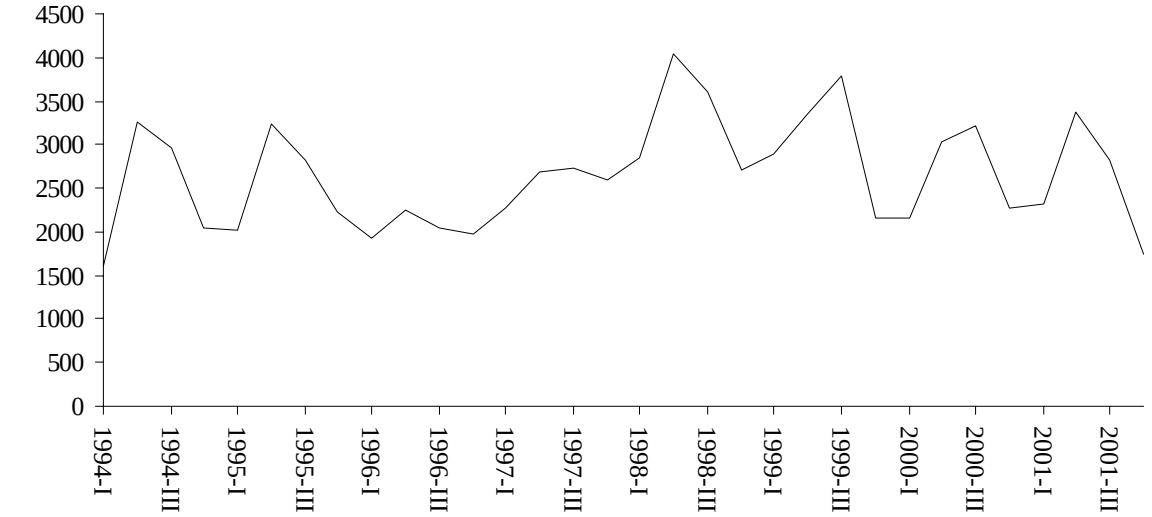


Figure 4. Reported vacancies, 1994-2001



A Cobb-Douglas specification for the matching function has been estimated:

$$\ln M_t = a + b\ln U_{t-1} + g\ln V_{t-1} + cT + e_t$$

Where *M* is matches. Since unemployment, *U*, and unfilled vacancies, *V*, are measured at the end of quarter, matches in period *t* are set to be a function of lagged *U* and *V*. *T* is a time trend, which may capture secular changes in the matching relationship. A simple OLS regression yields the following results (*t*-values are in parentheses):

$$\ln M_t = -14.8 + 1.7\ln U_{t-1} + 0.35\ln V_{t-1} + 0.024T$$
$$\quad\quad (2.55)\ \ (3.5)\quad\quad (1.6)\quad\quad (3.6)$$
$$R^2 = 0.75$$

This is a minimalist model. Nevertheless for numerous other specifications such as a squared time trend, seasonal dummies, and structural breaks the above result remains robust. Namely, the coefficient for unemployment is consistently significant and big, for vacancies it is insignificant, whereas the coefficient for the time trend is strongly significant and positive.

Here, signs for unemployment as well as for vacancies are in line with intuition. The elasticity for unemployment is very high compared to previous studies for Western Europe and North America where, depending on the specification of matches, the elasticity, b, is typically between 0.3 and 0.7. Further, $b - 1$ is a measure of the negative externality caused by unemployed persons on other unemployed persons (congestion). Here, it cannot be rejected that there is zero congestion so that the unemployed "do not step on each others toes" to get a job.

Likewise g, the elasticity for vacancies, is often associated with a positive externality of firms on unemployed persons, which gives rise to the thick-market effect: that is more vacancies represent a positive externality for the unemployed and a negative externality for other firms searching for workers. Here, there seems to be no thick market-effect. In short, unemployment seems to be what creates matches while new vacancies have no significant impact on hiring. Thus, there is a relative supply shortage in the labour market. In addition, although the estimated sum $b + g$ exceeds one, this is not significant, so that the hypothesis of constant returns to scale cannot be rejected.

It seems that in Latvia matches rely on the pool of unemployed. If vacancies are really insignificant for matches one might speculate that the labour market still fails to use this important variable to generate matches at a significant level, and hence may not yet be regarded as fully 'normalised'. However, the time trend, no matter which specification, is consistently highly significant and positive, which contrasts with all the evidence from Western Europe and North America.

A positive coefficient for the time trend indicates a secular increase in matching efficiency over time. Here is why this has been observed. Transition may in itself be seen as an enormous reallocation shock. Reorientation of production on a massive scale has taken place, leading to a similar reorientation in demand for labour with respect to different skills. It is easy to imagine, in the early days of transition, a labour market where firms may have been very uncertain with respect to which sort of labour they would need, where people may have been similarly uncertain with respect to which sort of labour they could actually supply and where, not least, the institutional framework for how job-seeking workers could meet firms seeking employees changed fundamentally. Or, put very simply, one would have expected the collapse of central planning to seriously disrupt the matching process in the labour market.

The finding of this paper is then that this disruption has been reversed, that matching efficiency is rising, which is what should be expected as the labour market normalises. Therefore a positive coefficient for the time trend can serve as a tentative test of normalisation of the labour market. Latvia passes this test.

While this result should be encouraging for transition economists as well as for policy makers a word of caution is appropriate. The result is based on 32 observations – transition still puts a limit on the amount of data for time series analysis. While the matching efficiency result is robust, the last word is certainly not said with respect to the Latvian matching function. Data on matches exist only as aggregate data for the whole country, therefore regional disaggregation or occupational disaggregation has still to rely on the casual observation of Beveridge curves.

6. Conclusions

This article has examined the Latvian labour market with respect to how it has adapted to a market economy environment. It has been shown that movements in the aggregate Beveridge curve following the Russian crisis can be interpreted according to theory.

A matching function for Latvia was also estimated (we believe for the first time here), that proved robust with respect to different specifications. The matching function indicates a secular increase in matching efficiency. As transition has proceeded, the labour market has transformed, making job seekers and employers more likely to have the proper knowledge and institutions, through which to meet each other.

Does the Latvian labour market, more than ten years into transition, show signs of normalisation? The analysis reported provides a qualified "yes" to this question. Another direct indicator of normalisation is the amount, variety, reliability and availability of data. In this respect the new series, starting from 2000 and collecting total vacancies (not only unfilled ones) per period, is welcome.

In conclusion, the emphasis on the coefficient of the time trend (improving efficiency) should not overshadow the seemingly large elasticity of matches with respect to unemployment. This elasticity may be overstated because in the current specification, the composition of the unemployment pool is not taken into account. Thus, for instance, secular fluctuations in unemployment are likely to be due to variation the numbers of short-term unemployed, who, by definition, are the major contributors to hires, while the long-term unemployed are a "dead weight". For the two types pooled together, slight changes in unemployment may lead to sizeable changes in matches inflating the elasticity with respect to total unemployment. Moreover, in Latvia the share of long-term unemployed in total unemployment is considerably higher than in most developed market economies. Therefore cross-sectional analysis of re-employment probabilities based on labour force surveys is an enticing direction of future research.

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Petrongolo, B. (2001). 'Reemployment Probabilities and Returns to Matching', *Journal of Labor* Economics, Vol. 19(3), pp. 716 – 741.

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ESTONIA

1 EUR = 15.64664 EEK (fixed)

Overview of developments and prospects

During the first quarter of 2002 Estonian GDP growth slowed down to 3.2%, mainly due to weaknesses in Estonia's main export partners. Domestic demand continued to underpin growth but its main engine – investment - was weaker than a quarter earlier. Private consumption in the first quarter grew by a modest 2.8% q-o-y. Such slow growth was surprising because employment figures were good and wages continued to grow strongly. The retail sector also suggested strong expansion.

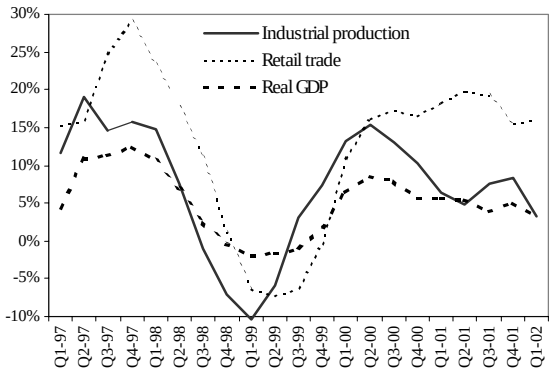
A favourable domestic investment climate and record low interest rates together with fast expansion in the construction sector and the growth of imported technology and equipment for domestic consumption boosted fixed capital formation. Thus, in the first quarter of 2002 investment was up by 5.1% as compared with the year before. Domestic investment was complemented by a stable and high inflow of foreign direct investment.

Investment is expected to grow further in 2002, especially in the government sector where large investments are expected in the energy sector together with other infrastructure and environment projects funded by EU pre-accession resources.

The public sector share in total domestic demand declined in the first quarter of 2002 despite the fact that public expenditure was higher than a year earlier because of higher EU accession fund related spending in the government budget.

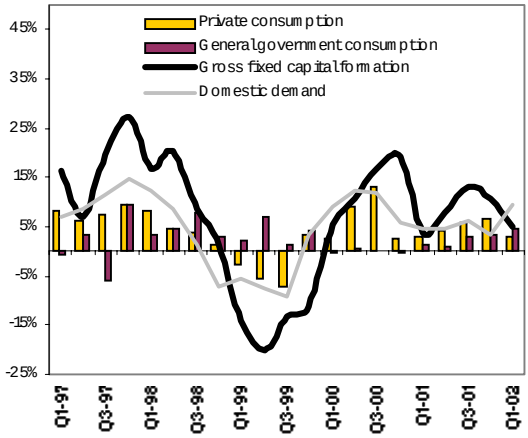
Industrial production grew moderately in January-February (3-4%), but dropped rapidly in March (-4.1%). The food processing industry in particular suffered because of demand decline in EU countries and Russia. During the second quarter strong domestic demand, particularly for construction materials and plastic products, led to an increase in industrial production.

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



Source: Statistical Office of Estonia

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



Source: Statistical Office of Estonia

Retail trade grew strongly in the first quarter of 2002, when the increase was 16.1% q-o-y basis and continued to increase through the first half of 2002. Sales of home equipment, furniture, cars and related goods grew particularly fast. The strong performance of the retail trade sector was influenced by good the labor market situation and affordable consumer loans.

Contrary to the forecasts of most analysts preliminary figures from the Statistical Office indicate that GDP growth in the second quarter was 6.5%. It appears that strong domestic demand combined with a favourable situation in the transit sector for Russian oil products, plus some modest recovery in Estonia's main trading partners, has produced a rapid recovery in GDP growth.

Prices

As is typical for the summer CPI inflation slowed down to +3.8% in June and +3.1% in July. Bearing in mind the low inflation in the Euro area, this implies some moderate price convergence. We foresee stabilisation of CPI growth at around +4% by the fourth quarter this year.

Declines in export, import and producer prices changes reflect the uncertain situation of the global economy. The export price index is difficult to interpret because of the somewhat surprising increase during the previous 12 months. However a decline of around 6% for fourth consecutive month is bad news for exporters and cannot be continue for much longer without causing some damage. Lower import and producer prices are welcome, and are a result of a weaker dollar and of falling oil prices, but cannot compensate for the negative effects of falling export prices. Regarding the much feared real estate bubble, there are signs of stabilization in the construction price index which shows an increase of +4.5% since the beginning of the year, as compared with +5.9% in the same period last year.

Labour

The declining unemployment trend continued in the first half of 2002 when the unemployment rate decreased from 11.2% in the first

quarter to 9.4% in the second quarter. Unemployment was also significantly smaller than in the second quarter of 2001 when the unemployment rate stood at 12.4%. Developments over the last five quarters mean that unemployment is back to same level as it was in the second quarter of 1997 (9.4%).

Total employment increased by 6,000 (1.1%) in the second quarter of 2002 as compared with the previous quarter, and as compared with the second quarter of 2001, it was up by 5,000 (0.9%). By sector, employment increased most in real estate, renting and business activities and trade.

