

Estonia, Latvia and Lithuania

From Plan to Market – Selected Issues

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I Introduction

This study elaborates upon the three basic interrelated challenges that the Baltic States have had to resolve: They had to create the institutional framework to support an independent state, stabilize their economies and implement market-oriented structural reforms. This analysis does not aspire to cover those issues comprehensively but focuses instead on the topics most relevant to central banks, such as macroeconomic stabilization, the institutional setup of monetary policy, developments in the banking sector, including banking supervision, and finally, integration in the European Union. Specific topics, e.g. agriculture, fiscal reform, energy sector reform, bankruptcy procedures, antimonopoly laws, consumer protection and foreign trade policy are not explicitly addressed here. Since the statistics on the Baltic States are still quite heterogeneous, cross-country comparisons are frequently based on quantitative indicators derived from different sources, which affects the quality of the evidence supporting the arguments in this paper.

Section 2 briefly describes the economic environment Estonia, Latvia and Lithuania inherited from the Soviet Union. Section 3 touches upon macroeconomic issues, including stabilization and current economic developments. Section 4 takes up selected structural issues in the real economy: changes in output structure, changes in the commodity composition of foreign trade and geographical destinations, and changes in foreign direct investment flows. Section 5 deals with structural problems inherent in institutional changes, such as the process of liberalization, privatization methods, the creation of a two-tier banking sector and the establishment of a monetary policy framework. The main policy challenges are covered in section 6, while specific policy problems related to the integration in the European Union are discussed in section 7 in the context of the European Commission's Opinions on whether the applicant transition economies are ready to join the EU. Concluding remarks follow in section 8.

2 Background and Initial Conditions

Estonia, Latvia and Lithuania reemerged as independent states on the world map only six years ago. At the outset, they had to confront jettisoning the legacy of fifty years of Soviet rule. They had to start dismantling the central planning system while at the same time establishing the institutions required in independent states. However, having previously experienced a period of national independence and market economy (1919 to 1940), they started out from a better position than other Soviet republics. Furthermore, the standard of living and the levels of productivity were higher in the Baltic States than elsewhere in the former Soviet Union. Moreover, due to the geographic location of the Baltics, i.e. their proximity to the Scandinavian peninsula, they already had a relatively well-developed transportation infrastructure that they could exploit for transit. Finally, they were not burdened with foreign debt, as Russia had assumed all external obligations of the former Soviet Union (FSU).

Before World War II, the Baltic States had been part of the European economy. After the takeover by the Soviet Union in 1940, all industrial

property and real estate was nationalized and the collectivization of agriculture was imposed. The policy of rapid industrialization in the 1950s and 1960s was a vehicle to integrate the Baltic States' economies with the rest of the Soviet Union in line with the division of labor specified by the five-year central plans. The Baltic States' industries were constructed chiefly to produce goods for the vast Soviet market rather than the small domestic markets. At the same time, the policy of forced industrialization led to a heavy reliance of the three countries on inputs imported from the rest of the Soviet Union; about 87% to 90% of their external trade was transacted with the other parts of the former Soviet Union. There was little direct trade among the Baltic countries themselves, as goods were shipped to the capital for further distribution. In general, the Baltic States imported energy and raw materials, while they shipped food and manufactured goods to the rest of the former Soviet State.

Industrialization was supported by the inflow of migrants from other parts of the Soviet Union, in particular from Russia. As a result, the ethnic composition of the population changed significantly under the Soviet regime. Estonia and Latvia, therefore, have large Russian minorities. The percentage of Estonian nationals in the total population fell from some 95% in 1945 to about 62% in 1989, while the share of Latvian nationals in the population of the country dropped from about 77% in 1935 to 52% in 1989. By comparison, Lithuanian nationals accounted for about 80% of the population in 1989.²⁾

3 Macroeconomic Developments and Policies

Macroeconomic stabilization was the most compelling challenge all three countries faced after their independence had been restored. The widespread liberalization of prices from 1991 to 1992 resulted in a surge of annual inflation to four-digit levels (see Country Tables). At the same time, economic activity declined at a rapid pace.

3.1 From Output Collapse to Growth

Economists hotly debated possible explanations of the output collapse in the transition economies without ever settling the issue.³⁾ A number of factors of the output breakdown can be identified: The Baltics had to absorb two major external shocks at an early stage of transition, namely the collapse of exports to the former Soviet Union in 1990 to 1991 (a demand shock) and the energy price shock (a supply shock) in 1992, when Russia substantially increased its export prices for oil and other raw materials in order to align them with world levels. Other factors were possibly at work as well. One is credit contraction (a supply shock), but there is little evidence of it, except in Latvia, where real interest rates rose to high levels in 1993. The role of institutional uncertainty is yet another – unmeasurable – factor, but it cannot be disregarded either. Both factors reinforced the decline in investment, which had dried up in the highly inflationary environment. All these shocks contributed to the massive cumulative decline of GDP by about 50%⁴⁾ from the 1990 level (official figures).

The deterioration of the former Soviet Union's economy hit Baltic exports hard despite the beneficial terms-of-trade shift resulting from the fact that the prices of manufactured goods were liberalized prior to those of imported inputs. This coincided with currency reforms in the Baltic States that necessitated new institutional and payment arrangements in trade with the former Soviet Union. Supply-side effects were significant as well: Previously the Baltic industries had benefited from Russian energy and raw materials that were below market prices. More expensive energy and raw materials in 1992 to 1993 rendered most of these industries unprofitable, as the share of industries with negative value added had been estimated to be higher in the Baltic States than the FSU average.⁵⁾ Finally, the liberalization of foreign trade brought competitive pressure in numerous sectors in spite of undervalued domestic currencies and low incomes. Consumers showed a preference for Western goods.

Following at least four years of decline, output started to recover only in 1994, which shows how severe the transition collapse had actually been.⁶⁾ The output composition has significantly changed: The Baltic States have undergone strong deindustrialization in absolute and relative terms, a trend that has only recently ended. The share of agricultural production has fallen considerably, while the share of services has increased rapidly. The service sector was the sector in which economic recovery started.

The pace of this recovery has been divergent across the Baltic States. Growth has been consistent in Estonia and Lithuania, whereas it came to a brief halt in Latvia, with Estonia clearly standing out as the growth leader. According to the recently revised figures, GDP growth in Estonia resumed in 1995 at a robust rate of 4.3%, and remained at 4.0% in 1996. Until the fourth quarter of 1996 economic growth was moderate. In the fourth quarter of 1996 the growth rate of GDP rose to 7.3% year on year, in the first quarter of 1997 it accelerated to 10.8%. Economic growth has been driven by consumption, investment and public spending. The share of investment in GDP was 26.8% in 1996. Investment by the public sector increased by 5% in 1996, while private investment advanced by 8% to 9%.⁷⁾ The current situation of the Estonian economy can be summarized by one word: overheating. Inflation has recently started to tick up, as economic growth has doubled its pace. Anecdotal evidence shows that consumption has been increasing recently, rapidly fueling imports (sales of cars and automotive parts have surged). The 70% growth in consumer credit from December 1996 to August 1997 and the 16% rise in real retail sales year on year in June 1997 support this view. At the same time, the current account gap, which had already been high relative to GDP, has continued to widen on the back of the increasing trade deficit. Fears of overheating prompted the authorities to tighten macroeconomic policy during 1997; they raised the minimum capital adequacy ratio for banks in order to curtail domestic credit expansion. Moreover, they downgraded loans drawn by regional authorities, which requires banks to make higher provisions. A balanced budget policy is pursued rigorously.

Latvia was the first of the three countries in which GDP began to recover in 1994 (0.6%) after bottoming out in 1993. In 1995, a widespread banking

crisis caused GDP to decline again by 1.6% in real terms. Growth resumed in 1996 at a moderate rate of 2.8%. In the first quarter of 1997, GDP grew by 2.6% year on year. Consumption stagnated in 1995 and 1996 due to the fall in real wages. Gross fixed capital formation increased by 12.6% and 7.5% in 1995 and 1996, respectively. Nevertheless, the investment share in GDP may be too low to warrant a sustained expansion. Gross capital formation was estimated at 21.9% of GDP in 1995, but since the increase in inventories accounted for almost one fourth of this figure, the share of gross fixed capital formation adjusted for the rise in inventories was in fact 16.6%.

In Lithuania, GDP stabilized in 1994 after an unprecedented collapse in 1991 to 1993, and economic growth resumed at a moderate rate in 1995. On the demand side, government spending and investment drove growth in 1995. The banking crisis did not stop economic growth as it did in Latvia, because the Lithuanian authorities chose a different policy response. The recapitalization of banks fed through to a rise in the budget deficit (see section 5.3 on banking below). Early in 1997, indicators signaled continued growth, albeit at a slightly lower pace than in the same period of 1996; GDP grew by 2.5% in the first half of 1997 compared to 3.1% in the same period of 1996. On the supply side, industrial production, agriculture and services were the engine of growth.⁸⁾

The resumption of economic growth has helped alleviate the problem of high unemployment. The official rate of unemployment appears to be rather low in the Baltic States by transition economy standards, but the data cannot be considered reliable, because the official figures are much lower than the ones produced by the ILO methodology. The proportion of long-term unemployment is high, which thwarts prospects of a rapid reduction in the unemployment rate. In Lithuania agriculture acted as a buffer for unemployment, since the share of the labor force in agriculture remained above 20% despite the considerable drop of the share of agriculture in GDP.

