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RUSSIA, CIS & BALTICS

EMERGING EUROPE MONITOR

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Business Monitor International's monthly report on macroeconomic performance, outlook and political risk

Parliament To Remain Pliant

Parliament continues to toe the Putin line, allowing a batch of Kremlin-sponsored reform legislation to be passed in late 2001. Activity was nowhere near as frenetic as during parliament's spring session, when the Duma passed around 160 laws in a final reading. Nevertheless, the roughly 90 laws that received the nod during the autumn sitting allowed, among other things, the launch of legal and pension system reform and the sale of non-agricultural land, and included Labour and Administrative Codes. The 2002 budget also cleared the final legislative hurdle with little fuss.

Although both sides will become more wary of rocking the electoral boat as the end-2003 parliamentary election hoves into sight, 2002 is expected to mark another year of productive relations between the executive and legislature. December's merger of Unity and Fatherland parties – two of the Duma's largest forces – marked a further step in the lower house's inexorable move towards Putin. The two parties, along with All Russia – Fatherland's partner in the 1999 election – and the People's Deputy and Russia's Regions groups, already operate an informal pro-Putin majority in the Duma that has allowed the Kremlin to side-step the sporadically determined opposition of the largest party to emerge from the last elections, the Communists.

The upper house of parliament, the Federation Council, also looks unlikely to

Russia - Continued on Page 2

REGIONAL INDICATORS

	1999	2000	2001e	2002f
GDP Growth, % y-o-y				
Russia	5.4	8.4	4.8	3.5
Ukraine	-0.2	5.8	9.0	5.0
Kazakhstan	2.7	9.8	11.0	7.0
Estonia	-3.9	3.9	5.0	4.0
Inflation, % y-o-y				
Russia	36.5	20.2	18.6	15.0
Ukraine	19.2	25.8	6.1	9.0
Kazakhstan	17.8	9.8	7.0	6.0
Estonia	0.3	1.4	4.2	4.5
C/A Balance, % GDP				
Russia	12.8	18.4	11.9	5.4
Ukraine	5.3	4.7	3.0	2.3
Kazakhstan	-1.0	5.9	0.7	-1.3
Estonia	-11.2	-6.0	-7.2	-7.1

e/f = BMI estimate/forecast. Sources: national central banks/national statistical bureaux/Economic Trends/IMF/BMI.

ALSO FEATURED INSIDE

UKRAINE - Concerns Should Not Be Overstated

Two developments have emerged as a source of some concern, with respected Finance Minister Ihor Mityukov's replacement by a lesser-known figure and the IMF's announcement that it will delay the disbursement of the next *tranche* from the US$2.6bn loan programme. However, concerns can be over-played.

Full Story on Page 6

GEORGIA - The Ongoing Crisis

Georgia does not have a normally functioning government and could be heading for state failure or fragmentation. President Eduard Shevardnadze is rapidly losing his grip on power, especially in the periphery of the country. Even in the centre, he is looking increasingly beleaguered.

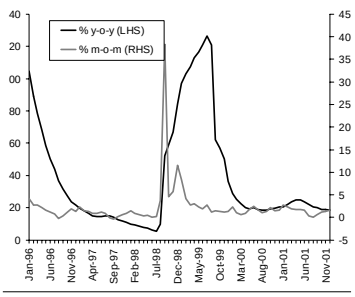
Full Story on Page 8

LITHUANIA - A Change Of Focus

With healthy real growth of 4.5% in 2001, low inflation and improving internal and external accounts in the face of a slowing global economy, the Lithuanian economy performed well in 2001. A change of peg to the euro from the dollar in February will benefit the majority of exporters, with nearly 50% of exports going to the EU.

Full Story on Page 12

Russian Inflation: High, But On Its Way Down

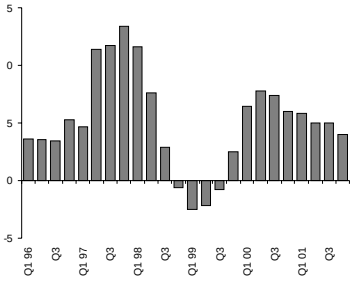


Consumer price inflation. Sources: Russian Economic Trends, Goskomstat, BMI.

At 18.6%, inflation ended 2001 in line with the government's revised expectations, thanks to the decision to forbid further tariff increases by the 'natural monopolies' in the latter part of the year. The government is planning to limit price increases by the natural monopolies in 2002 as well.

Full Story on Page 3

Estonian GDP: Slowing



Quarterly GDP. Source: Statiskaamet. e=BMI estimate

At 5%, quaterly GDP held up remarkably well in Q3 of 2001. BMI expects the rate of GDP growth to fall in Q4 to 4% as a result of lower domestic demand and weaker expectations. GDP growth will average 5% in 2001 and 4% in 2002 as a 29% increase in investment in 2001 starts to bear fruit and the global economy recovers in H2.

Full Story on Page 10

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Political Risk – Media, Chechnya Worries

- In January, President Vladimir Putin finally sacked Railways Minister Nikolai Aksyonenko, who was charged with abuse of office last October. The move has been widely interpreted as part of a campaign to gradually remove prominent members of the Yeltsin-era elite from positions of power.
- January's court order to close TV6 – the country's only national television station outside government control – has rekindled media freedom concerns.
- The authorities claim to have killed 92 Chechen guerrillas in late 2001-early 2002, in one of Russia's heaviest interventions in its breakaway republic for a year. The fighting on the ground confirms the obstacles to a political resolution to the conflict. The first official peace talks since the second Chechen war began in 1999 were held in November, but made little progress.

Russia's short-term political rating fell by two points in January to 73.0 from 75.0 in December.

Economic Risk – Another Rating Upgrade

- Ratings agency Standard & Poor's (S&P) in December followed the lead set by Moody's the previous month by upgrading Russia's foreign currency rating. The agency raised the rating from B to B+ (one notch below Moody's). The upgrades are a reward for the acceleration of economic reform under Putin and reflect optimism about economic fundamentals, despite the current uncertainty over oil prices.

The short-term economy rating was largely unchanged in January at 62.4.

Business Environment – Parliament Lends A Hand

- A number of reform measures adopted by parliament in its autumn sitting bode well for further gradual improvements in Russia's inhospitable business environment. In particular, reform of the pension and legal systems can now begin.

Due to the decline in the political rating, the composite rating fell to 67.5 in January from 69.0 in December.

All ratings are expressed as a number between 1 and 100. A high rating is an indicator of low risk. BMI's Risk Ratings source historical data and forecasts from BMI's Emerging Markets Online Service. For full access please contact Rob Anderson on +44 (0)20 7557 7171 or email randerson@businessmonitor.com, or see **www.emerging-markets-online.com**

POLITICAL OUTLOOK

While at home President Vladimir Putin continues to rule the roost, his efforts to revolutionise relations with the West appear to be falling on stony ground. With the war in Afghanistan over much more quickly than anyone had anticipated, cracks are already beginning to appear in the new alliance with the US.

continued from front page

emerge as a source of significant opposition to the executive, in the short term at least. On January 16, the chamber convened under the new rules forced through by Putin in 2000 to weaken the power of the regions, under which the Council's members are no longer the regional heads, but their appointees. The new system has deprived the chamber of its coherent membership, with representatives coming from all walks of life, although business and government appear to be common backgrounds. This diversity should deliver the executive an advantage in winning the chamber around to its policies. And, even if the house becomes less malleable, as predicted by some, this will not be for some time as it works to find its feet.

