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GOVERNMENT DEBT IN THE BALTIC STATES: FORTUNATE TRANSITION OR PRUDENT FISCAL POLICY?

Public debt is one of the most serious problems of transition economies, but not in the Baltic States. Among the New Member States (NMS-10), Estonia, Lithuania and Latvia have the lowest level of government debt.

Two main reasons can be mentioned for this: on the one hand, they did not inherit a great amount of debt from the Former Soviet Union, and on the other hand, a determined and strict fiscal policy was conducted in the last decade.

BACKGROUND OF BALTIC ECONOMIES

The Baltic States are preparing the launch of the euro with great commitment by fulfillment of all the criterion of Maastricht, except the one about inflation, which could be their critical point.

The 7.1% and 4.6% rate is one of the highest inflation rates in the EU at the meantime, which could cause some problems for the region, and the ever raising crude oil prices can also jack up inflation.

Table 1. Baltic inflation rates and real GDP growth

	Inflation rate May 2006	Inflation rate June 2006	GDP growth Q4 2005	GDP growth Q1 2006
Estonia	4.6%	4.3%	11.5%	11.7%
Latvia	7.1%	6.3%	10.5%	13.1%
Lithuania	3.6%	2.1%	8.1%	8.8%

Source: Eurostat, Statistical Offices of Estonia, Lithuania and Latvia

The Estonian National Bank just changed its purpose of launching the euro from 1st of January 2007, because of the high inflation rates. The two other countries faces the same problem, Lithuania was also close to limit, but it just slipped away in May, when the EU Commission decided to decline the implementation of the Euro, only because Lithuania's rate was 0.03% higher, than the allowed rate of 2.6% - data for Lithuania was 2.63%. Latvia plans to launch the new currency only in two years from now, but they may suffer a year delay as well.

The high inflation rate is accounted for the exaltation of the economy. There was no example in the last 5 years, when one of these 3 countries' growths has gone under 6%, which is a remarkable result, especially when the Euro-zone was in a smaller recession. The main reason for the national banks did not raise the basic rates in order to decrease the inflation was that there is no twin deficit in Baltic countries.

Table 2. Budget deficit in Baltic countries 2002-2005

	2002	2003	2004	2005
Estonia	1%	2.4%	1.5%	1.6%
Latvia	-2.3%	-1.2%	-0.9%	0.2%
Lithuania	-1.4%	-1.2%	-1.5%	-0.5%

Source: Eurostat, Statistical Offices of Estonia, Lithuania and Latvia

The budget deficit is under the 3% limit in Latvia and Lithuania, and in Estonia there is always a surplus, which can be only reached by a prudent, committed, and authentic fiscal policy. (*Table 2.*) Even more, public debt is also way below of the European average.

Government Debt

In the NMS-10 countries, in terms of public debt, Estonia, Latvia and Lithuania are in the best position. This is mainly because of the fact that the Former Soviet Union took over all the liabilities of the Baltic countries.

Table 3. Government debt in Baltic countries as a share of GDP

	2000.	2001.	2002.	2003.	2004.	2005.
Estonia	4.7%	4.7%	5.5%	6%	5.4%	4.8%
Latvia	12.9%	15%	13.5%	14.4%	14.6%	11.9%
Lithuania	23.8%	22.9%	22.3%	21.2%	19.5%	18.7%