Employment has been declining in Estonia and Latvia throughout the process of transition for two reasons. First, jobs have been shed in industry and agriculture, causing the shares of employment in industry and in agriculture, including forestry and fishery, in total employment to fall. Second, the labor force total has been shrinking due to emigration to Russia and Finland. The unemployment rate in Estonia, applying the ILO methodology, was 11.3% in the second quarter of 1997. According to the official figures, the unemployment rate dropped to 3.7% in September 1997 from 4.3% in December 1996. Latvia's poor growth record is reflected in the unemployment trends. The Latvian rate of unemployment edged up slightly in 1997 relative to 1996; the increased pace of modernization since 1996 is likely to displace more workers unless economic growth accelerates considerably. The official unemployment rate in Latvia was 7.3% in June 1997, compared with 7.1% a year before. However, according to the ILO methodology, the rate stood at 18.3% in November 1996. The Lithuanian unemployment rate was 5.6% in September 1997, down from 6.4% in September 1996. ILO estimates are not available.

3.2 Disinflation

Following price liberalization, the Baltic States experienced very high rates of inflation. By 1995, the CPI inflation rate had fallen below 30% in Estonia and Latvia and below 40% in Lithuania from rates of approximately 1,000% in 1992. Because it was slow to tackle stabilization, inflation subsided more slowly in Lithuania than in the two other countries. However, as its efforts became more intense, the pace of inflation in Lithuania caught up with the disinflation pace of the other two countries. 1997 may well bring the CPI inflation rate in Latvia and Lithuania to within single-digit levels; Estonia's inflation rate has recently edged up above 10% (see Country Tables).

The Baltic States have pursued exchange-rate-based counterinflationary strategies. Estonia and Lithuania introduced currency boards in 1992 and 1994, respectively, while Latvia opted for a peg of its currency to the SDR basket in January 1994 after a period of managed floating. The Baltics have conducted tight monetary and fiscal policies. Estonia has largely followed a policy of balancing the central government budget, which it relaxed only in 1995, while Latvia and Lithuania aimed to keep budget deficits under control. Latvia has recently decided to move toward a balanced budget as well. Lithuania and Estonia no longer permit the use of central bank credit to finance the budget deficit because this is inconsistent with the currency board setup. Latvia resorted to such financing only on a very limited scale that did not jeopardize its disinflation efforts. Inflation has not yet fallen to the levels in the anchor currency countries because relative prices have not fully adjusted yet (the prices of nontradables, in particular of those nontradables which are regulated by the authorities, rose relative to the prices of tradables), and because inflationary inertia is fed by entrenched inflationary expectations.⁹⁾ Energy and public transport prices do not fully cover the cost of production. Judging from the evidence, the different approaches to handling inflation in Estonia and Lithuania on the one hand and in Latvia on the other hand do not seem to lead to divergent inflationary outcomes, though, as inflation rates have recently dropped to levels around 10% in all three countries.

3.3 Large Current Account Deficits

Inflation rate differentials between the Baltic countries and their main Western trading partners caused the Baltics' currencies to appreciate in real terms. This is probably the main factor behind the yawning current account deficits. Additional factors are the internationally uncompetitive industries and the pressure to import advanced consumer and investment products needed to restructure productive capacities. Across the region, exports have been growing more slowly than imports. Large trade deficits have become the rule across transition economies since 1996, and the Baltics are no exception. On the back of trade deficits, current account gaps have reached high proportions to GDP: The current account deficits of Estonia, Latvia and Lithuania came to 10.3%, 9.0% and 9.0% of GDP, respectively, in 1996 (see Country Tables). The Estonian and Lithuanian current account deficits continued to widen further to 16.8% and 11.4% of GDP, respectively, in the

first quarter of 1997. The 1997 data on the Latvian current account were not available as of writing. However, the trade deficit was LVL 303.8 million (USD 525 million) in the January to July period compared with LVL 242.0 million in the same period of 1996, which suggests that a further deterioration of the current account has taken place because of the high correlation with the trade deficit. These developments in conjunction with recent currency crises in Southeast Asia and the Czech Republic raise the question of the sustainability of the current account deficit, i. e. the possibility of financing the deficit over time.

Economic theory offers but a general answer to the question of when a current account deficit exposes an economy to the risk of a currency crisis because the intertemporal budget constraint is quite lax. Subject to this constraint, any time profile of the current account is consistent with solvency provided the discounted sum of all current account balances is equal to the initial foreign debt of the country. Thus a country may run very large current account deficits for a long time and still remain solvent as long as it produces future surpluses to offset the earlier deficits. This model tacitly assumes that future policies are compatible with a current account time path that does not violate solvency. However, the sustainability of current account deficits depends on two additional factors: a country's willingness to service debts and the creditors' willingness to lend. The latter reflects the creditors' expectations about the future course of the borrower's economic policy and his willingness to pay. Diverting output from domestic to external use may become politically unfeasible. Therefore markets watch debt service ratios and will not accept values beyond a certain threshold they deem safe. Beyond that level, they simply cut off further lending, which may lead to a debt crisis. This suspension of long-term lending may bring about an abrupt reversal of short-term capital inflows, which could in turn ignite a currency crisis.

Practical conclusions should be based on empirical evidence, i.e. on the analysis of economic indicators of countries which have already experienced speculative attacks on their currency. Such evidence does not offer clear-cut criteria either, but it is much more operational. It can be said that, all other things being equal, a current account deficit is likely to be less sustainable if the imbalance is large relative to GDP. Moreover, the composition of this gap also affects sustainability. If the deficit is due to a reduction in national savings (higher imports of consumer goods) rather than an increase in national investment rates (imports of new technology), i.e. if the deficit finances consumption rather than investment, it is less sustainable. The composition and the size of the capital account are important as well: The higher the proportion of short-term capital inflows, the more vulnerable a country is to a currency crisis. The more fragile the financial system of a country, and the less politically stable, the more prone it is to a currency crisis.¹⁰⁾ The faster money supply expands, the more likely it is to lead to a consumption boom and to an asset price bubble. The most widely used indicators to help formulate a judgment are the ratio of current account to GDP, the inward FDI (foreign direct investment) coverage of a current account deficit, the cover of imports by foreign exchange reserves, the relative appreciation of

the exchange rate versus a hypothetical medium-term equilibrium rate and the external debt service ratio to exports.

Table 1 displays these indicators for the Baltic countries. Most of them suggest that the Baltic countries could be vulnerable to currency crises, but not to debt crises. Large current account deficits with regard to GDP have already been mentioned. Foreign currency reserves are low by emerging market standards, since they generally cover three months of imports. A positive factor is their continued growth, which implies that the capital account more than offsets the widening current account deficits. It also means that the financial markets' confidence has not eroded yet and that the countries may still avert a currency crisis. The real appreciation of the domestic currencies has been very strong, even adjusted for the initial undervaluation. In Estonia, money supply growth has been very high relative to nominal GDP; currency inflows are the only source of the monetary base. Confidence in the fixed exchange rate induced borrowers to take advantage of lower interest rates abroad. The share of foreign currency loans has been increasing, and accounted for 51% of total loans in June 1997. According to central bank data, the loan portfolio of the banking system increased by 88% between June 1996 and June 1997. This fueled a consumer boom; loans to individuals rose by 61.7% in the first half of 1997. The Latvian money supply has been growing rapidly as well in terms of nominal GDP growth. The share of external debt to exports is the only indicator that does not send a warning signal: The current account position is not threatened by the intertemporal constraint on the debt service.

Table 1

Selected Indicators of Current Account Sustainability						
	Current account as a percentage of GDP in 1996	FDI/CA deficit in 1996	FX reserves in months of imports at the end of 1996	Real appreciation 1994 to 1996, PPI based	Debt/exports in %	Money supply growth in % in the last 12 months
Estonia	10.3	33.6	2.6	77.5	14.4	53.1 August
	1st quarter 1997: 16.8					
Latvia	9.0	63.4	3.2	52.4	27.2	35.7 July
Lithuania	9.0	21.8	2.2	50.0	37.1	21.1 August
	1st quarter 1997: 11.4					

Source: IMF, central banks; BIS (real effective exchange rates).

No single gauge can reliably predict a currency crisis, but a number of warning signals show when the risk is high. Overall, Latvia is the least prone to a balance-of-payments crisis, followed by Lithuania, while Estonia seems to be the most exposed. This result is derived by ranking each country's position by the value of each indicator on a scale from one to three and summing up all scores; the lower a country's total, the less crisis-prone the country is.

4 Structural Change in the Real Economy

4.1 Change in Output Structure

The structure of output in the Baltic States has changed significantly since the onset of transition, and by 1997 they had all become service-oriented economies. Most countries in transition have experienced relative deindustrialization, which has been particularly pronounced in the Baltic States, though least so in Lithuania. This relative deindustrialization reflects a still incomplete restructuring process away from heavy industry toward a structure more in line with natural resources and comparative advantages. Lithuania is the first Baltic State in which the downsizing of industry came to a halt in 1995. In Estonia, industry rebounded quickly in 1997, but it is still too early to judge whether the recent growth of industrial sales indicates a permanent change (see Country Tables).

Agriculture is another sector which has lost much of its importance, with its share in GDP more than halving over the course of transition. Construction also contracted, following a decline in investment and a drop in consumer incomes to below the levels at which housing construction is affordable. The service sector has become the engine of economic growth across the region. The following figures illustrate the described processes.