Putin's Foreign Adventure Not Paying Off? – While Putin remains firmly in charge at home, his foreign policy drive since September to transform Russia's relationship with the West is looking increasingly unsuccessful. Although on a declarative level relations have warmed dramatically since Putin threw Russia's backing behind the war on international terrorism, on a practical level the West has yet to show its appreciation in a big way. One area in which it may do so in 2002 is Russia's World Trade Organisation (WTO) bid. Both the US and Europe have promised that negotiations will be sped up after becoming bogged down in mid-2001. WTO Director-General Mike Moore said in December that Russia could be a member by mid-2003.

Beyond this, however, the US stance could prove an increasing obstacle to relations, with the success of the US-led campaign in Afghanistan having boosted the position of hardliners, headed by Defence Secretary Donald Rumsfeld, who are less willing to coddle Russia. In December, Bush gave notice of the US' withdrawal from the Anti-Ballistic Missile (ABM) treaty so as to proceed with tests for a National Missile Defence (NMD) shield intended to protect the US from nuclear attack by 'rogue states'. Russia wished to preserve the ABM treaty, and it had been generally expected that some kind of deal incorporating a sharp cut in both sides' nuclear arsenal, as advocated by the cash-strapped Russians, would be threshed out in advance allowing the US to proceed with NMD while saving Russian face for accepting the inevitable. Bush has pledged to join Moscow in making cuts, but so far has shied away from enshrining them in a formal treaty. And, although Putin has made headway on turning the relationship with Nato to Russia's advantage, with the body agreeing in December to set up a Nato-Russia council, the extent of cooperation envisaged under the new body has been watered down due to fears from the US and the East European countries that recently joined Nato that Russia would be given a say in Nato decision-making.

With the war in Afghanistan over more quickly than anyone had expected, other cracks have begun to appear in the new alliance. In January, the US stepped up its criticism of Moscow's campaign in the breakaway republic of Chechnya and expressed renewed concerns

over media freedom in Russia. In turn, the continued presence of US forces in Central Asia is beginning to provoke a more frosty response from Moscow. Further strains in the relationship would appear if US hardliners lobby successfully to extend the 'war on terrorism' to Iraq, a move which is vehemently opposed by Russia. The thorny issue of Nato expansion will also be increasingly thrust to the fore, with the Baltic states hoping to receive an invitation to join the alliance later in 2002.

Although on the ground relations between Russia and the US already seem to be taking a turn for the worse, Putin himself has stood above the fray, reacting calmly to Bush's ABM announcement. However, unless he starts to see greater payback for his foreign policy adventure, he may conclude that it is time to reconsider. If not, domestic opposition to his new policy, which has been muted so far, would be likely to increase. Such complaint would be unlikely to jeopardise Putin's domestic authority, but would be likely to lead him to tone down his strongly pro-US stance.

Tariff Caps Limit Inflation

Inflation ended 2001 in line with the government's revised expectations. A 1.6% month-on-month (m-o-m) rise in the consumer price index put the year-on-year (y-o-y) rate at 18.6% in December, only moderately above the government's latest 18% end-year forecast, but, as anticipated, well in excess of its initial 12% expectation. This was the eighth consecutive month of falling or stable inflation after early-2001 concerns that the efforts of the Central Bank of Russia (CBR) to keep the rouble from being strengthened too much by booming commodity exports was excessively boosting the money supply and prices.

The H2 2001 inflation downtrend was assisted by the authorities' decision to forbid further tariff increases by the 'natural monopolies' (electricity, gas and the railways) in the latter part of the year. As part of reform efforts encouraged by the government itself, the natural monopolies are keen to raise domestic prices, which are considerably below world levels, to allow them to tackle severe under-investment. However, the government is less enthusiastic about the impact on inflation and the population. Its compromise for 2002 is to cap price increases by the natural monopolies at 35%, below the rates of up to 66% for which the companies concerned had been calling.

The government believes that such a rise will accommodate the budget's forecast that consumer price inflation will be no higher than 13% by end-year, although Minister for Economic Development and Trade German Gref warned in December that if the companies take the opportunity to raise prices all at the same time in January, the rate could be pushed up to 15.0-15.5%. Prime Minister Mikhail Kasyanov subsequently postponed a 14% increase in rail freight prices planned for January. The government is now due to discuss it in late January

	2000	2001e	2000/2001 Latest period		2002f	2003f
Population (mn)	145.5	145.1	-	-	144.6	144.2
Nominal GDP (US$bn)	251.1	308.8	-	-	339.9	355.5
GDP per capita (US$)	1,726	2,129	-	-	2,350	2,466
Real GDP growth (% y-o-y)	8.4	4.8	5.0	Jan-Sep	3.5	3.0
Industrial production index (% pa)	11.9	4.9	4.9	Jan-Dec	3.8	3.5
ILO unemployment (%)	9.8	9.0	8.8	Nov	9.5	9.8
Primary fiscal balance (RUBbn)	334.8	387.1	444.3	Jan-Oct	327.0	448.0
Primary fiscal balance (% of GDP)	4.7	4.3	-	-	3.0	3.5
Federal budget balance (RUBbn)	162.5	90.0	228.3	Jan-Oct	0.0	64.0
Federal budget balance (% of GDP)	2.3	1.0	-	-	0.0	0.5
Consumer prices (% m-o-m)	-	-	1.6	Dec		
Consumer prices (% y-o-y, end period)	20.2	18.6	18.6	Dec	15.0	13.0
M2 growth (% y-o-y, end period)	62.4	40.0	38.9	Nov	30.0	25.0
Refinance rate (% pa, end period) *	25.0	25.0	25.0	21-Jan	22.0	19.0
Exchange rate (RUB/US$, end period)	**28.160	30.140	30.56	23-Jan	34.000	38.000
Customs exports (US$bn, fob)	105.50	104.50	94.9	Jan-Nov	94.00	100.30
Customs imports (US$bn, cif)	44.90	53.00	47.8	Jan-Nov	61.00	65.50
Customs trade balance (US$bn, fob-cif)	60.60	51.50	47.1	Jan-Nov	33.00	34.80
Current account (US$bn)	46.32	36.80	28.56	Jan-Sep	18.30	15.40
as % of GDP	18.4	11.9	-	-	5.4	4.3
Foreign reserves (US$bn, end period)	24.3	32.5	32.5	Dec	35.0	37.0
Import cover (months)	4.7	5.4	-	-	5.3	5.0
Foreign debt stock (US$bn, end period)	142.20	139.00	-	-	136.00	134.00
as % of exports	123.44	121.29	-	-	130.77	121.49

e/f = BMI estimates/forecasts. Sources: Russian Economic Trends/Goskomstat/Central Bank of Russia/IMF/EBRD/BMI.

ECONOMIC OUTLOOK

Consumer price inflation ended 2001 below 20%, but only thanks to limits on tariff increases by the 'natural monopolies'.

BMI FORECAST SCENARIO

At 30.14/US$, the rouble ended 2001 slightly weaker than we had been expecting, with the unit's nominal depreciation picking up towards the end of the year on the back of usual end-of-year volatility and the falling oil price. The stepped-up depreciation continued into January, with the rouble reaching 30.56/US$ by January 23. The economy's fundamentals are stronger than for a long time, and BMI is still expecting a large current account surplus to be posted in 2002, both of which should give support to the rouble despite the fall in the oil price. Nevertheless, Central Bank of Russia (CBR) chairman Viktor Gerashcheko has recently commented that exchange rate policy should be geared towards the competitiveness of exports, suggesting that the CBR may be willing to contemplate a larger rouble depreciation this year than we had previously envisaged. We are now expecting the rouble to fall to around 34/US$ by end-2002, rather than to the 32/US$ previously envisaged. However, with inflation expected to remain high in 2002, this still implies a real appreciation.

alongside a timetable developed by the Ministry for Economic Development and Trade for other railway, gas and electricity sector price rises. The plan proposes staggering the increases in January, February and July.