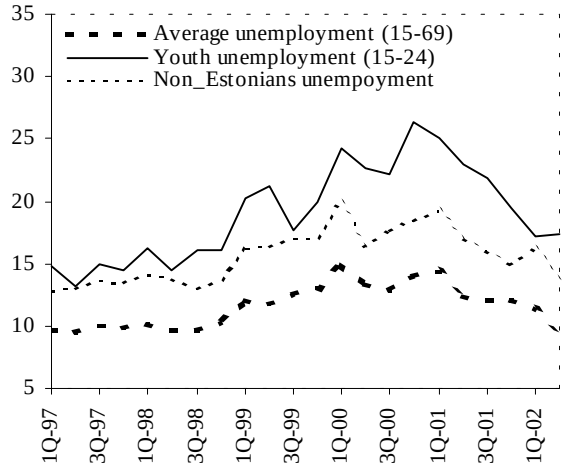
The number of inactive persons was also up by 16,000 (4%) as compared with the second quarter of 2001. This was largely because of growth in the number of people studying. However, the number of discouraged persons, which had increased up to the third quarter of 2001 and decreased in the next two quarters, increased again in the 2nd quarter of 2002 when the number of persons who had given up seeking a job stood at 19,200.

Although the general labour market situation has improved regional differences remain significant. The lowest unemployment remains in the area of the capital (Harju county) where unemployment was 8% in the second quarter of 2002 and highest in Ida Virumaa (in the North East of Estonia) where unemployment was 15.5%. Future prospects for the labour market look good and in we expect average unemployment in 2002 to be lower than last year.

Foreign trade

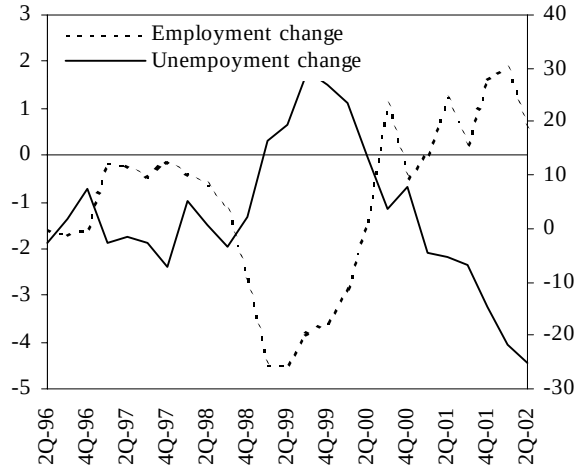
It is useful to evaluate the Estonian export performance in two different ways. One way is to consider the whole export sector including electronics components and the other is to exclude electronics components. It is clear that export volumes as a whole have declined despite a brief pause in April, when export volume was 1% higher in April 2001. However, since then the decline has continued – in May it was 12% and in June 14.4 % down as compared with the same period year ago. During the first half of 2002 export volume was 14.2 % less than a year ago.Thus the slowdown in the world economy

Total unemployment, youth unemployment and unemployment of non-Estonians



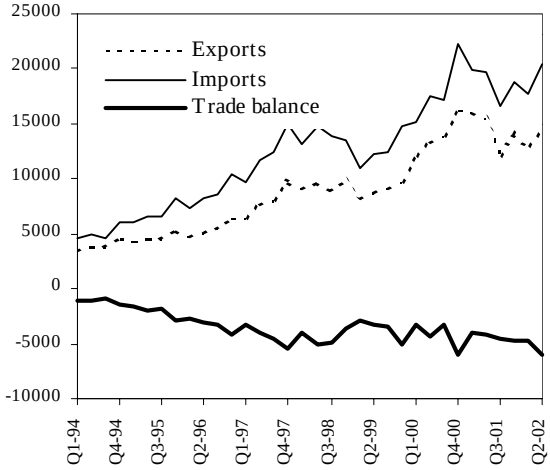
Source: Statistical Office of Estonia

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



Source: Statistical Office of Estonia

Foreign trade (mn EEK)



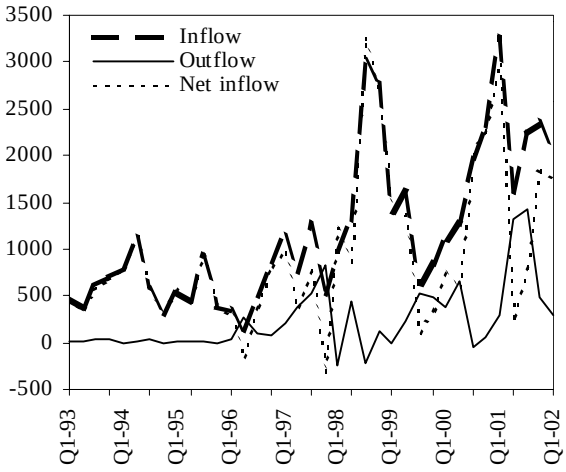
Source: Statistical Office of Estonia and Bank of Estonia

has affected Estonian exports, but this can be confined mainly to the electronic and telecommunication component sector. Other export sectors are competing quite successfully on the world market. Estonian exports without the electronic equipment (section XVI by Harmonised System) increased in the first half of 2002 by 8.3% as compared with the same period year ago. The export volume of sectors other than electronics has even increased in the second quarter. The most rapidly growing export groups as compared with the first half of 2001 were the production of components for the automotive industry (30.8% increase), furniture (15.7%), optical and precision equipment (9.7 %); paper products (8.2%); wood (7.5%) and textiles 4%. The positive situation in traditional export sectors is also reflected in the increase of employment in these sectors during the first half of 2002.

In the previous report it was mentioned that the situation in the electronic machinery and component sector was also improving. This remains a slow process, but one which continued also during the second quarter of 2002. In the first quarter of 2002 the export of these products was only 42.8 % of the level experienced during the same period a year ago. But during the second quarter this had increased to 52.8 % of the level a year ago. This suggests that step-by-step Estonian telecommunication and electronic component producers are finding niches on the world market.

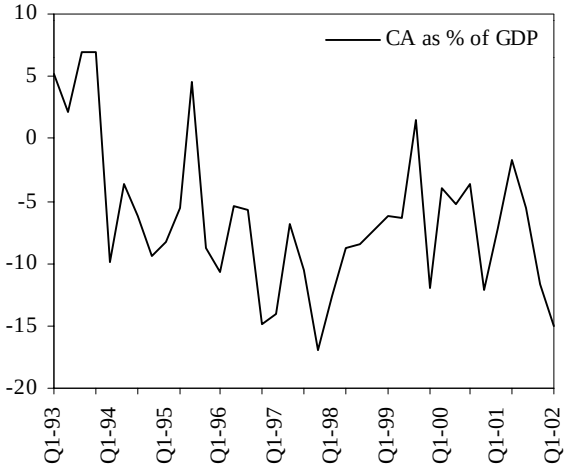
Interesting changes in the Estonian export structure are expected from the autumn of 2002, when in Muuga port, close to Tallinn a big producer of galvanized sheet steel Galvex will commence production. Galvex has a huge plant constructed at a cost of 3.8 bn EEK with an annual capacity of 3 million metric tons of galavnized steel. Materials will be imported from Russia and Ukraine and sold on the world market. Galvex is a subsidiary of International Steel Industries Ltd. In the current situation of the world market for steel products this may prove to be a risky venture.

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



Source: Statistical Office of Estonia and Bank of Estonia

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



Source: Bank of Estonia

Foreign investment

The Estonian current account deficit has persistently worsened since the second quarter of

2001, reaching 15.0% of GDP in the first quarter of 2002. In previous years the current account has normally improved in the early part of the year as compared with the end of the previous year, but this was not the case in 2002. Behind the negative trend is growing trade deficit, which was not covered by the surplus of service balance. Another reason for growing current account deficit is also a growing deficit in income balance, which reflects growing income earned by foreign residents in Estonia. In Q1-2002 the income from the direct investments of foreign investors in Estonia was 1.6 bn EEK of which 1.1 bn was reinvested. This is proof of the increasing profitability of foreign owned firms in Estonia and also an indicator of the attractiveness of the investment climate. The first quarter 2002 current account deficit was covered by the combined inflow of direct and portfolio investments so that balance of payment as a whole was positive and Estonian international reserves increased by 0.8 bn EEK.

However the Bank of Estonia has given several warnings about the potential dangers of a too liberal lending policy by the commercial banks and of government induced overheating of the economy by two supplementary budgets in 2002. Since January 2002 Bank of Estonia has published monthly balance of payments data. According to these data the current account deficit declined to the 10% of GDP in the second quarter of 2002.

The FDI inflow in first quarter of 2002 was 2.0bn EEK,of which 37 % was equity investment, 54% was reinvestment into existing firms and 9 % loans to subsidiaries. Thus reinvestments played a major role but the importance of loans to subsidiaries has declined.

As is traditional, around 60% of FDI came from Sweden and Finland. The financial sector was the leading recipient (44% of all investments) followed by transportation and telecommunication (27%) and manufacturing (12%). According to the monthly balance of payment data of Estonian Bank the second quarter FDI inflow was still around 2bn EEK.

At 287mn EEK the first quarter outflow of direct investment from Estonia was modest. Lithuania, with 63% of all Estonian outward

investments, was the major destination. Preliminary figures from the Bank of Estonia show that, in the second quarter of 2002, outward investment increased to 660mn EEK. This is related to the further investment by Hansapank into the Lithuanian Taupomasis Bankas and also to several investments into the Lithuanian manufacturing sector (metal work, transportation equipment).

Enterprises and banks

Borrowing is on the rise again – the loan portfolio of Estonian banks increased by +7.2% from March to June, and the y-o-y figure for the second quarter of 2002 is up by +20.6%. Interestingly, the biggest rise comes from the government (+26.7%), individual lending follows with only a +9.2% increase from March to June. These figures are somewhat counter-intuitive in the light of the surplus in tax collection and a common belief in over-consumption.

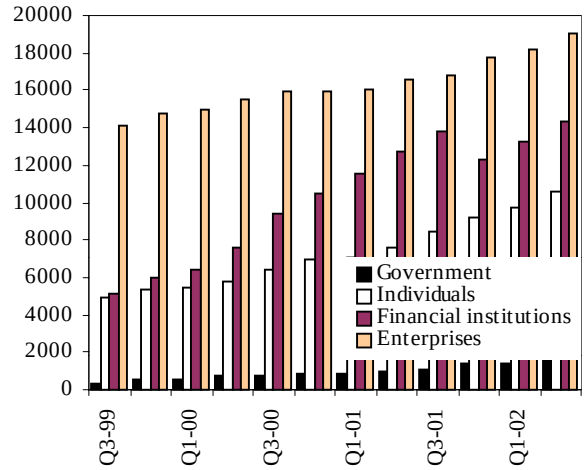
Interest rate movement on credit to individuals shows some evidence that banks have started to tighten borrowing conditions. The rate climbed to 11.7% in July from 9.6% just a month earlier.The tightness of the credit market is also reflected in the difference between total deposits and loans, which has fallen to a level of 671 mn EEK (1.5% of the loan portfolio) by the end of the second quarter Bearing in mind that bad loans are 4.7% of the loan portfolio this is potentially worrying.

In June the Estonian central bank issued a warning questioning the sustainability of credit developments, pointing at the impact of the ongoing loan boom on the current account deficit. However, taking into account the slower increase in the money supply, the interest rate movements and behaviour of different price indexes, we believe that the economy already has adequate incentives to enter a phase of self-stabilisation with more cautious investment and consumption spending. We therefore question the need for additional contractionary policies by the monetary authorities (which by definition would create distortions).