Table 2

Share of Sectors in Gross Value Added						
	Estonia		Latvia		Lithuania	
	1991	1995	1990	1996	1990	1995
	<i>in %</i>					
Agriculture	18.8	8.1	21.9	9.5	27.7	9.3
Industry	39.9	22.9	36.4	28.2	32.8	29.0
Construction	6.7	5.3	9.7	5.2	10.5	6.7
Services	34.6	63.7	31.9	57.1	29.0	55.0

Source: European Commission (Lithuania, Latvia in 1990 and Estonia in 1995), Bank of Latvia (1997), Estonian Statistical Yearbook 1994, own calculations.

In Estonia, tourism and banking are among the fastest expanding sectors. After an initial unprecedented decline, industrial production rebounded little during transition. It grew by a sluggish 1.4% and 1.3% in 1995 and 1996, respectively. Only recently has it started to show signs of strong recovery, with industrial sales expanding by 12% in the first seven months of 1997 compared with the same period of 1996.

In Latvia, too, economic growth has been driven by the service sector, mainly by transport and communications. Services grew by an estimated 4.7% in 1996. According to the data from 1995, the level of industrial production was approximately 38% of the 1990 level. Industrial production during transition declined faster than GDP and practically bottomed out only in 1996, when 1.1% growth was registered. In the first seven months of 1997, industrial output rose by 0.7% year on year. As economic growth accelerated, industry continued its relative decline.

In Lithuania, trade and transportation showed large gains within the expanding service sector. Industrial output rebounded only in 1995, and since then it has grown at a faster rate than GDP. According to the latest available figures, it advanced by 3.3% in January to July 1997 compared to the corresponding period of 1996.

4.2 Switch of Foreign Trade Destinations and Composition

During transition, the commodity composition of foreign trade and its geographical destinations have changed considerably. Trade has been successfully redirected to Western Europe. Estonia stands out as the country which redirected its trade away from the former Soviet Union to the largest extent. Finland has become Estonia's largest trade partner, ahead of Russia, which still remains the largest partner for the other two countries.

Before transition, Estonia had specialized in exports of heavy industry products to the rest of the Soviet Union. Meanwhile, it has shifted away from such an energy-intensive production structure. Estonia's main exports in 1996 were textiles, foodstuffs, machinery and equipment, timber, paper and chemicals. Between 1994 and 1996 the share of foodstuffs in total exports diminished from 22.2% to 16.0%, whereas the share of machinery and equipment widened from 9.3% to 13.5% and that of chemicals from 8.6% to 11.1%. It should be noted that reexport activities play an important role. In 1996, only 29% of machinery and equipment exports were of Estonian origin. The five major groups in total imports in 1996 were foodstuffs, mineral products, chemicals, textiles, and machinery and equipment. Estonia's trade dependence on the former Soviet Union has declined dramatically; the European Union is now its largest partner, accounting for a 66.7% share of total imports and a 51.6% share of total exports in 1996. Estonia's major export partners in 1996 were Finland (18.3%), Russia (16.7%), Sweden (11.5%), Latvia (8.4%), Germany (7.0%), Lithuania (5.8%) and Ukraine (5.1%). The major import partners were Finland (36.2%), Russia (12.9%), Sweden (8.4%), Germany (8.0%) and the Netherlands (3.7%).

Latvia had specialized in exporting manufactured goods (consumer appliances) to the rest of the Soviet Union before transition, from which it had purchased cheap energy and raw materials. After independence, post-Soviet markets shrank and raw materials became much more expensive. Latvian manufacturing proved quite uncompetitive and went through a phase of painful downsizing. Latvia found its niche as an exporter of low-value-added products. In 1996, Russia, Germany, Great Britain, Lithuania and Sweden were Latvia's most important export destinations, while its imports came mainly from Russia, Germany, Finland, Sweden and Lithuania. In the first half of 1997, exports to and imports from the European Union reached 50.8% and 53.1% of total exports and imports, respectively (42.8% and 49.5% in the corresponding period of 1996). Despite its reduced share, Russia has remained Latvia's single largest trade partner. In first half of 1997, Russia's share fell from 24.8% to 19.6% of Latvia's total exports and from 19.6% to 15.7% of Latvia's total imports. Wood products accounted for 31.7% of total exports in the first half of 1997, followed by textiles at 16.2%. Cars, electrical parts and mechanical equipment came to 19.2% of all imports, followed by mineral products at 14.2%.

The data on Lithuania's trade commodity structure display similar tendencies. Russia has remained Lithuania's single largest partner, but its share of imports shrank from 53.7% in 1993 to 26.0% in 1996 and from 33.1% to 23.8% of exports, respectively. Germany has become the second

largest partner, with shares of 15.7% and 13.0%, respectively, of exports and imports in 1996. Before the disintegration of the Soviet Union, Lithuania had been assigned the role of producing technologically advanced products, so its exports had concentrated on machines, processed metals, light industrial goods and chemicals. Food processing was another major export sector. During transition, the share of machinery and electrical equipment as well as mineral products in exports has diminished considerably, while the share of textiles has risen. The share of imports of mineral products has declined sharply while the share of imports of machinery and electrical equipment and of other items has augmented noticeably in total imports.

4.3 Foreign Direct Investment

The Baltic States opened their economies to FDI after independence by creating an “investor-friendly” legal framework allowing, among other things, nonresidents to freely repatriate after-tax profits or capital and to purchase or lease land. Moreover, they provided for tax incentives. FDI flows to region picked up once investor confidence had been boosted by the stabilization of the Baltic economies and the encouraging results of the structural reforms. This explains why inflows accelerated at a different pace in different countries: Estonia attracted foreign capital first and on the largest scale, as it was the first of the Baltics whose reform efforts were recognized by the international community of investors. Also, until 1995 Estonia’s legal system was more favorable to FDI than the systems of the other two countries, since foreign investors shared the same legal rights as local businesses and were allowed to purchase and own real estate. Such a favorable treatment was adopted by Latvia and Lithuania only in 1995 and 1996. Estonia has attracted not only the largest stock of FDI overall and per capita among the Baltic States (see Table 3), but also the third-largest FDI stock per capita after Hungary and Slovenia among transition economies. After peaking in 1994, inward FDI trended downward in 1995 and 1996 (see Country Tables), which coincides with the resumption of growth and the adoption of more favorable FDI regulations in the other Baltic States. The downward tendency appears to have reversed in 1997, as the preliminary data on Estonia show a considerable growth of FDI inflows into the country. A new phenomenon in Estonia is a rise of outward FDI to USD 40 million in 1996 from negligible amounts before.

In 1996 to 1997, Latvia and Lithuania started to catch up after financial markets had become convinced that the banking crises had been overcome, and both countries entered on a path of solid economic growth. In 1995 Latvia was adversely affected by a banking crisis, but FDI picked up again in 1996. Latvia attracted more FDI in 1996 than Estonia or Lithuania, both in nominal terms and on a per capita basis; FDI rose from USD 180 million in 1995 to USD 288 million in 1996. A number of measures were taken in 1996 to facilitate FDI flows to Latvia, such as the repeal of the limitations on foreign investment in branches of foreign enterprises in Latvia, the gradual liberalization of the real estate market and the lifting of the restrictions on the purchase of privatization certificates. Until the end of 1996, FDI was mainly directed to transportation, communications and banking.

In 1995 amendments to the 1990 law on foreign direct investment effectively put foreign investors on an equal footing with local enterprises in Lithuania, as foreign firms were no longer required to take out permits and were also allowed to buy land. Lithuania has only lately attracted a larger volume of inward FDI, which grew to USD 152.4 million in 1996 compared with USD 72 million in 1995. Preliminary data point to the continuation of an upward trend in 1997. Manufacturing, wholesale and retail trade, postal

services and telecommunications benefited the most. Within manufacturing, electrical equipment, food and beverages, tobacco, rubber and plastics, and furniture drew the most capital from abroad.

Table 3

	Cumulative FDI Inflows per Capita	
	1989 to 1995	1989 to 1996
	USD million	
Estonia	437	460
Latvia	221	280
Lithuania	95	135

Source: IMF

5 Structural Reforms

The authorities of the Baltic States soon recognized that they needed sweeping structural changes in order to establish the institutional framework required for a modern market economy. In general, transition to a market economy involves numerous tasks, such as a far-reaching deregulation of prices, which is crucial for guiding the efficient allocation of resources.¹¹⁾ The liberalization of trade, services and capital movements is the key to a competitive production sector and to the freedom of choice for consumers. Liberalization also encompasses the reduction of tariffs and of nontariff restrictions on trade, securing the rights of foreign direct investors and establishing currency convertibility. The widespread privatization of state assets is necessary to improve corporate governance; in other words, enterprises need to become more responsive to economic incentives. This would allow for the elimination of various forms of subsidies, including credits at below-market interest rates. The establishment of a two-tier banking system and an efficient tax administration is also indispensable for a national macroeconomic policy geared to the needs of a market economy. Bankruptcy procedures and regulations on collateral are required to foster the restructuring of companies and to support the enforcement of contractual obligations. Finally, suitable social nets need to be established, as transition brings about unemployment. The Baltic States have embarked on all these tasks and have made decisive progress in many regards.

