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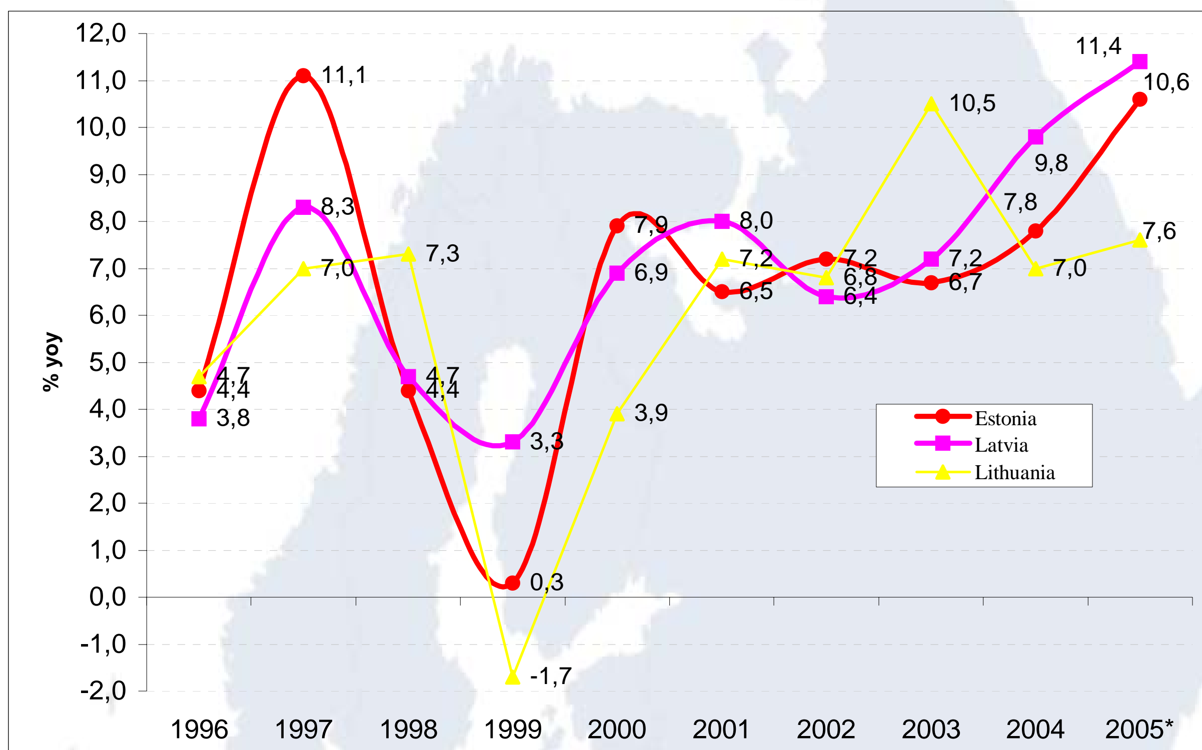
BUOYANT ECONOMIC GROWTH BY THE BALTIC TIGERS

All of the three Baltic countries – Latvia, Lithuania and Estonia – performed considerable economic performance in terms of real GDP growth rates. As for freshest data on third quarter of the year 2005 to the same period of the previous year, that predicts remarkable growth: Estonia performed 10.6%, Lithuania 7.6% and Latvia 11.4% real GDP growth. These results are noteworthy not only among New Member States (NMS) but also in worldwide context that proves for Baltic economies opportunity to converge in a faster tempo, even if from a lower level of development. Although this overall performance is impressive, the structure of the economic sectors underpinning this rise and the growth rate itself arise concerns to the long-term sustainability of such a rate.

BRIEF OVERVIEW OF GROWTH HISTORY

Following their renewed independence in the early 1990s, the Baltic countries have achieved impressive progress over a decade of transition. They have liberalized and opened their economies to the international market, and have implemented a significant number of difficult and complex market-oriented structural reforms. The tremendous output fall of the early nineties reflected the extent of the economic distortions existing before transition and the degree of restructuring required. By 1994-95 positive growth had resurfaced, and by 1997 growth in the Baltic was amongst the fastest in transition economies. The Russian crisis of 1998 brought a halt to fast growth, but did not reverse the trend. The Baltic countries are on the track to sustainable growth, although the deterioration of macroeconomic indicators has raised concerns and suggests that the transformation process, even if relatively advanced, is not yet over.