The budget

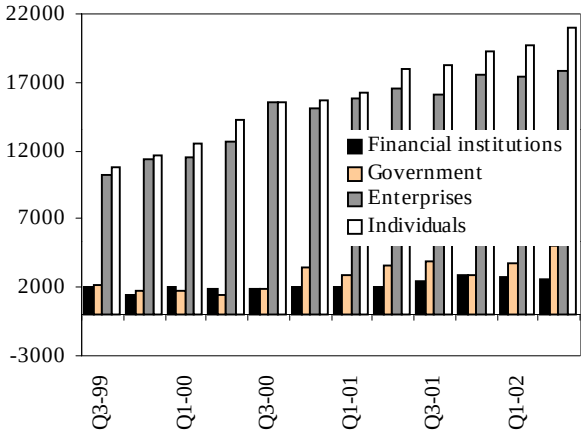
First quarter 2002 government revenues grew

Decomposition of the loan portfolio (mn EEK)



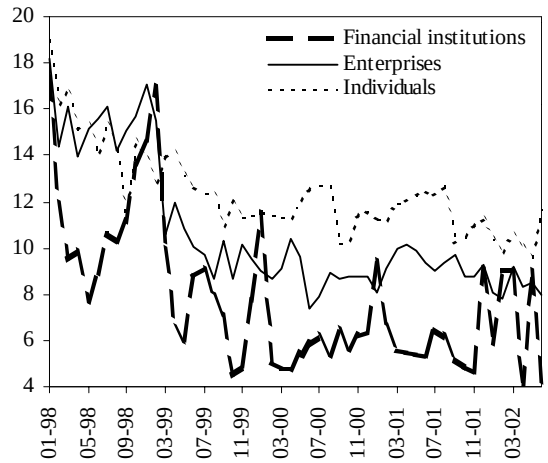
Source: Bank of Estonia

Decomposition of deposits in banks (mn EEK)



Source: Bank of Estonia

Interest rates (%)

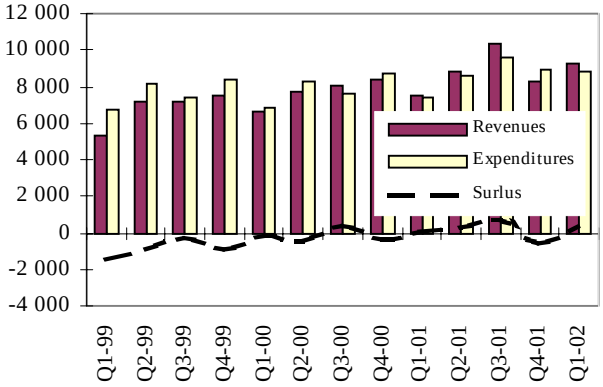


Source: Bank of Estonia

more than expected due to the strong growths in domestic demand, wage growth and positive employment developments. Revenues from tax on profits and social tax particularly good increases. Tax revenues have continued perform well during the whole first half of 2002.

Income from excise taxes improved due to stronger control over companies (alcohol) and expected increases of tax rates in the second half of the year (tobacco). At the same time the government expenditures have been seasonally low as transfers and tax reimbursements will take place in the second half of the year. As a result, the government sector ran a surplus of 383mn EEK in the first quarter of 2002. Accumulated budget revenues allowed government to accept additional budget expenditures of 404.7mn EEK (1.2% of the total central government budget). During the second quarter the collection of budget revenues has been also very successful and in August the budget surplus was around 2bn EEK. The government intends to adopt a second supplementary budget of around 780mn EEK in late September.

General government budget (mn EEK)



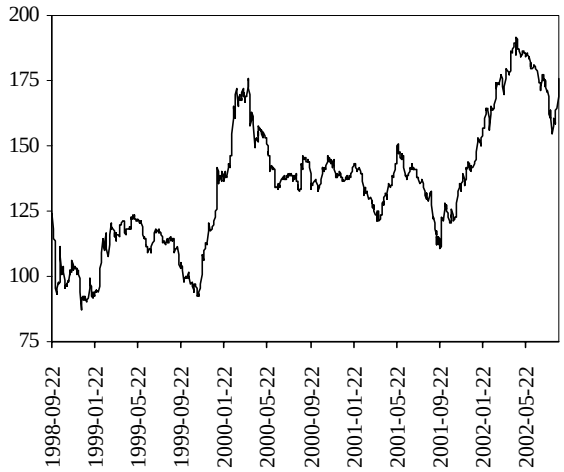
Source. Ministry of Finance and Bank of Estonia

Money and the exchange rate

The increase of M2 in the second quarter was modest, the y-o-y change was just +15%. The main engine was an increase in government deposits, followed by a rise in the deposits of individuals. M0 appears to be on a decreasing long-run trend as a result of lesser demand for cash related transactions.

The real exchange rate has started to appreciate – by the end of second quarter the REER increased by +4.2% on y-o-y basis. This somewhat problematic tendency is a direct result of USD/Euro exchange rate changes and can also be seen in export-import price indexes.

Tallinn Stock Exchange index (TALSE)



Source: Bank of Estonia

Financial markets

The problems of world markets, which are struggling with reestablishing the trust of the investors, have been transmitted to the Estonian stock exchange. The TALSE fell steadily from 191.33 at the end of April to 154.25 in August, which is the same level as in the beginning of the year. We believe that the fundamentals of the Estonian economy are still strong, and perhaps this is also reflected in the

quick recovery to of the TALSE ti 175.83 by the 23rd of August. Market experts say that in many cases foreign investors were selling and locals were buying. We see rationality in the behaviour of domestic investors and expect the Estonian stock market to end the year with good results. The main reasons for this belief are the results posted by listed companies and also the absence of problems with creative book keeping in the case of Estonian companies.

Key Economic Indicators

	1998	1999	2000	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2
Population (mn. mid-year)	1.43	1.41	1.37					1.36	1.36	1.36
Gross Domestic Product										
Nominal GDP (bn EEK)	73.54	76.33	87.23	22.37	21.92	25.810	24.53	24.31	24.13	
Nominal GDP (bn USD)	5.23	5.19	5.13	1.24	1.29	1.44	1.39	1.39	1.35	
Nominal GDP per capita (USD)	3772	3776	3751							
GNP per capita (USD at PPP)	7563	8190	-	-	-	-	-	-	-	
Aggregate Growth Indicators										
Real GDP (%)	4.6	-0.6	7.1	5.7	5.7	5.5	3.9	5.1	3.2	6.5
Private consumption (%)	4.3	-2.9	6.5	2.7	3.0	4.2	5.8	6.5	2.8	
Government consumption (%)	4.5	3.8	0.1	-0.3	1.3	1.1	2,8	3,3	4.7	
Gross fixed investment (%)	11.3	-14.8	13.3	19.3	3.8	7.9	13.0	10.7	5.1	
Industrial production (%)	3.20	-1.65	12.82	10.27	6.33	4.78	7.56	7.80	1.90	10.4
Agricultural production (%)	-4.99	-8.21	-	-	-	-	-	-	-	
Stabilization Indicators										
Consumer prices (avg. %)	10.58	3.30	4.02	5.38	5.89	6.71	6.05	4.38	4.30	
Unemployment rate (avg. %)	9.88	12.30	13.68	13.90	14.20	12.40	12.00	11.90	11.20	9.40
Average nominal wages (EEK)	4100	4418	4876	5279	5100	5775	5300	5879	5721	6353
Average nominal wages (USD)	292	301	287	293	298	318	306	337	322	372
Budget balance (% of GDP)	0.04	-4.19	-0.10	-0.39	-0.31	1.94	2.87	1.89	-	
Exchange rate EEK/USD (avg)	14.075	14.678	16.969	18.002	17.132	18.136	17.317	17.466	17.841	17.077
Exchange rate EEK/USD (end-period)	13.410	15.562	16.820	16.820	17.770	18.473	17.056	17.692	17.800	15.778
Trade and Balance of Payments										
Total exports fob (bn USD)[1]	2.68	2.52	3.32	0.92	0.95	0.87	0.71	0.79	0.72	0.84
Total imports fob (bn USD)	3.80	3.34	4.10	1.19	1.12	1.05	0.93	1.06	1.00	1.19
Trade balance (bn USD)	-1.12	-0.82	-0.78	-0.27	-0.18	-0.18	-0.22	-0.27	-0.28	-0.35
Current-account balance (bn USD)	-0.48	-0.25	-0.32	-0.15	-0.09	-0.03	-0.08	-0.16	-0.20	-0.16
Foreign Debt and Reserves										
Foreign debt (end-period. bn USD)[2]	0.2	0.2	0.1	-	-	-	-	0.1	0.1	0.2
International reserves (end-per. bn USD)	0.81	0.86	0.92	0.92	0.74	0.75	0.77	0.82	0.86-	0.85
Foreign Investment										
FDI inflows (bn USD)[3]	0.573	0.303	0.392	0.128	0.191	0.085	0.151	0.128	0.121	0.118
Cumulative FDI inflows (bn USD)[3,4]	1.192	1.495	1.887	1.892	2.083	2.168	2.319	2.447	2.568	2.684
Portfolio investment (bn USD)	0.007	0.140	0.076	-0.009	0.081	0.030	-0.014	-	-0.054	0.109
Monetary Growth										
M2. %[5]	4.21	23.50	25.11	1.55	5.23	5.63	3.10	7.98	0.29	3.01

[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.
[5] The definitions of monetary aggregates from 1993 and onwards have been changed.

LATVIA

1 EUR = 0.595 LVL (September 2002)

Overwiev of developments and prospects

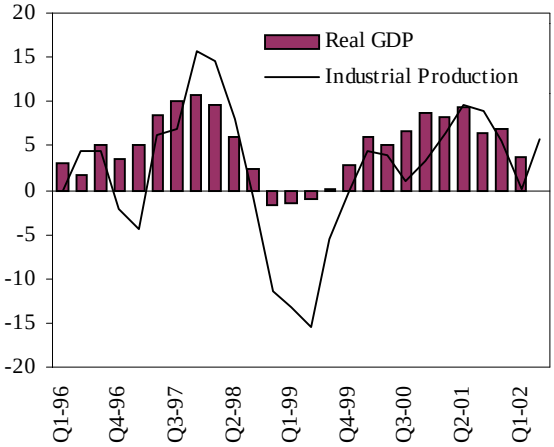
Recent economic performance in Latvia continues to be positive. In the first quarter of 2002, GDP growth was 3.8% as compared with the same period a year ago and in the second quarter it was 4.9%, yielding 4.4% for the first half of the year. The government expects that growth for 2002 as a whole will be in the region 4-5%. Unemployment has slightly decreased and inflation remains low. Foreign direct investment is at a high level. Fiscal policy is developing positively, with budget revenues growing faster than expenditures. Nevertheless, it should be noted that Latvia's growth continues to be driven predominantly by domestic demand and increased borrowing activity.

Although the growth rate of the first half of 2002 is down from the 6.4% and 6.8% growth experienced in the third and forth quarters of last year, it is still well above current growth levels in Europe. The main contributing sectors in the first quarter were: 8.9% annual growth in trade (share in GDP structure 19.3%), 6.8% in construction (4.2%), 4.1% in business services (11.2%) and 2.9% in manufacturing (15.0%).

During the first half of 2002, Latvia's fiscal position has improved. The budget deficit has decreased considerably as revenues – led by improved tax collection – have grown faster than expenditures.

Meanwhile, the current account deficit remains a potential problem. In the first half of 2002 the current account worsened considerably as compared with a year ago, but on the positive side, the entire current account deficit was covered by foreign direct investment inflow. The trade deficit continues to widen. Economic slowdown in Europe has reduced the demand for Latvian exports, at the same time rising local consumption has increased the demand for imports.

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



Source: Central Statistics Bureau of Latvia

In the privatization field, the second quarter of 2002 saw the public auction for cash of "Latvijas Kugniecibas" (LK) – Latvian Shipping Company – shares. It was no surprise that "Ventspils Nafta" (VN) emerged as the majority owner of LK, purchasing close to 50% of LK shares for LVL 0.35 per share (36% of the book value of equity). The next major privatization move is likely to involve sale of the remaining 37% of state owned shares in "Ventspils Nafta" itself. It remains to be seen whether the state will gain much from this deal, because the current VN majority owners, "Latvijas Naftas Tranzits" (LNT) have no interest in selling the state's shares for the highest possible price. Moreover, LNT is in a position where no major decision regarding VN can be taken without their consent.