5.1 Liberalization and Deregulation

The three countries have rapidly liberalized their economies from the very beginning of transition. They liberalized prices early in 1991 to 1992, and simultaneously freed foreign trade and, to a large extent, capital transactions. The regulated prices cover basic consumer necessities with a large impact on incomes, such as rents and public transportation, electricity rates and heating prices. Estonia clearly embraced a very liberal model for its economy and dismantled almost all barriers to foreign trade, while the other two countries have been more moderate in their efforts. Currencies have been made

convertible also for capital transactions. All three countries strive to harmonize their regulations with EU legislation.

In Estonia, the prices of the majority of goods have been freed, with the exception of the prices of land, oil shale, electricity, medicines, medical insurance services, public transportation and some municipal services. Regulated prices still make up close to 25% of the basket of consumer goods, which means that any changes will have a considerable effect on monthly inflation rates. Estonia is the only country in the region to have adopted a uniform tax rate on personal and corporate income (26%). The kroon has been convertible for current account transactions since the establishment of the currency board in 1992. In 1994 Estonia formally accepted the obligations of Article VIII of the IMF's Articles of Agreement. All foreign exchange controls had been removed by the end of 1994, and since then the currency has been fully convertible. Individuals are allowed to open accounts abroad. All restrictions on trade which originated in the Soviet time have been abolished as well. Tariffs are imposed only on imports of furs, and excise taxes are levied on cars, motorcycles and recreational boats; licensing is restricted to trade in drugs, arms and ammunition and similar items. Quantitative restrictions have been eliminated completely. There are no explicit export and import subsidies, and export tariffs exist only for objects of cultural value. The introduction of protective measures for a limited number of agricultural products is under consideration. This, however, should not be seen as a retreat from a liberal regime, but in conjunction with Estonia's transformation of the agriculture sector from a collectivist to a private system. The so-called producer subsidy equivalent calculated by the OECD was only 3% in 1995, compared with 49% for the EU.¹²⁾

In Latvia, price liberalization and the reform of the tax system started before independence in early 1991. Goods and services with administered prices still represent about 20% of the basket of consumer goods, namely energy supply, utilities, transport and rents, whose prices do not cover the full cost of production. Foreign trade, wages and interest rates were liberalized immediately after independence. Quantitative restrictions and export tariffs have been almost completely eliminated. Only agricultural products continue to be highly protected. The producer subsidy equivalent was calculated at 8% in 1995. The government is committed to reducing tariff protection but has postponed the issue, as it is negotiating for admission to the World Trade Organization. Latvia accepted the obligations of Article VIII of the IMF's Articles of Agreement in June 1994 and subsequently removed almost all controls on capital account transactions.

In Lithuania, prices were almost fully liberalized in 1991 to 1992. The government still controls the prices for energy, housing, utilities and public transportation. Goods with administered prices represent approximately 10% of the basket of consumer goods. As in Latvia, nontariff restrictions do not apply in Lithuania. Import tariffs have been significantly lowered. There are some export taxes on raw materials. The export licensing system was abolished in 1993. Since mid-1994, import tariffs on some agricultural products have been reduced. The producer subsidy equivalent was calculated

at 3% in 1995. The Lithuanian currency is fully convertible. Residents and nonresidents may open accounts in foreign currencies.

5.2 Privatization Methods and Results

The freeing of prices per se does not automatically ensure that economic agents decide on the basis of relative scarcities. Privatization is a means to improve corporate responsiveness to such scarcities. Under Soviet rule, all three countries had only marginal private sectors. The speed of privatization and the methods applied differ among the countries. The attitude to foreign participation is another distinctive feature.

Lithuania embraced privatization the earliest, but since it chose vouchers as the principal method of privatization, little new capital was injected, corporate governance was hardly changed and the restructuring of productive capacities was delayed. Insiders have taken control of numerous enterprises. Estonia, by contrast, chose to model its privatization on the method of Germany's Treuhandanstalt, i.e. it sought to attract cash-paying strategic investors. Estonians allowed foreigners to participate on an equal footing with nationals, while the other two countries restricted nonresidents' presence in the privatization process until recently. Latvia was slow with the start of the privatization process, but started to catch up in 1996 and 1997 and applied a multi-track method. Small-scale privatization has been completed in the region. Large-scale privatization, which has always proved a stumbling block in transition, was pioneered by Estonia. All Baltic States passed bankruptcy laws early in transition, but only Estonia attempted to apply its law actively to speed up the restructuring of state enterprises. The two other states have only recently started to use this legislative instrument. Estonia has been the least successful in privatizing the agriculture sector, as the restitution of property rights hampered the process.

In Estonia, ownership reform was one of the key issues during transition and proceeded without delays because there was a political consensus. The country followed a multi-track approach. Small firms were turned private largely through employee buyouts and auctions; small-scale privatization was completed in 1995. Large firms have favored privatization through sales to strategic investors; this approach was targeted at improving corporate governance through tenders and direct sales. The restructuring of privatized companies is usually left to the new owners, mostly on the basis of plans submitted at the time of bidding. With the exception of companies within the infrastructure sectors, almost all large enterprises had been sold by the end of 1996. More than three quarters of all state companies have already been sold to private investors. In 1996 the government launched a long-term program to sell infrastructure firms, namely ports, electricity companies, telecommunications firms, gas and railway networks. The privatization of agriculture has proved a more daunting task, and Estonia lags behind Latvia and Lithuania in this field. Restitution problems have impaired sales of land to potential buyers. A bankruptcy law was passed in 1992 and implemented more rigorously in Estonia than in other transition economies.¹³⁾

Latvia also chose a multi-track approach to privatization. It has mainly relied on voucher privatization. These tradable vouchers could and can still

be used for the purchase of shares in firms, land or housing units. Small-scale privatization and the privatization of agriculture are almost complete. With the privatization of large firms behind schedule, the Latvian government decided to push it in 1996 by transferring all remaining state assets to the newly created Privatization Agency. The figures reflect the success of this approach: Of the 380 state-owned firms that had been sold by the end of 1996, 200 were sold in 1996 alone; 147 firms were privatized in the first half of 1997. Big infrastructure companies, including shipping, telecommunications, electricity and energy, and oil firms will be put on the block in 1997. The government plans to complete the privatization of all remaining state enterprises by mid-1998, excepting railways, airports and the postal service. However, this plan may prove overly ambitious, as the poor financial condition of numerous firms and remaining legal inconsistencies tend to delay the process. Lately, international tenders and public offerings have become the preferred method of large-scale privatization. Foreigners are seen as active participants in a position to inject capital into the often ailing firms in need of restructuring. Restrictions on real estate purchases by nonresidents have been eased, which should help boost foreign direct investment; however, foreigners must own no more than 50% of a property. The introduction of a new solvency and bankruptcy act in September 1996 should enhance the restructuring of firms provided it is implemented efficiently.

Lithuania embarked on privatization in 1991, using a voucher system only. Up to 50% of all shares were reserved for managers and employees, so insiders took control of many firms. In late 1994, Parliament issued a “negative list” of 250 firms excluded from privatization (“strategic enterprises”). The first phase of privatization ended in 1995. In mid-1995, Lithuania changed its approach and adopted a program for the second stage of privatization for the sale of enterprises not bought during the first wave and the reclassified assets which had appeared on the “strategic list” before. This time the preferred mode of divestiture was cash sell-offs. The program had a slow start in 1996, as the initial offerings involved minority stakes or unattractive firms. In 1997 the range of firms eligible for privatization was expanded to include large enterprises in the transport, energy and telecommunications sectors. Lithuanian Oil, Lithuanian Telecom, air transport firms and Lithuanian Sea Transportation are being offered. The government decided to abolish the list of ineligible firms. While foreign citizens could not own land, they were allowed to hold a lease for up to 99 years until 1997, when the law was changed to also permit purchases by nonresidents. A bankruptcy act had been adopted in 1992, but supporting regulation was completed much later.

5.3 Banking Sectors

All three countries had to create two-tier banking structures. In a first step, the central banks in the individual countries became independent from the former Soviet central bank, and new national currencies were introduced. In a second step, the central banks gradually shed their commercial operations, a process which was completed in 1993. In contrast to Latvia and Lithuania, Estonia did not incorporate specialized banks into the central bank, but

created new banks on the basis of their assets instead. Latvia and Lithuania first incorporated specialized banks into their central banks in order to consolidate banking activities and then spun the specialized banks off from the central banks. Apart from that, at the beginning the Baltics pursued similar policies with regard to the banking sector. The new banking institutions flourished in the first years of transition, as it was easy to enter the sector. Licensing was lax and capital requirements were low, as they were left unadjusted for inflation and currency depreciation. Prudential regulation was mostly lacking, and enforcement was weak. Like those of other economies in transition, the Baltics' banking systems suffered from a number of common shortcomings, such as a considerable share of nonperforming loans, undeveloped legislative frameworks, weak supervision, inadequately skilled banking staff and large spreads between borrowing and lending interest rates in the absence of competition. These drawbacks have been largely overcome, but at the price of a banking crisis in each country.¹⁴⁾ Each country had to resort to at least some public funds to help restructure the banking sector. Estonia and Latvia relied on a decentralized model, injecting capital into the banks they considered viable and suitable for further privatization while leaving it to the banks themselves to deal with their bad loans. Lithuania chose a centralized approach instead: It set up a central agency to clean up the bad loans of selected banks and provided banks with government assets for recapitalization.