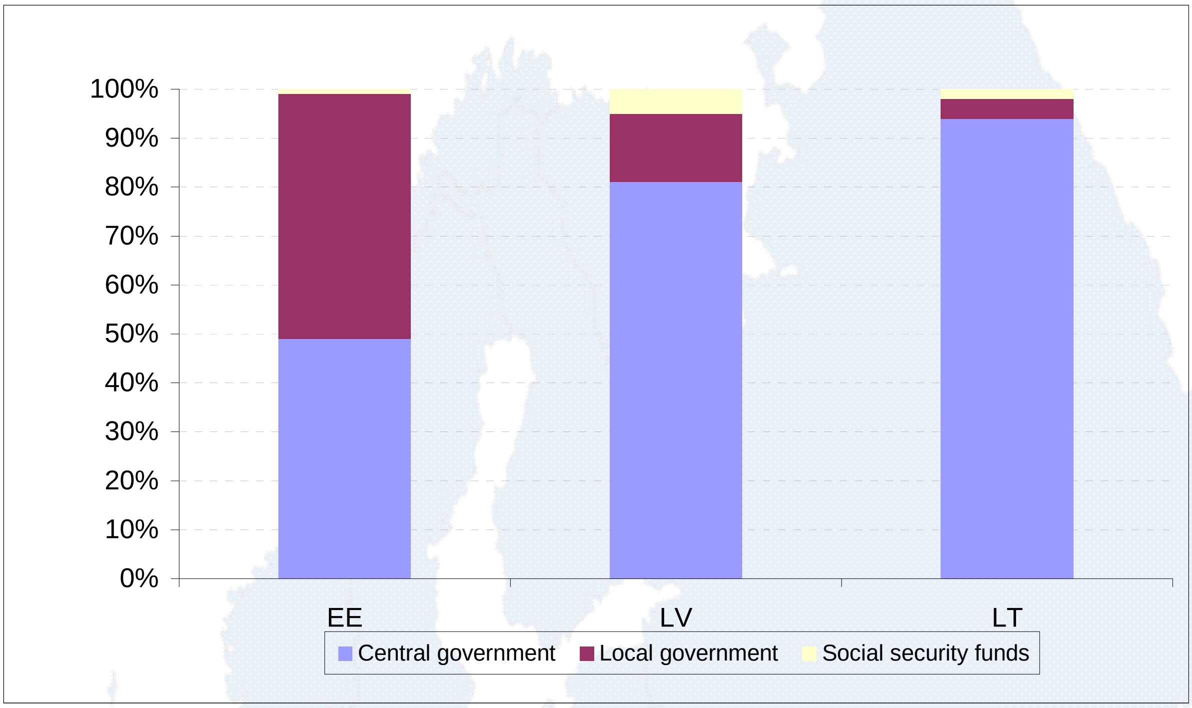
Source: Eurostat

This low level of government debt is a positive aspect for foreign investors and for the home country as well, as debt service does not reach a high share of GDP and spending on interest rates is small.

The structure of government debt should be looked from two important aspects. The first one is the breakdown by sub-sectors, and the other one by maturity. The ESA-95 divides general government into four sub-sectors (state government debt does not appear everywhere): central government, state government, local government, social security funds.

In Lithuania and Latvia, central government debt plays the highest role, while in Estonia, central and local debts are in a 50-50% share of all. In the European Union only Germany has near similar breakdown of government debt.

Chart 1. Breakdown of government debt by sub-sector in the Baltic countries



Source: Eurostat (data for 2004)

By maturity, most of the debts are classified as having a maturity of 7-10 years: in Estonia 34%, in Latvia 38% and in Lithuania 52% of the debt falls into this period. After that, the 1-5 years period is the most liked one, so the majority of the debt are denominated in a 1-10 year period.

Change Of Regime and Fiscal Policy

The base of the low government debt is the above mentioned absorption of the liabilities. This created the opportunity for these countries to make such a fiscal policy that could boost development in the long-run. Estonia was the example in the region, as a great financial stabilization was done after the change of regime. They liberalized the officially pegged prices, opened their markets ahead of foreign – mostly Scandinavian – capital, and abolished the non-profitable state companies. In consequence of these steps, inflation increased a lot, which they stopped by establishing a currency board. Parallel, the tax system was also reformed, it was simplified, a linear personal income tax was introduced, and the role of Internet became more important, as administration became faster. This model became so successful, that Latvia and Lithuania followed the same route after Estonia. The stabile growth, and stabile economy are the advantages of the region, but some negatives also arise:

- Higher inflation rate, which can delay the launch of Euro
- Higher current balance of payment: its about 8-10% in both three countries, they believe that foreign investments cover this amount of deficit

The Baltic countries may delay their entry into the Euro-zone, but anyway, they were admired by West-European analysts. One of the key facts, that this model can be successful is that financial markets do believe in the governments, credibility is very important, and Baltic countries have an exit strategy from the model – the Euro-zone – which makes the whole system more viable.

LAUNCH OF EURO

Baltic countries still believe, that – after Slovenia – they will be the first ones among NMS-10 to introduce the common currency. They already have the new coins done, the prices are shown in Euro as well, but they may face a one or two year delay because of their critical point, inflation. There must be no problem with the criterion of public debt, and there isn't any structural or macroeconomic element, that would cause an increase in the level of government debt.