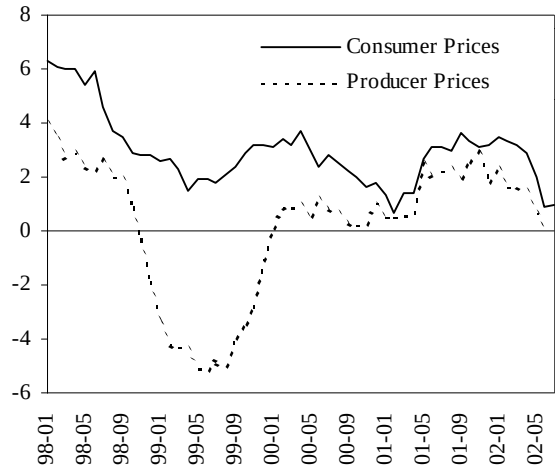
The political parties have entered the finishing straight before the October 5 parliamentary election. A total of 20 parties and 1020 candidates will be hoping to enter the *Saeima*. According to latest opinion polls party "Jaunais Laiks" (*New Era*), led by former Central Bank governor Repse, has the highest rating (16.8% would vote for his party), followed by the leftist party, PCTVL (*For Human Rights in a United Latvia*)(13.3%), and Tautas partija (*Peoples Party*) (10.8%).

Prices

In the second quarter, 2002, consumer prices increased by 1.9% as compared with the same period a year ago. As anticipated, the inflation rate decreased due to the slowdown in economy (the year-on-year inflation rate in the first quarter, 2002, was 3.3%). This may be regarded as a good corrective sign.

The main individual changes at the end of June 2002 as compared with a year ago were: in alcoholic beverages and tobacco (+2%), educational services (+7.1%), and medicaments and healthcare (+4.3%). Meanwhile, in clothing and footwear (-2.4%) and communication services (-8.1%) prices decreased. The rather significant drop in the prices of communication service was a consequence of the ongoing price war between Latvia's two largest mobile service providers (LMT and Tele2).

Price indices (% change over same period previous year)



Source: Central Statistics Bureau of Latvia

In the second quarter of 2002, producer prices increased by just 0.8% as compared with the same period a year ago. This indicator has decreased as compared with previous periods: in the first quarter of 2002 producer prices increased by 1.8%, year-on-year, and in the last quarter of 2001 by 2.4%. We expect producer prices growth to remain at around 1% in the nearest future.

Labour

The registered unemployment rate remains stable at around 8% of the economically active population. It increased slightly during the first months of 2002 (8.2%), but reverted to 8% in the second quarter of 2002 (and even 7.9% in June). Nevertheless, the current unemployment rate is higher (8.1% in the first half of 2002) then it was in the second half of 2001 (7.7%). Given the overall economic situation – somewhat slower growth but no signs of serious slowdown – we expect the unemployment rate to remain stable at around the 8% level.

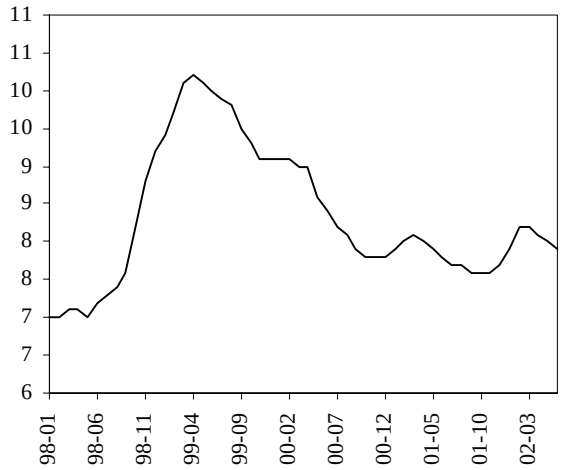
At the end of the second quarter of 2002, females made up 59% of the total number of unemployed and long-term unemployed (persons unable to find a job for more than a year) constituted 25% of the total. The highest unemployment rates (above 20%) continue to persist in the Eastern regions of Latvia.

At LVL 162 (USD 253), average gross monthly wages and salaries in the first quarter of 2002 were up by 8.3% as compared with a year ago.

Foreign trade

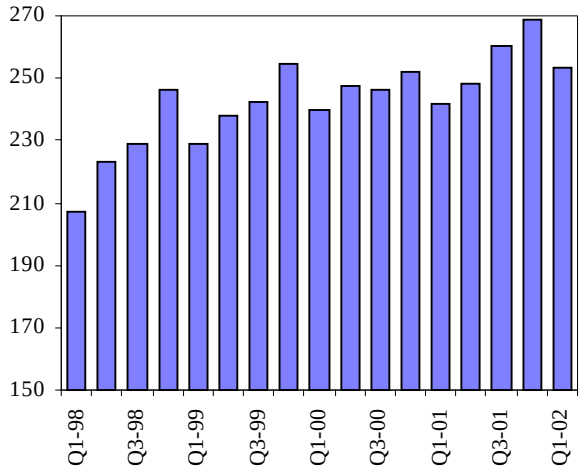
The trade deficit improved slightly during the first quarter of 2002 (17.4% of GDP) as compared with 23.3% during the last quarter of 2001. But this improvement seems to be a seasonal effect, i.e. the trade deficit always improves in the first quarter of the year (in the first quarter of 2000 the trade deficit was 16.5% of GDP). In the first half of 2002, exports rose by only a sluggish 4.8% (to 1.1 bn USD) as compared to a year ago, mainly because of the economic slowdown in Europe. Meanwhile imports rose by 11% (to USD 1.8bn) on a yearly basis.

Registered unempoyment (% of economically active population)



Source: Central Statistics Bureau of Latvia

Average monthly gross wages and salaries (USD)

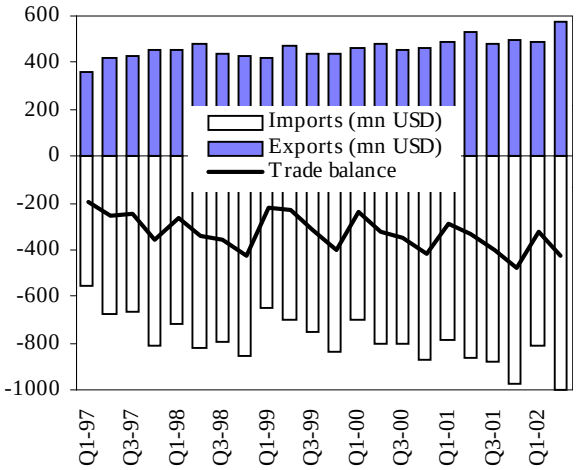


Source: Central Statistics Bureau of Latvia

This pattern – with import growth much higher than export growth – gives rise to some concern. It reflects the fact that economic growth has been driven primarily by domestic consumption demand, and is not supported with comparable export growth to the EU where economic problems have caused import demand to fall. Unless Latvia manages to recover demand in the EU or to temporarily redirect its exports to the East or to reduce the domestic demand for import goods, the trade deficit will remain large.

The EU share of exports in the first half of 2002 was 60%, and the CIS markets had 9.9%. This represents a decrease in export share to the EU from close to 70% at the beginning of 2001. Latvia's main export partners remain Germany (15.5%), Great Britain (15.1%), Sweden (10.7%), Lithuania (8.6%), and Russia (6.1%).

Exports, imports and the trade balance (mn USD)

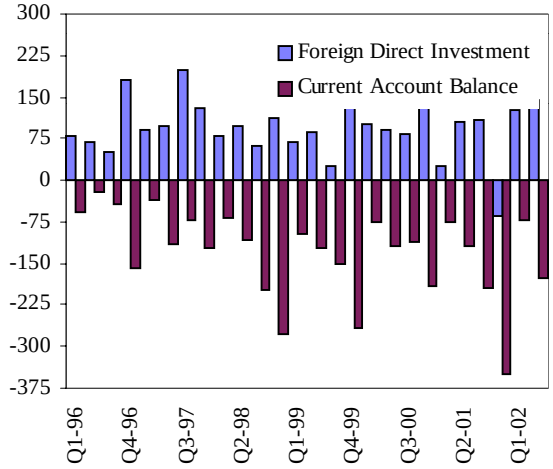


Source: Central Statistics Bureau of Latvia

Foreign investment

The inflow of foreign direct investment (FDI) in the first half of 2002 was USD 272 mn (USD 126 mn in the first quarter and USD 146 mn in the second), which is up by 108% as compared with a year ago. FDI fully covered the current account deficit, which amounted to USD 247 mn in the first 6 months of 2002. Most of the inflow came in form of equity capital. For example, in the second quarter of 2002, the acquisition of shares in Latvijas Kugnieciba by non-residents accounted for USD 37 mn of the inflow. It should be noted that part of this FDI inflow might be *artificial*, because 33% of Latvijas Kugniecibas shares were acquired via trust companies and offshore companies, meaning that the true owners might actually be of local origin. Nevertheless, the overall situation with foreign direct investment inflow can be regarded as rather satisfactory.

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



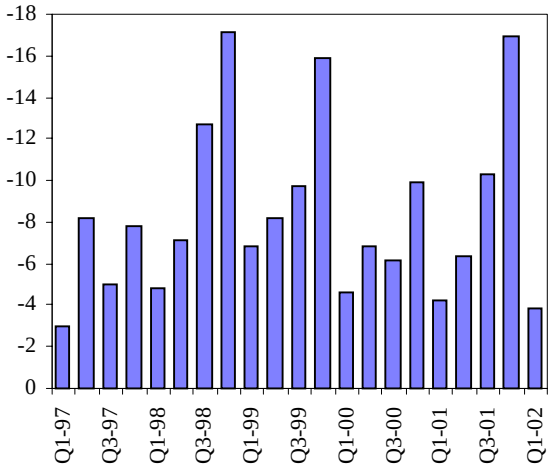
Source: Central Statistics Bureau of Latvia

In the second quarter of 2002, the net outflow of portfolio investment was LVL 62.9 mn. Portfolio investment abroad by residents increased by LVL 69.7 mn, while non-resident portfolio investment in Latvia rose only by LVL 6.8 mn. We may draw some parallels with the artificial FDI inflow here; it is possible that some localinvestors transferred funds into offshore accounts in order to participate in the privatization of Latvijas Kugnieciba.

The current account deficit in the first half of 2002 was USD 247 mn (USD 72 mn and USD 175 mn, in the first and second quarters, respectively), which is 28% higher as compared with a year ago. The deficit represents around 6% of first half GDP, up from only 3.9% in the first quarter. The sharp increase in the current account deficit during the second quarter of 2002 was caused by a combination of: i) a decline in the service surplus and ii) persistent widening of the trade deficit. In the first half of 2002, the services surplus covered around 50% of the goods deficit.

Controlling the current account deficit remains a major challenge for the government, particularly given Latvia's aim of EU accession, since this is one of the indicators closely watched by international observers.

Current account deficit (% of GDP)



Source: Central Statistics Bureau of Latvia

Enterprises and banking

The main event in the second quarter of 2002 was the public auction of 51% of "Latvijas Kugniecibas" (LK) shares. As predicted here, "Ventspils Nafta" (VN) emerged as the majority owner. Currently, "Ventspils Nafta" owns close to 50% of LK shares. Moreover, LK shares were acquired for a very low price of LVL 0.35 per share, which is only 36% of the book value of LK equity. This implies a tremendous wealth redistribution from the state towards private individuals connected with the Ventspils enterprises.

The next step in this wealth redistribution strategy is to acquire the remaining state share (37%) in VN. Meanwhile, Ventspils, Aivars Lembergs, who very likely is a significant indirect shareholder (through offshore companies) in Ventspils enterprises, has publicly announced that for practical purposes VN privatization is finished. The state's 37% of votes in VN give it no rights to determine strategy, dividend policy or any other significant decisions. According to the BNS News Service, August 2002, Lembergs emphasized that no major shareholder will emerge without an agreement with "Latvijas Naftas Tranzits", one of the Ventspils group enterprises, and currently the majority owner of VN.