The banking crises had similar roots in all countries, such as banks' lack of competence in assessing risks and poor lending practices, namely excessive lending to connected parties or a single borrower and lending without proper collateral, or even fraudulent lending. In Estonia, inherited bad loans had more impact than in Latvia and Lithuania, because the crisis hit earlier. Estonia was affected in 1992, thus almost at the outset of transition, whereas the two other countries faced banking crises in 1995 to 1996 at a relatively advanced stage of transition. The banking crises coincided with the peak reform period of the financial sector. The latter two countries had maintained permissive regulations for too long. In all three countries, the balance sheets of the large banks had deteriorated enough to entail the threat of insolvency due to bad loans. Poor provisioning for nonperforming loans was the rule, and banks were reluctant to report loans as nonviable. The lack of transparency in accounting practices helped mask the problems, so they did not surface until later. The crisis had the indisputably positive side effect in each country of prompting the adoption of prudential regulation in line with international standards (see Table 4). This was instrumental for cleansing the banking sector of insolvent institutions. Whereas Lithuania and Latvia are still grappling with the consequences of their banking crises, the worst is over and their banking sectors have started to grow again. A further consolidation of their banking systems is inevitable, and the presence of foreign banks is likely to increase.

The approach to the banking crises differed among the countries, which may have had an impact on the financial situation of the sectors after their recovery as well. Currently, the Estonian banking sector is basically sound and the strongest in the region, though it is overbanked.¹⁵⁾ After the crisis,

the banking sector went through a phase of consolidation, and the number of banks declined considerably from 42 in 1993 to 14 in early 1997. Estonia's strongest banks started expanding abroad; Hansapank acquired the sixth-largest Latvian bank in terms of total assets (Hansapank Latvia). The privatization of the sector is almost complete, with the state having assumed minority stakes in two institutions. Foreign banks can establish branches under the same conditions as domestic banks. The capital market and nonbank financial institutions are comparatively less developed. Deposit insurance is not yet in place, but the respective law has already been drafted (see Table 4).

Latvia is the only Baltic State in which the banking crisis had a visible impact on the real economy; it brought the already weak growth to a standstill. The crisis surfaced when the Bank of Latvia required all banks to submit financial audits of 1994 accounts based on International Accounting Standards (IAS). The then-largest Bank Baltija, which held 30% of total deposits, refused to comply; its difficulties soon became evident to the public, which started to withdraw deposits. The Bank of Latvia wanted to provide liquidity at first, but withheld its support once it realized that the bank's insolvency was mainly caused by fraudulent lending. Bank Baltija was declared insolvent in July 1995 and was closed. As a result of the banking crisis in 1995, the number of commercial banks in Latvia declined to 38 at the end of 1995 from 55 at the end of 1994. Many banks were liquidated (operations in one third of all banks were suspended). The four major banks which collapsed accounted for around 30% of all assets and 46% of all deposits from private persons. Given the lack of deposit insurance, there were also runs on solvent institutions because many people believed that further problems would erupt. Household deposits fell from LVL 277 million in December 1994 to LVL 116 million in December 1995.¹⁶) The Bank of Latvia did not rescue the banks, and instead initiated sweeping regulatory changes to avoid the recurrence of a systemic crisis. These changes included the adoption of the Law on Credit Institutions, the introduction of international auditing standards, frequent on-site examinations and restrictions on accepting deposits from the general public. Latvian prudential regulation has become stricter than EU standards in several respects (see Table 4). After a stringent review, the Bank of Latvia initially renewed only twelve banks' licenses to take deposits from individuals. These banks are referred to as core banks. The minimum capital requirement was raised to LVL 1 million effective from April 1996. To restore confidence in the banking system, the government came up with a plan to refund up to LVL 500 per depositor in four installments, starting with LVL 200 and followed by three installments of LVL 100 in the three subsequent years. However, it altered this plan in 1996, limiting compensation to the recovered value of liquidated assets. A new scheme limiting insurance to LVL 500 at core banks only is under discussion.

In the two years since the eruption of the crisis, the condition of the banking sector has much improved. The number of core banks which meet all prudential regulation requirements had risen to 19 by July 1997. The consolidation of the sector continued, with the number of banks falling from

38 to 32. Total performing assets increased by approximately 140%, while the share of nonperforming assets dropped from 25% to 7.5% between June 1995 and June 1997. The privatization of the two remaining public banks, Latvian Savings Bank and Unibanka, is in progress. Prior to privatization they will be recapitalized, which means that the state will in fact be directly

Table 4

Selected Prudential Regulation				
	Estonia	Latvia	Lithuania	EU standards
Minimum capital requirement	EEK 6 million from January 1993 EEK 15 million from June 1993 EEK 25 million from January 1995 EEK 35 million from January 1996 EEK 60 million from January 1997 EEK 75 million from January 1998	LVL 0.1 million until March 1993 LVL 1 million from April 1996 LVL 2 million from April 1998 ECU 5 million from January 2000	LTL 5 million from January 1994 ECU 1.9 million from July 1, 1995 ECU 3.8 million from January 1997 ECU 5 million from January 1998	ECU 5 million
Minimum registered capital for new banks	as above	LVL equivalent of ECU 5 million	as above	ECU 5 million
Capital adequacy ratio	10% risk weighted from October 1, 1997	10% risk weighted	13% risk weighted 10% from April 1997	8% risk weighted
Liquidity indicator	liquid assets at least 35% of liquid liabilities	liquid assets at least 30% of total liabilities	liquid assets at least 30% of total liabilities	none
Limits on lending as a percentage of own capital:				
• Credit concentration per client	25%	25% from January 1, 1996	25% (formerly 30%)	25%
• Total large exposure to all clients	800%	..	..	800%
Connected lending	20%	15%	10%	10%
Limits on FX exposure as a percentage of own capital (from January 1996)	30% overall 10% in any currency except for DEM	20% overall 10% in any currency	30% overall 20% except for USD	any amount exceeding 2% is subject to the capital adequacy rule
Loan classification and provisioning	loans overdue for 150 plus days have to be written off	10% for loans under observation 30% for substandard loans 60% for doubtful loans 100% for bad loans	..	no EU-wide standard
Deposit insurance	no deposit insurance (draft law: up to EEK 20,000 per depositor and 90% of deposit)	..	individual deposits up to LTL 4,000	ECU 15,000 until 1999, then ECU 20,000 ¹⁾
Audits	internal audits required; external audits based on International Accounting Standards	by international audit companies approved by the Bank of Latvia	audits based on international accounting standards from January 1997, checked by independent auditors	comprehensive external audits are standard practice
Quarterly balance sheet publication	..	required for banks accepting household deposits	..	no obligation, but most banks publish quarterly balance sheets

Source: central banks.

¹⁾ For those countries which already had ECU 15,000. Countries which started with limits below ECU 15,000 may retain these lower limits in the interim, but any change must be upward to converge to the specified limits.

involved in the restructuring of these banks. The minimum capital requirement will be raised to LVL 2 million in 1998 and then again to the EU standard of ECU 5 million in 2000. The requirement will enforce a further consolidation of the banking system. An ECU 5 million requirement has already been put in place as the minimum for new entrants into the business. A more stringent and detailed regulation of market risk evaluation is to be introduced.

In 1994 the Bank of Lithuania began to enforce loan loss provisioning. It intensified its supervision efforts in spring 1995 after the law on the Bank of Lithuania and the Commercial Bank Law had been passed in December 1994. Like in Latvia, these activities precipitated the eruption of the crisis, which started in those private banks which were saddled with nonperforming loans and which were undercapitalized. Consequently the activities of one large and two medium-sized banks were suspended. These banks accounted for 25% of total deposits. The three state-controlled banks, which held 50% of all deposits, were undercapitalized as well, but unlike the private banks, they were bailed out. The Bank of Lithuania acted as a lender of last resort to a limited degree, as it retained a buffer of foreign exchange reserves to preserve the integrity of the currency board arrangement and injected liquidity into two private banks. Unlike Estonia and Latvia, Lithuania opted for a centralized approach to dealing with nonperforming loans. The bad loans of the suspended private banks were transferred to a special asset management company; to avoid a moral hazard problem, the shareholders lost their rights and the full value of their shares when the state took over the administration of these institutions. The bad loans of the three large state banks were also transferred to the asset management agency. These banks were subsequently recapitalized by the government. To this effect, the government issued special bonds and transferred cash from the budget. Recapitalization is to be directly followed by the privatization of these banks. To restore confidence in the banking sector, the government decided to extend the limited protection scheme which used to cover deposits in state banks only to all banks on an equal footing (see Table 4).

5.4 Monetary Policy Frameworks

At the beginning of transition, the countries lacked an adequate institutional framework for monetary policy. In a first step, modern central banks had to be established. Subsequently, from 1992 to 1993, the central banks divested all commercial operations and actively helped introduce national currencies, which was indispensable for conducting an independent monetary policy.¹⁷⁾ The central banks of all three states opted for an exchange rate anchor. Estonia took this step right away, while Lithuania and Latvia did so after brief episodes with a managed floating regime. Estonia and Lithuania chose a currency board arrangement (CBA) for their exchange rate systems in June 1992 and April 1994, respectively. Latvia went for a peg to the SDR, a strategy which did not interfere with the creation of a full-fledged modern central bank and its monetary policy responsibility. However, the independence of the Latvian central bank does not live up to the standards imposed on the central banks of the EU countries by the Maastricht Treaty,

as it is allowed to finance budget deficits. All three central banks use only instruments of indirect monetary control; direct controls were phased out in 1993. Monetary policy instruments remained rudimentary in Estonia and Lithuania after the adoption of the CBA. Lithuania already elaborated and has started to implement a plan to gradually abandon the CBA, so it has begun to expand the range of its instruments.