INTRODUCTION OF THE EURO IN SLOVENIA

The European Central Bank and the European Commission published the Convergence Report on 16 May 2006, which has been prepared requests from Slovenia and Lithuania. It was concluded that Slovenia has achieved a high degree of sustainable economic convergence with the other Member States and that it fulfils the necessary conditions (the convergence criteria) to adopt the euro. That means, the euro is expected to become legal tender in Slovenia on 1st of January 2007 and will replace the Slovenian tolar at an irrevocably set conversion rate.

SLOVENIA IN THE ERM II

Slovenia became member of the EU in May 2004 together with nine other countries. If agreed by the Ecofin Council, it would be the first among these countries to adopt the euro, but for the adoption of euro the necessary precondition is the participation in ERM II.

Slovenia's membership in ERM II started on 28th of June 2004, and will last for at least two years. The aim of the entry in ERM II is to maintain a stabile exchange rate between the euro and the national currency in agreement with the competent European institutions. This central rate for Slovenia has been set at 239.640 SIT/EUR and the actual exchange rate can move around this central value within the agreed standard fluctuation band, which is +/- 15%.

To enter to the Euro-zone, Slovenia first must fulfill the necessary convergence criteria. The convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfillments of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors.

ECONOMIC CONVERGENCE

Price stability. Over the reference period from April 2005 to March 2006, the average rate of HICP inflation in Slovenia was 2.3%, i.e. below the current reference value of 2.6% for the criterion on price stability. Looking at recent trends, the annual average rate of HICP inflation reached 2.5% in 2005. The annual rate of HICP inflation was 2.6% in January 2006, before falling to 2.0% in March (*see Table 4.*).

Table 4. HICP in Slovenia- annual and monthly data (yoy)

	2000	2001	2002	2003	2004	2005	2006
Annual HICP	8.9	8.6	7.5	5.7	3.7	2.5	-
	XII. 2005	**I. 2006**	**II. 2006**	**III. 2006**	**IV. 2006**	**V. 2006**	**IV. 2005 III. 2006**
Monthly HICP	2.4	2.6	2.3	2	2.8	3.4	2.3
Reference Value	-	-	-	-	-	-	2.6

** Sources: European Commission calculation*
Source: European Commission (Eurostat).

A decline in non-energy industrial goods prices and lower food price inflation due to increased international and domestic competition counteracted the upward impact of oil price increases. According to the EU the 12-month average of annual HICP inflation rates is expected to remain stable in the coming months.

Fiscal indices. In the reference year 2005, the general government budget balance showed a deficit of 1.8% of GDP, i.e. well below the 3% reference value. The general government debt-to-GDP ratio was 29.1%, i.e. far below the 60% reference value (*see Table 5.*). Compared with the previous year, fiscal deficit decreased by 0.5 percentage points, while government debt ratio declined by 0.4 percentage points. In 2006 the deficit ratio is forecast by the European Commission to increase to 1.9% and the government debt ratio is projected to rise to 29.9%. Slovenia is not in an excessive deficit situation. In 2007 the deficit ratio is forecast to decline to 1.4% and the government debt ratio to remain broadly stable at its 2006 level.

Table 5. Fiscal development in Slovenia as a percentage of GDP

as a percentage of GDP	2004	2005	2006*
General government deficit	-2.3	-1.8	-1.9
Reference value	-3	-3	-3
General government gross deficit	29.5	29.1	29.9
Reference value	60	60	60

** Sources: European Commission projections*
Sources: European Commission and ECB

Exchange rate. Since joining ERM II the tolar has traded in a very narrow range, close to its euro central rate. During the period under review, the central bank was able to maintain the stability in the EUR/SIT exchange rate while keeping domestic short-term interest rates above those in the euro area. It contained volatility of its currency by using its foreign exchange swap facility.