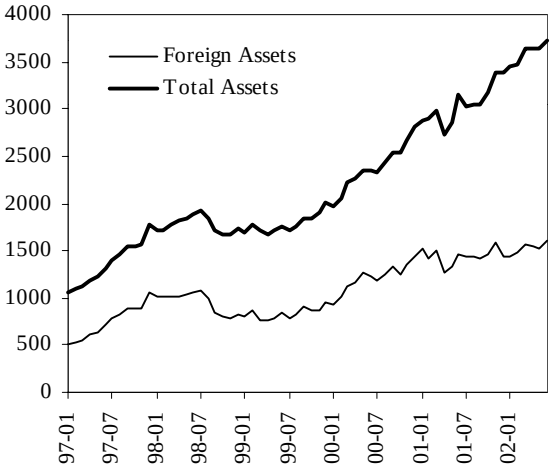
In the second quarter of 2002, the banking sector continued to grow rapidly. There was particularly strong growth in mortgage and consumption lending. At the end of June 2002, mortgage loans granted to private individuals had increased by 17.9% as compared with the end of 2001. Consumption loans had increased by 19.1% in the same period. The annual growth rate of loans was 41.2%. Increased bank competition in the lending market has exerted downward pressure on interest rates. At the end of June 2002, the weighted average rate on short-term loans in lats dropped to 7.8% and on long-term loans in lats it was 8.5%.

This pattern causes some concern. It is clear that Latvia's good economic growth performance has been led primarily by domestic demand driven consumption, with negative implications for both trade and current accounts. Nevertheless, the banking sector seems to be very pleased with the current situation. The demand for loans is sustained by higher increased deposits and to receive time deposits banks offer advantageous conditions to the public, and as a result the weighted average interest rates on time deposits have risen slightly.

In the first half of 2002, the commercial banks earned USD 273 mn, which is 5.6% more than in the corresponding period a year ago. The biggest part of revenues came from interest income (59.4%) and commissions (24.1%). The aggregate profits of Latvian banks in the first half of 2002 were USD 39 mn, which is 16.9% more than in the corresponding period a year ago. This pattern reveals that banks have managed to improve their efficiency, i.e. profits have grown faster than revenues.

The assets of the Latvian commercial banks at the end of the first half of 2002 were USD 6.3 bn, which is a 10.7% increase as compared with the end of 2001. The total value of deposits was USD 4.4 bn (+13.5%). The total value of loan portfolios was USD 3 bn (+12%). The capital and reserves were USD 0.6 bn (+11.8%). The three largest banks (by asset value) are Parex Bank, Unibanka and Hansabanka; jointly controlling 54.4% of the market.

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



Source: Central Statistics Bureau of Latvia

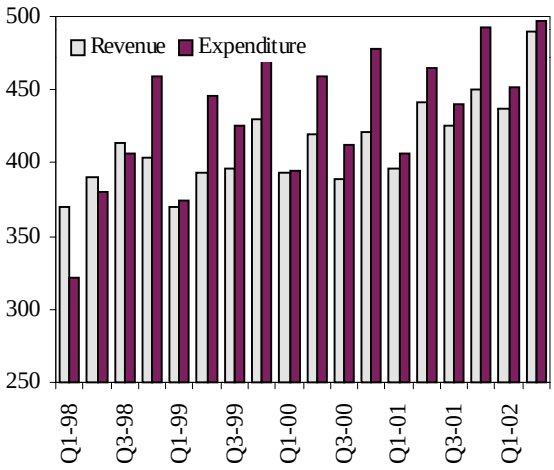
The budget

The budget deficit in the second quarter of 2002 was LVL 6.6 mn. Budget revenues were LVL 490 mn (+10.9% on annual basis), and budget expenditures were LVL 496 mn (+6.7%). We note positively that budget revenues have been growing faster than expenditures. The revenue side particularly gained from social security contributions, payments for using State capital, and the repayment of loans granted from the central government basic budget. The expenditure side was influenced by the fiscal deficit in the basic budget of the local government of Riga. The budget deficit in the first half of 2002 was LVL 21.4 mn, which is by LVL 11.5 mn lower than in the corresponding period a year ago.

With the exception of the enterprise income tax, collection of all taxes has improved considerably. In the first five months of the year, revenue from value added tax, personal income tax and excise taxes increased (if compared with a year ago) by 15.2%, 12.8% and 11.6%, respectively. Enterprise tax receipts have decreased due to the cut in corporate income tax from 25% to 22%. Nevertheless, the decrease in the corporate income tax rate should be considered a positive long-term factor for local businesses.

At the end of the first half of 2002, central government debt was LVL 0.74 bn (USD 1.2 bn) which is 16.7% up year-on-year. Of this, external debt amounted to USD 759 mn, a 35% annual increase. In the second quarter of 2002, domestic debt rose due to the issue of 5-year Treasury bonds. The annual increase in external debt is the result of an issue of EUR 200 mn worth of 7-year Eurobonds in November 2001.

Central government revenues and expenditures (mn LVL)



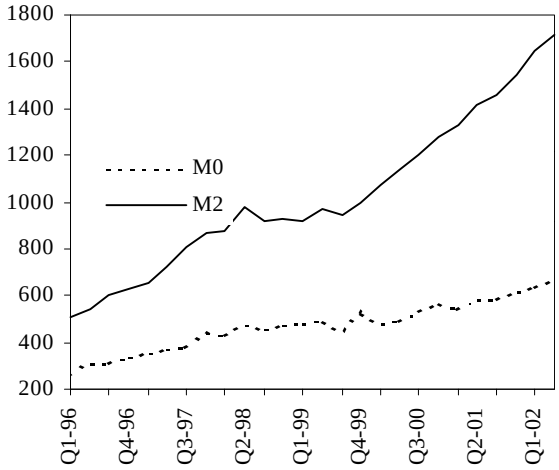
Source: Central Statistics Bureau of Latvia

Money and the exchange rate

At the end of the second quarter of 2002, the monetary base (M0) was LVL 666 mn, representing a 13.6% annual increase. Broad money (M2) has increased by 21% and reached LVL 1.7 bn. Increases in demand and time deposits (annual growth of 26.7%) in the banking sector caused the rise in broad money.

Money market rates remained stable throughout the second quarter of 2002. The 3-month inter-bank offer rate (RIGIBOR) was around 4.25%, and the 6-month rate – at around 4.5%.

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



Source: Central Statistics Bureau of Latvia

The weighted average interest rate of inter-bank loans in lats fell slightly to 2.8%.

International reserves at the Central Bank continue to grow. At the end of June 2002 they stood at USD 1.2 bn and covered around 112% of the monetary base and 4.5 months of imports.

Because of dollar weakness in global currency markets, the national currency appreciated against the US dollar, reaching 0.608 LVL/USD in mid-September 2002, after touching even lower levels earlier.

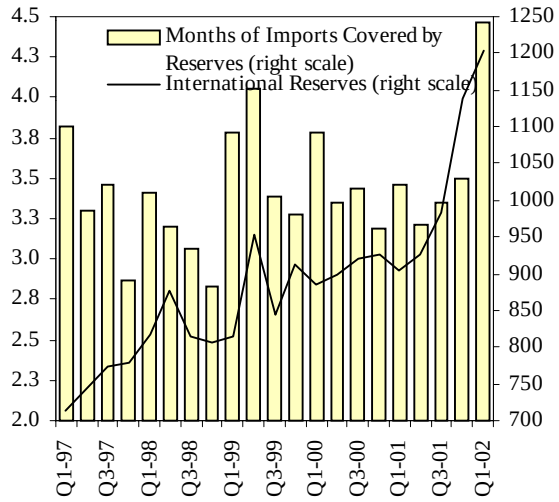
Financial markets

Capital market turnover in the second quarter of 2002 was LVL 103 mn (of which 55.7 mn was in equities and 47.2 in debt securities). Equity market activity was dominated by the public auction of "Latvijas Kugnieciba" (LK) – Latvian Shipping Company – shares, which formed 35% (or LVL 35.7 mn) of the total market turnover and 64% of equity market turnover. Together with secondary market transactions, trades with LK shares dominated the equity market turnover (87% of total). The second most active share was "Latvijas Gaze" – 9.5% of equity market turnover. There were no significant changes in the prices of the most active shares – Latvijas Gaze rose slightly (+2%), and Ventspils Nafta decreased (-4%).

The capitalization of the Latvian equity market at the end of June 2002 was USD 720 mn, with three companies – Latvijas Gaze (50%), Latvijas Kugnieciba (15%), and Ventspils Nafta (16%)- accounting for 81% of total capitalization.

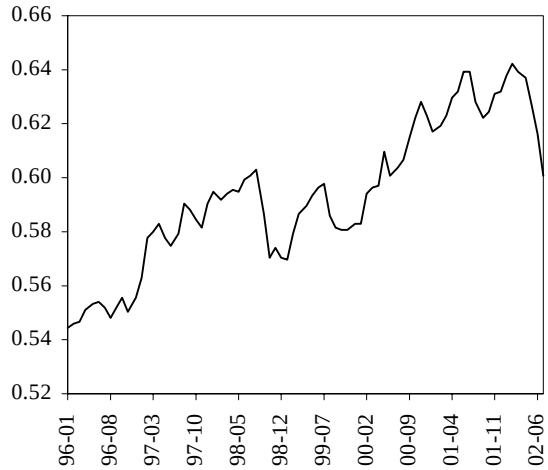
The hoped-for boost in market capitalization after the listing of LK shares remained unrealized because LK shares were sold for a very low price. The price per share was LVL 0.35, which is represents only 36% of LK's bookvalue of equity. Assuming LK had been sold for at least the book value of equity (in a fair international auction), market capitalization would have been almost USD 200 mn higher. As predicted, Ventspils Nafta, another listed enterprise, came out as the majority owner in LK.

Foreign reserves (mn USD) and months of imports coverage



Source: Central Statistics Bureau of Latvia

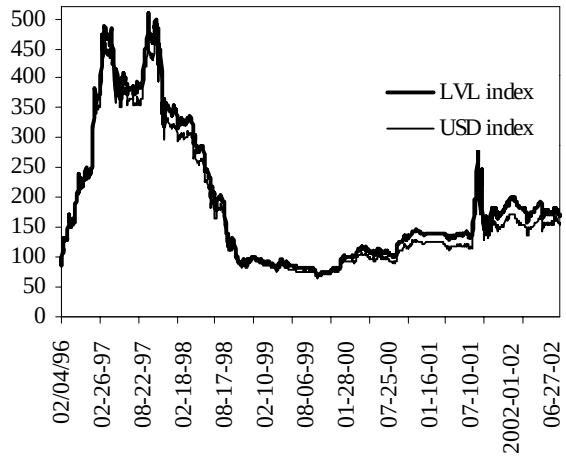
Average exchange rate for the period (LVL/USD)



Source: Central Statistics Bureau of Latvia

Following in the footsteps of Tallinn Stock Exchange, the Riga Stock Exchange (RSE) has become a part of the Helsinki Stock Exchange (HEX) Group. HEX Plc and RSE shareholders finalised ownership arrangements, making HEX the majority shareholder in the new RSE Group consisting of the Riga Stock Exchange and the Latvian Central Depository (LCD). HEX holds 92.98 per cent of RSE shares and RSE holds 81.08 per cent of LCD shares. The remaining 18.92 per cent of LCD shares is owned by the Latvian Privatization Agency, which has announced its intention to sell these shares within a year.