Chart 1. Real GDP growth of The Baltic Three 1996-2005



**Data of third quarter of 2005 corresponding to the same period of previous year*

Source: Eurostat, Bank of Estonia, Bank of Lithuania and Bank of Latvia

It is possible to draw some rule of fingers thru investigation of the real GDP growth indices. The indices of these countries show co-movement, so the economic structures bear similarities implying internal and external symmetry (reactions on negative and positive shocks analogous). They had similar starting points but till the middle of nineties these countries adopted different management of transition that created some divergence but later on the possible EU enlargement influenced the economic policy answers into direction of convergence. The Baltic States were able to establish macroeconomic stability through prudent monetary policies, strict control of public expenditures, effective banking supervision, and FDI attraction.

THE COMPOSITION OF GDP GROWTH ON SUPPLY SIDE

Compared to the corresponding period of the previous year, GDP of ***Latvia*** in the first nine months of 2005 increased by 10.1%, according to the Central Statistical Bureau of Latvia. The main contributor sectors of this nine-month growth were: trade by 17.3% with almost 20% share in GDP; transport and communications by 16.3% rise with more than 16% share in GDP; construction by 15.9% with 6% share in GDP; while manufacturing smoothed the overall rate by its 5.4% rise, but remarkable share, 13% of GDP. Compared to the corresponding period of the previous year, GDP in the third quarter in year 2005 rose by 11.4%. The increases were 17.8% in trade, 18.4% in transport and communications, 8.9% in manufacturing and 15.6% in construction. (*Source: Bank of Latvia*) As it can be observed the service sector seems to be the main pull factor of the Latvian economy. As for industry the seasonally adjusted industrial output index reached 6.4% year on year in the third quarter of 2005.

Compared to the corresponding period of the previous year, GDP of ***Estonia*** in the third quarter of 2005 increased by 10.6%, according to the Statistical Office of Estonia. It is true for Estonia as well that the service sector bears crucial importance, where the financial intermediation (29.5%), hotels and restaurants (24.5%), wholesale and retail trade (13.4%) transport, storage and communication (11.0%) were performed two digit rates. In the industry of Estonia the following branches leaded the expansion: manufacturing (13.3%), mining and quarrying (13.2%) and construction (20.7%). In the case of Agriculture we can talk about rather stagnation.

Compared to the corresponding period of the previous year, GDP of ***Lithuania*** in the third quarter of 2005 increased by 7.6%, according to the Department of Statistics of the Government of Lithuania. As for composition of Lithuanian growth, the performance of the economy was due to almost balanced development of industry and service sector. The contribution of agriculture is not significant both in share in GDP and in low or rather negative growth rates. The manufacturing (8.1%), the electricity, gas and water supply (9.8%) and the construction (12%) increased with above the average rates. The service sector came out with its growth of 9.0% in financial intermediation, 9.2% in real estate, renting and business activities and of 7.9% in other community, social and personal service activities.

The Composition of GDP Growth on Demand Side

From the sustainability view of the GDP the composition of demand or expenditure side is important. In this point of view, Baltic States have shown unfavorable trends, especially in the third quarter of the previous year.

In the case of ***Lithuania*** the main reason of remarkable growth was the rise in final consumption by 11.4% at constant prices (share in GDP almost 80%) in the third quarter of 2005, especially because of 12% robust growth of household consumption expenditures. The growth of final consumption of general government was of rate 7.4%. In the same time the third quarter of 2005 brought gross fixed capital formation of 14.1% (with around 7% share in GDP) as compared with the same period of previous year. As regarding to external demand, the 11.9% increase of exports compared to the 12.6% of imports show favorable development, as the growth of trade balance deficit were slower. (*Data from Eurostat*)

Estonia performed rise in final consumption of 8.3% at constant prices (share in GDP almost 80%) in the first three months of 2005 that is still higher than in the same period of previous year, thus the contribution of consumption also remarkable. The final consumption expenditures increase was due to 8.4% rise by households and 7.6% rise by general government. The gross fixed capital formation was 11.9%. The external sector expressed in the third quarter an export driven feature as the export grew by 18.5% while the import only by 17.9%. (*Data from Eurostat*)