Pressure on prices from the exchange rate is also likely to ease in 2002, despite some slight rouble volatility at the turn of the year.

Exchange Rate To Be Less Of A Problem in 2002 – Exchange rate-related inflationary pressure should moderate in 2002, as the fall in the price of oil and other key commodity exports should take some of the pressure off the rouble and require less intervention by the CBR. Growth in M2 money supply began a downward trend in May 2001, and in October stood at 43.9% y-o-y, compared with 60.2% a year previously.

Despite some exchange rate volatility in December-January, a large fall in the rouble that could push prices up does not seem likely, either. Some concern was prompted towards the end of 2001, when it emerged that the CBR's foreign exchange reserves, which have risen consistently since 1999 to around US$34bn by October, had fallen by around US$2.5bn in the final week of November and first week of December. The reserves appear to have been used to fund external debt payments and stem a slide in the rouble, which as a result depreciated by only around 1.5% in the final two months of the year.

The rouble continued its accelerated depreciation into the New Year, losing around 1.4% of its value by January 17. However, the exchange rate pressure is likely to be largely due to usual turn-of-year volatility, exacerbated by oil price uncertainty, rather than to any fundamental problems with the economy. And, although the rouble will be sensitive to oil price movements this year, and we are anticipating a greater weakening than before, we are still expecting a large current account surplus to be posted, which should provide support for the rouble.

Reform of the pension system is key to prevent an unsustainable burden on the public finances and a further drop in pensioners' already paltry income. It should also give a boost to the capital markets.

Pension Reform Launched

Provided all goes according to plan – admittedly a large assumption to make in a country that as recently as 1998 suffered financial sector meltdown – the reform of Russia's pension system launched at the beginning of 2002 should have several positive economic consequences. At the most fundamental level, change is essential to safeguard the public finances from an unsustainable burden, and to ensure that Russia's pensioners – who currently number around 38mn, or over a quarter of the total population – are not to see their living standard drop below even its current paltry level. Under the set-up inherited from the Soviet days, the current workforce funds the payments made to today's pensioners, but Russia's population is ageing, and it is estimated that by 2020 there will be only one worker for every pensioner.

The pension reform should additionally deliver a boost to Russia's fledgling capital markets. The current state system, which is to be kept on in modified form, does not invest the funds that flow through the Pension Fund. However, the reform envisages the establishment of a second pension tier under which savings accounts will be set up for individuals and invested. The investment of these funds is to remain in state hands up until mid-2003, and to focus mainly on short-term government securities. After that, the government will tender for privately-managed funds, and Russians will be given the option of continuing with the state or going private. It has been forecast that the private funds will attract around US$1.5bn in 2003-04. From around the end of 2003, the authorities are also expecting the funds to use a broader range of investment vehicles, including those abroad (up to 20% of the funds' assets can be directed abroad).

Even later into the reform, in 2004, the government is planning to give individuals the option of leaving the second tier entirely and moving to a completely private pension fund, although this will require further legislation. Russia currently has around 250 private funds, with assets of around RUB19.5bn (US$670mn) at end-September 2001, but none of them are particularly well developed.

During the pension revamp, employers' social tax payments to the Pension Fund will be split, with half continuing to go to the Fund, and the other half to the second tier funds. However, the Pension Fund is expecting the situation to be manageable. During 2003-04, it is planning to use its reserves to make up for the reduced inflow of funds. From 2004 onwards, it plans to turn to the government for assistance of around RUB50bn (US$1.7bn at 2001's exchange rate) a year.

KEY ECONOMIC SECTORS

The telecoms sector continues to make strides with the ongoing restructuring of fixed-line networks and the continuing expansion of mobile operators outside the capital.

Telcos Ring In The Changes

Russia's telecoms sector is becoming increasingly attractive on the back of the restructuring of fixed-line networks and the expansion of mobile operators outside the core Moscow market. In fixed-line services, the key development is the merger of a large number of under-capitalised and illiquid local telecoms operators (LTOs) into super-regional groups, which will then

enjoy a 49% free float of their total equity. An important step in this process took place in January, when the Anti-Monopoly Ministry approved the consolidation of local companies into the Urals grouping, **Uralsvyazinform**, setting a precedent for the other super-regionals. The completion of a one-for-one share swap for this region, together with similar deals for LTOs in the Northwest, Volga, South, Siberia and Far East regions, could be completed by end-2002. The government was also due in January to complete a review designed to determine an upper limit for tariff levels appropriate for ensuring sector profitability. Recent indications are that this might allow more than a threefold increase in landline tariffs over the medium-term.

While regulatory changes are improving the outlook for fixed-line, mobile operators are still largely reliant upon their own initiative. **Mobile TeleSystems** (MTS) is still the dominant market player, and December subscriber numbers confirmed that it remains the leader in the race for the regions, adding 50,000 subscribers in the first three weeks of its new St Petersburg operations, and 60,000 across the other provinces. Additionally, the company recently unveiled the purchase of a controlling stake in **Kuban GSM**, the leading mobile operator in the Krasnodar region, and the largest local mobile concern.

Still, it is too soon to rule out the **Vimpelcom** challenge. The second largest player appears to be winning the battle for the Moscow market, adding 220,000 new subscribers in the city during December 2001, against 140,000 for MTS. Moreover, its under-performance in the regions has largely been a corollary of a shortage of capital to carry out infrastructure expansion, rather than any shortfall in managerial ambition. Cash injections from a partnership with local conglomerate **Alfa Group** and a planned US$250mn bond issue, slated to take place in H1 2002, will help to remedy this, while Vimpelcom is also likely to acquire a licence to operate in St Petersburg and the Northwest region. With the prospect of both Vimpelcom and MTS then looking to expand into the largely undeveloped markets of other CIS states, the bracing effects of their constant competition on management strategies can only be to the benefit of investors.

Oil Update: Disagreement Over Export Cuts

A Q1 2002 cut in exports announced by the government to help Opec massage the oil price has been opposed by those companies focused on market share. Suspicions that Russia will shirk its obligations to the cartel have weighed on global oil prices.

The authorities' decision in December to support Opec's efforts to raise the oil price by cutting Russian exports by 150,000 b/d in Q1 2002 was not advocated by all of Russia's oil companies. **Lukoil**, the country's largest, has been one of the most supportive of cuts, with its vice-president, Leonid Fedun arguing that they should last for six months and affect production as well as exports. The company's output has been steady in recent years and is due to rise by a modest 2% in 2002 (to around 1.6mn b/d). Helping Opec massage the oil price higher is therefore clearly to Lukoil's advantage, especially since it also has larger operating costs than some other firms. While supporting the export cuts to stabilise the oil price, **Tyumen Oil Company** (TNK) foresees drawbacks, arguing that the cuts would force it to reduce planned capital expenditure in 2002 to US$700mn from an original US$1.0bn.

The country's second-largest producer, **Yukos**, has opposed the cuts outright. The company has expanded significantly, with output up by 17% in 2001, and is clearly more interested in increasing its market share than contributing towards higher prices. While Russia exports on average 3mn b/d of oil, implying that a collective reduction of around 5% will be needed from the oil majors to meet Russia's Opec pledge, Yukos has announced plans for another 17-20% rise in output in 2002.

With Yukos not the only company to stand by ambitious output targets for 2002 (**Sibneft** is forecasting a 26% increase in its own production), there are widespread doubts as to whether Russia will fulfil its obligations. The government is also doing what it can to help the oil firms by, for example, allowing them to make up for reduced crude exports by exporting more oil products. The oil companies therefore look unlikely to be affected as much as suggested by the officially announced export cut. However, the suspicions over Russian non-compliance have led to concern that Opec members will not feel obliged to comply, either, and have therefore weighed on global oil prices. While Opec's announced 1.5mn b/d output cut for the first six months of the year has in the short term staved off further large declines in the oil price, uncertainty will continue to reign as to whether it will be enough to steady prices further into 2002.