Riga stock market index (DJRSE)



Source: Central Statistics Bureau of Latvia

Key Economic Indicators

	1999	2000	2001	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2
Population (mn. mid-year)	2.43	2.37	2.35					
Gross Domestic Product								
Nominal GDP (bn LVL)	3.90	4.33	4.74	1.18	1.18	1.30	1.18	-
Nominal GDP (bn USD)	6.26	7.13	7.56	1.86	1.87	2.06	1.85	-
Nominal GDP per capita (USD)	2575	3010	3216					
GDP per capita (USD at PPP)	4294	4807	5300					
Aggregate Growth Indicators								
Real GDP (%)	1.08	6.83	7.56	9.30	6.40	6.80	3.80	4.9
Private consumption (%)[1]	5.61	10.14	10.02					
Government consumption (%)[1]	4.18	7.38	10.55					
Gross fixed investment (%)[1]	0.06	17.50	5.89					
Industrial production (%)[2]	-8.58	3.23	7.67	9.53	9.10	5.57	0.10	5.70
Agricultural production (%)	-7.30	9.20	5.90					
Stabilization Indicators								
Consumer prices (avg. %)	2.38	2.64	2.49	2.40	3.23	3.20	3.33	1.93
Unemployment rate (avg. %)	9.68	8.40	7.80	7.90	7.67	7.63	8.10	8.00
Average nominal wages (LVL)	141	149	160	157	164	169	161	171
Average nominal wages (USD)	241	246	255	248	260	269	252	273
Budget balance (% of GDP)	-3.43	-2.82	-1.88	-1.95	-1.16	-3.31	-1.25	-
Exchange rate LVL/USD (avg)	0.585	0.607	0.628	0.634	0.630	0.629	0.640	0.627
Exchange rate LVL/USD (end-period)	0.583	0.613	0.638	0.639	0.619	0.638	0.641	0.605
Trade and Balance of Payments								
Total exports fob (bn USD)	1.77	1.87	2.00	0.53	0.48	0.50	0.49	0.57
Total imports cif (bn USD)	2.94	3.18	3.50	0.86	0.88	0.98	0.81	1.00
Trade balance (end. bn USD)	-1.17	-1.32	-1.50	-0.33	-0.40	-0.48	-0.32	-0.43
Current-account balance (bn USD)	-0.64	-0.50	-0.73	-0.12	-0.19	-0.35	-0.07	-0.18
Foreign Debt and Reserves								
Foreign debt (bn USD)	0.62	0.57	0.72	0.54	0.56	0.72	0.71	0.76
International reserves (bn USD)	0.91	0.92	1.22	0.93	0.99	1.22	1.20	1.22
Foreign Investment								
FDI inflows (bn USD)	0.347	0.407	0.175	0.105	0.109	-0.064	0.126	0.146
Cumulative FDI inflows (bn USD)[3]	1.79	2.19	2.37	2.32	2.43	2.37	2.49	2.64
Portfolio investment (bn USD)[4]	0.273	-0.196	0.082	-0.133	0.007	0.228	-0.031	-0.063
Monetary Growth								
M2 (%)	8.0	27.9	20.8	6.3	3.4	5.5	6.8	4.0

[1]Data revised.

[2] The figures are recalculated according to the structure of industrial value added in 2000.

[3]Cumulative from 1995.

[4]Methodology of calculation has changed from 1999.

LITHUANIA

1 EUR = 3.4528 LTL (fixed)

Overview of developments and prospects

The positive trend of Lithuania's macroeconomic performance in 2001 continued in the first half of 2002 with real growth of 4.5% in the first quarter and an estimated 6.9% in the second quarter. The first quarter current account deficit was a modest 3% of GDP.

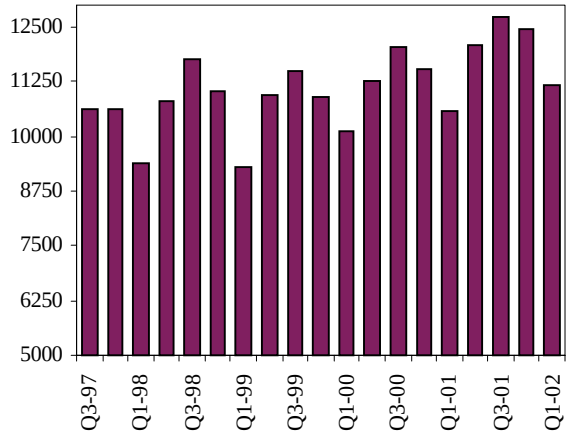
The centre-left government led by Prime Minister Brazauskas commands a majority in the parliament (Seimas) and this together with the broad political consensus in favour of EU and NATO accessions means that it has been possible to make progress on a number of needed measures. Structural reforms are to advance in a number of areas. The government is committed to introducing additional measures to strengthen municipal finances, implementing additional expenditure reduction measures for the Health Insurance Fund, and finalising the pension reform. Political pressures may emerge, however, in the run-up to the December presidential elections, complicating the preparation of the 2003 budget.

The state authorities plan to strengthen supervision of banking institutions, insurance companies and capital markets. Reforms are also anticipated in the areas of business environment, labour legislation and privatisation.

The IMF macroeconomic outlook for 2002 envisages faster growth and a slightly higher current account deficit, while inflation, wage, and employment projections remain largely unchanged. Moreover, the IMF believes that the currency board arrangement will continue to anchor macroeconomic policies.

The Ministry of Finance now expects that real GDP will grow by 4.4% in 2002, as compared with 4.0% envisaged earlier. But private consumption is still expected to lag GDP growth. This is based on the expectation of relatively low wage growth and that unemployment will decline only slowly.

GDP at current prices (bn LTL)



Source: Statistical Office of Lithuania

According to the Ministry of Finance, CPI growth is expected to remain subdued at 1.5%, but the current account deficit is now projected to widen to 5-6% of GDP in 2002.

FDI is expected to finance about half of the current account deficit, at the same time both the public and private sectors are likely to have access to international markets on more favourable terms than hitherto. Net external debt is expected to increase to about 28% of GDP during 2002, but the external liquidity position is likely to strengthen further, with the reserve coverage of short-term debt projected to increase to 64%.

Broad money is expected to grow at 17% and credit is expected to expand after a period of stagnation. The pick-up in credit growth does not appear to raise immediate concerns regarding the quality of bank portfolios.

Output and aggregate demand

Lithuania's gross domestic product (GDP) of the first quarter 2002 grew by 4.5% against the corresponding period of 2001 and amounted to LTL 11.2 bn. at current prices. Per capita GDP was LTL 32000 (EUR 928) at current prices, representing growth of about 5% on a year to year basis at constant prices.

The following sectors contributed most to first quarter 2002 GDP growth: value added in construction (increased by 9.1%), trade (8.4%), hotels and restaurants (9.2%), transport and communications (10.2%) and financial services (9.5%).

Construction grew strongly because of capital repairs and construction of new non-residential buildings. The introduction of compulsory insurance vehicles gave a considerable boost to value added in financial services.

The biggest component of GDP in the first quarter of 2002 was private consumption (67.5%). This is nearly the same share as a year before (66.3%). However, at 14.8%, the share of gross domestic investment in GDP decreased by 3.6%, while the share of gross capital formation increased from 15.5% in the first quarter of last year to 15.9% in 2002.

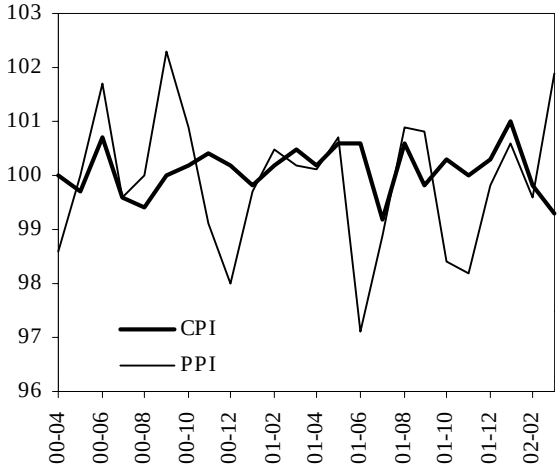
Prices

Inflation remains modest: during the first quarter the consumer price index (CPI) increased by 2.5% as compared with the same quarter of 2001 but was just 0.1% up from the end of 2001. Annual inflation at the end of the quarter (March 2002 as compared with March 2001) was 1.6%.

Producer prices have fallen. The producer price index (PPI) decreased by 3.6% in the first quarter of 2002 as compared with the same period in 2001.

The prices of animal products decreased by 1.1% in the first quarter of 2002 as compared with the same period of 2001.

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



Source: Statistical Office of Lithuania

Labour

Despite a growing economy, registered unemployment has decreased only very slowly and real wages have increased only marginally. Thus the registered unemployment rate was 12.6% at the end of the first quarter of 2002 as compared with 13.2% a year before. This meant that the number of registered unemployed was 221,100 at the end of March.

Manufacturing was the largest sector in terms of employment in the first quarter of 2002 (it employed 18% of the labour force). The other important sectors were: agriculture and forestry (about 17%), wholesale and retail trade, repair of household goods (about 16%) and educational establishments (about 11%).

The biggest drop in employment over the year was observed in agriculture and forestry (by about 23,000or 8%), health care and social work (by 8,000 or 8%).

On the other hand, in electricity, gas and water supply the number of employed increased by about 4,000 (10%), and by 4,000 (5%) in construction, transport, storage an communications. In other activities (not mentioned above) employment fell by a total of 3,000 or 5%.

Average monthly gross earnings in the first quarter of 2002 were nearly LTL 1088 (EUR 315),

marginally up by 0.1% as against the fourth quarter of 2001.

Monthly earnings in the public sector were LTL 1111, down by 1.5% from the fourth quarter of 2001; whereas those in the private sector were LTL 1065, representing an increase of 1.7% over the fourth quarter of 2001.

Average monthly gross earnings in the first quarter of 2002 as compared with the same period in 2001 rose by 4.5%; in the public sector they went up by 2.9% but in the private sector grew by 6.3%. Thus, real wages grew very little as compared with the same period of the previous year.

Foreign trade

Lithuanian exports grew by 1.0% and imports by 5.7% in the as quarter of 2002, as compared with the same period of 2001.

Total exports were LTL 4.3bn, while imports were LTL 6bn. Thus the trade balance was negative (LTL 1.7bn).

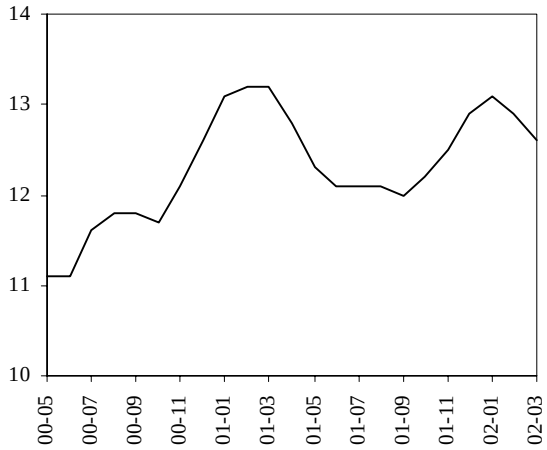
The biggest component of first quarter exports was mineral products (mainly oil products) (18.9%). However exports of this sector were down by 23.4% as compared with the first quarter of 2001 reflecting the not very successful operations of the Mazeikiai Oil Refinery.

Textiles exports accounted for 18.2% of total exports with the total virtually the same as in the first quarter of 2001.

Machinery and electric equipment accounted for 11.2% of total exports and vehicles and transport equipment for 10.8%. The exports of these commodity groups grew by 6.6% and 52.0% respectively.
Output of the chemical industry accounted for 7.5% of total exports and the export of these commodities (mostly fertilisers for agriculture) grew by 8.5%.

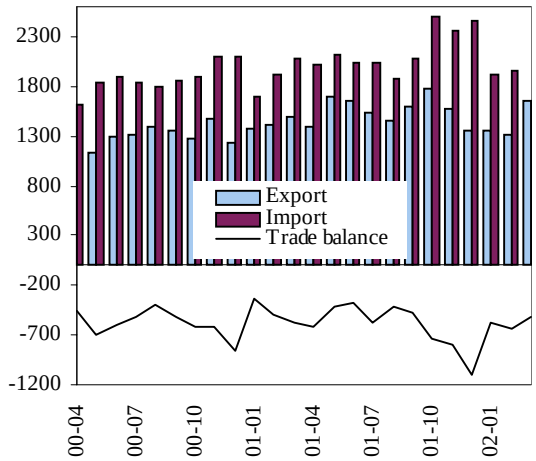
Wood and articles of wood made up 5.7% of total exports. These exports grew by 1.0%. The largest import group was machinery and electric equipment with 18.1% of total imports, representing an increase of 14.3% as compared with the first quarter of 2001.