The ***Latvian*** economy's third-quarter final consumption growth was 9.4%: the households performed a 10.3% while the general government a 6.2% increase compared to the same period of previous year. The investment activity boosted by the date on rise of gross fixed capital formation: 28.8%. This is a remarkable index if considering that in the last 6 quarters the gross fixed capital formation index was not lower than 15.9%. The 23.2% export growth and the 11% import growth expresses strong external demand influence on the growth performance. (*Data from Eurostat*)

As for summary, the growth of all three economies was driven mainly by consumption, especially by household expenditure growth (as the share of final consumption is the biggest), thus reflecting the unsustainable feature of such two-digit expansion. Nevertheless, all of them outperformed the real GDP growth rate with the growth rate of gross fixed capital formation reflecting the pulling effect of investments on economy. Additionally with exception of Lithuania the rise in exports exceeded the rise in imports reflecting improving processes in external balances.

EXPECTATIONS

The unexpectedly rapid economic growth in the third quarter suggests that the actual growth rates will outperform the current forecasts for 2005. Nevertheless, buoyant economic development is threatening the monetary policy as it can be accompanied by higher inflation pressure.

Although several economic sectors achieved good results, the rapidly expanding domestic demand, as the main contributor to the economic growth, fostering buoyant short-term development, but unable to secure sufficiently stable growth rate in the longer term.

Nevertheless a growth performance characterized by smaller rates expected in the next years is also remarkable as it can be still above the average growth rates of 1996-2004 GDP (*Table1.*), but likely on a more sustainable way with less consumption and more export and investment driven growth.

Table 1. Average growth rates of GDP and projections for the potential growth in Baltic Countries

	Average growth rate of GDP	Potential growth rates	Projections for potential growth	Eurostat forecasts	
	1996-2004	1996-2005	2006-2010	2006	2007
Estonia	6.3	5.9	5.8	7.2	7.4
Latvia	6.4	6.3	6.3	7.7	7.1
Lithuania	5.6	5.6	5.7	6.2	5.8

Source: National Bank of Hungary, Eurostat

A favorable sign from the external environment is that the Euro-zone and EU25 GDP both grew by 0.6% in the third quarter of 2005 according to revised estimates from Eurostat, the Statistical Office of the European Communities. In the second quarter of 2005, growth rates were +0.4% in the euro-zone and +0.5% in the EU25.

SLOVAKIA IS IN THE EXCHANGE RATE MECHANISM II.

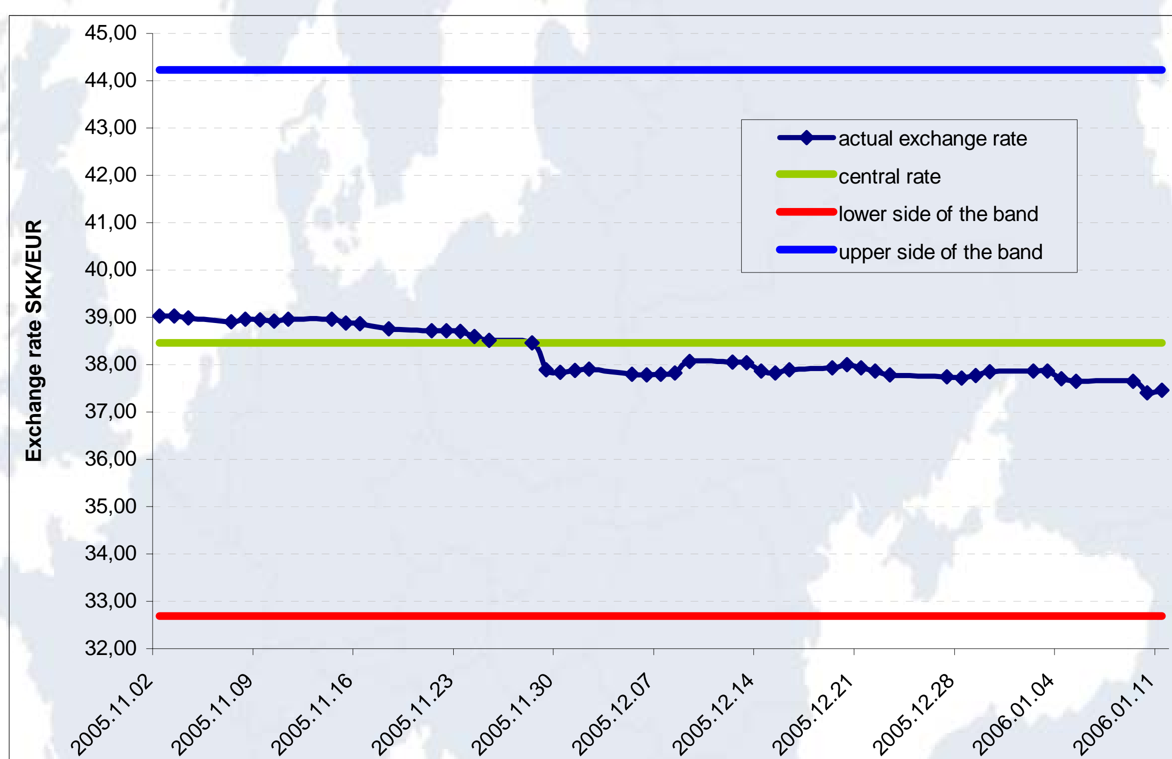
Slovakia entered the Exchange Rate Mechanism II (ERM II) on the 25th of November 2005, while Bratislava was originally supposed to have become a member of the ERM II only in June 2006. The central rate of the Slovak crown has been set at 1 EUR = 38.4550 SKK. Slovakia is the first among the four bigger East European countries, which entered the ERM II. Apart from Slovakia, ERM II members so far include: Estonia, Latvia, Lithuania, Slovenia, Cyprus, Malta and Denmark.