BMI is for the moment maintaining its US$18/b average forecast for the Opec basket in 2002. However, even if the oil price falls sharply again, Russia's oil companies should still be able to remain profitable, probably down to a price of around US$12/b. Investment plans would be hit, though. Yukos head Mikhail Khodorkovsky has argued that if the oil price fell to US$16/b, some of the firms' investment projects would no longer be profitable. He also said that output would contract below a price of US$14/b.

Political Risk – US Loses Patience On Piracy

- Trade relations took a turn for the worse in January, with the US poised to impose US$75mn in sanctions on Ukrainian goods in retaliation for Kiev's lack of progress in tackling Ukraine's flourishing pirated compact disc market. It is unclear whether a law on piracy passed by parliament at the last minute would be enough to prompt a retraction of the sanctions.

Ukraine's short-term political rating jumped in January to 68.0 from 60.0 in May 2001, when there was a political crisis.

Economic Risk – 2002 Budget Adopted

- Parliament's adoption in December of a restrained 2002 budget is a positive development. Deputies, facing elections in March, had demanded that the revenue target be raised by a third, but in the end the government was forced only to concede a rise of about 2%. The budget targets a 1.7% of GDP deficit.

The short-term economy rating was stable at 57.6.

Business Environment – Watch This Space

- The authorities have announced plans to resume the sell-off of electricity distribution companies in H2 2002. Successful privatisation of the companies is key to reforming the corrupt and crumbling energy sector.

The composite rating increased appreciably to 62.6 from 58.8.

All ratings are expressed as a number between 1 and 100. A high rating is an indicator of low risk. BMI's Risk Ratings source historical data and forecasts from BMI's Emerging Markets Online Service. For full access please contact Rob Anderson on +44 (0)20 7557 7171 or email randerson@businessmonitor.com, or see **www.emerging-markets-online.com**

POLITICAL OUTLOOK

Although there are some concerns over policymaking in the run-up to March's elections, the situation will become clearer after the poll, with, in a best-case scenario, a return to power of reformist former prime minister Viktor Yushchenko.

BMI FORECAST SCENARIO

Official figures point to a second year of very strong economic growth in 2001, with real GDP up by 9.0% after 5.8% growth in 2000. Growth was powered by industry, which saw a 14.2% rise in output, and by agriculture, which benefited from a very good harvest. A repeat performance in 2002 is unlikely, with exports facing a tougher external environment, especially with key trading partner Russia expected to witness a decline in growth. This year's budget assumes 6% real GDP growth, but, although the 3.5% rate that BMI was previously forecasting is now looking on the low side, we are not as optimistic as the government, and are instead expecting around 5.0%.

Concerns Should Not Be Overstated

Since parliament's approval of the 2002 budget in mid-December, a couple of developments have emerged as a source of some concern, with respected Finance Minister Ihor Mityukov's replacement by a lesser-known figure, Ihor Yushko, followed by an announcement from the IMF that it will delay the disbursement of the next *tranche* from the sovereign's US$2.6bn loan programme. The Fund will withhold the cash until the authorities prepare a plan for the payment of some UAH4bn owed to corporates in the form of overdue value-added tax (VAT) refunds, and wishes in future to see the government treat the refunds as an integral part of fiscal plans, rather than as an off-budget item.

However, concerns can be over-played. While Mityukov's departure is likely to represent a political move by President Leonid Kuchma to buttress his position ahead of March's parliamentary elections, investors should not read too much into this. "Although Kuchma may have tired of Mityukov, and is perhaps using Yushko as a pawn, he does have a reasonable background as a state secretary within the finance ministry," underlines Alex Garrard, Emerging Europe debt strategist for **UBS Warburg**, in London. In fact, Garrard believes that the political situation is improving, with reformist former prime minister Viktor Yushchenko – who was ousted by a Communist Party-led no-confidence vote last May – performing extremely well in the opinion polls. Importantly, the former head of government has also been very careful to distance himself in the run-up to the election from the parliamentary factions that are most vocally opposed to the president. As a result, if he does well at the polls and regains his position, he ought to be able to come to a reasonably durable understanding with Kuchma. All the more so, given that the unpopular president's own power-base is looking increasingly vulnerable.

If the VAT problem has not been resolved prior to the poll, it is reasonable to expect a clearing-up of the issue reasonably swiftly after. Garrard believes that such a scenario will provide room for an upgrade by rating agency **Standard & Poor's** (S&P), which currently places the sovereign at Caa1.

	1999	2000	2001e	2000/2001 Latest period		2002f	2003f
Population, mn	50.1	49.6	49.2	-	-	48.8	48.4
GDP, US$bn	31.6	31.8	39.4	-	-	43.8	46.9
Real GDP, % y-o-y	-0.2	5.8	9.0	9.0	Jan-Dec	5.0	3.0
Industrial output, % y-o-y	4.3	12.9	14.2	14.2	Jan-Dec	7.5	5.0
Budget, UAHbn	-2.8	-1.1	-3.8	-1.5	Jan-Nov	-6.0	-5.4
Budget, % of GDP	-2.1	-0.7	-1.8	-	-	-2.5	-2.0
Inflation, eop % y-o-y	19.2	25.8	6.1	6.1	Dec	9.0	10.0
UAH/US$, end-period	5.22	5.43	5.30	5.31	10 Jan	5.60	5.90
Exports, US$bn	13.19	15.72	17.10	8.41	Jan-Jun	17.90	18.90
Imports, US$bn	12.95	14.94	16.60	7.98	Jan-Jun	17.60	18.80
Trade balance, US$bn	0.24	0.78	0.50	0.44	Jan-Jun	0.30	0.10
Current account balance, US$bn	1.66	1.48	1.20	0.85	Jan-Jun	1.00	0.80
Foreign reserves, US$bn	1.05	1.35	3.00	2.87	Nov	3.50	4.00
External debt, US$bn	11.48	10.00	9.50	-	-	9.50	10.00

f = BMI forecast. Sources: Ukrainian Economic Trends/Ukrainian authorities/IMF/EBRD/BMI.

Political Risk –Aliyev Under Fire

- President Haydar Aliyev is coming under increasing pressure, with the frequency and size of opposition rallies growing. The coming months will see police crackdowns on demonstrators as Aliyev asserts his authoritarian rule. The key demands being made by the opposition are Aliyev's resignation, the release of political prisoners and a resolution to the conflict with Armenia over Nagorno-Karabakh. The opposition parties advocate a more aggressive stance towards Armenia. Their increasing popularity suggests that Aliyev's chosen successor, his son Ilham, will face a tough contest for the presidency when his father eventually gives up the reins.

Economic Risk – An Optimistic Budget

- The 2002 budget, which has been passed by parliament and approved by the IMF, appears optimistic to BMI. Weak economic management and the government's over-dependency on oil at a time of unstable oil prices could well cause a revenue shortfall. The government will need to make consistent progress in encouraging the development of the non-oil sectors.

Business Environment – Red Tape Rules

- The investment climate improved in late 2001 thanks to new rules on customs tariffs. However, the instances of bribery and corruption do not appear to be diminishing. British construction company Morrison is pulling out of Azerbaijan, citing corruption, red tape, taxation policy and payment arrears from its joint venture partners (local government) as the reasons. The company was due to build a five-star hotel in Baku and had already spent £4.5mn on it.

Privatisation Across The Sectors

The government's confidence in the economy is high on the back of a strong performance in 2001. The 9.9% rise in GDP was driven by increased industrial and agricultural output, albeit with the oil and gas sectors still accounting for the lion's share of production. The state's coffers were topped up by the privatisation of the aluminium and machinery sectors, and metallurgy is on track to post strong growth in 2002.