The independence of the central banks of Estonia (Article 3), Latvia (Article 13) and Lithuania (Article 3) from government is explicitly laid down in the respective central bank acts. The Banks of Estonia and Lithuania report to Parliament, which has no say in the course of monetary policy. The central bank acts moreover enshrine personal independence; the terms of the governors are longer than the political cycles in each country. The Chairman of the Board of the Bank of Estonia and its President are appointed by the President of Estonia for five-year terms (Article 7).¹⁸⁾ They can be dismissed only if found guilty of a crime by a court (Article 12). The Governor of the Bank of Latvia is appointed by Parliament for a six-year term (Article 22) on recommendation of at least ten members of Parliament.¹⁹⁾ The Governor and other board members can be dismissed only if found guilty by a court or if they are unable to perform functions for a prolonged period (six months). Of course, they also have the option to resign (Article 22). The Chairman of the Bank of Lithuania is appointed for five years by Parliament on recommendation of the President (Article 10).²⁰⁾ The instances which may lead to a dismissal are also limited and are unrelated to monetary policy issues (Article 12). They comprise the inability to perform a function, a court conviction or an appointment to the board of another financial institution. However, the formal independence of the Bank of Lithuania has been compromised on a few occasions. During the banking crisis, the Governor and board members were pressed to resign.

The Estonian and Lithuanian central banks are financially independent from their respective governments, i.e. they cannot be forced to finance budget deficits either by extending direct credits to the fiscal authorities or by purchasing government securities or by simply printing money. This is consistent with their currency board systems, under which the monetary base must not exceed the gold and foreign exchange reserves of the Bank.²¹⁾ The Latvian central bank is allowed to finance budget deficits, and it did so during the banking crisis in 1995. These loans must not exceed one twelfth of the annual revenue of the current budget (Article 36).

The functional independence of the central banks in Lithuania and Estonia is limited, as they have to follow the strict rules prescribed by the CBA (a tie-your-hands mechanism). They cannot independently determine the goals of monetary policy, as the exchange rate is the goal, and they may use only the instruments of modern central banking which are compatible with the CBA. They are free to impose a system of prudential regulation. However, the Lithuanian parliament set a precedent by overriding the regulations in deciding to let two state banks operate without fully complying with the Bank of Lithuania's prudential regulation and thus waived capital adequacy requirements pending the privatization of the two banks. The right to alter the exchange rate system and exchange rate levels is

restricted to Parliament in Estonia and Lithuania. In Latvia, by contrast, this right is incumbent on the central bank (Article 4). All three central banks have been allocated own capital and are responsible for their own budgets; they are expected to finance all expenses from their revenues. They are required to distribute the profit which remains after appropriation to the state budget.

The formal division into a final goal and intermediate and operational targets is followed in Latvia, but not in Estonia or Lithuania. The CBA defines the actual target structure of central banks in the former two countries; the exchange rate is the intermediate and operational target, and the monetary base is fully backed by foreign exchange in each country. In Estonia and in Lithuania (Article 7), the final goal is to achieve currency stability. This framework is consistent with the CBA setup, since the external stability of a currency can conflict at times with its internal stability. The Bank of Lithuania is called upon to support government policy to the point where it does not interfere with the ultimate goal. The Latvian central bank pursues the goal of price stability (Article 3). Latvia uses the exchange rate as an actual intermediate target and net domestic assets as an operational target. The latter is in line with monetary theory, according to which the monetary base is endogenous under a fixed exchange rate regime and the central bank controls only domestic credit.

There are no standing refinancing facilities in Estonia, and no official interest rate is announced. In the second half of 1996, a standing deposit facility for banks was established in response to the excess liquidity of the banking sector. The Bank of Estonia is allowed to issue certificates of deposit, which it may repurchase from commercial banks under exceptional circumstances in its function of a lender of last resort. This is where the classical setup of a currency board is somewhat watered down. In Lithuania the regulations are more prudent; i.e. any foreign exchange in excess of the full cover of the monetary base can be used for lender-of-last-resort operations. Thus, the Bank of Lithuania may extend short-term liquidity loans to commercial banks or purchase government securities from them. Latvia has a refinancing facility for overnight loans as well as lombard credits and auctioned credits (uncollateralized); weekly auctions of the latter have been held since late 1993. The maturity is one month; moreover the Bank rations these auction credits by keeping allotments low. The Bank of Latvia has been accepting nonnegotiable term deposits from commercial banks since March 1995, which constitutes a liquidity-absorbing instrument. The denomination is LVL 10,000, to set it apart from the Treasury bill market denomination of LVL 100,000.

Open market operations (OMOs) are not forbidden in Estonia, which wanted to stimulate the development of the money market. Since May 1993 one-month discount certificates of deposit have been issued and auctioned off to commercial banks once a month, but the amounts are very limited. Therefore they can hardly be qualified as an instrument for the Bank of Estonia to control money supply; banking liquidity is changed by market-initiated transactions through the foreign exchange window. Lithuania intends to develop OMOs in the process of phasing out the CBA. Latvia has

introduced repurchase agreements, although the money market is relatively illiquid. As the country has run budget deficits, the Treasury bill market offers a certain scope for OMOs. Treasury bill auctions were introduced in 1993; originally, 28-day bills were issued, then 91-day bills were added.

Reserve requirements are in place in all three countries. The approach to remuneration is not uniform. In Estonia, required reserves, which have been 10% for all deposits and most other liabilities since the end of 1992, are not remunerated. Excess reserves are remunerated at the Bundesbank's discount rate minus a preset margin. The other two countries do not pay interest on reserves held at their central banks. In Latvia, reserve requirements were introduced in July 1993, and a uniform ratio of 8% has been applied since then to commercial banks' lat and foreign exchange deposits. In Lithuania, the reserve requirement has been in place since 1991 and came to a uniform 12% until the banking crisis. During the banking crisis, the Bank of Lithuania lowered the reserve level temporarily to 5%.

As mentioned above, the cornerstone of the monetary system in Lithuania and Estonia is the CBA. Estonia has pegged the kroon to the Deutsche mark, while Lithuania has tied its litas to the U.S. dollar. In both countries, the monetary base is fully backed by liquid international reserves. The Eesti Pank cannot devalue the currency; this right is reserved to Parliament (Law on the Security of the Estonian Crown). The Bank of Estonia stands ready to buy and sell foreign exchange at the rate of 8 kroons to the Deutsche mark. It must not start any form of intervention aimed at achieving discretionary monetary policy goals. The Estonian currency is almost fully convertible within the capital account; thus the Bank of Estonia exerts almost no control over currency movements. In July 1996, the bank eliminated buy and sell rates to foster interest rate arbitrage. Lithuania, whose CBA started operating in March 1994, chose a rate of 4 litas to the U.S. dollar. Only under exceptional circumstances and with government approval can the Bank of Lithuania switch to a different anchor currency. The Law on the Credibility of the Litas specifies that the total amount of litas in circulation must at no time exceed the gold and foreign exchange reserves held by the Bank of Lithuania. The Bank retains the right to foreign exchange intervention. Latvia pegged its lat to the SDR in January 1994 at the rate of 0.8 lats per SDR. The Bank of Latvia is allowed to conduct either sterilized or nonsterilized foreign exchange intervention, but because the volumes are small, the latter is the rule. The Bank has influenced the liquidity of the banking sector by means of foreign exchange intervention: In 1996 the monetary base grew mostly due to unsterilized foreign exchange intervention.

The aspirations of the Baltic countries to join the European Union are likely to shape the evolution of their institutional frameworks for monetary policy. The analysis in this section shows that while all elements of central banking are in place in Latvia, the independence of its central bank still has to be reinforced. The two other countries will have to gradually dismantle their CBAs and at the same time replace them by institutional arrangements compatible with indirect monetary controls. This task is challenging, as these countries do not want to risk losing the hard-won confidence in their currencies.

6 Policy Challenges

The Baltic countries face numerous policy challenges. Most of them result from the plans to enter the European Union, which are discussed in section 7. This section tackles two general challenges, both related to macroeconomic policy.

6.1 The Phasing-out of the CBA

From the economic standpoint, a currency board arrangement is a system of fixed exchange rates in which the monetary base is automatically linked to foreign exchange flows. A CBA enhances the credibility of a counter-inflationary policy, as the scope for discretionary monetary action becomes strictly limited and is fairly transparent. In contrast to a conventional fixed peg, parity changes under a CBA require a parliamentary decision and a formal change of laws. Market participants see a strong link between the operation of the CBA and financial stabilization in Estonia and Lithuania. Both countries have signaled their intention to eventually dismantle their currency boards, as a CBA is a restrictive solution despite its instrumental role in bringing inflation down. Furthermore, a CBA is incompatible with EU central banking standards.