Registered unemployment (%)



Source: Lithuanian Labour Exchange

Foreign Trade (mn LTL)



Source: Lithuanian Ministry of Finance

Mineral products (mostly oil) accountered for 17.8% and vehicles and transport equipment 13.2% of the total imports. Imports of mineral products declined by 25.3%, but of vehicles and transport equipment increased by 72.7% as compared with the first quarter of 2001.

Chemical accounted for 10.1% of total imports (up by 18.2%) and textiles for 8.7% (up by 2.6%).

The most active trade in the first quarter of 2002 was carried out with the EU and the CIS countries.

Great Britain, Russia, Germany, Latvia and France continued to be the main foreign trade partners. Great Britain was the distination for 15.1% of Lithuania's exports in the first quarter of 2002 and was the source of 3.8% of imports.

The share of exports going to Russia was 12.9% and Russia's share in Lithuanian imports was 22.7%. Germany had an export share of 11.4% and was the source of 16.8% of imports.

France had an export share of 5.3% and an import share of 3.7%.

Foreign investment

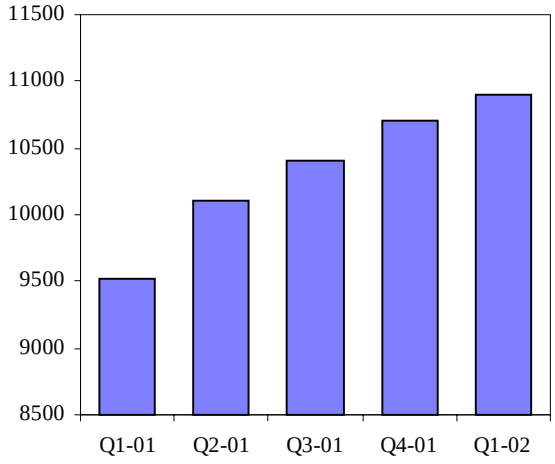
The stock of foreign direct investment (FDI) as of 1st April 2002 was LTL 10.9 bn, (up by 2.1% over the 1st January 2002 when it was LTL 10.7 bn). This implies that per capita FDI in Lithuania was LTL 3140 (EUR 910).

The main investing countries were as follows: Denmark (LTL 2 bn or 18.5%), Sweden (LTL 1.8bn or 16.8%), Estonia (LTL 1.1 bn or 10.3%), Germany (LTL 1 bn. or 9.5%) and the USA (LTL 0.9 million or 8.1%).

The main receiving sectors are: manufacturing (25% of total FDI), trade (19%), financial services (21%) and communication services (15%).

A strategic investment agreement regarding the sale of a 34% stake of AB Lietuvos Dujos (Lithuanian Gas) was signed in mid-June between the State Property Fund and the consortium of Ruhrgas AG and EON Energie AG companies. LTL116m of the fee had already

Foreign direct investment (mn LTL)



Source: Bank of Lithuania

been transferred by the buyer to the privatisation fund at the end of June. According to the privatisation scheme of the company, its shares must be distributed between a strategic investor and a supplier of raw material. Therefore, a tender for gas supplier with respect to acquisition of further 34% stake of AB Lietuvos Dujos shares was announced at the same time.

Foreign investors are looking forward to the privatisation of the Lithuanian alcohol production industry, where the preparation process for privatisation started this year.

Enterprises

Despite the global recession in the telecom sector, there have been extensive recent developments in the Lithuanian telecom sector.

Thus, cellular penetration overtook the density of fixed lines (38%) in mid-2002 and is expected to reach 40% by the end of the year.

The development of the sector over the first half of the year was marked by intense competition within the segment of international calls. Currently, the Lithuanian international traffic market is estimated to amount to LTL 150mn, of which Lietuvos Telekomas (LT) and its subsidiary Voicecom have about 45%, Omnitel has 30%, Bite GSM has15-20% and the remaining share belongs to Tele2 and a handful of Internet telephony providers.

The expected merger of Telia and Sonera, two Scandinavian incumbents, is likely to trigger the formation of a regional provider across the Baltic States. In the first place Telia and Sonera are the majority shareholders in Lithuanian, Latvian and Estonian national fixed-line carriers.

Moreover, Telia and Sonera started to consolidate their cellular business in the Baltic back in 2001 whereby Omnitel, Latvian LMT and Estonian EMT established the Baltic Sea Alliance. At the end of 2001 the members of the alliance reduced roaming charges across the three countries. Future plans include co-operation in design of new products, harmonisation of services and more efficient use of technical resources.

Growing competition has had an impact on the fixed-line services (-15.1%) and leased lines (-16.8%). Data transmission and interconnection revenue, on the other hand, grew by 72.3% and 17.3% respectively.

LT has been diversifying its services in preparation for the end of its monopoly in fixed telephony in 2003. A Memorandum of Understanding was signed with Tieto Enator, one of the largest IT service providers in Scandinavia, to set up a joint venture that would provide IT services in Lithuania and other Baltic states. The new company will be created from the information systems department of LT that currently employs around 200 people.

Comliet, the largest subsidiary of LT engaged in design, installation and service of NMT technology telecommunication networks, has established its presence in Latvia. In February 2002 a representative office was opened in Riga, and in April the company signed an agreement on purchase of 75% in Datu Tikli SIA. The acquired Latvian company engages in the implementation of low voltage network projects, construction and maintenance of telecommunications networks.

Nelte, a leading provider of paging, internet and call centre services in Lithuania, sold its call centre business operated under the brand name NelteLink to Transcom Worldwide, a customer relationship management company with headquarters in Luxemburg. Although no financial details on the deal have been released, Transcom Worldwide announced plans to increase the number of employees from around 100 to 200 by the end of the current year.

NelteLink services 12,000-13,000 calls daily which totals around 4mn calls per year and has 60-70% of the total call centre market in Lithuania, while the remaining share belongs to Lintel, a 100% subsidiary of LT.

Facing fierce competition, Lithuania's telecommunication companies plan large investments in cellular network development and its optimisation, introduction of new wireless technologies and enhanced customer service.

Omnitel, a leading mobile carrier, has plans to develop a package of e-services, self-service solutions and personalised services. The company plans to invest approximately LTL 260mn in 2002.

Bite GSM, "number two" on the mobile market, will invest over LTL 120m into further expansion of the network and new technological solutions.

Tele2, the smallest mobile operator, will adhere to its strategy of offering the lowest price and will expand its countrywide network coverage to 95% in 2002.

The budget

Budget revenues were LTL 5.4bn over the period January-July 2002. Of that amount, LTL 1.5bn was personal income tax, VAT was LTL 2.1bn, and excise taxes from alcohol, fuel and tobacco were LTL 0.8bn.

In June public debt increased by LTL 51 million and at the end of the month amounted to LTL 13.9bn, i.e. accounted for 27.3% of the projected GDP.

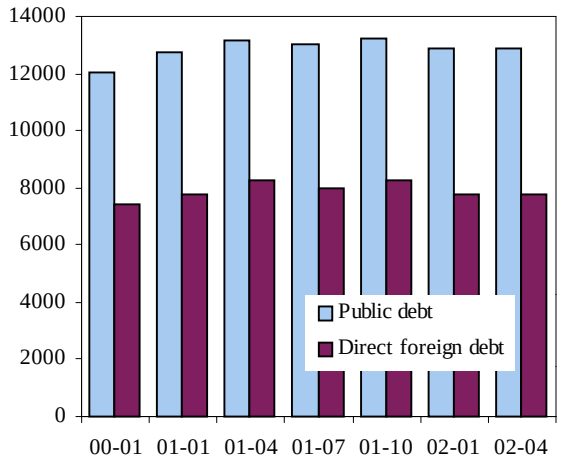
The increase in public debt was a result of the extension of a guarantee for a loan to AB Mazeikiu Nafta (Mazeikiai Oil Refinery). As of the end of June contingent liabilities (state guarantees) amounted to LTL 2bn, or 14.2% of the total debt.

In June direct state debt decreased by LTL 86.1 mn to LTL 12bn, or 85.8% of total debt.

Direct foreign debt (loans received on behalf of the state) decreased by LTL 174 mn in June and as of the end of June was LTL 8.6 bn, or 61.5% of the total state debt. In June the state received LTL 3.2 million under previous agreements and external lenders were repaid LTL 35 million of loans. Additionally, debt outstanding decreased by LTL 142 million due to favourable changes in the exchange rate.

Direct domestic debt increased by LTL 88 million and as of the end of June constituted LTL 3.4 bn, or 24.3% of total state debt.

Public Debt (mn LTL)



Source: Bank of Lithuania & Lithuanian Ministry of Finance

In June contingent foreign debt (state guarantees issued on loans in foreign currency) increased by LTL 136 million and amounted to LTL 1.9 bn, or 13.5% of total state debt. During the month, debtors received LTL 264.5 million, of which LTL 261 million (USD 75 million) was the amount received by AB Mazeikiu Nafta from Yukos Oil Corporation of the Russian Federation under a state guaranteed loan agreement. During the same period, debtors repaid LTL 84.9 million of foreign state guaranteed debt.

In June contingent domestic debt (state guarantees issued on loans in Litas) increased by LTL 0.8 mn and at the end of the month stood at LTL 103.7mn, or 0.7% of total state debt.

Total long-term debt (including state guarantees) amounted to LTL 13.2bn, or 94.6% of the total debt; while short-term debt was LTL 747 million, or only 5.4% of the total debt.

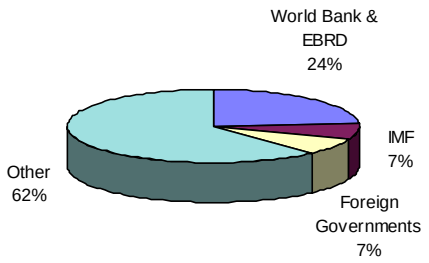
As of June 30, total foreign debt amounted to LTL 10.4bn or 75% of total state debt. The structure of Lithuania debt was as follows: to international development organisations (the World Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Nordic Investment Bank and others)- LTL 1.85bn; to foreign government institutions- LTL 623.6 mn, to the International Monetary Fund – LTL 481.5mn; and to other creditors (commercial banks and financial institutions) – LTL 7.48bn.

Total domestic debt at the end of June constituted LTL 3.48bn, or 25% of the total state debt. The state owed in Litas: to commercial banks – LTL 2.17bn, to financial institutions and private persons – LTL 1.92bn, to other state sectors – LTL 119.5mn.

At the end of July the social security fund "Sodra" announced their budget for the next year in the end of July. Revenues will be LTL 4.6bn. and expenditure will be LTL 4.5bn.

According to Sodra, it is expected that due to the extension of the pension age the number of pensioners will increase by 5,000. At the same time the number or working age people will increase by 40,000 and the number of recipients unemployed benefit is expected to decrease by 15,000.

Direct Foreign Debt by creditors as of 1 October 2001 (mn LTL)



Source: Bank of Lithuania

The Sodra budget also is based on the assumption that the number of people who are not paying contributions (mostly farmers) will increase by 18,000.

At the beginning of July the Lithuanian Government finally decided on how to compensate for the non-returned property when it was agreed to use 10% of AB Lietuvos Telekomas shares as compensation for land and other immovable property.

The exchange rate

The nominal effective exchange rate of the Litas, as calculated by the Bank of Lithuania, against the currencies of its main trade partners appreciated by 3.6% during the first quarter of 2002. Against the currencies of the EU countries the nominal appreciation was 3%, against currencies of the CIS countries it was 5%.

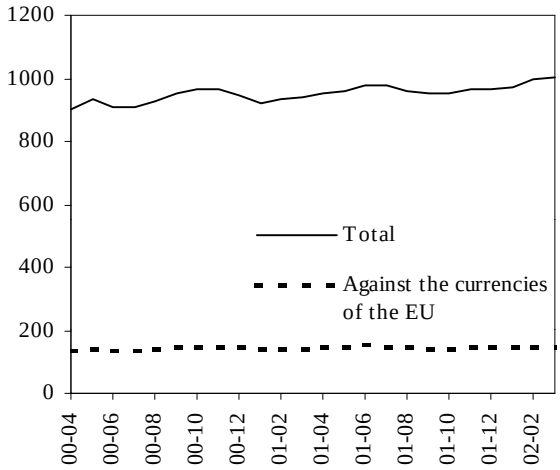
At the same time the real effective exchange rate appreciated by 1.1%. Against the currencies of the EU countries the Litas appreciated by 1.9% and against currencies of the CIS countries by 1.3%.