Unnamed German companies have expressed an interest in an ore treatment factory and a pipe mill. An even bigger pull for foreign capital in Q1 2002 will be the sell-off of telecoms and utilities companies, which is due to start with **Baku City Telecom** and three regional electricity distribution companies.

Rural reforms have begun to reap rewards. Most farms are now in private hands, making Azerbaijan a leader among the CIS states in terms of private land ownership. Farmers are receiving soft loans in Q1 2002 from the European Bank for Reconstruction and Development (EBRD), Germany's **KfW Bank** and the state budget for machinery purchases. The aim is to boost local food production so as to reduce the country's dependency on imported produce. The food sector is set to grow by 8% in 2002 and to secure new export deals. UK supermarket **Sainsbury's** is involved in talks on buying pomegranate juice. Foreign investors are also attracted to sturgeon and caviar production, which the government is planning to privatise this year.

Government To Seek More Foreign Investment – The 2002 budget, which targets a 1.2% of GDP deficit, forecasts GDP growth of at least 7%, and inflation of 2-3%. Macroeconomic stability is expected to be preserved, with the government likely to pursue a prudent policy in the next few months focused on completing tax reform, investing in recently privatised small- and medium-sized enterprises and attracting foreign direct investment (FDI) to non-oil sectors – provided that foreigners are not put off by fears of political instability. American investors are likely to be a particular target, now that the US government has lifted restrictions (see *RCBM*, December 2001).

	1998	1999	2000	2001e	2000/2001 Latest period		2002f
Population, mn	7.91	7.98	8.05	8.12	-	-	8.20
GDP, US$bn	4.4	4.6	5.3	5.6	-	-	5.9
Real GDP, % y-o-y	10.0	7.4	11.4	9.9	9.9	Jan-Dec	7.0
Industrial output, % y-o-y	2.2	3.6	6.9	5.1	5.1	Jan-Dec	4.0
Budget, AZMbn	-314.5	-459.6	-246.6	-130	131.7	Jan-Sep	-430
Budget, % of GDP	-1.8	-2.4	-1.0	-0.5	0.7	Jan-Sep	-1.5
Inflation, eop % y-o-y	-7.6	-0.5	2.1	1.4	1.4	Dec	2.0
AZM/US$, end-period	3,890	4,378	4,565	4,774	4,795	14-Jan	4,980
Exports, US$bn	0.7	1.0	1.9	2.1	1.1	Jan-Jun	2.2
Imports, US$bn	1.7	1.4	1.5	1.6	0.7	Jan-Jun	1.7
Trade balance, US$bn	-1.0	-0.4	0.3	0.5	0.4	Jan-Jun	0.5
Current account balance, US$bn	-1.4	-0.6	-0.2	0.3	0.0	Jan-Jun	0.3
Foreign reserves, US$bn	0.4	0.7	0.7	1.0	1.0	Aug	1.0
External debt, US$bn	0.7	1.0	1.3	-	-	-	-

e/f = BMI estimates/forecasts. Sources: Azerbaijan Economic Trends/Azeri authorities/IMF/EBRD/BMI.

ECONOMIC OUTLOOK

The pace of privatisations of medium and large enterprises has been slow but will pick up in the next few months. Further expansion of the private sector is crucial if budget targets are to be met.

BMI FORECAST SCENARIO

A relatively high 0.9% month-on-month (m-o-m) rise in consumer prices in December saw the year-on-year (y-o-y) rate climb modestly that month, but only to 1.4%. Average inflation for 2001 was 1.5%. BMI had been expecting a higher end-year rate of around 4.0%, dropping to 3.5% in 2002, but the 2001 outturn confirms a pattern of very subdued inflation that has encouraged us to revise downwards our end-2002 forecast to 2.0%. The economy continued to expand at a robust rate last year, with figures released recently putting the real GDP growth rate at nearly 10%. High levels of growth have been supported by the development of the oil and gas sectors, which has attracted large sums of foreign investment, and, although the oil price is on course to be significantly lower in 2002, hitting the value of exports, continued energy-related development should allow another year of respectable growth to be recorded.

Political Risk – A Weak State

- Georgia does not have a normally functioning government and could be heading for state failure or fragmentation. President Eduard Shevardnadze is rapidly losing his grip on power, especially in the periphery. Even in the centre, he is looking increasingly beleaguered.

Economic Risk – Corruption Hinders Growth

- A new IMF loan *tranche* is to be targeted towards poverty relief. While the elite thrives on corruption, average Georgians are impoverished, with many having lost their jobs at state-run enterprises.
- Under pressure from the IMF, the government has lowered its GDP growth forecast for 2002 to 3.5% from 4.5%. Changes in tax and customs administration plus a drop in the level of graft are key to attaining budget revenue targets.

Business Environment – Grey Economy Hits Bottom Line

- Foreign firms are seeing their profits hit by a rampant black market, rife corruption and high taxes. Due to the unconventional economy, British American Tobacco (BAT) is threatening to close its factory. Its Georgian-made goods are subject to high taxes and cannot compete with smuggled and counterfeit cigarettes.
- The security of expatriate personnel is a growing concern in the light of recent kidnappings and muggings. Foreign companies spend around 20% of their overheads on security.

POLITICAL OUTLOOK

Parliamentary support for President Shevardnadze is waning. Constitutional amendments are imminent within the next few months.

BMI FORECAST SCENARIO

Real year-on-year (y-o-y) GDP growth of 4.8% reported for the first nine months of 2001 suggests that growth could have been as high as 4.0% for the year as a whole, factoring in a negative impact on activity in Q4 of a more depressed external environment. This would be the highest growth posted for several years, but was assisted by a low base in 2000, when growth was held back to just 1.9% by drought. While the agricultural sector will have performed much better in 2001, industry was hit by energy shortages, and actually saw output decline by 0.8% year-on-year (y-o-y) in the first 10 months. BMI expects the severe structural problems in the economy to prevent it growing by more than 3.0% in 2002.

The Ongoing Crisis

There could be a leadership change in 2002. President Eduard Shevardnadze intends to stay in power until the end of his term in 2005, but power is slipping through his fingers. A political crisis was sparked in October by public demonstrations against a politically motivated security police raid on an independent television channel. The protesters called for Shevardnadze to resign, and when Shevardnadze's sacking of his security minister, Vakhtang Kutateladze, failed to appease them, the president dismissed his entire government. Parliament's speaker, Zurab Zhvania resigned, as did popular reformist Justice Minister Mikhail Saakashvili, with both men having rocked the boat by criticising Shevardnadze's lack of commitment to tackling corruption.

In December, almost the entire government was reappointed and a new speaker elected, Nino Burdzhanadze. Under the current constitution, she would take over if the president resigned or died, but this is to change. Shevardnadze plans to amend the constitution and create the post of prime minister. **BMI** anticipates that Shevardnadze will then install his chosen successor as premier, and later ensure he takes over the presidency. Shevardnadze has yet to nominate a potential successor, but one possibility is Aslan Abashidze, currently head of the autonomous region of Adjaria and also the president's new envoy to Abkhazia, his mission to return the breakaway republic to Tbilisi's fold. The government has so far failed to find a peaceful solution to the demands for independence from this region and also from the renegade South Ossetia.

The political crisis is sure to deepen. By reappointing most of the old government except two key reformers, Shevardnadze has lined up with the conservatives. However there are still reformers in parliament and, with public support, pressure for new parliamentary elections is growing. Georgia's international image has suffered from the recent political fiasco. Even the US, which has consistently given moral, military and significant financial aid to Georgia since its independence in 1991, is alarmed at the weak governance and lawlessness that afflict the republic.