SLOVAKIAN CROWN INCLUDED IN THE ERM II

Slovakia is now one step closer to adopting the common European currency. On the 25th of November 2005 the country joined the ERM II, where countries have to keep their currencies for at least two years before adopting the euro. The core level on which the crown is pegged to the euro was set at 38.4550 SKK to 1 EUR and the ERM II standard fluctuation band of plus/minus 15% will be observed around the central rate of the Slovakian Crown. The lower compulsory intervention rate is 32.6868 SKK/EUR and the upper intervention rate is 44.2233 SKK/EUR.

Chart 2. Daily exchange rate SKK/EUR in Slovakia

November 2005- January 2006



Source: National Bank of Slovakia

The entry was purposely sudden and unannounced in order to avoid speculative deals of foreign-exchange market players. It was surprising for analysts as well who expected the country to join the system in summer 2006. But thanks to the earlier-than-expected entry into the ERM II, Slovakia will have more time to prepare for the introduction of the euro. Slovakia said it now aims to adopt the euro in 2009. According to the Finance Minister, Ivan Miklos,

the reforms, favourable economic development and the policy consistency in sticking to the convergence program allowed the country to complete negotiations on Slovakia's entry extremely quickly.

With the agreement the Slovak authorities must engage to promote wage developments that are kept in line with productivity growth, thereby contributing to achieving price stability in a sustainable manner, furthermore to pursue sound fiscal policies, which are essential for preserving macroeconomic stability. The Slovak government's medium term fiscal strategy requires a high degree of budgetary discipline and the authorities, together with the EU must closely monitor macroeconomic developments.

The Role of ERM II

The ERM II links the currencies of non-euro area Member States to the euro. By helping to ensure that the non-euro area countries participating in the mechanism orient their policies towards stability, fosters convergence and thereby helps them in their efforts to adopt the euro. Participation in the ERM II is not compulsory for the Member States, but the membership is one of the convergence criteria for the eventual adoption of the euro.

Joining the ERM II can offer a number of important advantages. First of all, it can foster policy discipline towards stable macroeconomic environment. Second, it can enhance policy credibility and help guide expectations of the economic players because of the exchange rate stability. What is more the membership can also speed up disinflation and reduce inflation volatility through anchoring inflation expectations. Last but not least staying in ERM II also helps to assess the sustainability of the central parity of a country's currency against the euro.

Introduction of the Euro

After joining the ERM II, the main task of Slovakia remained to satisfy all the Maastricht criteria (on exchange-rate stability, public debt, general government deficit, long-term interest rates and inflation) for adopting the euro in 2009. The EU's 2004 convergence report indicates that Slovakia not achieved all the criteria, but according to the Central Bank the country will fulfil them by 2007. Now there are problems with the inflation criterion, and the government deficit criterion. The public finance deficit criterion is fulfilled not at all up to now. Analysts said, achieving the public debt criterion, the long-term interest rates criterion should probably not be a problem for Slovakia. Exchange-rate stability (ERM2 membership is necessary but probably not sufficient to achieve this) could prove more difficult, depending on how narrowly ECOFIN decides to define exchange rate stability.