Long-term interest rate. Over the reference period from April 2005 to March 2006, long-term interest rates in Slovenia were 3.8% on average, and thus stood well below the reference value of 5.9% for the interest rate criterion. The process of interest rate convergence was also supported by the expectation of adoption of the euro. Overall, long-term interest rates in Slovenia have moved steadily towards rates in the euro area, reflecting market confidence in general economic and fiscal developments in Slovenia and a credible monetary and exchange rate policy. (*Table 6.*)

Table 6. Long-term interest rates in Slovenia

	XII. 2005	I. 2006	II. 2006	III. 2006	IV. 2005 III. 2006
Long-term interest rate	3.7	3.7	3.7	3.8	3.8
Reference value*	-	-	-	-	5.9
Euro area	3.4	3.4	3.6	3.7	3.4

** Sources: European Commission calculations*
Sources: European Commission and ECB

INTRODUCTION OF THE EURO

The last stage is the adoption of the euro after all the necessary convergence criteria have been met. The European Commission today proposed that with effect from 1st of January

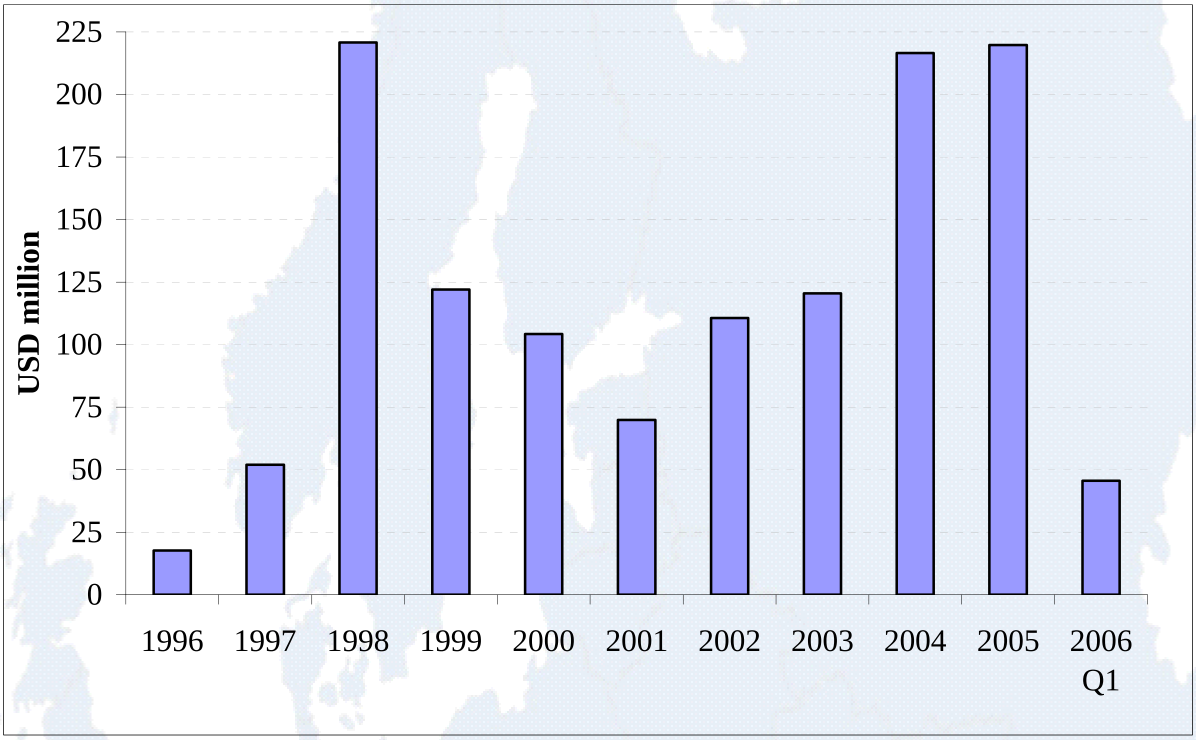
2007 the euro will replace Slovenia's currency, the tolar, at the fixed and irrevocable conversion rate SIT/EUR 239.640. But the final decision on the conversion rate must be taken by the finance ministers of the EU together with Slovenia during the next ECOFIN Council on 11th of July 2006. In the period from the date when the conversion rate is irrevocably set to the date of the actual adoption of the euro, when the conversion rate becomes effective, the euro shall remain a foreign currency.

After adoption of the euro, it will become the monetary unit of the Republic of Slovenia, and euro banknotes and euro coins will be the legal tender in the country. The Bank of Slovenia will become part of the Euro-zone and will take the responsibility for conducting monetary policy of the EU. Moreover, the Governor of the Bank of Slovenia will become a member of the Governing Council of the ECB.