In general, current account deficits and capital inflows make a CBA a straitjacket for an economy. CBAs have been the cornerstone of economic stability in Estonia and Lithuania, but their drawbacks are becoming a serious constraint on monetary policy under conditions of massive foreign currency inflows. Capital inflows lead to an automatic rise in the money supply, which may make CBAs ineffective in fighting inflation. CBAs also reduce the ability to cope with various shocks, such as big changes in commodity prices, since the exchange rate cannot adjust. The freedom of a currency board to act as a lender of last resort is very limited, because currency boards cannot increase the money supply in periods of financial stress to assure the liquidity of the banking system. Estonia and Lithuania are likely to dismantle their CBAs for the above reasons in the coming years, but intend to link their currencies to the euro should the Deutsche mark cease to exist. The phasing-out process will probably be gradual. Another radical method would be to simply float the exchange rate,²²⁾ which is, however, less probable because EU integration requirements have to be met.

Lithuania's plan to peg its exchange rate to the euro,²³⁾ which involves three steps, has won approval from the IMF. In a first step, which has already started, the monetary powers of the Bank of Lithuania are to be gradually increased, while the CBA will remain operative. When the first step is completed, the central bank will stop covering its monetary base entirely with foreign exchange and buy government bonds from the public. With a sufficient portfolio, it can then engage in open market operations. In step two, the CBA will be eliminated, while keeping the litas pegged to the U.S. dollar. After completion of this step, the Bank of Lithuania will be able to conduct sterilized intervention if necessary. In step three, the U.S. dollar will be gradually replaced by a U.S. dollar-Deutsche mark mix in which the Deutsche mark's share will be steadily increased. No intention to devalue the litas has been expressed in the plan. However, the ever-deteriorating current

account may suggest an overvaluation of the litas with respect to the level at which the current account is balanced in the medium term.

Estonia has not presented a formal plan to exit the CBA yet. For eventual participation in EMU, Estonia will have to abandon the CBA sooner or later and replace it by a full-fledged central bank that uses various indirect instruments of monetary control.

6.2 Current Account Deficits

All the Baltic States have the problem of high and widening current-account shortfalls and strong capital inflows, and at the same time have fixed exchange rate regimes. According to economic theory, monetary restraint is ineffective under a fixed exchange rate, as a small open economy has a severely limited capacity to sterilize foreign exchange flows over time. In the beginning, a monetary contraction causes interest rates to rise, which attracts higher inflows of liquid foreign capital. These inflows can be sterilized only temporarily. Subsequently, money supply grows, inducing a return of interest rates to their initial level. A fiscal tightening would be needed to trim aggregate demand. Another theoretical way to cope with the problem is to devalue the domestic currency in order to stimulate exports and curtail imports, but this is incompatible with the currency board system and will have inflationary consequences unless productive capacities are underutilized. A combination of both methods, namely devaluation and fiscal restraint, which is called expenditure switching and expenditure reducing in the literature, is the most effective approach, as it works against the inflationary bias of a devaluation.

Estonia and Latvia have reacted to the emerging problems by adhering to theory. Both countries tightened their fiscal policies in 1997 by adopting balanced general government budgets. Estonia pursued this policy rigorously, while Latvia may show a small deficit at the end of 1997. Since the current account gaps continued to widen, the countries may be forced to tighten their budgets further. Lithuania continued to run a limited budget deficit in 1997. Estonia also attempted to curb domestic credit expansion by raising the capital adequacy ratio to 10%, which is higher than the 8% BIS requirement, and by reclassifying the risk of loans to local governments. This unusual step may be ineffective, as higher interest rates are likely to induce more capital inflows under the condition of high capital mobility. Then, the money supply would continue to grow at a rapid pace, which would translate into a higher demand for imports, adversely impacting the current account.

7 Integration with Europe

The Baltic States declared integration with Western Europe a strategic goal from the beginning of their independence, and there is broad political consensus in this matter. The three states see admission to the EU as part of a historical process culminating in their cultural, political and economic integration with the rest of Europe. To speed European integration, Estonia, Latvia and Lithuania concluded Free Trade Agreements early in transition, and in 1995, negotiated so-called Association Agreements (Europe Agreements) with the EU along with seven other transition economies. In autumn 1995, the three countries officially presented their applications for membership. In July 1997, the European Commission put Estonia on a shortlist of five countries it recommends for the beginning of entry negotiations on the basis of a thorough examination of ten applicants from Central and Eastern Europe. The European Commission is of the opinion that Latvia and Lithuania will not be able to cope with competitive pressure within the EU in the medium term, and that the market structures of their economies still need further development. Therefore, the Commission suggests that negotiations for accession to the EU start as soon as these countries have made sufficient progress in the critical areas pinpointed by the Commission. The areas requiring considerable improvements are shown in Table 5.

In its comprehensive opinion, the Commission states that all three countries are established democracies and meet the political criteria for membership. Estonia also meets the criterion of a functioning market economy and should be able to withstand competitive pressures within the EU in the medium term contingent on further progress in specific areas (see Table 5). Estonia still needs to realign its legal framework with the *acquis communautaire* and enforce the relevant national laws.

Table 5

Summary of the European Commission Conclusions				
	Fit to start entry negotiations soon	Areas requiring further progress toward a market economy	Areas in need of reform to withstand competitive pressure	Areas in which legislation requires amendment
Estonia	yes	<ul style="list-style-type: none"> land reform pension reform 	<ul style="list-style-type: none"> export base (too narrow) 	<ul style="list-style-type: none"> intellectual property public procurement financial services taxation transparency of state aid
Latvia	no	<ul style="list-style-type: none"> effective implementation of created legislative framework (must be speeded up) privatization (must be completed) establishment of regulatory bodies (is not comprehensive yet) 	<ul style="list-style-type: none"> exports (consist mostly of low-value-added items) industrial restructuring banking sector (weaknesses) agriculture (in need of modernization) 	<ul style="list-style-type: none"> intellectual property public markets personal data competition taxation
Lithuania	no	<ul style="list-style-type: none"> relative price adjustment large-scale privatization bankruptcy proceedings enforcement of financial discipline on enterprises 	<ul style="list-style-type: none"> industry (substantial restructuring required) agriculture (modernization required) banking sector (weaknesses) 	<ul style="list-style-type: none"> intellectual property public markets capital market liberalization financial services taxation competition

It is estimated that the per capita GDP in Estonia, Latvia and Lithuania came to no more than 25% of the average level in the EU in purchasing power terms in 1995. Thus the applicants would be net beneficiaries in the EU. They would be eligible for substantial agricultural assistance from the CAP and for regional aid, assuming these systems are still unreformed at the time of accession. However, the Baltic economies are tiny by international standards, so the states' prospective entry is not going to have a visible impact on the Community's GDP or budget. This should facilitate the negotiation process in the future.

8 Conclusions

Estonia, Latvia and Lithuania have made significant progress in transition. All three have succeeded in introducing national currencies, which was indispensable for exiting the hyperinflationary ruble area and creating independent monetary systems. They all embarked on comprehensive reforms to transform themselves into full-fledged market economies. They liberalized and deregulated their prices and trade regimes, and made their currencies convertible. Their economic stabilization has progressed consistently. Economic growth resumed at a moderate pace with a tendency to accelerate, and inflation has fallen to the lowest levels among transition economies. However, the exchange-rate-based stabilization brought about the well-known side effect of real-term currency appreciation resulting from the inflation differential and also from capital inflows that were encouraged by successful stabilization. This real-term appreciation caused huge trade deficits because imports rose much faster than exports, which ultimately entailed current account deficits of approximately 10% of GDP. So far, the Estonian, Latvian and Lithuanian commitment to stabilization has been rewarded by greater credibility and improved confidence of international financial markets, which has allowed the countries to finance these deficits. However, the shortfalls may prove unsustainable in the future if current negative trends continue. Therefore, the countries have started to correct their macroeconomic policies in 1997.

Structural reforms have also made headway: The most difficult step in transition, the privatization of large enterprises, is being tackled with vigor. Laws and institutions are being harmonized with EU legislation.

Estonia clearly stands out in the group of the Baltic States as the most committed to liberal reforms from the early days of transition. It has eliminated bureaucratic impediments to entrepreneurship more thoroughly than the other countries. Its privatization is the most advanced, and its banking system is the soundest. It has attracted the largest FDI stock and has redirected trade to the West more than the other two countries. It has recorded the best growth performance of the group, although accelerating growth in 1997 has led to an overheating of the economy. This is reflected in the recent break in the disinflation process: Estonia is lagging behind Latvia and Lithuania. The overheating exacerbated the current account deficit, as the trade gap has widened to almost 25% of GDP.

In the opinion of the European Commission, Estonia qualifies for an early start of negotiations on EU accession. Latvia and Lithuania have been judged

unable to cope with competitive pressures within the EU in the medium term unless they achieve more progress with reforms and with the harmonization of their laws. Their progress will be reviewed again at the latest at the end of 1998. The two countries have recently accelerated their reforming efforts, which at the time of writing has brought their potential entry into the EU within closer reach.