Assessment of whether Slovakia will meet the inflation criterion around 2007-08 is more difficult because the reference rate is variable: an applicant must have an inflation rate no more than 1.5 percentage points higher than the average of the three lowest-inflation EU members. Currently the reference rate is 2.5% (at the end of 2005) and on that basis Slovakia should be able to make this level. In January-November this year inflation was running at 2.6%; and according to the forecasts the annual average inflation will be 2.8% in 2005, falling to 2.5% in 2006 and 2.2% in 2007. But Slovakia must take attention henceforward to keep the inflation at a low level.

As a result, the major problem about Slovakia's bid to adopt the euro at the start of 2009 on whether it will meet the Maastricht fiscal criterion - of a general government deficit no greater than 3% of GDP - by the reference year, 2007. Excluding the costs of pension reform, the

analysts forecast that the deficit will be 3.4% in 2005, 3.2% in 2006 and 2.4% in 2007. However, pension reforms must be included in the calculation of the budget deficit, although there is an expectation that some discounting will be possible for the purposes of assessment by the Maastricht criteria. The costs are significant - in 2006, for example, they are calculated to be 1.3% of GDP, which raises the targeted budget deficit for that year to 4.2% of GDP. (*Source: Economists Intelligence Unit*)

Moreover Slovakia's economy has grown strongly since it joined the EU in 2004 (in the third quarter of 2005 was 365505 million SKK= 9.5 bill. EUR), thanks to the lion's share of foreign investment into the EU's new Eastern European members. One of the most successful sectors is the automotive sector, with firms such as Peugeot-Citroen, Kia Motors, Ford, Hyundai and Volkswagen. But with the general election due in September 2006, there is a danger that the government is coming under intense pressure to increase wages and benefits for healthcare workers, teachers and pensioners and hereby further is worsening the government deficit.

SINCE CROWN IS THE MEMBER OF THE ERM II

The Slovak crown strengthened against the euro immediately after the announcement of Slovak's entry to the ERM II. During three days the exchange rate strengthened by 0.60 SKK towards the reference European currency to 37.892 SKK to one euro. The majority of analysts expected that the crown remain approximately at this level in the coming months. These assumptions seem to be true till now.

CONTINUOUSLY SURPASSING INWARD FDI IN KAZAKHSTAN

Kazakhstan, accounting for two-thirds of the GDP for the whole Central Asian region (Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan), has the highest per capita FDI among the members of the Commonwealth of Independent States (CIS). The country has received more than USD 4 billion yearly since 2001 according to the National Bank of Kazakhstan.

SMOOTH TRANSITION FROM PLANNED TO MARKET ECONOMY

Kazakhstan has several advantages compared to other countries of the Central Asian region, which originate from the transparent, stable transition of the country from centrally-planned to market economy. The main pillar of the economic development was the political stability provided by President Nursultan Nazarbayev who has been the leader of the country since 1991. Despite the orange revolutions of the region and the authoritarian presidential rule he was reelected on 4th December 2005. Political stability was accompanied by economic reforms. The electricity industry was privatized, a sophisticated financial service sector was created and the government introduced a private pension plan giving a boost to the Kazak stock exchange. Additionally the autonomy of local governments increased thanks to the decentralization process.

The reforms were successful as the backward trend of GDP growth turned in 1995. Kazakhstan became one of the fastest growing economies of the world as the growth of GDP has been above 9% since 2000. The high rate of growth is based on the rich oil and natural gas reserves (2 trillion cubic meters). The largest onshore fields can be found in Tengiz belonging to the 10 largest oil fields (reserves of 6-9 billion barrels) and in Karachaganak (2.2 billion barrels). Recently an offshore field called Kashagan has been discovered which is three times larger than Tengiz (*Embassy of Kazakhstan to the USA and Canada*).

The stability of economy is proved by other indicators as well (*Table 1.*). Inflation rate decreased from 1892% to a steady 6-7%. The budget has had minor deficit and the unemployment rate has been falling year by year since 2000. The stability and transparency was rewarded as Moody's upgraded the credit rating of the country to Baa3- in September 2002 and to Ba1/NP in November 2004. At the same time Standard & Poor's and Fitch Ratings raised the long-term local and foreign currency ratings of Kazakhstan to BBB and BBB- in 2004.