PERMANENT AND RELATIVELY HIGH INWARD FDI IN ARMENIA

In the first quarter of 2006 the Foreign Direct Investments (FDI) exceeded USD 45 million which is in line with the tendencies of the previous years. This means that the total amount of FDI has reached USD 1.3 billion since 1996. (*Chart 2.*)

Chart 2. Development of FDI to the Republic of Armenia 1996-2006



Source: National Statistical Service of the Republic of Armenia

The investments targeted nearly all the sectors including public services, food industry and the financial sector. The most important investors are coming from all over the world which reflects to the country's policy as sharing the economic relations instead of the Russian dependence. Within 1998 and 2002 the biggest investor was still the Russian Federation (22%), but then Greece (20%), Canada (14%), USA (11%), France (8%), UK (5%) and other EU countries (7%).

BACKGROUND

This remarkable performance during the past 10 years has both external and internal reasons. Beside the growing supply of international investment capital and the rising risk-bearing capacity the Armenian government made considerable efforts in order to create proper economic environment for investors.

The country which became independent on 21st of September 1991 had to cope with hyperinflation, disintegration and economic fall down as the country's GDP fell almost 60% from 1989 to 1993. Despite of this tough period a successful stabilization was implemented by the government. Consequently the GDP reached its 1989 level in 2004, the rate of inflation became moderate and the official unemployment rate declines. However the rise of foreign direct investments often leads to a massive current account deficit, the most fascinating development is that how the shrinking state budget deficit made it easier to reduce the current account deficit which is on the other hand now fully covered by FDI as non-debt generating capital inflow. (*Table 7.*)

Table 7. Main economic indicators 2000-2006

	2000	2001	2002	2003	2004	2005	2006 Q1
GDP growth	5.9	9.6	13.2	13.9	10.1	13.9	8.0
Unemploymnet	11.7	10.4	10.8	10.1	9.0	7.6	7.7
CPI	3.1	1.1	2.0	4.7	7.0	0.6	-0.9
Current Account deficit %GDP	14.5	9.4	6.2	6.8	4.7	4.2	-
State Budget deficit %GDP	4.9	4.3	2.6	1.3	1.7	1.7	1.2
FDI %GDP	5.5	3.3	4.7	4.3	6.1	4.5	-

Source: National Statistical Service of the Republic of Armenia, Central Bank of the Republic of Armenia

RESULTS

As a result of the favorable processes the country's ranks at the Index of Economic Freedom (*prepared and published by The Heritage Foundation and the Wall Street Journal, see Table 8.*) become better and better. The index was first calculated for Armenia in 1996 when the country ranked at 108 in the World. The past few years shows clearly how Armenia became the leader of the region by reaching the 27th position in 2006. From the three Caucasus countries Georgia stays at the 68th spot and Azerbaijan at the 123rd.

Table 8. Development of Indices of Economic Freedom in the Region

	1996	2000	2001	2002	2003	2004	2005	2006 Q1
Armenia	108	88	75	52	43	42	41	27
Georgia	121	124	114	115	102	87	96	68
Azerbaijan	137	145	128	118	113	111	107	123
Turkey	52	42	60	101	113	106	104	85
Iran	138	155	152	152	150	149	148	156
Russia	104	121	127	125	116	118	127	122

Source: The Heritage Foundation, Wall Street Journal

According to The Heritage Foundation, Armenia offers equal official treatment to foreign investors, who have the same right to establish businesses as native Armenians in nearly all sectors of the economy. The government continues to restrict ownership of land by foreigners, although they may lease it. The International Monetary Fund reports that there are no restrictions or controls on the holding of foreign exchange accounts, invisible transactions, or current transfers and no repatriation requirements.

FUTURE PROSPECTS

However the privatization of the Kajaran Copper and Molybdenum Plant boosted the foreign direct investments in 2005, the country's monetary program (approved by the Central Bank) estimates the foreign direct investments to hit 230 million USD in 2006. Enhancement of production capacities, implementation of several construction projects are mentioned as explanation. Whether these plans become true or not, if the global investment climate will not change dramatically Armenia will definitely receive considerable foreign direct investments in the future.