Annex

Estonia – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997 ¹⁾	latest
GDP current prices EEK million	13,158.0	22,060.0	30,268.0	41,279.0	52,379.0	16,200.0	Q2
GDP in USD million		1,668.3	2,329.9	3,600.4	4,352.6	1,182.2	Q2
GDP % change	- 21.6	- 8.5	- 1.8	4.3	4.0	11.7	H1
Industrial output % change		- 30.0	- 3.5	1.4	1.3	12.2	Jan.–July
CPI % change	1,069.0	89.8	47.7	29.0	23.1	11.9	Sep./Sep.
PPI % change		99.9	36.8	25.6	14.9	9.3	Sep./Sep.
Unemployment rate							
government, end of period	..	3.9	4.5	4.1	4.3	3.6	Sep.
Unemployment rate	..	6.6	7.6	..	..	11.3	Q2
Trade balance USD million	- 90.4	- 144.9	- 355.2	- 673.6	- 1,057.7	- 246.4	Q1
Trade balance % GDP		- 8.7	- 15.2	- 18.7	- 24.3	- 20.8	Q1
Exports USD million	460.7	811.7	1,327.4	1,856.3	2,063.8	620.8	Q1
% change		76.2	63.5	39.8	11.2		
Imports USD million	- 551.1	- 956.6	- 1,682.5	- 2,530.0	- 3,121.5	- 867.2	Q1
% change		73.6	75.9	50.4	23.4		
Current account USD million	36.2	21.6	- 165.0	- 165.4	- 447.3	- 162.5	Q1
Current account % GDP	..	1.3	- 7.1	- 4.6	- 10.3	- 16.8	Q1
Central gov't budget balance % GDP	..	0.2	0.0	0.2	0.7	..	..
General gov't balance % GDP	..	- 0.6	1.3	- 0.8	- 1.6	..	..
Gross external debt USD million	..	140.0	170.0	247.0	297.0	283.0	March
Gross foreign reserves							
excluding gold USD million	170.2	386.1	443.4	579.9	636.8	620.1	Q2
Nominal gross wage in EEK	549.0	1,066.0	1,734.0	2,375.0	2,986.0	..	..
Nominal gross wage in USD	..	80.6	133.5	207.2	248.1	..	..
Nominal gross wage % change		94.2	62.7	37.0	25.7	..	..
Real wage % change	..	2.3	10.2	6.2	2.1	..	..
FDI inflows in USD million	82.3	162.2	214.4	201.5	150.2	81.0	Q1
Average EEK/USD ²⁾	12.912	13.223	12.991	11.465	12.034	13.703	Q2
Average EEK/DEM	..	8.0	8.0	8.0	8.0	8.0	
REER index	100	214.4	279.0	339.4	380.7	396.5	Jan.–July
REER change in %	..	114.4	30.1	21.6	12.2	4.2	Jan.–July

Sources: European Commission, IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves), own calculations. Statistical Yearbook of Estonia 1996: wages.

¹⁾ Latest: Reuters.

²⁾ End-of-period rate for 1992, data for 1996 are preliminary REER from BIS.

Latvia – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997 ¹⁾	latest
GDP current prices LVL million	1,004.6	1,467.0	2,042.6	2,349.2	2,768.7	1,510.0	H1
GDP in USD million	1,364.9	2,173.3	3,647.5	4,449.2	5,024.9	2,621.5	H1
GDP % change	..	- 30.4	0.6	- 1.6	2.8	4.6	H1/H11996
Industrial output % change	..	- 29.8	- 2.2	- 6.3	1.0	0.7	Jan.–July
CPI % change	951.0	109.1	35.9	25.1	17.7	8.1	Sep. yoy
PPI % change						2.9	Sep. yoy
Unemployment rate	2.3	5.8	6.4	6.3	7.0	7.1	Sep.
Trade balance USD million	- 40.0	3.0	- 301.0	- 580.0	- 927.0	- 525.5	Jan.–July
Trade balance % GDP	- 2.9	0.1	- 8.3	- 13.0	- 18.4	..	..
Exports USD million	800.0	1,054.0	1,022.0	1,368.0	1,502.0	..	..
% change	..	31.7	- 3.0	33.9	9.8	..	..
Imports USD million	- 840.0	-1,051.0	-1,322.0	-1,947.0	-2,429.0	..	..
% change	..	25.1	25.8	47.3	24.8	..	..
Current account USD million	191.0	417.0	201.0	- 16.0	- 454.0	..	..
Current account % GDP	14.0	19.2	5.5	- 0.4	- 9.0	..	..
FDI inflows in USD million	29.0	45.0	214.0	180.0	288.0	..	..
Average LVL/USD	0.736	0.675	0.56	0.528	0.551	0.576	H1
REER, PPI based	100.0	260.6	345.2	357.6	396.8	428.8	Jan.–July
REER change in %		160.6	32.5	3.6	11.0	8.1	Jan.–July
Consolidated state deficit	..	..	- 2.0	- 4.0	- 0.8	..	..
Gross external debt USD million	57.0	224.0	386.0	403.4	408.8	..	..
Gross foreign reserves excluding gold USD million	..	431.6	545.2	505.7	654.1	672.5	July

Sources: European Commission (industrial output, budget balance), IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves, unemployment rate), national sources: own calculations.

¹⁾ Latest: Reuters.

Data for 1997 are preliminary. Consolidated budget balance on an accrual basis. 1997 GDP, trade balance and LVL/USD: own calculations.
OECD External Debt Statistics. REER: BIS.

Lithuania – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997 ¹⁾	latest
GDP current prices LTL million	3,387.0	11,108.0	16,981.0	23,829.0	31,115.0	17,230.0	H1
GDP in USD million	1,910.3	2,557.1	4,268.7	5,957.3	7,778.8	4,307.5	H1
GDP % change	- 34.0	- 30.4	1.0	3.0	3.6	2.5	H1'97/ H1'96
Industrial output % change	..	..	- 26.6	5.3	3.7	3.3	Jan.–July
CPI % change	1,020.8	410.2	72.2	39.6	24.6	8.7	Sep. yoy
PPI % change	..	..	..	..	..	3.4	Sep. yoy
Unemployment rate	3.6	3.8	4.5	7.3	6.2	5.9	Oct.
Trade balance USD million	..	- 154.7	- 204.9	- 697.9	- 887.1	- 224.1	Q1
Trade balance % GDP	..	- 6.0	- 4.8	- 11.7	- 11.4	- 5.2	Q1
Exports USD million	..	2,025.8	2,029.2	2,706.1	3,281.6	927.1	Q1
% change	..	..	0.2	33.4	21.3	..	..
Imports USD million	..	- 2,180.5	- 2,234.1	- 3,404.0	- 4,168.7	- 1,151.8	Q1
% change	..	..	2.5	52.4	22.5	..	..
Current account USD million	..	- 85.7	- 94.0	- 614.4	- 699.9	- 233.1	Q1 1997
Current account % GDP	..	- 3.4	- 2.2	- 10.3	- 9.0	- 5.4	Q1
Inward FDI flows, USD million	..	30.2	31.3	72.6	152.4	57.1	Q1
Inward FDI stock in USD million	..	..	262.2	353.9	647.0	..	..
Average LTL/USD	1.773.0	4.344.0	3.978.0	4.0	4.0	4.0	Q2 1997
REER 1992 = 100	..	..	..	..	..	..	..
General gov't balance % GDP	..	..	- 1.8	- 1.8	- 2.5	- 0.6	Q1
Gross external debt USD million	..	..	505.3	826.3	1,216.8	1,205.9	June
Gross foreign reserves excluding gold USD million	45.3	350.4	525.5	757.1	772.2	870.5	Q2 1997

Sources: European Commission (industrial output, unemployment, budget balance), IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves), national sources: own calculations.

¹⁾ Latest: Reuters.

Data for 1996 are preliminary. National budget: Bank of Lithuania, 2/97. Net external debt: Bank of Lithuania, Annual Report 1996. REER: BIS.

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- 1 *Foreign Research Division of the Oesterreichische Nationalbank and The Vienna Institute for Comparative Studies. The standard disclaimer applies. I gratefully acknowledge the valuable comments of Olga Radzyner.*
- 2 *See Starrels (1993).*
- 3 *See, e.g., Laski (1993) and Winiński (1993) as exponents of opposite views.*
- 4 *The quality of the statistical data, especially those for the final years of Soviet rule and the early years of transition, does not measure up to OECD standards, which must be taken into account when interpreting the data.*
- 5 *See Senik-Leygonie and Hughes (1992).*
- 6 *See Country Tables in the Annex.*
- 7 *According to the Eesti Pank Bulletin No. 3 (1997), nominal investment rose by 33% in 1996. Since the GDP deflator is unknown, a range is given for the increase of private investment. National accounts are available for 1994 only.*
- 8 *See The Bank of Lithuania (1997b).*
- 9 *See Richards and Tersman (1996).*
- 10 *See Milesi-Ferretti and Razin (1996).*
- 11 *The removal of price controls was also instrumental in eliminating the undesired monetary balances held by the public ("monetary overhang") through open inflation.*
- 12 *See the avis of the European Commission on Estonia.*
- 13 *See EBRD (1996), Estonia: Country profile.*
- 14 *See Krzak (1997) for more details on the evolution of the banking sectors in the Baltic countries.*
- 15 *See "Die grossen estlaendischen Banken rechnen mit Marktkonsolidierung" in Frankfurter Allgemeine Zeitung of October 6, 1997.*
- 16 *The 1995 exchange rate was 0.528 lats per U.S. dollar.*
- 17 *This helped the central banks insulate themselves against hyperinflationary tendencies in the rest of the former Soviet Union.*
- 18 *See the Law on the Central Bank of the Republic of Estonia.*
- 19 *See the Law on the Bank of Latvia.*
- 20 *See the Law on the Bank of Lithuania.*
- 21 *See e.g. the Law of the Republic of Lithuania on the Convertibility of the Litas.*
- 22 *Such a course was taken by Singapore and Malaysia in the early 1970s.*
- 23 *See Bank of Lithuania (1997c).*

Editorial close: November 10