Table 2. Main economic indicators of Kazakhstan

	1994	1995	2000	2001	2002	2003	2004	2005*
GDP growth (%)	-12.6	-8.2	9.8	13.5	9.8	9.2	9.6	9
Inflation (%)	1892	176.3	13.2	8.4	6.6	6.8	6.6	7.4
Budget balance (% of GDP)	-6.8	-3.6	-0.1	-0.2	-0.1	-1.1	-0.3	-0.57
Unemployment rate (%)	7.5	11	12.8	10.4	9.3	8.8	8.4	7.6

**Estimation*

Source: National Bank of Kazakhstan

Stability was not the only factor playing an important role in boosting inward FDI. The investment climate has also been continuously improved. The main principles of investment policy include predictability, transparent legal norms, protection of investors' legal rights, and

equal conditions for foreign and local investors, sanctity of contracts and encouraging direct investment to the priority sectors of the economy. Governmental measures are taken after consulting with foreign investors within the framework of the Foreign Investors' Council (Companies like Ernst and Young, Baker and McKenzie, ABN AMRO Bank, TotalFinaElf, Chevron Texaco, Mitsubishi Corporation, Samsung or Deutsche Bank can be found in the FIC.). The main principles and the priorities were laid down in the law of Foreign Investments in 1994 followed by the law of State Support of Direct Investments in 1997 and the Investment Law in 2003 modifying priorities and means of support based on previous experiences. Foreign investors enjoy fewer limits on the foreign ownership, relief from the property tax and land tax, privileges in custom tariffs (imported capital goods used for priority projects are duty free), state grants (not more than 30% of the volume of capital investment) and lower royalties on oil (USD 1.5-2 per barrel compared with USD 6-7 in the Russian Federation by *UNCTAD*). The government guarantees the tax stability and the right to repatriate capital.

TENDENCIES OF INWARD FDI

The stability of economy and the advantageous investment climate is reflected in the high inward FDI. Azerbaijan, Kazakhstan, the Russian Federation and Ukraine accounted for 93% of total FDI inflows to the CIS in 2004. In the amount of inward FDI only the Russian Federation (USD 7958 million in 2003 and 11672 million in 2004 according to UNCTAD) overtakes Kazakhstan, but it has the highest per capita inward FDI of the region.

Table 3. Ratings of the top 4 target countries of the CIS member states

	Inward FDI Performance Index Rankings					Inward FDI Potential Index Rankings				
	1995	2000	2001	2002	2003	1995	2000	2001	2002	2003
Azerbaijan	3	10	35	13	3	104	124	107	100	82
Kazakhstan	8	23	13	11	7	72	84	74	64	59
Russian Federation	101	104	106	111	97	31	39	33	30	27
Ukraine	98	98	92	91	74	53	81	76	69	62