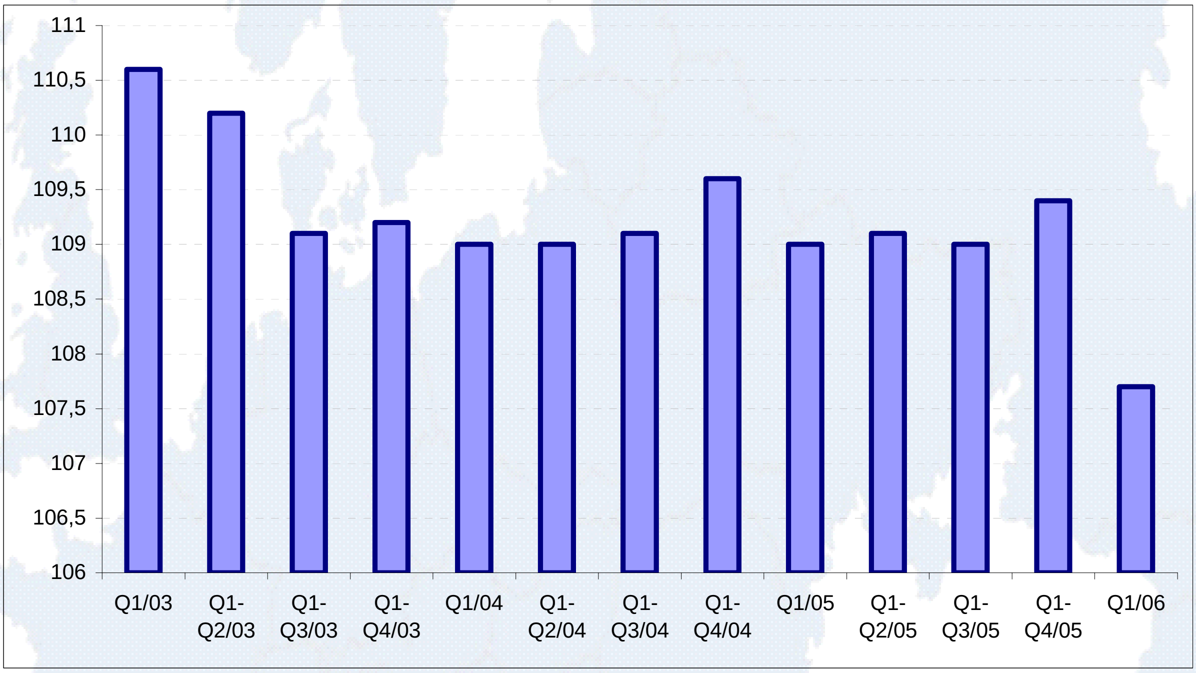
DECELERATING, BUT STILL HIGH REAL GDP GROWTH RATE IN KAZAKHSTAN

The GDP growth was stable in the last 5 years in Kazakhstan. The country was the second fastest growing economy in the world in real terms with annual real GDP growth rates higher than 9%. According to the recently released data of the Agency of Statistics of the Republic of Kazakhstan GDP grew by 7.7% in the first quarter of 2006 compared to the same period of the previous year, which is 1.3 percentage point lower than the growth measured in the first quarter of 2005.

TENDENCIES OF REAL GDP GROWTH

Since the -1.9% decrease of GDP in 1998 turned into a 2.7% GDP growth in1999 the GDP growth rate has been above 9% in the last five years, reaching a peak in 2001 (13.5% real growth rate). This stability characterizes also the quarterly development of GDP as it is shown in *Chart 3.*

Chart 3. Development of Real GDP 2003-2006 (growth compared to the same period of previous year)



Source: Agency of Statistics of the Republic of Kazakhstan

The pattern of GDP growth was quite similar in the last two years. After three almost equal quarters the fourth quarter of the year showed a slightly higher increase, which can be the result of higher demand on gas in winter months. In case this trend is going on in 2006 it can be expected that real GDP growth rate will be about 1 percentage point lower than in the last two years.