	1998	1999	2000	2001e	2001/2002 Latest period		2002f
Population, mn	5.3	5.4	5.3	5.3	-	-	5.3
GDP, US$bn	3.6	2.8	3.0	3.2	-	-	3.2
Real GDP, % y-o-y	2.9	3.0	1.9	4.0	4.8	Jan-Sep	3.0
Industrial output, % y-o-y	-6.0	7.4	6.1	-1.0	-0.8	Jan-Oct	1.0
Budget, GELmn	-309.9	-379.6	-242.6	-190	-	-	-170
Budget, % of GDP	-6.1	-6.7	-4.1	-3.0	-2.0	Jan-Jun	-2.5
Inflation, eop % y-o-y	10.6	10.9	4.6	3.4	3.4	Dec	5.0
GEL/US$, end-period	1.80	1.93	1.98	2.08	2.08	18-Jan	2.2
Exports, US$bn	0.3	0.3	0.5	0.5	0.5	Jan-Dec*	-
Imports, US$bn	1.0	0.9	1.0	1.0	1.0	Jan-Dec*	-
Trade balance, US$bn	-0.7	-0.5	-0.5	-0.5	-0.5	Jan-Dec*	-
Current account balance, US$bn	-0.3	-0.2	-0.3	-0.3	-0.3	Jan-Dec*	-
Foreign reserves, US$bn	0.1	0.1	0.1	0.1	0.1	Oct	0.1
External debt, US$bn	1.7	1.7	1.6	-	-	-	-

*e/f = BMI estimates/forecasts. Sources: Georgian authorities/IMF/EBRD/BMI. * 2000 figures.*

Political Risk – US Presence Bolsters Akayev

- 3,000 US troops are due to be stationed for at least 12 months at Manas airport, near the capital Bishkek, for deployment to Afghanistan on military and humanitarian missions. President Askar Akayev is exploiting support from the US to crack down on political dissent and Islamic extremists to bolster his regime.
- A power struggle is underway between the executive and legislative branches which could lead to the president dissolving the parliament. Akayev is trying to silence the opposition in the parliament, and an outspoken deputy has been arrested on trumped-up charges.

Economic Risk – In Debt But On Track

- Financing the deficit and keeping debt within sustainable limits are top of the agenda. Investors are deterred by the economic risk posed by Kyrgyzstan's debt burden.

Business Environment – Less Red Tape And Tax

- Foreign companies such as mining firm Cameco Corporation (Canada), complain of government scrutiny and excessive bureaucracy in the granting of permits and licences. The government has promised to cut red tape, simplify taxation and make the customs systems more efficient. A new profit tax of 10%, down from 33%, is to be introduced in 2003. The next few months will see a cut in import duties to meet World Trade Organisation (WTO) rules. Akayev intends to oversee additional changes in the tax and fiscal regimes for the mining industry to lure more foreign capital to this key sector.

Under A Heavy Debt Burden

The external debt burden is the overriding economic challenge at present. External debt stands at US$1.43bn, according to Finance Minister Temirbak Akmataliyev. In 2001, the government repaid about US$41mn. It had been due to pay over US$100mn, but US$58mn of the sum was restructured in November. Favourable terms were negotiated on the restructuring of Kyrgyzstan's debts to the Paris Club of creditors, with France reportedly ensuring this to reward Bishkek's cooperation on the possible deployment of French troops in the republic. Outstanding external debt was estimated at 125% of GDP in 2001. This is expected to fall to 115% in 2002, when the government is due to pay US$80.1mn. The government is likely to be more prudent in its borrowing and to seek further concessions on its debt servicing.

The 5.3% GDP growth posted in 2001 was driven by the construction industry and agriculture. Growth is officially projected to slow in 2002 to 4.5%. Prices have stabilised, with inflation at its lowest for a decade in 2001, at 4% (down from 9.6% in 2000). The authorities are forecasting 6-8% for 2002.

With social discontent on the rise, a reversal of recent years' economic decline is crucial. The poverty rate (50% of the population) is fostering support both for extremists and for those critical of Akayev's economic policy of "selling out to the West". In December, the IMF approved a US$93mn loan, with US$15mn available immediately for poverty relief. The government is expected to take further steps towards macroeconomic stabilisation such as strong fiscal adjustments, new tax measures and lower spending on the public sector. It is also envisaged that the economy, which already gains much of its momentum from the mining (especially gold) sector will become more oriented toward exports. Export growth is forecast to be positive in 2002, at 2.9%, after a decline of 4.3% in 2001 (IMF figures). The authorities are hoping to attract foreign direct investment (FDI) to other sectors, too, by privatising a number of strategic enterprises. Forthcoming sell-offs include **Kyrgyzenergo**, **Kyrgyzgas**, **Kyrgyztelecom**, the **Kyrgyzstan aba Dzholdoru** national airline, the **Kara Balta** ore-mining plant and the **Kyrgyz Chemical Metallurgical Works**.

	1998	1999	2000	2001e	2001/2002 Latest period		2002f
Population, mn	4.8	4.8	4.9	4.9	-	-	5.0
GDP, US$bn	1.6	1.2	1.3	1.4	-	-	1.6
Real GDP, % y-o-y	2.1	3.6	5.1	5.0	6.7	Jan-Sep	3.8
Industrial output, % y-o-y	5.0	-4.0	7.0	7.0	7.1	Jan-Sep	5.5
Budget, KGSbn	-1.0	-1.2	-1.2	0.0	0.3	Jan-Oct	-0.8
Budget, % of GDP	-3.0	-2.5	-2.0	0.0	0.5	Jan-Oct	-1.0
Inflation, eop % y-o-y	18.4	39.9	9.5	4.0	4.0	Dec	8.0
KGS/US$, end-period	29.4	45.4	48.3	48	47.9	18-Jan	50
Exports, US$bn	0.54	0.46	0.51	0.49	0.51	Jan-Dec*	-
Imports, US$bn	0.76	0.55	0.50	0.46	0.50	Jan-Dec*	-
Trade balance, US$bn	-0.22	-0.08	0.01	0.02	0.01	Jan-Dec*	-
Current account balance, US$bn	-0.41	-0.25	-0.16	-0.14	-0.16	Jan-Dec*	-
Foreign reserves, US$bn	0.16	0.23	0.24	0.22	0.23	Nov	0.22
External debt, US$bn	1.5	1.7	1.7	1.8	-	-	1.8

*e/f = BMI estimates/forecasts. Sources: Kyrgyz authorities/IMF/EBRD//BMI. * 2000 data.*

ECONOMIC OUTLOOK

Kyrgyzstan is reaping economic benefits from closer relations with the USA and its allies but will continue to struggle with its external debt this year.

BMI FORECAST SCENARIO

Kyrgyzstan posted a 0.5% of GDP budget surplus in the first 10 months of 2001. While the authorities are unlikely to have achieved their 1.0% of GDP budget surplus for the full year, a deficit is unlikely to have been posted. Keeping the budget under control is a vital part of IMF-backed efforts to reduce the country's crippling debt burden. The 2002 budget targets revenues of KGS11.69bn and expenditure of KGS11.17bn, leaving a KGS0.52bn, or 0.6% of GDP surplus. BMI is not expecting this to be drastically missed, although the authorities could have problems achieving a surplus, with economic growth likely to slow as economies worldwide face the pinch.

Political Risk – Tanks Will Please Nato

- In a move that will bolster Nato accession prospects, the Estonian defence commission has presented its report on the acquisition of Main Battle Tanks (MBT) and, in addition, Defence Minister Juri Luik is expected to decide on the purchase of second-hand tanks from abroad. So far the favourite is the German Leopard I, with Italy and Norway also as possible sellers. Nato is keen for new members to actively contribute to mutual defence and to have Nato-standard equipment.