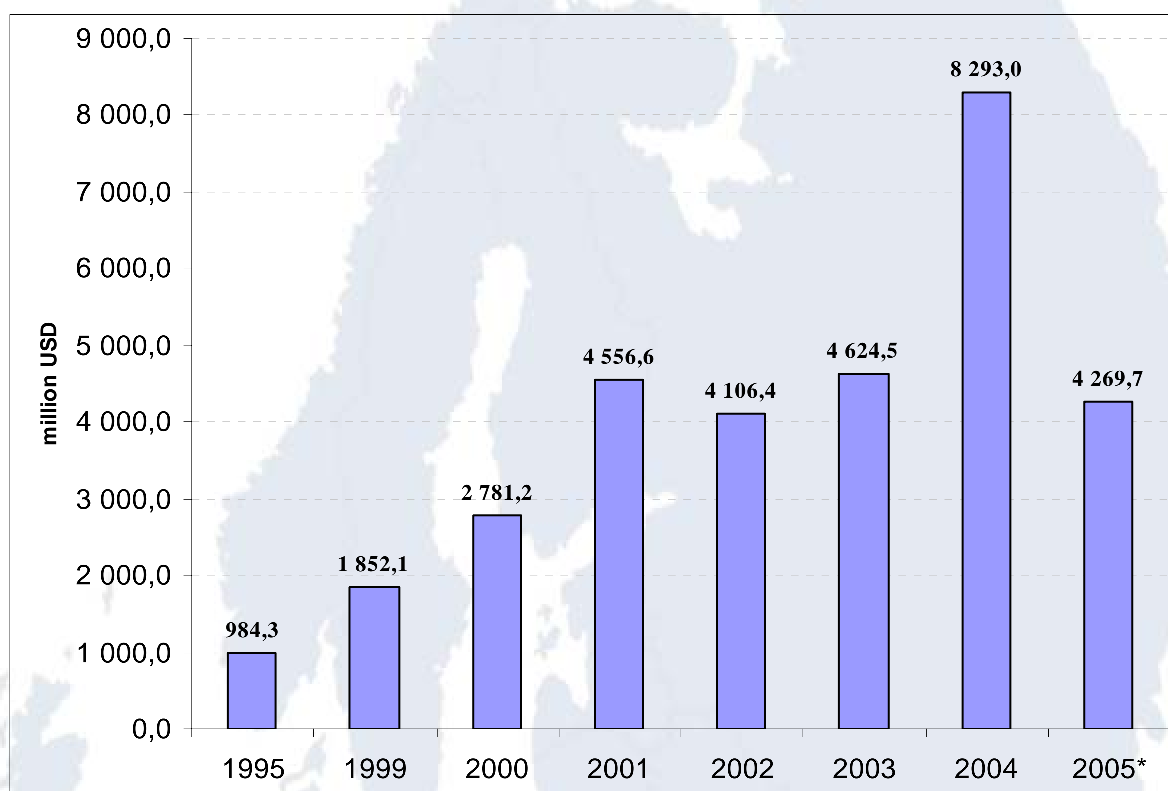
Source: UNCTAD

Concerning the Inward FDI Potential each country has an improving position in the ranking and Kazakhstan is the second best behind the Russian Federation in the region in 2003. In the ranking of Inward FDI Performance Kazakhstan has the same position in the region following Azerbaijan but significantly overtaking the Russian Federation and Ukraine in 2003. From the top 4 members of the CIS only Kazakhstan is in the group of front-runners according to UNCTAD, which means that the country has high FDI potential resulting in high FDI performance.

The Kazak inward FDI has been over USD 4 billions since 2001 reaching USD 8.2 billions in 2004, which led to a 16% increase in oil and gas output. There are global oil companies such as BG Group (United Kingdom), Agip (Italy), Chevron Corp. (United States), ExxonMobil (United States), Lukoil (Russian Federation), Shell (Netherlands) or BP (United Kingdom) and independent oil companies in the country. No wonder that the main investing countries are the United States, United Kingdom, Italy and the Netherlands. The proportion of inward FDI connected to the extraction of petroleum or natural gas was between 45 and 74% from 1999 till 2004. Adding all the investment targeting infrastructure, manufacturing, transport and geological exploration connected to oil and natural gas the proportion is even higher

between 71 and 84% by the National Bank of Kazakhstan. The trend is going on in 2005 as the foreign direct investment of the first nine months surpassed USD 4 billions.

Chart 3. Development of FDI 1995-2005



**First 9 months of 2005*

Source: UNCTAD

EXPECTATIONS

High oil and gas prices will further encourage the investment in Kazakhstan and other natural-resource-rich countries of the region. These countries can become fierce competitors of the Kazak economy by improving their political and business environment. Although the prospects of the inward FDI seem to be positive the government cannot be satisfied with the country's performance. In order to maintain the high rate of growth and inward FDI the government should diversify the economy, ensure the competitiveness of non-oil exports and solve social problems like income inequalities (16-17% of the population live in poverty).

Priority areas of diversifying the economy were set in the Innovative Industrial Development Strategy till 2015 adopted in 2003. Agriculture is one of the priority fields as Kazakhstan is one of the world's largest grain, meat and wool producer. The mining industry provides also good opportunities for future investors as the country owns the second biggest reserves of uranium, chromium, lead, silver and zinc, the third biggest reserves of manganese and is in the leading ten countries in terms of reserves of copper, coal, iron and gold. These primary sectors indicate the necessity of investment in the manufacturing sector as well. The location of the country (the biggest land-locked country in the world) urges to improve infrastructure and transport. Last but not least, the government also supports investments in telecommunication and in cultural and tourism sectors.

Diversification and ensuring the competitiveness of non-oil exports are made difficult by the appreciating local currency (Tenge) due to increased oil exports and significant capital inflows. As a result the production costs (including wages) expressed in USD rise to internationally uncompetitive levels. Thus the Kazakh government is facing a real challenge when implementing its new Innovative Industrial Development Strategy.