The Composition of GDP Growth on Supply Side

In the last five years there has been relatively small change in the structure of GDP by production. Production of goods and the service sector contributes to the GDP almost equally, but the share of services slowly increased to 51.8% in 2005. Agriculture experienced excellent yields in the previous year thus its contribution to GDP was higher than in the previous years (around 4-5%), reaching 7.8%. Mining and manufacturing are the two pulling factors in industry. 26% of GDP is produced in these two sectors, while construction is lagging behind with its slowly increasing share of around 6%. In the service sector trade and transport are the two biggest contributors together producing 23% of GDP. Although the share of communication services is very low it has started to grow recently, reaching 2.6% of GDP. Another characteristic feature of supply side is the strong reliance on oil related production and services that have a share of almost 13% in GDP. The contribution of the oil sector is increasing thanks to high oil prices. This structure could be observed in the first quarter of 2006 with some seasonal differences. The share of production was around 45%. The contribution of agriculture was just slightly above 2% because of the unproductive winter period. In the previous two quarters (Q3 and Q4 of 2005) agricultural production was responsible for 15% and 8% accordingly. The same seasonal differences can be observed in case of the construction sector.

Table 9. Structure of GDP in the last three quarters

(%)	Q3/05	Q4/05	Q1/06
Agriculture	15.10	8.04	2.18
Industry	26.67	31.36	36.60
Construction	12.90	11.61	6.25
Wholesale/retail trade	13.78	14.76	18.46
Transport and communication	11.98	9.36	11.75
Financial intermediation	1.34	1.70	0.77
Public administration	1.47	1.14	1.42
Other activities	16.74	22.04	22.57

Source: Agency of Statistics of the Republic of Kazakhstan

Concerning the real growth rate of the different sectors it can be said that services have been growing faster in the last five years than real GDP. Around 60% of year-to-year growth originated from this sector. In the production sector industry was growing faster than real GDP mainly thanks to the dynamic growth of mining (above 12%), especially oil extraction (above 14%). Construction experienced a faster growth rate as well. Trade and transport are two of the most rapidly developing sectors, but communication is the leading sector among services with a real growth rate of 32%, which represents 7.4% of year-to-year growth in GDP.

The Composition of GDP Growth on Demand Side

The demand side of GDP is rather unbalanced. Following the data of *Table 10.* the following statements can be made.

Table 10. Structure of GDP by expenditure

(%)	2000	2001	2002	2003	2004	2005
Final consumption	76.84	74.68	73.23	70.38	71.76	63.10
Households	64.32	61.42	60.95	58.23	58.50	51.57
Government	11.74	12.26	10.72	10.64	11.58	11.53
Gross fixed capital formation	19.55	23.01	17.67	17.46	17.07	25.07
Net export	3.61	2.31	9.11	12.17	11.17	9.16

Source: Agency of Statistics of the Republic of Kazakhstan

Although the share of final consumption decreased by 13.7 percentage points between 2000 and 2005, it still contributes to 63% of GDP. The share of governmental consumption was relatively stable, while the contribution of households' consumption was decreasing. Gross capital formation seems to be growing thanks to political and economic stability and the renewed investment policy creating favorable conditions for foreign investors. Because of huge amounts of natural resources and high oil prices the country is a net exporter. Its net exporting position contributes to GDP by almost 10%.

The share of expenditure elements from GDP growth is changing yearly. In some years (2002, 2004) consumption is the main driving force behind growth, accompanied by decreasing gross capital formation or slightly worsening net exporter position. In other years consumption has still a remarkable share in GDP growth (above 30%), but increased gross capital formation or excellent net exporter positions balance the structure of GDP by expenditure. In 2005 private consumption was supported by wage rises and expansion of bank credits.

Expectations

There were three factors which maintained buoyant economy in 2005: high world commodity prices, domestic demand and strong investment. According to the Asian Development Bank GDP growth will remain high in the coming two years, reaching 8.5% in each year. ADB estimations expect that the current account balance will be positive again (0.7% of GDP in 2006 and 0.5% of GDP in 2007) thanks to continuing high commodity prices in the future.

Domestic demand and investment could be balanced. The benefits of high oil revenues will leak to private sector and further boost consumption. High commodity prices and the start of oil production from Kashagan oilfield, scheduled for 2008, will attract more investment and after 2008 the new production capacity will improve the current account balance as a result of higher exports. As favorable commodity market conditions will not last forever, the government needs to implement a diversification program in order to maintain real GDP growth and a positive current account balance in the future.