Economic Risk – Budget Passed

- On the day that Mart Laar resigned, President Arnold Ruutel signed the 2002 budget into law. The budget is balanced, but has been the cause of considerable opposition from local authorities who say it denies them urgently-needed funds. Ruutel, a former communist, said he signed it 'with a heavy heart'. Centrists in government are likely to push for real increases in the 2003 budget, even if this means going into deficit.

Business Environment – Tax Unchanged

- There are fears that the proposed new government coalition will lean leftwards, increasing taxation and putting a larger proportion of the tax burden on business and the better-off. But the relevant parties have already agreed that the tax system, with its non-progressive structure, will remain unchanged. The tax regime has been one of the strongest draws for foreign direct investment (FDI), and its overhaul would have a serious impact on investment.

POLITICAL OUTLOOK

The resignation of Prime Minister Mart Laar may alter the government's stance on EU and Nato accession. Like Laar, his successor, Siim Kallas is pro-EU and pro-Nato. Whether he is as staunch a supporter as his predecessor remains to be seen.

BMI FORECAST SCENARIO

Estonia posted a year-end 2001 budget surplus equivelant to 1.0% of GDP. Revenues totalled EEK30.5bn (US$1.75bn), 2.4% over target, while expenditures totalled EEK29.6bn (US$1.70bn), 0.7% below target. These figures are slightly better than BMI expected and will improve the government's reputation with the international financial institutions, particularly the IMF. There will be calls, however, from some quarters to spend more on public services in Estonia, and less on defence. BMI believes that the budget deficit will be balanced, as forecast by the government, at EEK34.9bn, and that populist opportunities to increase spending or reduce revenue, particularly by changing tax laws, will be resisted.

PM Mart Laar Resigns

The political vacuum caused by the resignation of prime minister Mart Laar on January 8, citing secret deals between the opposition Centrist Party and coalition partner the Reform Party, appears, at the time of writing, to be coming to an end. Finance Minister Siim Kallas had agreed to lead a Centrist-Reform coalition, which requires parliamentary approval. Should this not be forthcoming, an election will be called.

A Stricter Stance Towards EU Membership May Be Adopted – The proposed coalition's cabinet still includes several Pro Patria Union ministers as well as Centrists and Reform Party members, and Kallas retains his post as finance minister. The change of government may have implications for Laar's priorities of EU and Nato accession. Laar was well respected in Europe for his steady leadership and dynamic restructuring of the economy. Fortunately Kallas is also well respected internationally, so there is unlikely to be a Berlusconi-style breach with European leaders. However, the new composition of the government does suggest a possible slowing of integration with the West . It was the signs of growing Centrist influence – with negative implications for EU and Nato membership – that prompted Laar's resignation.

Domestically it seems unlikely there will be much opposition – other than to spending 2% of GDP on defence – to Nato membership, given the still-fresh memories of Soviet occupation. There is, however, growing disillusionment towards the EU, which the Centrists are exploiting. This is most likely to manifest itself as a more robust stance in negotiations with Brussels, mostly for the benefit of the home audience. The two main points of contention are the duty free and electricity sectors. So far only 20 of the 31 chapters of the *acquis communautaire*, the body of EU law, have been closed, but several are close to completion in H1 2002, which should leave the country on course for accession in the first wave in 2004. At this stage it seems unlikely that EU accession will be delayed by the new government's policies, although it may be a little less smooth than planned by Laar.

	1999	2000	2001e	2001/2002 Latest period		2002f
Population (mn)	1.44	1.44	1.44	-	-	1.44
Real GDP growth (% y-o-y)	-0.7	6.9	5.0	5.3	Jan-Sep	4.0
Industrial Sales Volume, % y-o-y	-3.9	9.1	6.2	6.2	Jan-Dec	4.8
Retail Sales Volume, % y-o-y	5.5	11.8	8.7	13.0	Jan-Sep	7.5
Consolidated budget balance (% of GDP)	-4.6	-0.7	1.0	1.0	Jan-Dec	-0.3
Consumer prices (% y-o-y, end period)	3.8	5.1	4.2	4.2	Dec	4.5
Producer prices (% y-o-y, end period)	0.0	0.0	0.7	0.7	Dec	3.7
Exchange Rate(EEK/EUR, end period)	15.60	15.60	15.60	-	-	15.6
Exchange Rate(EEK/US$), end period)	15.562	16.82	17.76	17.76	Dec-30	16.00
Exports (US$bn, fob)*	2.52	3.29	3.46	3.23	Jan-Nov	3.69
Imports (US$bn, fob)*	3.34	4.08	4.35	4.05	Jan-Nov	4.65
Trade balance (US$bn, fob-fob)*	-0.82	-0.79	-0.89	-0.74	Jan-Nov	-0.96
Current account (US$bn)	-0.25	-0.31	-0.39	0.31	Jan-Sep	-0.43
as % of GDP	-5.8	-6.8	-7.2	-	-	-7.1
Foreign reserves (US$mn, end period)	853	921	830	794	Nov	880
Gross external debt, % of GDP	58.70	59.20	61.7	-	-	62.5

*e/f = BMI estimates/forecasts. * central bank figures. Sources: Bank of Estonia/IMF/BMI.*

Political Risk – Ethnic Russian Problem

- The EU's annual report on Latvia urges reform of its criminal justice system, in which 42% of inmates are awaiting trial and few fundamental changes have been seen since the fall of the iron curtain. But the most politically dangerous aspect is the preponderance of ethnic Russians – they make up 30-35% of the population, yet over 40% of the prison population.

Economic Risk – Recession 'Over'

- In a new report entitled 'Transition to a market Economy: the First 10 Years', the World Bank says that in that decade the country's output halved, resulting in a recession worse than the Great Depression. According to the World Bank, 49% of national output was wiped out, and GDP fell to 61% of its 1990 level, a worse drop than most other post-communist countries. However, the report concluded that the decline is undoubtedly over.

Business Environment – EBRD Urges Further Privatisation

- The European Bank for Reconstruction & Development has strongly advised Latvia to continue its privatization programme in order to maintain Foreign Direct Investment (FDI) inflows, and to improve the business environment. FDI in the third quarter of 2001 was LBL69.4mn (US$110mn), higher than in the first two quarters, according to the central bank.

Rimsevics New Head, Currency Peg To Remain

After the 'father of the lat', Einars Repse, resigned as head of the central bank to enter politics in November, there was speculation that he would be replaced by his deputy, Ilmars Rimsevics. Rimsevics was subsequently elected by a parliamentary majority of 68-1, with 17 abstentions, and took the post on December 21. He told parliament 'my appointment would secure continuation of policies and predictability', and his appointment was greeted with widespread approval by the media, business and finance figures. Rimsevics, as Repse's deputy since 1992, worked on the introduction of the lat and dealt with the 1995 Latvian banking crisis and the Asian and Russian crises of 1997 and 1998. The appointment was widely expected, and indeed is almost seen as a continuation of Repse's regime at the bank, which largely explains the lat's stability in the wake of Repse's resignation.

Rimsevics To Pursue EU And Currency Peg Policies – In particular, it is almost certain that the aim of membership of the European Monetary Union and adoption of the euro will remain during his six-year term. Indeed, he may preside over his own redundancy if Latvia joins the EU and adopts the euro in 2004. Until that time the peg to the SDR basket of currencies is also likely to remain in place, a policy which has so far ensured stability even in times of crisis.

However, the collapse of the Argentinean economy has prompted a debate on the wisdom of currency pegs. Argentina's simple peg of one peso to the dollar is thought to have denied the government tools to deal with economic shocks, forcing the abandonment of the peg at the last possible moment, when considerable damage to the economy had already occurred. This was also the case in the crises of the 1990s in Russia, Mexico, Brazil, Asia and, in 2001, in Turkey. However, Argentina went one step further, with a currency board that effectively made the peso a proxy dollar. This was exacerbated by a lack of fiscal discipline – which is essential if exchange-rate adjustments cannot be made. Assuming continued prudence from Rimsevics and from the finance ministry, the peg ought to serve Latvia well in the run-up to EU accession and euro adoption, a period in which currency stability is paramount.