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

The peg from the dollar to the Euro was in response to closer economic integration with the EU. The re-pegging exchange rate of USD 0.8632 per Euro was slightly appreciated as compared with the average of USD 0.8962 per Euro for 2001. The authorities and entrepreneurs were generally confident that the economy remained competitive.

Commercial banks indicated that most large corporations and many medium enterprises had converted their dollar liabilities into Euros or Litas. Large corporations indicated that many dollar liabilities had been converted into Euro immediately prior to the re-pegging. Companies exposed to trade in products priced in dollars appear to have kept a portion of their liabilities in dollars, which in part explains a

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

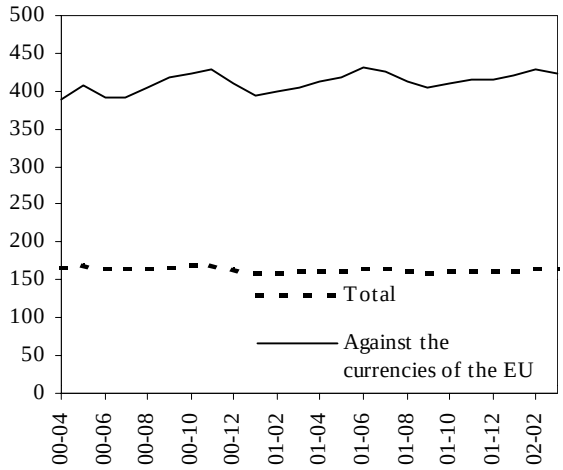


Source: Bank of Lithuania

relatively large share of dollar denominated loans. Some companies also kept their liabilities in dollars, betting that the Euro would depreciate. Moreover, companies have started to negotiate their export and import prices in Euro, even in trade with the CIS, thereby providing a hedge to their operations.

Leading commercial banks have also indicated that more than 50% of the stock of mortgage loans at end-March were denominated either in Litas or in Euro, but the deposits of households remained largely denominated in dollars. Therefore, some households have incurred unrealised losses associated with the recent appreciation of the Euro. Households have been reluctant to convert dollar deposits into Euro or Litas to avoid early withdrawal penalties, but bankers are of the view that they will be gradually converted as the contracts mature.

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



Source: Bank of Lithuania

Money

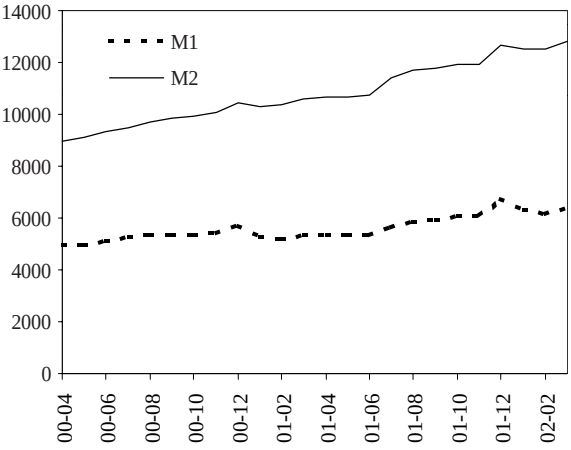
Over the first quarter of 2002 the monetary base decreased by 1.1% and at the end of March stood at 4.2 bn LTL. The biggest portion in national currency made up 14.6%, and required reserves in foreign currencies accounted for 10.7%.

Broad money M2 amounted to 12.8bn LTL at the end of March representing growth of 1.1% over the quarter. The growth reflected an increase in the net domestic assets of the banking system, at the same time demonstrating greater confidence in the banking system.

M1 increased by 5.3%, while the amount of quasi money went up by 8.3% during the quarter.

The share of demand deposits was lower at the end of March as compared with the end of January, while that of both foreign currency deposits and time and savings deposits also decreased. The amount of currency in circulation decreased by 3.2% over the quarter.

Money supply (mn LTL)



Source: Bank of Lithuania

Capital markets

Eleven auctions of Government securities were conducted in the first quarter of 2002. The nominal value of the Treasury bills and government

bonds sold were LTL 125mn and LTL 267mn respectively. The average T-bill yield was 4.4%. while the average Government bonds yield was 5.6%.

From 26 June 2002, amendments and supplements to the trading rules of the Stock Exchange came into force. The main purpose of the rules is to harmonise the trading rules of the Stock Exchange with EU requirements, set out on 28 May 2001 in the European Parliament and Council Directive.

This Directive regulates the admission of securities to the Official Trading List of the Stock Exchange and disclosure of information about those securities. Therefore, the amendments and supplements to the NSEL trading rules also cover those areas.

Securities turnover of the Stock Exchange during the second quarter was LTL 437 million.

Transaction values were among the smallest quarterly results of the last five years. The average transaction value during the three monthsunder review fell from LTL 10.8 to LTL 7.3thousand. This ratio was smallest in May and amounted to LTL 3400.

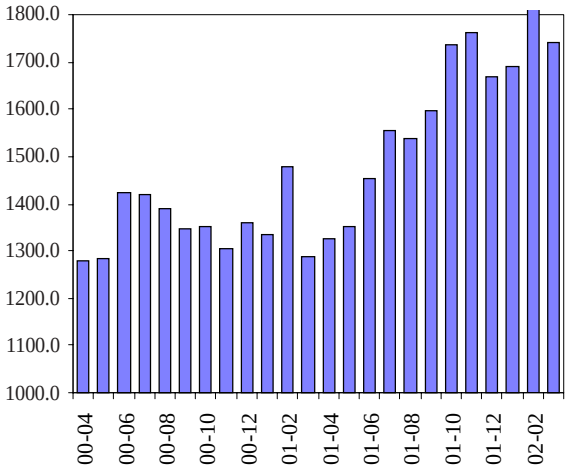
The share of equities turnover in total turnover of the second quarter fell from 29% to 17%. Turnover generated from privatisation and execution of tender offers accounted for 22.4% of block trade share turnover.

During the first six months of this year, the turnover generated from the privatisation and execution of tender offers accounted for 27% of block trade share turnover, as compared with only 7.2% during the first six months of 2001.

The situation on the market was dynamic and changeable during the second quarter. Prices of 20 listed shares moved down and prices of 22 other listed shares improved. A notable loser was LT whose share price fell by 25% during the second quarter. During the same period the LITIN index lost 17%. However, LITIN-10, which represents the 10 most actively traded companies, gained 16%.

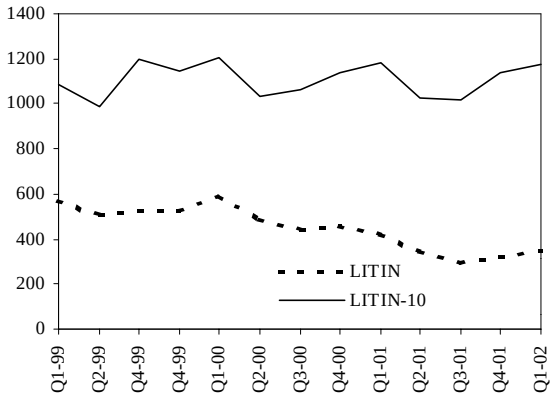
The turnover in the first six months of 2002, as compared to the same period of 2001, was down

International reserves (mn USD)



Source: Lithuanian Ministry of Finance

The LITIN and LITIN-10 index



Source: National Stock Exchange of Lithuania

by LTL 39 million. As forecast, trading in T-bills was more active and grew by 5%. Total central market turnover increased by 18%. Trading of shares in the central market is where the price (variable) of shares is defined by the market according to the number and prices of public orders during a trading session. This is in contrast to direct trade where the price is fixed and amount of shares (fixed minimal amount) is defined by the seller before placing the order.

The NSEL members traded more actively on the central market, where demand rose 7 times and the supply/demand ratio dropped from 7.3 to 1.9. Even though the number of the performed transactions was smaller, the average value of shares on the central market grew from LTL 3500 to LTL 5300.

Investors were more interested the central market, largely because shares of the most attractive companies (like LT, Mazeikiai Oil Refinery, etc.) were offered there. This contributed to the increase of central market share turnover by 25% and its share in the total turnover of shares grew from 25% to 42%.

Key Economic Indicators

	1998	1999	2000	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1
Population (mn. mid-year)	3.71	3.71	3.69	3.69	3.69	3.69	3.69	3.69	3.69
Gross Domestic Product									
Nominal GDP (bn LTL)	42.77	41.84	44.93	11.52	10.68	12.09	12.75	12.40	11.20
Nominal GDP (bn USD)	10.69	10.46	11.23	2.88	2.67	3.02	3.19	3.10	2.90
Nominal GDP per capita (USD)	2881	2820	3044	833	766	867	913	892	810
GNP per capita (USD at PPP)	6283	6490	-						
Aggregate Growth Indicators									
Real GDP (%)	5.05	-4.19	2.64	3.65	6.39	6.74	8.22	7.90	4.50
Private consumption (%)	-1.81	0.78	3.77	1.3	-7.8	7.0	3.9	1.6	1.20
Government consumption (%)	3.99	15.98	-0.70	13.0	-19.2	23.8	-15.4	12.0	-1.00
Gross fixed investment (%)	5.1	-11.8	-12.2	4.2	-32.0	23.5	23.8	n/a	0.40
Industrial production (%)	9.3	-9.6	8.8	14.5	6.0	8.3	2.0	3.8	1.40
Agricultural production (%)	n/a	-11.68	-1.78	-10.9	-14.0	-9.7	-6.2	-9.8	-0.30
Stabilization Indicators									
Consumer prices (avg. %)	5.10	0.89	0.93	1.41	0.56	1.51	2.04	2.10	2.50
Unemployment rate (avg. %)	6.40	8.37	11.53	12.13	13.17	12.40	12.07	12.10	12.60
Average nominal wages (LTL)	1009	1075	1089	1113	1041	1067	1068	1087	1088
Average nominal wages (USD)	252	269	272	278	260	267	267	272	275
Budget balance (% of GDP)	-1.26	-4.33	-0.97	-0.58	0.83	0.20	-0.05	-2.50	-1.00
Exchange rate LTL/USD (avg)	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000	3.950
Exchange rate LTL/USD (end-period)	4.000	4.000	4.000	4.000	4.000	4.000	4.000	4.000	3.950
Trade and Balance of Payments									
Total exports fob (bn USD)	3.96	3.15	5.20	1.30	1.40	1.55	1.56	1.20	1.10
Total imports fob (bn USD)	5.48	4.55	5.83	1.59	1.49	1.64	1.59	1.90	1.50
Trade balance (bn USD)	-1.52	-1.40	-0.62	-0.29	-0.09	-0.09	-0.03	-0.50	-0.40
Current-account balance (bn USD)	-1.298	-1.194	-0.675	-0.254	-0.145	-0.138	-0.014	-0.300	-0.10
Foreign Debt and Reserves									
Foreign debt (end. bn USD)	1.682	1.854	1.880	1.880	2.107	1.998	2.065	1.949	1.970
International reserves (end. bn USD)	1.460	1.242	1.180	1.359	1.287	1.455	1.598	1.661	1.730
Foreign Investment									
FDI inflows (bn USD)	0.926	0.486	0.374	0.114	0.133	0.207	0.107	0.066	0.075
Cumulative FDI inflows (bn USD)[1]	1.4325	1.9189	2.2926	2.2926	2.4260	2.6333	2.7405	2.6750	2.7500
Portfolio investment (bn USD)	-0.043	0.508	0.418	-0.007	0.236	-0.039	0.030	0.480	0
Monetary growth									
M2 (%)	14.51	7.74	16.53	6.10	1.50	3.07	7.08	8.35	1.100

[1] Cumulative from 1996.