	1999	2000	2001e	2001 Latest period		2002f
Real GDP Growth, % y-o-y	1.1	6.6	7.3	8.8	Jan-Jun	5.2
Industrial output, % y-o-y	-8.8	3.2	7.2	4.3	Sep	5.0
Retail sales volume, % y-o-y	12.0	9.0	9.5	5.0	Sep	6.5
Consolidated budget balance (% of GDP)	-3.5	-2.8	-2.0	-	-	-2.5
Consumer prices (% y-o-y, end period)	2.4	1.8	3.6	3.6	Sep	2.9
Producer prices (% y-o-y, end period)	-4.0	1.0	1.7	1.9	Sep	2.0
Exchange rate, LVL/US$ end period	0.583	0.613	0.63	0.63	Dec-31	0.62
Exports, US$bn	1.89	2.06	2.30	1.62	Jan-Sep	2.46
Imports, US$bn	2.92	3.12	3.48	2.52	Jan-Sep	3.76
Trade balance, US$bn	-1.03	-1.06	-1.18	-0.90	Jan-Sep	-1.29
Current account, US$bn	-0.65	-0.49	-0.52	-0.37	Jan-Sep	-0.60
- % of GDP	-9.6	-6.9	-7.2	-	-	-7.3
Foreign exchange reserves, US$mn eop	840.2	850.9	910.0	914.1	Sep	950.0
Gross external debt,% of GDP	57.2	66.6	66.0	-	-	65.6

e/f= BMI estimates/forecasts. Sources: Latvian authorities

ECONOMIC OUTLOOK

The change in central bank governor should not be a cause for concern and Latvia is likely to pursue the same predictable monetary policies as before.

BMI FORECAST SCENARIO

Latvia will record the highest rate of real GDP growth in Central and Eastern Europe (CEE) in 2001 at an estimated 7.3%. In the climate of the current European economic slowdown this represents a strong performance, which has been driven by solid domestic demand, although exports have also grown robustly. Demand pressures will, however, lead to a higher inflation rate, which we expect to have doubled to 3.6% from 1.8% in 2000. Latvia will continue to record strong real GDP growth in 2002 of about 5.2%, which is again likely to be among the highest in CEE.

Political Risk – Nato Accession

- The 19 Nato members have committed themselves to inviting one nation to join their ranks when they meet in Prague in November, with the possibility of others also being invited. Lithuania and the other Baltic nations hope to be invited and have invested financial and political capital to this end. No indication has yet been given as to which country will be invited, although Lithuania has a good chance. Membership would be very popular amongst Lithuanians with the memory of the Soviet occupation still fresh in their minds. Moscow remains opposed to Baltic membership of Nato although its rhetoric has been tempered slightly since September 11.

Economic Risk – A Change Of Peg

- The changeover in the Litas peg from the dollar to the euro is likely to be smooth. Since independence, Lithuania has re-directed the majority of its trade towards the EU and a currency peg to its main trade partner will be easier to maintain. The importance of the change in peg should not, however, be over estimated, as the country's largest trade partner is the UK, where the Euro has not been introduced.

Business Environment – Tax Reform

- Tax reform that was agreed by parliament at the end of 2001 is likely to be unpopular domestically, not least because it reduces the number of loopholes in the system. Internationally, however, it is a popular move that is likely to improve the reputation of the Lithuanian administration with the international financial institutions.

POLITICAL OUTLOOK

When presidents Bush and Adamkus met at the White House, Nato and EU accession and the performance of the Lithuanian economy in 2001 are likely to be on the agenda.

BMI FORECAST SCENARIO

The current account deficit widened by just US$0.02bn in Q3, from US$0.28bn in H1 to US$0.30bn, a considerable improvement and ahead of the market's expectations. The goods, services, income and transfers balances all showed an improvement and BMI has therefore revised downwards its forecast for the year-end current account deficit from 5.8% to 4.3%. BMI does not expect such a strong performance in 2002 as the slowdown in Europe hits Lithuanian exports and continued strong domestic demand, the driver of this year's economic growth, keeps imports relatively high.

Vilni-Us Versus Them

Lithuania's president, Valdas Adamkus will meet US President George W Bush at the White House on January 23. Nato accession is likely to be on the agenda following the Baltic nation's rapid progress in building an army almost from scratch in an attempt to assure its independence from Russia. It is as yet unclear whether the efforts of all three Baltic nations to expand their military power will result in an invitation to join the 19 current members of Nato, especially given Russia's closer ties with the West since September. Moscow strongly opposes Baltic membership of Nato.

The Lithuanian economy performed well in 2001. We estimate a healthy rate of real GDP growth for the year of 4.5%. Inflation increased moderately to a year-end 2.0% in 2001 from 1.4% in 2000 but is still very low. Both internal and external accounts improved markedly in 2001. The budget deficit fell to 1.7% of GDP in 2001 from 2.8% in 2000. Tax reform was signed into law late last year as part of a budget that foresees a deficit of 1.5% of GDP in 2002, and was praised by the IMF for broadening the tax base and reducing the number of exemptions. We expect the deficit to nudge down to 1.6% in 2002. The current account deficit registered a record post-independence low in Q3 2001 of 0.4% of GDP, well below **BMI**'s and market expectations, thanks to improving trade, services, income and transfers balances. To take into account the unexpectedly strong Q3 data, we have revised down our end-year estimate to a deficit of 4.3% of GDP, compared with a 6.0% deficit in 2000. A change in the Litas peg to the euro from the dollar in February will help the majority of exporters, with nearly 50% of exports going to the EU, although this effect should not be overstated as Lithuania's largest trading partner, accounting for almost 15% of exports, is the UK where the Euro has not been introduced. **BMI** expects recent restructuring and privatisations, combined with an upturn in EU demand in H2 2002, to help Lithuania continue the respectable progress seen this year into 2002.

	1999	2000	2001e	2001/2002 Latest period		2002f
Real GDP growth (% y-o-y)	-3.9	3.9	4.5	5.1	Jan-Sep	3.9
Industrial sales volume (% y-o-y)	-9.9	7.0	10.5	18.2	Jan-Oct	7.0
Consolidated budget balance (% of GDP)	-8.0	-2.8	-1.7	-	-	-1.6
Consumer prices (% y-o-y, end period)	0.3	1.4	2.0	2.0	Dec	2.6
Producer prices (% y-o-y, end period)	-	2.3	-5.5	-6.2	Nov	3.0
Exchange rate (LTL/US$, end period)	4.00	4.00	4.00	-	-	3.96
Exports (US$bn, fob)*	3.15	4.05	4.55	4.25	Jan-Nov	4.71
Imports (US$bn, fob)*	4.55	5.15	6.15	5.67	Jan-Nov	5.95
Trade balance (US$bn, fob-fob)*	-1.40	-1.10	-1.60	-1.42	Jan-Nov	-1.24
Current account (US$bn)	-1.19	-0.67	-0.52	-0.30	Jan-Sep	-0.79
as % of GDP	-11.2	-6.0	-4.3	-	-	-6.3
Foreign reserves (US$bn, end period)†	1.19	1.31	1.65	1.76	Nov	1.80
Public foreign debt, % of GDP	22.3	21.9	21.7	21.3	Oct	21.4

**Balance of payments method. † Total reserves minus gold. e/f = BMI estimates/forecasts. Sources: Bank of Lithuania/Department of Statistics/IMF/BMI*

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